FINANSSIVALVONTA
FINANSINSPEKTIONEN
FINANCIAL SUPERVISORY AUTHORITY

30.1.2012

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Finantsinspektioon, 10th Anniversary Seminar 20.1.2012
Panel III – The Opportunities and Challenges of Cross-Border Co-operation

"Cross-Border Solvency and Liquidity Supervision Issues"

Warm thanks to Raul for invitation. And congratulations to Finantsinspektioon for a successful 10 years of operation. I also want to thank you all at Finantsinspektioon for the very good cooperation between our authorities.

I attended five years ago your fifth anniversary. If I recall correctly, the most actively debated topic was whether "pehme maandumine" – soft landing – was the most likely way forward. Today's challenges are different…

0. Content of the Panel remarks

I would like to discuss four issues related to cross-border cooperation in the area of supervising solvency and liquidity in cross-border financial groups:

Firstly, the implementation of the Basel III and Solvency II reforms – as they form the basic framework for the supervision of cross-border financial groups, like all institutions.

Secondly, I would like to recall the main issues at stake when we discuss the home-host relationships.

Thirdly, what are the main specific questions regarding the supervision of solvency and liquidity.

And finally, what I consider to be the main challenges currently for cross-border cooperation.

1. Implementation of the Basel III and Solvency II reforms

As a starting point, we at the Fin-FSA regard the globally agreed tightening of the solvency and liquidity requirements highly necessary to foster the stability of the financial system. In the current difficult conditions of the European debt crisis, strengthening of the capital base is crucial in restoring confidence in banks and in allowing the revival of banks' term funding which, in turn, is crucial in securing continued bank lending to the economy.

However, I feel that we should be careful if we want to add further regulatory burden in our present macro-economic situation, where growth is turning negative and we are facing greater risk of a recession. Banks have a limited ability to draw on accumulated capital and liquidity buffers and – in particular – accommodate to new burdens in the form of possible levies and taxes. One should avoid actions - both regulatory and supervisory - that deepen the negative procyclical effects. There is also the risk that too stringent actions move business activities outside the traditional banking sector. This

is encouraged as long as the shadow banking sector is less heavily regulated – especially in terms of capital adequacy wise - than the banking sector.

To this end, there are several areas that need to be explored. As an example the European Commission launched on Monday a review on bank structural reforms. The group will be headed by Mr Liikanen, the Governor of Bank of Finland. It will examine, inter alia, whether banks should build firewalls to ring-fence the assets of savers against investment banking losses.

When implementing new rules nationally, I think it is very important to maintain and even foster the level-playing-field across banks. It is important to have a single set of harmonized prudential rules (i.e. the Single Rule Book) throughout the EU.

We are also supportive of using the transition periods as proposed by the Commission for implementing the new rules. Anticipation of the rules would not be advantageous in our view, given the need to maintain a harmonized approach as well as the increasingly dire macro-economic conditions.

New regulatory initiatives developed at the global level – such as the consideration of capital surcharges on locally systemic institutions ("local SIFIs") and the implementation of the requirements on recovery and resolution plans – should be adopted in a congruent fashion in the EU. Hence, I very much welcome the proposal of the Danish presidency to include the treatment of the "local SIFIs" already in the present CRR/CRD IV -package.

When it comes to the detailed content of the solvency and liquidity requirements, I think that to the extent that specific EU solutions are not available, it is of utmost importance to have a fully coordinated approach amongst Nordic/Baltic supervisors. As an example I would like to mention restrictions on internal models. Bank or insurance groups operating in the highly integrated Nordic/Baltic market benefit greatly from a coordinated approach and we should avoid negative distortions or arbitrage across local markets. What is needed, is a proactive and open exchange of views and information before any decisions are made. And, then aim at a coordinated approach, whenever possible.

2. General home-host issues

Moving to the home-host cooperation in prudential supervision, the main principle issue – sometimes causing tension – is how to balance the need to manage centrally capital and liquidity at the group level and to maintain adequate local buffers for the protection of the host-country related interests. There are clear benefits of centralized management of capital and liquidity, such as being able to reap economies of scale and to deploy financial resources where they are most needed. Centralized management can also increase the stability of the financial groups as a whole.

However, the host-viewpoint is equally important. In case of a local subsidiary, it needs to meet the legally-based requirements for adequate financial buffers like any other local institution in order to

secure the safety and soundness of the operations of the subsidiary and to maintain level-playing-field in the local market.

Distinction between normal and crisis times is also important. Bank of England Governor Mr Mervyn King famously said that banks are international when they live, but they are national when they die. And, recognition of this feature can create ring-fencing by national authorities in crisis times – as we have seen in the past. Also branches can create issues for local markets – as we also know from the previous crisis; and I am referring of course to the Icelandic banks.

Given the possibility of not having centrally managed capital or liquidity available at the local level when most needed, host authorities do have legitimate questions about how far centralization can go and what should be put in place to safeguard the interests of the host countries? The EU framework has been developing towards centralized capital and liquidity management. But as long as we have local national responsibility for financial stability and protecting the interests of the local customers we need to have a balanced approach covering both interests – also regarding liquidity buffers of significant branches. And we need to have smooth cross-border supervisory cooperation.

