THE HIGH-LEVEL GROUP ON FINANCIAL SUPERVISION IN THE EU

Chaired by
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AVANT-PROPOS

I would like to thank the President of the European Commission, José Manuel Barroso, for the very important mandate he conferred on me in October 2008 to chair an outstanding group of people to give advice on the future of European financial regulation and supervision. The work has been very stimulating. I am grateful to all members of the group for their excellent contributions to the work, and for all other views and papers submitted to us by many interested parties.

This report is published as the world faces a very serious economic and financial crisis.

The European Union is suffering.

An economic recession.

Higher unemployment.

Huge government spending to stabilize the banking system – debts that future generations will have to pay back.

Financial regulation and supervision have been too weak or have provided the wrong incentives. Global markets have fanned the contagion. Opacity, complexity have made things much worse.

Repair is necessary and urgent.

Action is required at all levels – Global, European and National and in all financial sectors.

We must work with our partners to converge towards high global standards, through the IMF, FSF, the Basel committee and G20 processes. This is critical. But let us recognize that the implementation and enforcement of these standards will only be effective and lasting if the European Union, with the biggest capital markets in the world, has a strong and integrated European system of regulation and supervision.

In spite of some progress, too much of the European Union's framework today remains seriously fragmented. The regulatory rule book itself. The European Unions' supervisory structures. Its crisis mechanisms.

This report lays out a framework to take the European Union forward.

Towards a new regulatory agenda – to reduce risk and improve risk management; to improve systemic shock absorbers; to weaken pro-cyclical amplifiers; to strengthen transparency; and to get the incentives in financial markets right.

Towards stronger coordinated supervision – macro-prudential and micro-prudential. Building on existing structures. Ambitiously, step by step but with a simple objective. Much stronger, coordinated supervision for all financial actors in the European Un ion. With equivalent standards for all, thereby preserving fair competition throughout the internal market.

Towards effective crisis management procedures – to build confidence among supervisors. And real trust. With agreed methods and criteria. So all Member States can feel that their investors, their depositors, their citizens are properly protected in the European Union.

In essence, we have two alternatives: the first *"chacun pour soi"* beggar-thy-neighbour solutions; or the second - enhanced, pragmatic, sensible European cooperation for the benefit of all to preserve an open world economy. This will bring undoubted economic gains, and this is what we favour.

We must begin work immediately.

Jacques de Larosière
Chairman

DISCLAIMER

The views expressed in this report are those of the High-Level Group on supervision.

The Members of the Group support all the recommendations.

However, they do not necessarily agree on all the detailed points made in the report.

INTRODUCTION

1) Since July 2007, the world has faced, and continues to face, the most serious and disruptive financial crisis since 1929. Originating primarily in the United States, the crisis is now global, deep, even worsening. It has proven to be highly contagious and complex, rippling rapidly through different market segments and countries. Many parts of the financial system remain under severe strain. Some markets and institutions have stopped functioning. This, in turn, has negatively affected the real economy. Financial markets depend on trust. But much of this trust has evaporated.

2) Significant global economic damage is occurring, strongly impacting on the cost and availability of credit; household budgets; mortgages; pensions; big and small company financing; far more restricted access to wholesale funding and now spillovers to the more fragile emerging country economies. The economies of the OECD are shrinking into recession and unemployment is increasing rapidly. So far banks and insurance companies have written off more than 1 trillion euros. Even now, 18 months after the beginning of the crisis, the full scale of the losses is unknown. Since August 2007, falls in global stock markets alone have resulted in losses in the value of the listed companies of more than €16 trillion, equivalent to about 1.5 times the GDP of the European Union.

3) Governments and Central Banks across the world have taken many measures to try to improve the economic situation and reduce the systemic dangers: economic stimulus packages of various forms; huge injections of Central Bank liquidity; recapitalising financial institutions; providing guarantees for certain types of financial activity and in particular inter-bank lending; or through direct asset purchases, and *"Bad Bank"* solutions are being contemplated by some governments. So far there has been limited success.

4) The Group believes that the world's monetary authorities and its regulatory and supervisory financial authorities can and must do much better in the future to reduce the chances of events like these happening again. This is not to say that all crises can be prevented in the future. This would not be a realistic objective. But what could and should be prevented is the kind of systemic and inter-connected vulnerabilities we have seen and which have carried such contagious effects. To prevent the recurrence of this type of crisis, a number of critical policy changes are called for. These concern the European Union but also the global system at large.

5) Chapter 1 of this report begins by analysing the complex causes of this financial crisis, a sine qua non to determine the correct regulatory and supervisory responses.

CHAPTER I: CAUSES OF THE FINANCIAL CRISIS

Macroeconomic issues

6) Ample liquidity and low interest rates have been the major underlying factor behind the present crisis, but financial innovation amplified and accelerated the consequences of excess liquidity and rapid credit expansion. Strong macro-economic growth since the mid-nineties gave an illusion that permanent and sustainable high levels of growth were not only possible, but likely. This was a period of benign macroeconomic conditions, low rates of inflation and low interest rates. Credit volume grew rapidly and, as consumer inflation remained low, central banks - particularly in the US - felt no need tighten monetary policy. Rather than in the prices of goods and services, excess liquidity showed up in rapidly rising asset prices. These monetary policies fed into growing imbalances in global financial and commodity markets.

7) In turn, very low US interest rates helped create a widespread housing bubble. This was fuelled by unregulated, or insufficiently regulated, mortgage lending and complex securitization financing techniques. Insufficient oversight over US government sponsored entities (GSEs) like Fannie Mae and Freddie Mac and strong political pressure on these GSEs to promote home ownership for low income households aggravated the situation. Within Europe there are different housing finance models. Whilst a number of EU Member States witnessed unsustainable increases in house prices, in some Member States they grew more moderately and, in general, mortgage lending was more responsible.

8) In the US, personal saving fell from 7% as a percentage of disposable income in 1990, to below zero in 2005 and 2006. Consumer credit and mortgages expanded rapidly. In particular, subprime mortgage lending in the US rose significantly from $180 billion in 2001 to $625 billion in 2005.

9) This was accompanied by the accumulation of huge global imbalances. The credit expansion in the US[1] was financed by massive capital inflows from the major emerging countries with external surpluses, notably China. By pegging their currencies to the dollar, China and other economies such as Saudi Arabia in practice imported loose US monetary policy, thus allowing global imbalances to build up. Current account surpluses in these countries were recycled into US government securities and other lower-risk assets, depressing their yields and encouraging other investors to search for higher yields from more risky assets…

10) In this environment of plentiful liquidity and low returns, investors actively sought higher yields and went searching for opportunities. Risk became mis-priced. Those originating investment products responded to this by developing more and more innovative and complex instruments designed to offer improved yields, often combined with increased leverage. In particular, financial institutions converted their loans into mortgage or asset backed securities (ABS), subsequently turned into collateralised debt obligations (CDOs) often via off-balance special purpose vehicles (SPVs) and structured investment vehicles (SIVs), generating a dramatic expansion of leverage within the financial system as a

[1] Evidenced by a current account deficit of above 5% of GDP (or $700 billion a year) over a number of years.

whole. The issuance of US ABS, for example, quadrupled from $337 billion in 2000 to over $1,250 billion in 2006 and non-agency US mortgage-backed securities (MBS) rose from roughly $100 billion in 2000 to $773 billion in 2006. Although securitisation is in principle a desirable economic model, it was accompanied by opacity which camouflaged the poor quality of the underlying assets. This contributed to credit expansion and the belief that risks were spread.

11) This led to increases in leverage and even more risky financial products. In the macro conditions preceding the crisis described above, high levels of liquidity resulted finally in risk premia falling to historically low levels. Exceptionally low interest rates combined with fierce competition pushed most market participants – both banks and investors – to search for higher returns, whether through an increase in leverage or investment in more risky financial products. Greater risks were taken, but not properly priced as shown by the historically very low spreads. Financial institutions engaged in very high leverage (on and off balance sheet) - with many financial institutions having a leverage ratio of beyond 30 - sometimes as high as 60 - making them exceedingly vulnerable to even a modest fall in asset values.

12) These problems developed dynamically. The rapid recognition of profits which accounting rules allowed led both to a view that risks were falling and to increases in financial results. This combination, when accompanied by constant capital ratios, resulted in a fast expansion of balance sheets and made institutions vulnerable to changes in valuation as economic circumstances deteriorated.

Risk management

13) There have been quite fundamental failures in the assessment of risk, both by financial firms and by those who regulated and supervised them. There are many manifestations of this: a misunderstanding of the interaction between credit and liquidity and a failure to verify fully the leverage of institutions were among the most important. The cumulative effect of these failures was an overestimation of the ability of financial firms as a whole to manage their risks, and a corresponding underestimation of the capital they should hold.

14) The extreme complexity of structured financial products, sometimes involving several layers of CDOs, made proper risk assessment challenging for even the most sophisticated in the market. Moreover, model-based risk assessments underestimated the exposure to common shocks and tail risks and thereby the overall risk exposure. Stress-testing too often was based on mild or even wrong assumptions. Clearly, no bank expected a total freezing of the inter-bank or commercial paper markets.

15) This was aggravated further by a lack of transparency in important segments of financial markets – even within financial institutions – and the build up of a "shadow" banking system. There was little knowledge of either the size or location of credit risks. While securitised instruments were meant to spread risks more evenly across the financial system, the nature of the system made it impossible to verify whether risk had actually been spread or simply re-concentrated in less visible parts of the system. This contributed to uncertainty on the credit quality of counterparties, a breakdown in confidence and, in turn, the spreading of tensions to other parts of the financial sector.

16) Two aspects are important in this respect. First, the fact that the Basel 1 framework did not cater adequately for, and in fact encouraged, pushing risk taking off balance-sheets. This has been partly corrected by the Basel 2 framework. Second, the explosive growth of the Over-The-Counter credit derivatives markets, which were supposed to mitigate risk, but in fact added to it.

17) The originate-to-distribute model as it developed, created perverse incentives. Not only did it blur the relationship between borrower and lender but also it diverted attention away from the ability of the borrower to pay towards lending – often without recourse - against collateral. A mortgage lender knowing beforehand that he would transfer (sell) his entire default risks through MBS or CDOs had no incentive to ensure high lending standards. The lack of regulation, in particular on the US mortgage market, made things far worse. Empirical evidence suggests that there was a drastic deterioration in mortgage lending standards in the US in the period 2005 to 2007 with default rates increasing.

18) This was compounded by financial institutions and supervisors substantially underestimating liquidity risk. Many financial institutions did not manage the maturity transformation process with sufficient care. What looked like an attractive business model in the context of liquid money markets and positively sloped yield curves (borrowing short and lending long), turned out to be a dangerous trap once liquidity in credit markets dried up and the yield curve flattened.

The role of Credit Rating Agencies

19) Credit Rating Agencies (CRAs) lowered the perception of credit risk by giving AAA ratings to the senior tranches of structured financial products like CDOs, the same rating they gave to standard government and corporate bonds.

20) The major underestimation by CRAs of the credit default risks of instruments collateralised by subprime mortgages resulted largely from flaws in their rating methodologies. The lack of sufficient historical data relating to the US sub-prime market, the underestimation of correlations in the defaults that would occur during a downturn and the inability to take into account the severe weakening of underwriting standards by certain originators have contributed to poor rating performances of structured products between 2004 and 2007.

21) The conflicts of interests in CRAs made matters worse. The issuer-pays model, as it has developed, has had particularly damaging effects in the area of structured finance. Since structured products are designed to take advantage of different investor risk appetites, they are structured for each tranche to achieve a particular rating. Conflicts of interests become more acute as the rating implications of different structures were discussed between the originator and the CRA. Issuers shopped around to ensure they could get an AAA rating for their products.

22) Furthermore, the fact that regulators required certain regulated investors to only invest in AAA-rated products also increased demand for such financial assets.

Corporate governance failures

23) Failures in risk assessment and risk management were aggravated by the fact that the checks and balances of corporate governance also failed. Many boards and senior managements of financial firms neither understood the characteristics of the new, highly complex financial products they were dealing with, nor were they aware of the aggregate exposure of their companies, thus seriously underestimating the risks they were running. Many board members did not provide the necessary oversight or control of management. Nor did the owners of these companies – the shareholders.

24) Remuneration and incentive schemes within financial institutions contributed to excessive risk-taking by rewarding short-term expansion of the volume of (risky) trades rather than the long-term profitability of investments. Furthermore, shareholders' pressure on management to deliver higher share prices and dividends for investors meant that exceeding expected quarterly earnings became the benchmark for many companies' performance.

Regulatory, supervisory and crisis management failures

25) These pressures were not contained by regulatory or supervisory policy or practice. Some long-standing policies such as the definition of capital requirements for banks placed too much reliance on both the risk management capabilities of the banks themselves and on the adequacy of ratings. In fact, it has been the regulated financial institutions that have turned out to be the largest source of problems. For instance, capital requirements were particularly light on proprietary trading transactions while (as events showed later) the risks involved in these transactions proved to be much higher than the internal models had expected.

26) One of the mistakes made was that insufficient attention was given to the liquidity of markets. In addition, too much attention was paid to each individual firm and too little to the impact of general developments on sectors or markets as a whole. These problems occurred in very many markets and countries, and aggregated together contributed substantially to the developing problems. Once problems escalated into specific crises, there were real problems of information exchange and collective decision making involving central banks, supervisors and finance ministries.

27) Derivatives markets rapidly expanded (especially credit derivatives markets) and off-balance sheet vehicles were allowed to proliferate– with credit derivatives playing a significant role triggering the crisis. While US supervisors should have been able to identify (and prevent) the marked deterioration in mortgage lending standards and intervene accordingly, EU supervisors had a more difficult task in assessing the extent to which exposure to subprime risk had seeped into EU-based financial institutions. Nevertheless, they failed to spot the degree to which a number of EU financial institutions had accumulated – often in off balance-sheet constructions- exceptionally high exposure to highly complex, later to become illiquid financial assets. Taken together, these developments led over time to opacity and a lack of transparency.

28) This points to serious limitations in the existing supervisory framework globally, both in a national and cross-border context. It suggests that financial supervisors frequently did not

have and in some cases did not insist in getting, or received too late, all the relevant information on the global magnitude of the excess leveraging; that they did not fully understand or evaluate the size of the risks; and that they did not seem to share their information properly with their counterparts in other Member States or with the US. In fact, the business model of US-type investment banks and the way they expanded was not really challenged by supervisors and standard setters. Insufficient supervisory and regulatory resources combined with an inadequate mix of skills as well as different national systems of supervision made the situation worse.

29) Regulators and supervisors focused on the micro-prudential supervision of individual financial institutions and not sufficiently on the macro-systemic risks of a contagion of correlated horizontal shocks. Strong international competition among financial centres also contributed to national regulators and supervisors being reluctant to take unilateral action.

30) Whilst the building up of imbalances and risks was widely acknowledged and commented upon, there was little consensus among policy makers or regulators at the highest level on the seriousness of the problem, or on the measures to be taken. There was little impact of early warning in terms of action – and most early warnings were feeble anyway.

31) Multilateral surveillance (IMF) did not function efficiently, as it did not lead to a timely correction of macroeconomic imbalances and exchange rate misalignments. Nor did concerns about the stability of the international financial system lead to sufficient coordinated action, for example through the IMF, FSF, G8 or anywhere else.

The dynamics of the crisis

32) The crisis eventually erupted when inflation pressures in the US economy required a tightening of monetary policy from mid-2006 and it became apparent that the sub-prime housing bubble in the US was going to burst amid rising interest rates. Starting in July 2007, accumulating losses on US sub-prime mortgages triggered widespread disruption of credit markets, as uncertainty about the ultimate size and location of credit losses undermined investor confidence. Exposure to these losses had been spread among financial institutions around the world, including Europe, inter alia via credit derivative markets.

33) The pro-cyclical nature of some aspects of the regulatory framework was then brought into sharp relief. Financial institutions understandably tried to dispose of assets once they realised that they had overstretched their leverage, thus lowering market prices for these assets. Regulatory requirements (accounting rules and capital requirements) helped trigger a negative feed-back loop amplified by major impacts in the credit markets.

34) Financial institutions, required to value their trading book according to mark-to-market principles, (which pushed up profits and reserves during the bull-run) were required to write down the assets in their balance sheet as markets deleveraged. Already excessively leveraged, they were required to either sell further assets to maintain capital levels, or to reduce their loan volume. "Fire sales" made by one financial institution in turn forced all other financial institutions holding similar assets to mark the value of these assets down

"to market". Many hedge funds acted similarly and margin calls intensified liquidity problems.

35) Once credit rating agencies started to revise their credit ratings for CDOs downwards, banks were required to adjust their risk-weighted capital requirements upwards. Once again, already highly leveraged, and faced with increasing difficulties in raising equity, a range of financial institutions hastened to dispose of assets, putting further pressure on asset prices. When, despite the fear of possible negative signalling effects, banks tried to raise fresh capital, more or less at the same time, they were faced by weakening equity markets. This obliged them to look for funding from sovereign wealth funds and, in due course, from heavy state intervention. What was initially a liquidity problem rapidly, for a number of institutions, turned into a solvency problem.

36) The lack of market transparency, combined with the sudden downgrade of credit ratings, and the US Government's decision not to save Lehman Brothers led to a wide-spread breakdown of trust and a crisis of confidence that, in autumn 2008, practically shut down inter-bank money markets, thus creating a large-scale liquidity crisis, which still weighs heavily on financial markets in the EU and beyond. The complexity of a number of financial instruments and the intrinsic vulnerability of the underlying assets also explain why problems in the relatively small US sub-prime market brought the global financial system to the verge of a full-scale dislocation. The longer it took to reveal the true amount of losses, the more widespread and entrenched the crisis of confidence has become. And it remains largely unresolved to this day.

37) The regulatory response to this worsening situation was weakened by an inadequate crisis management infrastructure in the EU, both in terms of the cooperation between national supervisors and between public authorities. The ECB was among the first to react swiftly by provide liquidity to the inter-bank market. In the absence of a common framework for crisis management, Member States were faced with a very difficult situation. Especially for the larger financial institutions they had to react quickly and pragmatically to avoid a banking failure. These actions, given the speed of events, for obvious reasons were not fully coordinated and led sometimes to negative spill-over effects on other Member States.

CHAPTER II: POLICY AND REGULATORY REPAIR

I. INTRODUCTION

The present report draws a distinction between financial regulation and supervision.

38) Regulation is the set of rules and standards that govern financial institutions; their main objective is to foster financial stability and to protect the customers of financial services. Regulation can take different forms, ranging from information requirements to strict measures such as capital requirements. On the other hand, supervision is the process designed to oversee financial institutions in order to ensure that rules and standards are properly applied. This being said, in practice, regulation and supervision are intertwined and will therefore, in some instances, have to be assessed together in this chapter and the following one.

39) As underlined in the previous chapter, the present crisis results from the complex interaction of market failures, global financial and monetary imbalances, inappropriate regulation, weak supervision and poor macro-prudential oversight. It would be simplistic to believe therefore that these problems can be "resolved" just by more regulation. Nevertheless, it remains the case that good regulation is a necessary condition for the preservation of financial stability.

40) A robust and competitive financial system should facilitate intermediation between those with financial resources and those with investment needs. This process relies on confidence in the integrity of institutions and the continuity of markets. *"This confidence, taken for granted in well-functioning financial systems, has been lost in the present crisis in substantial part due to its recent complexity and opacity,…weak credit standards, mis-judged maturity mismatches, wildly excessive use of leverage on and off-balance sheet, gaps in regulatory oversight, accounting and risk management practices that exaggerated cycles, a flawed system of credit ratings and weakness of governance* [2]".

    All must be addressed.

41) This chapter outlines some changes in regulation that are required to strengthen financial stability and the protection of customers so to avoid – if not the occurrence of crises, which are unavoidable – at least a repetition of the extraordinary type of systemic breakdown that we are now witnessing. Most of the issues are global in nature, and not just specific to the EU.

42) What should be the right focus when designing regulation? It should concentrate on the major sources of weaknesses of the present set-up (e.g. dealing with financial bubbles, strengthening regulatory oversight on institutions that have proven to be poorly regulated, adapting regulatory and accounting practices that have aggravated pro-cyclicality, promoting correct incentives to good governance and transparency, ensuring international consistency in standards and rules as well as much stronger coordination between regulators and supervisors). Over-regulation, of course, should be avoided because it

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2 G30 report, Washington, January 2009.

slows down financial innovation and thereby undermines economic growth in the wider economy. Furthermore, the enforcement of existing regulation, when adequate (or improving it where necessary), and better supervision, can be as important as creating new regulation.

II. THE LINK BETWEEN MACROECONOMIC AND REGULATORY POLICY

43) The fundamental underlying factor which made the crisis possible was the ample liquidity and the related low interest rate conditions which prevailed globally since the mid-nineties. These conditions fuelled risk taking by investors, banks and other financial institutions, leading ultimately to the crisis.

44) The low level of long term interest rate over the last five years – period of sustained growth – is an important factor that contrasts with previous expansionary periods.

45) As industrial economies recovered during this period, corporate investment did not pick up as would have been expected. "*As a result, the worldwide excess of desired savings over actual investment ... pushed its way into the main markets that were opened to investment, housing in industrial countries, lifting house prices and rising residential construction*[3]". This phenomenon, which affected also financial assets, took place in the US but also in the EU, where significant housing bubbles developed in the UK, Ireland and Spain.

46) This explanation is not inconsistent with the one focusing on excessive liquidity fuelled by too loose monetary policy. Actually the two lines of reasoning complement each other: too low interest rates encouraged investment in housing and financial assets, but had monetary policy been stricter, there would have been somewhat less expansion in the US, more limited house prices increases and smaller current account deficits. By the same token, if countries with big surpluses had allowed their currencies to appreciate, smaller current account deficits and surpluses would have been the consequence. This raises the question of what competent authorities can do in order to at least mitigate the risks of bubbles building up, instead of simply intervening *ex-post* by injecting liquidity to limit the damage from a macro-economic standpoint.

47) The lack of precise and credible information on whether a given state of asset markets is already a bubble is not a sufficient argument against trying to prevent a serious bubble.

48) It is commonly agreed today that monetary authorities cannot avoid the creation of bubbles by targeting asset prices and they should not try to prick bubbles. However, they can and should adequately communicate their concerns on the sustainability of strong increases in asset prices and contribute to a more objective assessment of systemic risks. Equally, they can and should implement a monetary policy that looks not only at consumer prices, but also at overall monetary and credit developments, and they should be ready to gradually tighten monetary policy when money or credit grow in an excessive and unsustainable manner. Other competent authorities can also use certain tools to contain money and credit growth. These are of particular importance in the context of the

[3] See "the global roots of the current financial crisis and its implications for regulation" by Kashyap, Raghuram Rajan and Stein.

euro zone, where country-specific monetary policies tailored to countries' positions in the economic cycle, and especially in the asset market cycle, cannot be implemented. The following are examples of regulatory tools which can help meet counter-cyclical objectives:

- introducing dynamic provisioning or counter-cyclical reserves on banks in *"good times"* to limit credit expansion and so alleviate pro-cyclicality effects in the *"bad times"*;

- making rules on loans to value more restrictive;

- modifying tax rules that excessively stimulate the demand for assets.

49) These tools were not, or were hardly, used by monetary and regulatory authorities in the run-up to the present crisis. This should be a lesson for the future. Overall cooperation between monetary and regulatory authorities will have to be strengthened, with a view to defining and implementing the policy-mix that can best maintain a stable and balanced macro-economic framework. In this context, it will be important for the ECB to become more involved in over-seeing the macro-prudential aspects of banking activities (see next chapter on supervision). Banks should be subject to more and more intense scrutiny as the bubble builds up.