Therefore in my opinion these host country interests need to be observed in the implementation of the Basel III and Solvency II reforms in the EU. Using mediation at the EU level could turn useful to sort out possible conflicts between supervisors, but rendering final say on issues very important to local financial stability could be very difficult to agree on by host countries.

3. Capital adequacy requirements for cross-border groups

Turning to the issue of adequate capital levels more precisely at the group and solo levels, home and host supervisors need to ensure that consolidated and local capital buffers are both sufficient.

It is important that the local solo capital buffer adequately covers the specific risks in that market – including macro-economic risks – as well as any risk-shifts within the group in question to the local entity. The substantial derivative and market risk positions of Nordea Bank Finland are a case in point. The risk-based capital needs of the local unit need to be met.

I find the EBA Guideline (developed by CEBS) on the assessment of capital adequacy in cross-border groups (the JRAD-Guideline) very useful in establishing a strong supervisory process for colleges, where both home and host authorities are jointly involved at the assessment of capital adequacy for the group and its significant entities. The experiences from using that process and the common rating scales etc. are very encouraging, and college work has been significantly improved.

However, at the Nordic level we have gone further than this by agreeing to a Nordic approach to capital allocation in cross-border groups. In this approach, the assessment of the capital buffers should be based on bottom-up stress tests taking into account local capital needs, but also considering the entire group's capital reserves. According to our agreement:

- A stress test –based capital buffer, built on a 3 year macro- stress test scenario should be maintained at the group level.
- Two thirds the subsidiary's stress test buffer should be held locally, while one third can be held in the consolidated capital reserve at the group level.

Hence, the bottom-up approach ensures that local risks are taken into account, while the group-perspective is recognized by allowing part of the subsidiary's buffer to be stored in the group's overall consolidated capital reserve, and capital can be better managed at the group level.

An agreement like the one we have reached in the Nordic area seems to be lacking (according to our information) for many EU cross-border banking groups.

4. Liquidity arrangements for cross-border groups

Probably liquidity supervision issues are even more challenging in our Nordic/Baltic context in the current juncture than the capital issues. At the moment, liquidity risks have significantly increased due to the overall market turmoil and we are facing the implementation of the entirely new liquidity requirements for banks.

In the liquidity area, we have the same basic tension. We consider that a sufficiently strong position of the host supervisor should be maintained, given the great interests regarding local financial stability and the protection of local customers. The proposal of the Danish presidency to maintain host supervisor's role in the joint decision process regarding the liquidity requirements of the local subsidiaries is, hence, very welcome.

When considering the balance of group- and solo-level liquidity management, I think several aspects are relevant:

- First, liquidity risk controls need to be arranged so that they cover not only group-level risk management but also risks in individual subsidiaries and branches within the group.
- Second, the risk control should be based on realistic assumptions about the transferability of liquid assets and collateral – both external (such as political, legal, regulatory and tax aspects) and internal factors should be considered.
- Third, decisions on where to locate the liquidity buffer should reflect the group structure and business operations of the supervised entity, as well as the needs of the local units to have buffers available.
- Fourth, banks whose operations largely involve different currencies should hold assets denominated in those currencies in the liquidity buffer – much in line with the recent ESRB recommendations.

We also know from the past crises that local assets can be needed to cover the claims of the local depositors. If all assets are held at the group level they may not be available to protect local deposi-

tors. Such a case can occur, for instance, if a branch is there just to collect deposits without any local lending activities.

5. Main current issues for cross-border cooperation

In this difficult environment, three issues seem to me to be of utmost importance in cross-border co-operation. And, these issues should be tackled efficiently and as a matter of urgency in our supervisory colleges.

- First, frequent information collection on risks, financial and liquidity conditions of the group and its main entities, and effective exchange of information across supervisory authorities such that all share the same and up-to-date view.
- Second, making sure of the adequacy of the capital and liquidity contingency plans.
- And, third, making sure that the group has adequate stress testing in place to spot potential vulnerabilities in its risk management.

In our view, colleges work very well in the Nordic/Baltic area in running effective supervision plans (such as inspection plans) and address common supervisory issues such as model validations. But in the three areas I mentioned further efforts would be needed also in our case.

6. Conclusion

As a conclusion it can be stated that requiring water-proof capital adequacy and liquidity buffers at group and local levels would not allow the efficient functioning of cross-border banking or financial groups. The question that remains to be answered is: How much leeway can host authorities give, i.e. what are the risks of centrally managed capital and liquidity buffers given the legal responsibilities of host authorities, the accountability towards society under local legislation. My above view represented mainly that of a host supervisor. In the future we might have a “proper” European prudential financial authority with all the powers attached to it, responsible for the supervision of major cross-border groups, including solvency and liquidity questions. However, before that can happen, many legal, tax and regulatory issues, like bank resolution and burden sharing, have to be agreed upon. Until then I am a strong believer in a good, open and constructive co-operation between supervisory authorities. And also here the mutual trust is the key.

With these remarks I end my comments.

Thank you.