50) Finally, a far more effective and symmetric *"multilateral surveillance"* by the IMF covering exchange rates and underlying economic policies is called for if one wants to avoid the continuation of unsustainable deficits (see chapter on global issues).

III. CORRECTING REGULATORY WEAKNESSES

Reforming certain key-aspects of the present regulatory framework

51) Although the relative importance assigned to regulation (versus institutional incentives - such as governance and risk assessment, - or monetary conditions…) can be discussed, it is a fact that global financial services regulation did not prevent or at least contain the crisis as well as market aberrations. A profound review of regulatory policy is therefore needed. A consensus, both in Europe and internationally, needs to be developed on which financial services regulatory measures are needed for the protection of customers, the safeguarding of financial stability, and the sustainability of economic growth.

52) This should be done being mindful of the usefulness of self-regulation by the private sector. Public and self-regulation should complement each other and supervisors should check that where there is self-regulation it is being properly implemented. This was not sufficiently carried out in the recent past.

The following issues must be addressed as a matter of urgency.

a) The Basel 2 framework

53) It is wrong to blame the Basel 2 rules *per se* for being one of the major causes of the crisis. These rules entered into force only on 1 January 2008 in the EU and will only be

applicable in the US on 1 April 2010. Furthermore, the Basel 2 framework contains several improvements which would have helped mitigate to some extent the emergence of the crisis had they been fully applied in the preceding years. For example, had the capital treatment for liquidity lines given to special purpose vehicles been in application then they might have mitigated some of the difficulties. In this regard Basel 2 is an improvement relative to the previous "leverage ratios" that failed to deal effectively with off-balance sheet operations.

54) The Basel 2 framework nevertheless needs fundamental review. It underestimated some important risks and over-estimated banks' ability to handle them. The perceived wisdom that distribution of risks through securitisation took risk away from the banks turned out, on a global basis, also to be incorrect. These mistakes led to too little capital being required. This must be changed. The Basel methodology seems to have been too much based on recent past economic data and good liquidity conditions.

55) Liquidity issues are important in the context both of individual financial firms and of the regulatory system. The Group believes that both require greater attention than they have hitherto been afforded. Supervisors need to pay greater attention to the specific maturity mismatches of the firms they supervise, and those drawing up capital regulations need to incorporate more fully the impact on capital of liquidity pressures on banks' behaviour.

56) A reflection is also needed with regard to the reliance of Basel 2 on external ratings. There has undoubtedly been excessive reliance by many buy-side firms on ratings provided by CRAs. If CRAs perform to a proper level of competence and of integrity, their services will be of significant value and should form a helpful part of financial markets. These arguments support Recommendation 3. But the use of ratings should never eliminate the need for those making investment decisions to apply their own judgement. A particular failing has been the acceptance by investors of ratings of structured products without understanding the basis on which those products were provided.

57) The use by sophisticated banks of internal risk models for trading and banking book exposures has been another fundamental problem. These models were often not properly understood by board members (even though the Basel 2 rules increased the demands on boards to understand the risk management of the institutions). Whilst the models may pass the test for normal conditions, they were clearly based on too short statistical horizons and this proved inadequate for the recent exceptional circumstances.

58) Future rules will have to be better complemented by more reliance on judgement, instead of being exclusively based on internal risk models. Supervisors, board members and managers should understand fully new financial products and the nature and extent of the risks that are being taken; stress testing should be undertaken without undue constraints; professional due diligence should be put right at the centre of their daily work.

59) Against this background, the Group is of the view that the review of the Basel 2 framework should be articulated around the following elements:

- The crisis has shown that there should be more capital, and more high quality capital, in the banking system, over and above the present regulatory minimum levels. Banks should hold more capital, especially in good times, not only to cover idiosyncratic risks but also to incorporate the broader macro-prudential risks. The goal should be to increase minimum requirements. This should be done gradually in order to avoid pro-cyclical drawbacks and an aggravation of the present credit crunch.

- The crisis has revealed the strong pro-cyclical impact of the current regulatory framework, stemming in particular from the interaction of risk-sensitive capital requirements and the application of the mark-to-market principle in distressed market conditions. Instead of having a dampening effect, the rules have amplified market trends upwards and downwards - both in the banking and insurance sectors.

60) How to reduce the pro-cyclical effect of Basel 2? Of course, it is inevitable that a system based on risk-sensitivity is to some extent pro-cyclical: during a recession, the quality of credit deteriorates and capital requirements rise. The opposite happens during an upswing. But there is a significant measure of "excessive" pro-cyclicality in the Basel framework that must be reduced by using several methods[4].

- concerning the banking book, it is important that banks, as is the present rule, effectively assess risks using "through the cycle" approaches which would reduce the pro-cyclicality of the present measurement of probability of losses and default;

- more generally, regulation should introduce specific counter-cyclical measures. The general principle should be to slow down the inherent tendency to build up risk-taking and over-extension in times of high growth in demand for credit and expanding bank profits. In this respect, the "dynamic provisioning" introduced by the Bank of Spain appears as a practical way of dealing with this issue: building up counter-cyclical buffers, which rise during expansions and allow them under certain circumstances to be drawn down in recessions. This would be facilitated if fiscal authorities would treat reserves taken against future expected losses in a sensible way. Another method would be to move capital requirements in a similar anti-cyclical way;

- this approach makes sense from a micro-prudential point of view because it reduces the risk of bank failures. But it is also desirable from a macro-prudential and macro-economic perspective. Indeed, such a measure would tend to place some restraint on over rapid credit expansion and reduce the dangers of market over-reactions during recessionary times;

- with respect to the trading book of banks, there is a need to reduce pro-cyclicality and to increase capital requirements. The present statistical VaR models are clearly pro-cyclical (too often derived, as they are, from observations of too short time periods to capture fully market prices movements and from other questionable assumptions). If volatility goes down in a year, the models combined with the accounting rules tend to understate the risks involved (often low volatility and credit growth are signs of irrational low risk aversion and hence of upcoming reversals). More generally, the level of capital required against trading books has been well too low relative to the risks being taken in a system where banks heavily relied on liquidity through "marketable instruments" which eventually, when liquidity evaporated, proved not to be marketable. If banks engage in proprietary activities for a significant part of their total activities, much higher capital requirements will be needed.

[4] See Lord Turner, The Financial Crisis and the Future of Financial Regulation, Economoist's inaugural city Lecture, 21 January 2009.

It is important that such recommendations be quickly adopted at international level by the Basel committee and the FSF who should define the appropriate details.

61) Measuring and limiting liquidity risk is crucial, but cannot be achieved merely through quantitative criteria. Indeed the "originate-and-distribute" model which has developed hand in hand with securitisation has introduced a new dimension to the liquidity issue. That dimension has not sufficiently been taken into account by the existing framework. The assessment by institutions and regulators of the "right" liquidity levels is difficult because it much depends on the assumptions made on the liquidity of specific assets and complex securities as well as secured funding. Therefore the assets of the banking system should be examined in terms not only of their levels, but also of their quality (counterparty risk, transparency of complex instruments…) and of their maturity transformation risk (e.g. dependence on short term funding). These liquidity constraints should be carefully assessed by supervisors. Indeed a "mismatch ratio" or increases in liquidity ratios must be consistent with the nature of assets and the time horizons of their holdings by banks.

The Basel committee should in the future concentrate more on liquidity risk management. Even though this is a very difficult task, it should come forward with a set of norms to complement the existing qualitative criteria (these norms should cover the need to maintain, given the nature of the risk portfolio, an appropriate mix of long term funding and liquid assets).

62) There should be stricter rules (as has been recommended by the FSF) for off-balance sheet vehicles. This means clarifying the scope of prudential regulation applicable to these vehicles and determining, if needed, higher capital requirements. Better transparency should also be ensured.

63) The EU should agree on a clear, common and comprehensive definition of own funds. This definition should in particular clarify whether, and if so which, hybrid instruments should be considered as Tier 1. This definition would have to be confirmed at international level by the Basel committee and applied globally. Consideration should also be given to the possibility of limiting Tier 1 instruments in the future to equity and reserves.

64) In order to ensure that management and banks' board members possess the necessary competence to fully understand complex instruments and methods, the "fit and proper" criteria should be reviewed and strengthened. Also, internationally harmonized rules should be implemented for strengthening the mandates and resources for banks’ internal control and audit functions. Regulators and supervisors should also be better trained to understand risk assessment models.

65) The Group supports the work initiated by the Basel committee on the above issues. It will however be important that the Basel committee works as expeditiously as possible. It took 8 years to revise Basel 1. This is far too long, especially given the speed at which the banking sector evolves. It will be important for the Basel committee to find ways to agree on the details of the above reforms far more quickly.

<u>Recommendation 1</u>: The Group sees the need for a fundamental review of the Basel 2 rules. The Basel Committee of Banking Supervisors should therefore be invited to urgently amend the rules with a view to:

- ***gradually increase minimum capital requirements;***
- ***reduce pro-cyclicality, by e.g. encouraging dynamic provisioning or capital buffers;***
- ***introduce stricter rules for off-balance sheet items;***
- ***tighten norms on liquidity management; and***
- ***strengthen the rules for bank's internal control and risk management, notably by reinforcing the "fit and proper" criteria for management and board members.***

Furthermore, it is essential that rules are complemented by more reliance on judgement.

<u>Recommendation 2</u>: In the EU, a common definition of regulatory capital should be adopted, clarifying whether, and if so which, hybrid instruments should be considered as tier 1 capital. This definition should be confirmed by the Basel Committee.

b) Credit Rating Agencies

66) Given the pivotal and quasi-regulatory role that they play in today's financial markets, Credit Rating Agencies must be regulated effectively to ensure that their ratings are independent, objective and of the highest possible quality. This is all the more true given the oligopolistic nature of this business. The stability and functioning of financial markets should not depend on the opinions of a small number of agencies – whose opinions often were proven wrong, and who have much too frequently substituted for rigorous due diligence by firms.

67) The Commission has made a proposal for a Regulation on CRAs. However, the system of licensing and oversight contained in this proposal is too cumbersome. The allocation of work between the home and host authorities, in particular, is likely to lack effectiveness and efficiency. The Group is of the view that it would be far more rational to entrust the Committee of European Securities Regulators (CESR) with the task of licensing CRAs in the EU, monitoring their performance, and in the light of this imposing changes (as is proposed in the new supervisory framework proposed in the next chapter).

68) Beyond this proposal for a Regulation, a fundamental review of CRAs economic model should be conducted, notably in order to eliminate the conflicts of interests that currently exist. One drawback of the present model is that CRAs are entirely financed by the issuers and not by the users, which is a source of conflict of interest. The modalities of a switch from the current "issuer pays" model to a "buyer pays" model should be considered at international level. Furthermore, and even though this may well be a difficult task in practice, consideration should be given to the ways in which the formulation of ratings could be completely separated from the advice given to issuers on the engineering of complex products.

69) The use of ratings required by some financial regulations raises a number of problems, but is probably unavoidable at this stage. However, it should be significantly reduced over time.

70) Regulators should have a close eye on the performance of CRAs with the recognition and allowable use of their ratings made dependent on their performance. This role should be entrusted to CESR, who should on an annual basis approve those CRAs whose ratings can be used for regulatory purposes. Should the performance of a given CRA be insufficient, its activities could be restricted or its licence withdrawn by CESR.

71) Finally, the rating of structured products should be transformed with a new, distinct code alerting investors about the complexity of the instrument.

72) These recommendations will of course have to dovetail with increased due diligence from the buy-side. Supervisors should check that financial institutions have the capacity to complement the use of external ratings (on which they should no longer excessively rely upon) with sound independent evaluations.

<u>Recommendation 3</u>: Concerning the regulation of Credit Rating Agencies (CRAs), the Group recommends that:

- ***within the EU, a strengthened CESR should be in charge of registering and supervising CRAs;***
- ***a fundamental review of CRAs' business model, its financing and of the scope for separating rating and advisory activities should be undertaken;***
- ***the use of ratings in financial regulations should be significantly reduced over time;***
- ***the rating for structured products should be transformed by introducing distinct codes for such products.***

It is crucial that these regulatory changes are accompanied by increased due diligence and judgement by investors and improved supervision.

c) The mark-to-market principle

73) The crisis has brought into relief the difficulty to apply the mark-to-market principle in certain market conditions as well as the strong pro-cyclical impact that this principle can have. The Group considers that a wide reflection is needed on the mark-to-market principle. Whilst in general this principle makes sense, there may be specific conditions where this principle should not apply because it can mislead investors and distort managers' policies.

74) It is particularly important that banks can retain the possibility to keep assets, accounted for amortised cost at historical or original fair value (corrected, of course, for future impairments), over a long period in the banking book - which does not mean that banks should have the discretion to switch assets at will from the banking to the trading book. The swift October 2008 decision by the EU to modify IAS-39, thereby introducing more flexibility as well as convergence with US GAAP, is to be commended. It is irrelevant to

mark-to-market, on a daily basis, assets that are intended to be held and managed on a long-term horizon provided that they are reasonably matched by financing.

75) Differences between business models must also be taken into account. For example, intermediation of credit and liquidity requires disclosure and transparency but not necessarily mark-to-market rules which, while being appropriate for investment banks and trading activities, are not consistent with the traditional loan activity and the policy of holding long term investments. Long-term economic value should be central to any valuation method: it may be based, for instance, on an assessment of the future cash flows deriving from the security as long as there is an explicit minimum holding period and as long as the cash flows can be considered as sustainable over a long period.

76) Another matter to be addressed relates to situations where assets can no longer be marked-to-market because there is no active market for the assets concerned. Financial institutions in such circumstances have no other solution than to use internal modelling processes. The quality and adequacy of these processes should of course be assessed by auditors. The methodologies used should be transparent. Furthermore internal modelling processes should also be overseen by the level 3 committees, in order to ensure consistency and avoid competitive distortions.

77) To ensure convergence of accounting practices and a level playing-field at the global level, it should be the role of the International Accounting Standard Board (IASB) to foster the emergence of a consensus as to where and how the mark-to-market principle should apply – and where it should not. The IASB must, to this end, open itself up more to the views of the regulatory, supervisory and business communities. This should be coupled with developing a far more responsive, open, accountable and balanced governance structure. If such a consensus does not emerge, it should be the role of the international community to set limits to the application of the mark-to-market principle.

78) The valuation of impaired assets is now at the centre of the political debate. It is of crucial importance that valuation of these assets is carried-out on the basis of common methodologies at international level. The Group encourages all parties to arrive at a solution which will minimise competition distortions and costs for taxpayers. If there are widely variant solutions – market uncertainty will not be improved.

79) Regarding the issue of pro-cylicality, as a matter of principle, the accounting system should be neutral and not be allowed to change business models – which it has been doing in the past by "incentivising" banks to act short term. The public good of financial stability must be embedded in accounting standard setting. This would be facilitated if the regulatory community would have a permanent seat in the IASB (see chapter on global repair).

***Recommendation 4**: With respect to accounting rules the Group considers that a wider reflection on the mark-to-market principle is needed and in particular recommends that:*

- ***expeditious solutions should be found to the remaining accounting issues concerning complex products;***
- ***accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment;***

- ***the IASB and other accounting standard setters should clarify and agree on a common, transparent methodology for the valuation of assets in illiquid markets where mark-to-market cannot be applied;***
- ***the IASB further opens its standard-setting process to the regulatory, supervisory and business communities;***
- ***the oversight and governance structure of the IASB be strengthened.***

d) Insurance

80) The crisis originated and developed in the banking sector. But the insurance sector has been far from immune. The largest insurance company in the world has had to be bailed out because of its entanglement with the entire financial sector, inter alia through credit default swaps activities. In addition, the failure of the business models of monoline insurers has created significant market and regulatory concern. It is therefore important, especially at a time where Europe is in the process of overhauling its regulatory framework for the entire insurance sector, to draw the lessons from the crisis in the US insurance sector. Insurance companies can in particular be subject to major market and concentration risks. Compared to banks, insurance companies tend to be more sensitive to stock market developments (and less to liquidity and credit risks, even if the crisis has shown that they are not immune to those risks either).

81) Solvency 2 is an important step forward in the effort to improve insurance regulation, to foster risk assessments and to rationalise the management of large firms. Solvency 2 should therefore be adopted urgently. The directive, especially if complemented by measures which draw the lessons from the crisis, would remedy the present fragmentation of rules in the EU and allow for a more comprehensive, qualitative and economic assessment of the risks mentioned above. The directive would also facilitate the management and supervision of large insurance groups. With colleges of supervisors for all cross-border groups the directive would strengthen and organise better supervisory cooperation – something lacking up to now in spite of the efforts made by the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The AIG case in the US has illustrated in dramatic terms what happens when there is a lack of supervisory cooperation.

82) Differences of views between "home" and "host" Member States on the operation of the group support regime have so far prevented a successful conclusion of the negotiation of the directive. This should be addressed by providing adequate safeguards for host Member States. In addition, the Group believes that the new supervisory framework proposed in the chapter on supervision (and in particular, the setting up of a binding mediation mechanism between home and host supervisors) plus the development of harmonised insurance guarantees schemes could contribute to finding a solution for the current deadlock. All the above measures (safeguards, binding mediation, insurance guarantee schemes) should be implemented together concurrently with Solvency 2. It would be highly desirable to agree the above package by May 2009 when the European Parliament breaks for its elections.

Recommendation 5: The Group considers that the Solvency 2 directive must be adopted and include a balanced group support regime, coupled with sufficient safeguards for host Member States, a binding mediation process between supervisors and the setting-up of harmonised insurance guarantee schemes.

e) Supervisory and sanctioning powers

83) A sound prudential and conduct of business framework for the financial sector must rest on strong supervisory and sanctioning regimes. Supervisory authorities must be equipped with sufficient powers to act when financial institutions have inadequate risk management and control mechanisms as well as inadequate solvency of liquidity positions. There should also be equal, strong and deterrent sanctions regimes against all financial crimes - sanctions which should be enforced effectively.

84) Neither of these exist for the time being in the EU. Member States sanctioning regimes are in general weak and heterogeneous. Sanctions for insider trading range from a few thousands of euros in one Member State to millions of euros or jail in another. This can induce regulatory arbitrage in a single market. Sanctions should therefore be urgently strengthened and harmonised. The huge pecuniary differences between the level of fines that can be levied in the competition area and financial fraud penalties is striking. Furthermore, Member States should review their capacity to adequately detect financial crimes when they occur. Where needed, more resources and more sophisticated detection processes should be deployed.

Recommendation 6:* *The Group considers that:

- ***Competent authorities in all Member States must have sufficient supervisory powers, including sanctions, to ensure the compliance of financial institutions with the applicable rules;***
- ***Competent authorities should also be equipped with strong, equivalent and deterrent sanction regimes to counter all types of financial crime.***

Closing the gaps in regulation

a) The "parallel banking system"

85) In addition to the weaknesses identified in the present regulatory framework, and in particular in the Basel 2 framework, it is advisable to look into the activities of the "parallel banking system" (encompassing hedge funds, investment banks, other funds, various off-balance sheet items, mortgage brokers in some jurisdictions). The Group considers that appropriate regulation must be extended, in a proportionate manner, to all firms or entities conducting financial activities which may have a systemic impact (i.e. in the form of counterparty, maturity, interest rate risks…) even if they have no direct links with the public at large. This is all the more important since such institutions, having no deposit base, can be very vulnerable when liquidity evaporates – resulting in major impacts in the real economy.

86) Concerning hedge funds, the Group considers they did not play a major role in the emergence of the crisis. Their role has largely been limited to a transmission function, notably through massive selling of shares and short-selling transactions. We should also recognise that in the EU, unlike the US, the great bulk of hedge fund managers are registered and subject to information requirements. This is the case in particular in the UK, where all hedge funds managers are subject to registration and regulation, as all fund managers are, and where the largest 30 are subject to direct information requirements often obtained on a global basis as well as to indirect monitoring via the banks and prime brokers.

87) It would be desirable that all other Member States as well as the US adopt a comparable set of measures. Indeed, hedge funds can add to the leverage of the system and, given the scale at which they can operate, should a problem arise, the concentrated unwinding of their positions could cause major dislocation.

88) There is a need for greater transparency since banks, the main lenders to hedge funds, and their supervisors have not been able to obtain a global view of the risks they were engaging in. At the very least, supervisors need to know which hedge funds are of systemic importance. And they should have a clear on-going view on the strategies, risk structure and leverage of these systemically important funds. This need for supervisory information requires the introduction of a formal authority to register these funds, to assess their strategies, their methods and their leverage. This is necessary for the exercise of macro-prudential oversight and therefore essential for financial stability.

89) Appropriate regulation in the US must also be redesigned for large investment banks and broker dealers when they are not organised as bank holding companies.

90) In this context, particular attention has to be paid to institutions which engage in proprietary trading to create value for their shareholders, i.e. investment banks and commercial banks who have engaged in these activities (that are not essentially different from some hedge funds). The conventional wisdom has been that light regulatory principles could apply to these because they were trading "at their own risk". Evidence has shown that the investment banks were subject to very thin capital requirements, became highly leveraged and then created severe systemic problems. Furthermore, it turned out that these institutions were subject to only very weak supervision by the Securities and Exchange Commission (SEC), which meant that no one had a precise view on their involvement with hedge funds and SPVs; nor had the competent authorities a view on the magnitude of the proprietary investments of these institutions, in particular in the US real estate sector.

91) While these institutions should not be controlled like ordinary banks, adequate capital requirements should be set for proprietary trading and reporting obligations should be applied in order to assess their degree of leverage. Furthermore, the wrong incentives that induced excessive risk taking (in particular because of the way in which bonuses are structured) must be rectified.

92) Where a bank actually owns a hedge fund (or a private equity fund), the Group does not believe that such ownership should be necessarily prohibited. It believes however that this situation should induce very strict capital requirements and very close monitoring by the supervisory authorities.

<u>Recommendation 7</u>: Concerning the "parallel banking system" the Group recommends to:

- ***extend appropriate regulation, in a proportionate manner, to all firms or entities conducting financial activities of a potentially systemic nature, even if they have no direct dealings with the public at large;***

- ***improve transparency in all financial markets - and notably for systemically important hedge funds - by imposing, in all EU Member States and internationally, registration and information requirements on hedge fund managers, concerning their strategies, methods and leverage, including their worldwide activities;***

- ***introduce appropriate capital requirements on banks owning or operating a hedge fund or being otherwise engaged in significant proprietary trading and to closely monitor them.***

b) Securitised products and derivatives markets

93) The crisis has revealed that there will be a need to take a wide look at the functioning of derivative markets. The simplification and standardisation of most over-the-counter (OTC) derivatives and the development of appropriate risk-mitigation techniques plus transparency measures could go a long way towards restoring trust in the functioning of these markets. It might also be worth considering whether there are any benefits in extending the relevant parts of the current code of conduct on clearing and settlement from cash equities to derivatives.

94) In the short-run, an important goal should be to reduce the counterparty risks that exist in the system. This should be done by the creation in the EU of at least one well-capitalised central clearing house for over-the-counter credit-default swaps (CDS), which would have to be simplified and standardized. This clearing house should be supervised by CESR and by the relevant monetary authorities, and notably the ECB (about 80% of the CDS market is denominated in euros[5]). This is vital to realize the highly needed reduction from gross to net positions in counterparty risks, particularly in cases of default such as Lehman Brothers.

95) To restore confidence in securitized markets, it is important to oblige at the international level issuers of complex securities to retain on their books for the life of the instrument a meaningful amount of the underlying risk (non-hedged).

<u>Recommendation 8</u>: Concerning securitised products and derivatives markets, the Group recommends to:

- ***simplify and standardise over-the-counter derivatives;***
- ***introduce and require the use of at least one well-capitalised central clearing house for credit default swaps in the EU;***
- ***guarantee that issuers of securitised products retain on their books for the life of the instrument a meaningful amount of the underlying risk (non-hedged).***

[5] Use of central bank money should be made for securities settlement, as proposed by Target 2 securities.

c) Investment funds

i) Money market funds issues

96) Another area which deserves attention is the regulation of the investment fund industry. A small number of investment funds in the EU have faced temporary difficulties in meeting investor redemption demands because of the unexpected contraction of liquidity in previously highly liquid markets (e.g. asset backed commercial paper, short-term banking paper).

97) This highlights in particular the need for a common EU definition of money market funds, and a stricter codification of the assets in which they can invest in order to limit exposure to credit, market and liquidity risks.

ii) Depository issues

98) The Madoff case has illustrated the importance of better controlling the quality of processes and functions in the case of funds, funds of funds and delegations of responsibilities. Several measures seem appropriate:

- delegation of investment management functions should only take place after proper due diligence and continuous monitoring by the "delegator";
- an independent depository should be appointed, preferably a third party;
- The depository institution, as custodians, should remain responsible for safe-keeping duties of all the funds assets at all times, in order to be able to perform effectively its compliance-control functions. Delegation of depository functions to a third party should therefore be forbidden. Nevertheless, the depositary institution may have to use sub-custodians to safe-keep foreign assets. Sub-custodians must be completely independent of the fund or the manager. The depositary must continue to perform effective duties as is presently requested. The quality of this duties should be the object of supervision;
- delegation practices to institutions outside of the EU should not be used to pervert EU legislation (UCITS provides strict "Chinese walls" between asset management functions and depositary-safe-keeping functions. This segregation should be respected whatever the delegation model is used).

***Recommendation 9**: With respect to investment funds, the Group proposes to further develop common rules for investment funds in the EU, notably concerning definitions, codification of assets and rules for delegation. This should be accompanied by a tighter supervisory control over the independent role of depositories and custodians.*

IV. EQUIPPING EUROPE WITH A CONSISTENT SET OF RULES

99) While the above areas for regulatory repair are relevant for all major jurisdictions in the world, and should be addressed internationally, Europe suffers from an additional problem in comparison to all single jurisdictions: the lack of a consistent set of rules.

100) An efficient Single Market should have a harmonised set of core rules.

101) There are at least four reasons for this:

- a single financial market - which is one of the key-features of the Union - cannot function properly if national rules and regulations are significantly different from one country to the other;

- such a diversity is bound to lead to competitive distortions among financial institutions and encourage regulatory arbitrage;

- for cross-border groups, regulatory diversity goes against efficiency and the normal group approaches to risk management and capital allocation;

- in cases of institutional failures, the management of crises in case of cross-border institutions is made all the more difficult.

102) The present regulatory framework in Europe lacks cohesiveness. The main cause of this situation stems from the options provided to EU members in the enforcement of common directives. These options lead to a wide diversity of national transpositions related to local traditions, legislations and practices.

103) This problem has been well-identified since the very beginning of the single financial market process. But the solutions have not always met the challenges. The fundamental cause for this lack of harmonisation is that the level 1directives have too often left, as a political choice, a range of national options. In these circumstances, it is unreasonable to expect the level 3 committees to be able to impose a single solution. Even when a directive does not include national options, it can lead to diverse interpretations which cannot be eliminated at level 3 in the present legal set-up.

104) As has been pointed out above, most of these issues relate to the effectiveness of the single financial market more than to the crisis. But three observations can be made here: firstly, the mandate of this Group is not limited to recommendations directly related to the issues that have arisen in the crisis; secondly, a number of important differences between Member States (different bankruptcy laws, different reporting obligations, different definitions of economic capital…) have compounded the problems of crisis prevention and management; thirdly, the crisis has shown that financial policy actions in one country can have detrimental effects on other countries. To avoid as much as possible spill-over effects and build the necessary trust, some institutionalised and binding arrangements are needed.

a) Examples of current regulatory inconsistencies

105) A few examples of excessive diversity can be stressed:

- the differences regarding the sectoral extent of EU supervision. Some EU countries have an extended definition of credit institutions (i.e. "établissements de crédit"), while other members have much more limited definitions. This is a source of problematic divergences between members that can lead to laxer supervision and regulatory arbitrage;
- reporting obligations are very diverse in the EU, some institutions -especially the non-listed ones- have no obligation to issue accounting reports. The transparency of the system is negatively affected by such differences;
- the definition of core capital differs from one Member State to another, with an impact in terms of communication. Some companies do not subtract goodwill from the definition of core capital;
- there are different accounting practices for provisions related to pensions. These differences create serious distortions in the calculation of prudential own funds in different nations;
- the directive on insurance mediation has led to highly divergent transpositions in the Member States. Some Member States have transposed the directive as it is with almost no national additions, while others have complemented the directive with very extensive national rules. Given that the directive grants a single passport to insurance intermediaries, these different transpositions induce competition distortions;
- there is limited harmonisation of the way in which insurance companies have to calculate their technical provisions, which makes it difficult to compare the solvency standing of insurance companies across the Community;
- the differences in the definition of regulatory capital regarding financial institutions are striking within the EU (for example, the treatment of subordinated debt as core tier 1 is the object of different adaptations). This goes at the heart of the efficiency and the enforcement of the Basel directive on capital requirements;
- there is no single agreed methodology to validate risks assessments by financial institutions;
- there are still substantial differences in the modalities related to deposit insurance;
- there is no harmonisation whatsoever for insurance guarantee schemes.

106) This brief analysis, based on concrete examples, leads to the conclusion that keeping intact the "present arrangements" is not the best option in the context of the Single Market.

b) The way forward

107) How to correct such a situation?

First of all, it must be noted that harmonisation is not an end in itself and that consistency does not need identical rules everywhere. There are national approaches that can be beneficial to the interested countries while not falling into the drawbacks mentioned above. National exceptions should be looked at with this in mind.

108) Furthermore, allowing a country, under appropriate circumstances, to adopt safeguards or regulatory measures stricter than the common framework should not be rejected. As long as agreed minimum core standards are harmonized and enforced, a country could take more restrictive measures if it considers they are domestically appropriate to safeguard financial stability. This should of course be done while respecting the principles of the internal market.

109) This being said the problem of regulatory inconsistencies must be solved at two different levels:

- the global level. The EU participates in a number of international arrangements (e.g. Basel committee, FSF) and multilateral institutions (e.g. IMF) that cannot be unilaterally changed by the EU. If and when some changes in those global rules appeared necessary, Europe should "speak with one voice" as we will mention in the global chapter;

- the European level. The European Institutions and the level 3 committees should equip the EU financial sector with a set of consistent core rules. Future legislation should be based, wherever possible, on regulations (which are of direct application). When directives are used, the co-legislator should strive to achieve maximum harmonisation of the core issues. Furthermore, a process should be launched to remove key-differences stemming from the derogations, exceptions and vague provisions currently contained in some directives (see chapter on supervision).

***Recommendation 10*: In order to tackle the current absence of a truly harmonised set of core rules in the EU, the Group recommends that:**

- ***Member States and the European Parliament should avoid in the future legislation that permits inconsistent transposition and application;***

- ***the Commission and the level 3 Committees should identify those national exceptions, the removal of which would improve the functioning of the single financial market; reduce distortions of competition and regulatory arbitrage; or improve the efficiency of cross-border financial activity in the EU. Notwithstanding, a Member State should be able to adopt more stringent national regulatory measures considered to be domestically appropriate for safeguarding financial stability as long as the principles of the internal market and agreed minimum core standards are respected.***

V. CORPORATE GOVERNANCE

110) This is one of the most important failures of the present crisis.

111) Corporate governance has never been spoken about as much as over the last decade. Procedural progress has no doubt been achieved (establishment of board committees, standards set by the banking supervision committee) but looking back at the causes of

the crisis, it is clear that the financial system at large did not carry out its tasks with enough consideration for the long-term interest of its stakeholders. Most of the incentives – many of them being the result of official action – encouraged financial institutions to act in a short-term perspective and to make as much profit as possible to the detriment of credit quality and prudence; interest rates were low and funding plentiful; the new accounting rules were systematically biased towards short-term performance (indeed these rules led to immediate mark-to-market recognition of profit without allowing a discount for future potential losses). As a result of all this, the long-term, "through the cycle" perspective has been neglected.

112) In such an environment, investors and shareholders became accustomed to higher and higher revenues and returns on equity which hugely outpaced for many years real economic growth rates. Few managers avoided the "herd instinct" – leading them to join the competitive race even if they might have suspected (or should have known) that risk premia were falling and that securitisation as it was applied could not shield the financial system against bad risks.

113) This is a sombre picture and not an easy one to correct; much of this behaviour was ingrained in the incentive structure mentioned above.

114) There should be no illusion that regulation alone can solve all these problems and transform the mindset that presided over the functioning (and downward spiral) of the system.

115) However, good, well-targeted measures could help mitigate or eliminate a number of misled incentives; the Group believes that several recommendations put forward in this report would be useful in this respect. They are:

- reform of the accounting system;
- a building-up of buffers in the form of dynamic provisioning or higher capital requirements in the good times;
- closing of regulatory gaps (e.g. off-balance sheet operations, oversight of hedge funds).

116) The Group however wishes to stress two further aspects of corporate governance that require specific attention: remuneration and risk management.

Remuneration issues

117) The crisis has launched a debate on remuneration in the financial services industry. There are two dimensions to this problem: one is the often excessive level of remuneration in the financial sector; the other one is the structure of this remuneration, notably the fact that they induce too high risk-taking and encourage short-termism to the detriment of long-term performance. Social-political dissatisfaction has tended recently to focus, for understandable reasons, on the former. However, it is primarily the latter issue which has had an adverse impact on risk management and has thereby contributed to the crisis. It is therefore on the structure of remuneration that policy-makers should concentrate reforms going forward.

118) It is extremely important to re-align compensation incentives with shareholder interests and long-term, firm-wide profitability. Compensation schemes must become fully transparent. Industry has already come up with various sets of useful principles to try and achieve this. The principles agreed in 2008 by the Institute of International Finance, for example, are a first step.

119) Without dealing with remuneration in financial institutions that have received public support, nor impinging on the responsibility of financial institutions in this field, it seems appropriate to outline a few principles that should guide compensation policies. Such principles include:

- the assessment of bonuses should be set in a multi-year framework. This would allow, say over five years, to spread out the actual payment of the bonus pool of each trading unit through the cycle and to deduct any potential losses occurring during the period. This would be a more realistic and less short-term incentivised method than present practice;

- these standards should apply not only to proprietary trading but also to asset managers;

- bonuses should reflect actual performance and therefore should not be "guaranteed" in advance.

120) Supervisors should oversee the adequacy of financial institutions' compensation policies. And if they consider that these policies conflict with sound underwriting practice, adequate risk management or are systematically encouraging short-term risk-taking, they should require the institutions concerned to reassess their remuneration policies. If supervisors are not satisfied by the measures taken they should use the possibility opened by pillar 2 of the Basel framework to require the financial institutions concerned to provide additional capital.

121) Of course the same guidelines should apply in relation to other financial institutions in order to avoid competitive distortions and loopholes. As suggested in the "global repair" chapter of this report, consistent enforcement of these measures at global level should be ensured to avoid excessive risk-taking.

***Recommendation 11**: In view of the corporate governance failures revealed by the current financial crisis, the Group considers that compensation incentives must be better aligned with shareholder interests and long-term firm-wide profitability by basing the structure of financial sector compensation schemes on the following principles:*

- ***the assessment of bonuses should be set in a multi-year framework, spreading bonus payments over the cycle;***
- ***the same principles should apply to proprietary traders and asset managers;***
- ***bonuses should reflect actual performance and not be guaranteed in advance.***

Supervisors should oversee the suitability of financial institutions' compensation policies, require changes where compensation policies encourage excessive risk-taking and, where necessary, impose additional capital requirements under pillar 2 of Basel 2 in case no adequate remedial action is being taken.

Internal risk management

122) In many cases, risk monitoring and management practices within financial institutions have dramatically failed in the crisis.

123) In the future, the risk management function must be fully independent within the firms and it should carry out effective and not arbitrarily constrained stress testing exercises. Firms should organise themselves internally so that incentives are not too much tilted towards risk taking – neglecting risk control. To contribute to this, the Senior Risk Officer in an institution should hold a very high rank in the hierarchy (at senior management level with direct access to the board). Changes to remuneration structures will also be needed: effective checks and balances are indeed unlikely to work if those who are supposed to control risk remain under-paid compared to those whose job it is to take risks.

124) But all this must not be construed as exonerating issuers and investors from their duties. For issuers, transparency and clarity in the description of assets put on the market is of the essence as this report has often stressed; but investors and in particular asset managers must not rely (as has too often been the case) on credit rating agencies assessments; they must exercise informed judgement; penalties should be enforced by supervisors when this is not applied. Supervisory control of firms' risk management should be considerably reinforced through rigorous and frequent inspection regimes.

***Recommendation 12*: With respect to internal risk management, the Group recommends that:**

- ***the risk management function within financial institutions must be made independent and responsible for effective, independent stress testing;***
- ***senior risk officers should hold a very high rank in the company hierarchy, and***
- ***internal risk assessment and proper due diligence must not be neglected by over-reliance on external ratings.***

Supervisors are called upon to frequently inspect financial institutions' internal risk management systems.

VI. CRISIS MANAGEMENT AND RESOLUTION

125) As a general observation, it has been clearly demonstrated that the stakes in a banking crisis are high for Governments and society at large because such a situation has the potential to jeopardise financial stability and the real economy. The crisis has also shown that crisis prevention, crisis management and crisis resolution tools should all be handled in a consistent regulatory framework.

126) Of course, crisis prevention should be the first preoccupation of national and EU authorities (see chapter on supervision). Supervisors should act as early as possible in order to address the vulnerabilities identified in a given institution, and use all means available to them to this effect (e.g. calling on contributions from shareholders, fostering

the acquisition of the institution concerned by a stronger one). In this respect, the role of central banks which are by essence well placed to observe the first signs of vulnerability of a bank is of crucial importance. Therefore in countries where supervision is not in the hands of the central bank, a close collaboration must be ensured between supervisors and central banks. But crises will always occur and recent experiences in managing crises have shown that many improvements to the present system are called for.

a) Dealing with the moral hazard issue

127) "Constructive ambiguity" regarding decisions whether or not public sector support will be made available can be useful to contain moral hazard. However, the cure for moral hazard is not to be ambiguous on the issue of public sector involvement as such in crisis management. Two aspects need to be distinguished and require different treatment. On the one hand, a clear and consistent framework for crisis management is required with full transparency and certainty that the authorities have developed concrete crisis management plans to be used in cases where absence of such public sector support is likely to create uncertainty and threaten financial stability. On the other hand, constructive ambiguity and uncertainty is appropriate in the application of these arrangements in future individual cases of distressed banks[6].

b) Framework for dealing with distressed banks

128) In the management of a crisis, priority should always be given to private-sector solutions (e.g. restructuring). When these solutions appear insufficient, then public authorities have to play a more prominent role and the injection of public money becomes often inevitable.

129) As far as domestic national banks are concerned, crisis management should be kept at the national level. National supervisors know the banks well, the political authorities have at their disposal a consistent legal framework and taxpayers' concerns can be dealt with in the democratic framework of an elected government. For cross-border institutions at EU level, because of different supervisory, crisis management and resolution tools as well as different company and insolvency laws, the situation is much more complex to handle. There are inconsistencies between national legislation preventing an orderly and efficient handling of an institution in difficulty.

130) For example, company law provisions in some countries prevent in times of crisis the transfer of assets from one legal entity to another within the same group. This makes it impossible to transfer assets where they are needed, even though this may be crucial to safeguard the viability of the group as a whole. Another problem is that some countries place, in their national laws, emphasis on the protection of the institution while other countries attach a greater priority to the protection of creditors. In the crisis resolution phase, other problems appear: for example, the ranks of creditors are different from one Member State to the other.

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[6] This approach is recommended by Charles Goodhart and Dirk Schoenmaker, "Fiscal Burden Sharing in Cross Border Banking Crises", in International Journal of Central Banking, to be published early 2009.

131) The lack of consistent crisis management and resolution tools across the Single Market places Europe at a disadvantage vis-à-vis the US and these issues should be addressed by the adoption at EU level of adequate measures.

c) Deposit Guarantee Schemes (DGS)

132) The crisis has demonstrated that the current organisation of DGSs in the Member States was a major weakness in the EU banking regulatory framework[7]. The Commission recent proposal is an important step to improve the current regime, as it will improve the protection of depositors.

133) A critical element of this proposal is the requirement that all Member States apply the same amount of DGS protection for each depositor. The EU cannot indeed continue to rely on the principle of a minimum coverage level, which can be topped-up at national level. This principle presents two major flaws: first, in a situation where a national banking sector is perceived as becoming fragile, there is the risk that deposits would be moved to the countries with the most protective regime (thus weakening banks in the first country even further); second, it would mean that in the same Member State the customers of a local bank and those using the services of a third country branch could enjoy different coverage levels. As the crisis has shown, this cannot be reconciled with the notion of a well-functioning Single Market.

134) Another important element to be taken into account is the way in which the DGSs are funded. In this respect, the Group is of the view that preference should be given to schemes which are pre-funded by the financial sector. Such schemes are better to foster confidence and help avoiding pro-cyclical effects resulting from banks having to pay into the schemes at a time where they are already in difficulty.

135) Normally, pre-funded DGSs should take care in the future of losses incurred by depositors. Nonetheless, it is probable that for very large and cross border institutions, pre-funded mechanisms might not be sufficient to cover these guarantees. In order to preserve trust in the system, it should be made clear that in those cases pre-funded schemes would have to be topped-up by the State.

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[7] The Commission's recent proposal is an important step to improve the current DGS-regime, as it strengthens harmonisation and improves the protection of depositors. However, the directive still leaves a large degree of discretion to member states, particularly in relation to funding arrangements, administrative responsibility and the role of DGS in the overall crisis management framework. Leaving these issues unresolved at EU-level implies that significant weaknesses remain in the DGS-framework, including inter alia:

- *Unsustainable funding* – the current lack of sophisticated and risk sensitive funding arrangements involves a significant risk that governments will have to carry the financial burden indented for the banks, or worse, that the DGS fails on their commitments (both of which illustrated by the Icelandic case). In particular, in relation to the any of the 43 European LFCIs identified earlier in the chapter, no current scheme can be expected to have the capacity to make reimbursements without involving public funds.

- *Limited use in crisis management* – Even if DGS' had that capacity, the pay box nature of most schemes makes it unlikely that they ever will be utilised for LFCIs, because of the large externalities associated with letting such institutions fail.

- *Negative effects on financial stability* – reliance on ex-post funding and lack of risk sensitive premiums weakens market discipline (moral hazard), distort the efficient allocation of deposits, as well as it may be a source of pro-cyclicality.

Obstacle to efficient crisis management – due to incompatible schemes (trigger points, early intervention powers etc.) and diverging incentives among member.

136) The idea of a pooled EU fund, composed of the national deposit guarantee funds, has been discussed by the Group, but has not been supported. The setting-up and management of such a fund would raise numerous political and practical problems. Furthermore, one fails to see the added-value that such a fund would have in comparison to national funds operating under well-harmonised rules (notably for coverage levels and the triggering of the scheme).

EU harmonization should not go as far either as laying down rules on the possible use of DGSs in the management of a crisis. It should not prohibit additional roles beyond the base task for a DGS to act ex post, in the crisis resolution phase, as a pay box by reimbursing the guaranteed amount to depositors in a defaulted bank. Most member countries limit their national DGS to this pay box function. Some countries, however, extend the activities by giving their DGS also a rescue function. The Group did not see any need for EU harmonization in this respect.

137) There is a specific case (of the Icelandic type) when a supervisory authority allows some of its banks to mushroom large branches in other EU countries, whilst the home Member State is not able to honour the deposit guarantee schemes which are inadequate for such exposures. The guarantee responsibilities then *de facto* fall into the jurisdiction of the host country. This is not acceptable and should at least be addressed, for example, in the following way: the host Member State should have the right to inquire whether the funds available in the DGS of the home Member State are indeed sufficient to protect fully the depositors in the host Member State. Should the host Member State not have sufficient guarantees that this is indeed the case, the only way to address this kind of problem is to give sufficient powers to the host supervisory authorities to take measures that would at the very beginning curtail the expansive trends observed.

138) The Group has not entered into the specifics of the protection of policy-holders and investors. It nevertheless considers that the above general principles, and in particular the equal protection of all customers in the Single Market, should also be implemented in the insurance and investment sectors.

d) Burden sharing

139) The issue of burden sharing in cases of crisis resolution is extremely complicated for two reasons. First, cases where financial support from both public sector and private sector is needed to reach an acceptable solution are more complex than rescues where either private or public money is involved. Second, agreement on burden sharing on an *ex post* basis, at the moment of the rescue operation, is more difficult to reach than when one can rely on predetermined, *ex ante* arrangements.

140) As noted above, the current lack of pan-EU mechanism to resolve a crisis affecting a cross-border group implies that there is no choice but to resolve this crisis at national entity-level or to agree on improvised, *ad hoc* cross-border solutions. The lack of a financing mechanism to support the resolution of a cross-border group further complicates the situation.

141) On the basis of the experiences learnt from the crisis, the Group believes that the Member States should become able to manage a crisis in a more adequate way than is feasible today. There would be merit, in order to achieve this, in developing more

detailed criteria on burden sharing than the principles established in the current Memorandum of Understanding (MoU), which limits the sharing of a fiscal burden to two main principles: the economic impact of the crisis on the Member States concerned (equity principle) and the allocation of home/host supervisory powers (accountability principle).

142) Burden sharing arrangements could, in addition, include one of the following criteria, or a combination thereof:

- the deposits of the institution;
- the assets (either in terms of accounting values, market values or risk-weighted values) of the institution;
- the revenue flows of the institution;
- the share of payment system flows of the institution;
- the division of supervisory responsibility; the party responsible for supervisory work, analysis and decision being also responsible for an appropriately larger share of the costs.

143) These criteria would preferably be implemented by amending the 2008 MoU. Where needed, additional criteria could be agreed.

<u>Recommendation 13</u>: The Group calls for a coherent and workable regulatory framework for crisis management in the EU:

- ***without pre-judging the intervention in future individual cases of distressed financial institutions, a transparent and clear framework for managing crises should be developed;***
- ***all relevant authorities in the EU should be equipped with appropriate and equivalent crisis prevention and crisis intervention tools;***
- ***legal obstacles which stand in the way of using these tools in a cross-border context should be removed, with adequate measures to be adopted at EU level.***

<u>Recommendation 14</u>: Deposit Guarantee Schemes (DGS) in the EU should be harmonised and preferably be pre-funded by the private sector (in exceptional cases topped up by the State) and provide high, equal protection to all bank customers throughout the EU.

The principle of high, equal protection of all customers should also be implemented in the insurance and investment sectors.

The Group recognises that the present arrangements for safeguarding the interests of depositors in host countries have not proved robust in all cases, and recommends that the existing powers of host countries in respect of branches be reviewed to deal with the problems which have occurred in this context.

Recommendation 15*: In view of the absence of an EU-level mechanisms for financing cross-border crisis resolution efforts, Member States should agree on more detailed criteria for burden sharing than those contained in the existing Memorandum of Understanding (MoU) and amend the MoU accordingly.

CHAPTER III: EU SUPERVISORY REPAIR

I. INTRODUCTION

144) The previous chapter proposed changes to the European regulation of financial services. This chapter examines the policies and practices of supervision of financial services within the EU and proposes both short and longer term changes. Regulation and supervision are interdependent: competent supervision cannot make good failures in financial regulatory policy; but without competent and well designed supervision good regulatory policies will be ineffective. High standards in both are therefore required.

Macro and Micro prudential supervision

145) The experience of the past few years has brought to the fore the important distinction between micro-prudential and macro-prudential supervision. Both are clearly intertwined, in substance as well as in operational terms. Both are necessary and will be covered in this chapter.

146) Micro-prudential supervision has traditionally been the centre of the attention of supervisors around the world. The main objective of micro-prudential supervision is to supervise and limit the distress of individual financial institutions, thus protecting the customers of the institution in question. The fact that the financial system as a whole may be exposed to common risks is not always fully taken into account. However, by preventing the failure of individual financial institutions, micro-prudential supervision attempts to prevent (or at least mitigate) the risk of contagion and the subsequent negative externalities in terms of confidence in the overall financial system.

147) The objective of macro-prudential supervision is to limit the distress of the financial system as a whole in order to protect the overall economy from significant losses in real output. While risks to the financial system can in principle arise from the failure of one financial institution alone if it is large enough in relation to the country concerned and/or with multiple branches/subsidiaries in other countries, the much more important global systemic risk arises from a common exposure of many financial institutions to the same risk factors. Macro-prudential analysis therefore must pay particular attention to common or correlated shocks and to shocks to those parts of the financial system that trigger contagious knock-on or feedback effects.

148) Macro-prudential supervision cannot be meaningful unless it can somehow impact on supervision at the micro-level; whilst micro-prudential supervision cannot effectively safeguard financial stability without adequately taking account of macro-level developments.

The objective of supervision

149) The prime objective of supervision is to ensure that the rules applicable to the financial sector are adequately implemented, in order to preserve financial stability and thereby to ensure confidence in the financial system as a whole and sufficient protection for the

customers of financial services. One function of supervisors is to detect problems at an early stage to prevent crises from occurring. However, it is inevitable that there will be failures from time to time, and the arrangements for supervision have to be seen with this in mind. But once a crisis has broken out, supervisors have a critical role to play (together with central banks and finance ministries) to manage the crisis as effectively as possible to limit the damage to the wider economy and society as a whole.

150) Supervision must ensure that all supervised entities are subject to a high minimum set of core standards. When carrying-out their duties, supervisors should not favour a particular institution, or type of institution, to the detriment of others. Competition distortions and regulatory arbitrage stemming from different supervisory practices must be avoided, because they have the potential of undermining financial stability – inter alia by encouraging a shift of financial activity to countries with lax supervision. The supervisory system has to be perceived as fair and balanced. Furthermore, a level playing field is vital for the credibility of supervisory arrangements, their acceptance by market operators big and small and for generating optimal cooperation between supervisors and financial institutions. This is of particular importance in the context of the Single Market, built as it is, *inter alia*, on the principles of undistorted competition, freedom of establishment and the free flow of capital. Confidence will be gained in the European Union from common approaches by all Member States.

151) The supervisory objective of maintaining financial stability must take into account an important constraint which is to allow the financial industry to perform its allocative economic function with the greatest possible efficiency, and thereby contribute to sustainable economic growth. Supervision should aim to encourage the smooth functioning of markets and the development of a competitive industry. Poor supervisory organisation or unduly intrusive supervisory rules and practices will translate into costs for the financial sector and, in turn, for customers, taxpayers and the wider economy. Therefore supervision should be carried-out as effectively as possible and at the lowest possible cost. This, again, is crucial if the Single Market is to deliver all its benefits to customers and companies.

II. LESSONS FROM THE CRISIS: WHAT WENT WRONG?

152) Chapter 1 examined in detail the causes of the crisis. These were many; often with a global dimension. Although the way in which the financial sector has been supervised in the EU has not been one of the primary causes behind the crisis, there have been real and important supervisory failures, from both a macro and micro-prudential standpoint. The following significant problems have come to light:

a) Lack of adequate macro-prudential supervision

153) The present EU supervisory arrangements place too much emphasis on the supervision of individual firms, and too little on the macro-prudential side. The fact that this failing is duplicated elsewhere in the world makes it a greater, not a lesser, issue. The Group believes that to be effective macro-prudential supervision must encompass all sectors of finance and not be confined to banks, as well as the wider macro-economic context. This oversight also should take account of global issues. Macro-prudential supervision requires, in addition to the judgements made by individual Member States, a judgement

to be taken at EU level. The Group believes that this requires that an Institution at EU level be entrusted with this task. It recommends that the ECB/ESCB[8] be explicitly and formally charged with this responsibility in the European Union.

b) Ineffective Early Warning mechanisms

154) Insofar as macro-prudential risks were identified (and there was no shortage of comments about worrying developments in both macroeconomic imbalances and the lowering price of risk, for example) there was no mechanism to ensure that this assessment of risk was translated into action. The Group believes, if the responsibility it proposes to be given to the ECB/ESCB is to work, that there must be an effective and enforceable mechanism to check that the risks identified by the macro-prudential analysis have resulted in specific action by the new European Authorities (see below) and national supervisors. The Group therefore recommends a formal process to give teeth to this.

c) Problems of competences

155) There have been a significant number of instances of different types of failure in the supervision, by national supervisors, of particular institutions, i.e. in their oversight duties supervisors failed to perform to an adequate standard their responsibilities. One of these instances – the supervision of Northern Rock by the UK Financial Services Authority – has been examined in detail, but other, less well documented examples abound (e.g. IKB, Fortis). The Group believes there is advantage in analysing and publishing the circumstances of those failures, so that lessons can be learnt and future supervisory behaviour improved. Although the Group does not believe that any system can avoid errors of judgment occurring, it considers that the supervisory experience of the crisis points to the need for well staffed, experienced and well trained supervisors in all Member States, and the Group accordingly makes recommendations designed to achieve this.

d) Failures to challenge supervisory practices on a cross-border basis

156) The present processes and practices for challenging the decisions of a national supervisor have proven to be inadequate; for example the embryonic peer review arrangements being developed within the level 3 committees proved ineffective. At present (and until any practical arrangements for supervision on an EU basis are both agreed in principle and translated into practice), extensive reliance is and will be placed on the judgements and decisions of the home supervisor. This is particularly important when a financial institution spreads its activities into countries other than its home base by branching from its home country. This can, as occurred with the Icelandic banks, create significant risks in countries other than that of the home regulator, yet the ability of the host countries affected to challenge the decisions of the home regulator do not sufficiently recognise these risks.

157) The Group believes that an effective means of challenging the decisions of the home regulator is needed, and therefore makes recommendations designed both to achieve a step change in the speed and effectiveness of the present arrangements for peer review

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8 ESCB is the European System of Central Banks. It includes all the national central banks of the EU.

(which are at a very early stage of development), and to give force to a considered decision (if arrived at), that a home regulator has not met the necessary supervisory standards. The Group considers that a binding mediation mechanism is required to deal with such cross-border supervisory problems. Without such an effective and binding mechanism, pressure will build up and some Member States might in the future try to limit the branching activities of any firm supervised by a supervisor which has been judged to have failed to meet the standards. Such fragmentation would represent a major step backwards for the Single Market.

158) Equally, the Group believes that an effective mechanism is needed to allow home supervisors to challenge decisions made by host supervisors.

e) Lack of frankness and cooperation between supervisors

159) As the crisis developed, in too many instances supervisors in Member States were not prepared to discuss with appropriate frankness and at an early stage the vulnerabilities of financial institutions which they supervised. Information flow among supervisors was far from being optimal, especially in the build-up phase of the crisis. This has led to an erosion of mutual confidence among supervisors. Although the Group recognises the issues of commercial confidentiality and legal constraints involved in candid discussions, it believes that much more frank exchange of information is called for and makes recommendations to achieve this.

f) Lack of consistent supervisory powers across Member States

160) There are substantial differences in the powers granted to national supervisors in different Member States, both in respect of what they can do by way of supervision and in respect of the enforcement actions (including sanctions) open to them when a firm is in breach of its duties. The Group recommends an urgent review of these differences in powers and subsequent action to bring all supervisors up to a high level minimum standard. This will involve substantial increase in the powers of a number of Member States supervisors.

g) Lack of resources in the level 3 committees

161) The resources available to the level 3 committees severely limited the work which they could undertake, and their speed of reaction. This, combined with the heavy workload required of them in implementing the Financial Services Action Plan, meant that they were unable to perform very much either by way of peer review or by way of identifying sector wide risk issues. The Group therefore believes that the resources available to the three committees should be significantly increased, and makes recommendations to that end.

h) No means for supervisors to take common decisions

162) There are a number of reasons why the level 3 committees have been unable to contribute to the effective management of the crisis, notably their inability to take urgent decisions. For example, they were not able to agree and implement common decisions in relation to money-market funds or short-selling. The basic reason for this problem is that the level 3 committees do not have the legal powers to take decisions. As a consequence, they understandably have failed to develop either the attitude or the

procedures needed to respond rapidly to the emerging crisis. If their legal powers are expanded, changes in both will be required.

163) The above diagnosis is of course easy to establish with hindsight. It is not the Group's intention to blame the supervisory community in the EU for a crisis which is the result of the interaction of a number of complex and global factors – many of which (i.e. global imbalances, excess liquidity, too low interest rates…) were beyond the remit of micro-prudential supervisors. We should also recognize that some regulation applied by supervisors played a negative role in fuelling the crisis. In the previous chapter on regulation, we noted that some "public" regulation may well have aggravated things, generated perverse effects and contributed to the excesses of securitisation. In addition, in some instances, the absence of clarity of some rules (e.g. pillar 2 of Basel) led supervisors to be passive, rather than pro-active.

164) It remains however the case that the evidence clearly shows that the crisis prevention function of supervisors in the EU has not been performed well, and is not fit for purpose[9].

165) This chapter will not enter into the details of recent trends that have resulted in an increasingly integrated European financial market (see annex 3) nor into the description of the present supervisory arrangements (see annex 4).

166) What is proposed here is basically a new structure to make European supervision more effective and so improve financial stability in all the member countries of the EU. There are two elements to this: strengthening the quality of both national supervision and European supervision. The evidence given to the" Group by the level 3 committees was clear that, under their existing mandate as advisory committees to the Commission and with their present working methods, their ability to develop their work further will be severely constrained.

III. WHAT TO DO: BUILDING A EUROPEAN SYSTEM OF SUPERVISION AND CRISIS MANAGEMENT

a) The role of the ECB

167) A number of people, including representatives of the ECB, have suggested that the ECB could play a major role in a new European supervisory system in two respects: a role in macro-prudential supervision and a role in micro-prudential supervision.

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9 This general statement does not reflect the fact that some banks in the EU fared better than others. Was this related to differences in national supervision? It could be that some banks' supervisors had a more "prudent" approach than others (see for example the Spanish approach to off-balance sheet transactions which was the most rigorous and also their requirement for dynamic provisioning which provided cushions to the banks when the crisis erupted). It could be also that some financial institutions had developed, by tradition, better internal controls and risk management which led, for example, to a more cautious behaviour to securitisation than had been the case in others (the US investment bank model was less used by EU banks). Those European banks which held to the universal banking model have been to some extent better protected although a number of them, in their investment capacities, were caught by buying toxic securities.

All this shows that the context in which the crisis developed is complex and that there is no single explanation.

168) In the area of macro-prudential supervision, the suggested responsibilities could cover financial stability analysis; the development of early warning systems to signal the emergence of risks and vulnerabilities in the financial system; macro-stress testing exercises to verify the degree of resilience of the financial sector to specific shocks and propagation mechanisms with cross-border and cross-sector dimensions; as well as the definition of reporting and disclosure requirements relevant from a macro-prudential standpoint.

169) In the area of micro-prudential supervision, the views have been put forward to the Group that the ECB could become responsible for the direct supervision of cross-border banks in the EU or only in the euro zone. This could cover all cross-border banks or only the systemically important ones. In such a scenario, the competences, currently assigned to national supervisory authorities, would be transferred to the ECB which would, *inter alia*, licence the institutions concerned, enforce capital requirements, carry-out on-site inspections.

170) Alternatively, the ECB could be granted a leading oversight and coordination function in the micro-supervision of cross-border banks in the EU. Whilst the colleges composed of national supervisors would continue to directly supervise cross-border banks, the ECB could play a binding mediation role to resolve conflicts between national supervisors, define supervisory practices and arrangements to promote supervisory convergence and become responsible for regulation related to issues such as pro-cyclicality, leverage, risk concentration or liquidity mismatch.

171) These ideas have been carefully appraised by the Group. While the Group supports an extended role for the ECB in macro-prudential oversight (as discussed below), it does not support any role for the ECB for micro-prudential supervision. The main reasons for this are:

- the ECB is primarily responsible for monetary stability. Adding micro-supervisory duties could impinge on its fundamental mandate;

- in case of a crisis, the supervisor will be heavily involved with the providers of financial support (typically Ministries of Finance) given the likelihood that tax payers money may be called upon. This could result in political pressure and interference, thereby jeopardising the ECB's independence;

- giving a micro-prudential role to the ECB would be extremely complex because in the case of a crisis the ECB would have to deal with a multiplicity of Member States Treasuries and supervisors;

- conferring micro-prudential duties to the ECB would be particularly difficult given the fact that a number of ECB/ESCB members have no competence in terms of supervision;

- conferring responsibilities to the ECB/Eurosystem which is not responsible for the monetary policy of a number of European countries, would not resolve the issue of the need for a comprehensive, integrated system of supervision;

- finally, the ECB is not entitled by the Treaty to deal with insurance companies. In a financial sector where transactions in banking and insurance activities can have very comparable economic effects, a system of micro-prudential supervision which was excluded from considering insurance activities would run severe risks of fragmented supervision.

172) For all these reasons, the Group takes the view that the ECB should not become responsible for the micro-supervision of financial institutions. However, the Group considers that the ECB should be tasked with the role in ensuring adequate macro-prudential supervision in the EU.

b) Macro-prudential supervision: the case for reform

173) A key lesson to be drawn from the crisis, as noted above, is the urgent need to upgrade macro-prudential supervision in the EU for all financial activities.

174) Central banks have a key role to play in a sound macro-prudential system. However, in order for them, and in particular the ECB/ESCB, to be able to fully play their role in preserving financial stability, they should receive an explicit formal mandate to assess high-level macro-financial risks to the system and to issue warnings where required.

175) Within the EU, the ECB, as the heart of the ESCB, is uniquely placed for performing this task: i.e. identifying those macro-prudential risks which all national supervisors should take account of. The ECB/ESCB therefore should be able to require from national supervisors all the information necessary for the discharge of this responsibility.

176) In view of the integrated financial market in the EU and the geographical distribution of financial activities, it is essential that within the ESCB all national central banks are associated to this process, not merely those of the euro area.

177) This could be achieved in the following way. A new group, replacing the current Banking Supervision Committee (BSC) of the ECB, called the European Systemic Risk Council (ESRC) should be set up under the auspices and with the logistical support of the ECB. Its task will be to form judgements and make recommendations on macro-prudential policy, issue risk warnings, compare observations on macro-economic and prudential developments and give direction on these issues.

178) As the responsibility for conducting macro-prudential supervision is proposed to be allocated to the ECB/ESCB, it is logical to compose the ESRC with the central banks of the ESCB. It would therefore be composed of the members of the ECB/ESCB General Council (the President of the ECB, the vice-president of the ECB and the Governors of the 27 central banks), plus the Chairpersons of CEBS, CEIOPS and CESR and one representative of European Commission. The President of the ECB would chair the ESRC. The ESRC should be supported by a secretariat provided by the ECB.

179) But given the importance of having this group interact closely with those supervisors who are not part of central banks, it should be clearly stated that whenever the subject discussed justifies a wider presence of insurance and securities supervisors (as well as banking supervisors for those countries where banking supervision is carried-out outside the central bank), it would be assured. In such cases, a Governor could choose to be represented by the Head of the appropriate national supervisory authority.

180) For a new system of macro-prudential supervision to work effectively, two main conditions must be met:

- A proper flow of information between national supervisors and the ECB/ESCB must be mandatory. Appropriate procedures will have to be put in place so that all relevant information can be transmitted to the ECB/ESCB in a way which guarantees confidentiality. In this context, ECB/ESCB staff could be invited to attend meetings - and ask questions- between supervisors and the systemically important financial groups in order to receive first-hand relevant information. ECB/ESCB staff could be invited to participate in the relevant colleges of micro-prudential supervisors. But the ECB/ESCB would not be responsible for micro-prudential supervision;

- It is crucial that there is an effective early warning mechanism as soon as signs of weaknesses are detected in the financial system. And a graduated risk warning framework for ensuring that, in the future, the identification of risks translates into appropriate action.

181) Depending on the nature of the risks detected, a proper action has to be taken by the relevant EU authorities. Different types of actions could be required. For example:

- if credit expansion appeared to become excessive in one or several member countries, the ESRC would liaise with the relevant central bank (and/or banking supervisor), give advice on the appropriate measures to be taken (e.g. triggering dynamic provisions). Central banks would be expected to take into account the findings of the ESRC. If the ESRC has issued a specific risk warning calling for a response by national supervisors, the ESRC should review their responses, and, if necessary, indicate whether and what further action it judged necessary, by reporting to the Economic and Financial Committee (EFC), on the basis described below;

- if the issue is more related to a global dysfunction of the system (e.g. too high maturity transformation, abuse of off-balance sheet transactions, abuse of regulatory arbitrage by non-banks), the ESRC would have to warn the global supervisory system (see chapter 4 on global repair) in order to define appropriate and coherent actions at both the EU and global levels. If the problems pertain to prudential issues in the EU, then the level 3 committees should be required to address them;

- If the concerns were related to fiscal matters (e.g. excessive deficits or the accumulation of debt), the ESRC would immediately relate to the EFC.

182) As soon as the risks detected would appear to have a potentially serious negative impact on the financial sector or the economy as a whole, the ESRC should inform the Chairman of EFC. In such circumstances, the EFC, working with the Commission, could play an essential role by developing an action-oriented strategy to deal with serious risks requiring political or legislative action. It must be clear to everyone who should act and according to which timetable. Furthermore, a process should be established to regularly evaluate the effectiveness of the supervisory/regulatory actions that have been agreed and decide whether other actions are necessary. A "rendez-vous clause" should be set to check that the actions taken have actually been effective. It would be the responsibility of the Chairman of the EFC to decide if and when the EFC (in its full composition, i.e. with the central banks) and/or the ECOFIN Council should

be informed or associated in the deliberations. The EFC should also advise on how to relate with the European Parliament and on whether the information needs to be made public – which can be helpful in certain circumstances.

<u>Recommendation 16</u>: A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up under the auspices and with the logistical support of the ECB.

- ***The ESRC should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR as well as one representative of the European Commission. Whenever the subject discussed justifies the presence of insurance and securities supervisors, the Governor could choose to be represented by the Head of the appropriate national supervisory authority;***
- ***The ESRC should pool and analyse all information, relevant for financial stability, pertaining to macro-economic conditions and to macro-prudential developments in all the financial sectors.***
- ***A proper flow of information between the ESRC and the micro-prudential supervisors must be ensured.***

<u>Recommendation 17</u>: an effective risk warning system shall be put in place under the auspices of the ESRC and of the Economic and Financial Committee (EFC).

- ***The ESRC should prioritise and issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU.***
- ***If the risks are of a serious nature, potentially having a negative impact on the financial sector or the economy as a whole, the ESRC shall inform the chairman of the EFC. The EFC, working with the Commission, will then implement a strategy ensuring that the risks are effectively addressed.***
- ***If the risks identified relate to a global dysfunction of the monetary and financial system, the ESRC will warn the IMF, the FSF and the BIS in order to define appropriate action at both EU and global levels.***
- ***If the ESRC judges that the response of a national supervisor to a priority risk warning is inadequate, it shall, after discussion with that supervisor, inform the chairman of the EFC, with a view to further action being taken against that supervisor.***

c) Micro-supervision: moving towards a European System of Financial Supervision (ESFS)

183) After having examined the present arrangements and in particular the cooperation within the level 3 committees, the Group considers that the structure and the role bestowed on the existing committees are not sufficient to ensure financial stability in the EU and all its Member States. Although the level 3 committees have contributed significantly to the process of European financial integration, there are a number of inefficiencies which can

no longer be dealt with within their present legal structure (i.e. as advisory bodies to the Commission).

This is why the Group proposes the establishment of a European System of Financial Supervision (ESFS).

184) The ESFS should constitute an integrated network of European financial supervisors, working with enhanced level 3 committees ("Authorities"). Therefore the ESFS would be a largely decentralised structure, fully respecting the proportionality and subsidiarity principles of the Treaty. So existing national supervisors, who are closest to the markets and institutions they supervise, would continue to carry-out day-to-day supervision and preserve the majority of their present competences (see annex 3).

185) But in order to be in a position to effectively supervise an increasingly integrated and consolidated EU financial market (and especially the large cross-border institutions, which pose systemic risks), the Authorities will carry-out a defined number of tasks that are better performed at the EU level. The supervisor of the home Member State will continue to function as the first point of contact for the firm, whilst the European centre should coordinate the application of common high level supervisory standards, guarantee strong cooperation with the other supervisors, and, as importantly, guarantee that the interests of host supervisors are properly safeguarded.

186) As far as cross-border institutions are concerned, the ESFS should continue to rely heavily on the colleges of supervisors to be introduced by the revised CRD and the Solvency 2 directives. However, these colleges of supervisors should be strengthened by the participation of representatives of the secretariat of the level 3 committees as well as of ECB/ESCB observers.

187) The ESFS must be independent from possible political and industry influences, at both EU and national level. This means that supervisors should have clear mandates and tasks as well as sufficient resources and powers. In order to strengthen legitimacy and as a counterpart for independence, proper accountability to the political authorities at the EU and national levels should be ensured. In short, supervisory work must be independent from the political authorities, but fully accountable to them[10].

[10] Based on various internationally recognised standards and codes (i.e. the G10 Basel Core Principles for Effective Banking Supervision (BCP), the IAIS Insurance Core Principles and the IOSCO Objectives and Principles of Securities Regulation), supervisory independence can be defined as a situation in which the supervisor is able to exercise its judgment and powers independently with respect to the enforcement of prudential and/or conduct of business rules, i.e. without being improperly influenced or overruled by the parties under supervision, the government, the Parliament, or any other interested third party. As such, the supervisory authority must be empowered and able to make its own independent judgements (e.g. with respect to licensing, on-site inspections, off-site monitoring, sanctioning, and enforcement of the sanctions), without other authorities or the industry having the right or possibility to intervene. Moreover, the supervisor itself must base its decisions on purely objective and non-discriminatory grounds. However, supervisory independence differs from central bank independence (i.e. in relation to monetary policy), in the sense that the government (usually the Finance minister) remains politically responsible for maintaining the stability of the financial system, and the failure of one or more financial institutions, markets or infrastructures can have serious implications for the economy and tax payer's money10. Consequently, the supervisory authority should operate within a certain scope of responsibilities and under an explicit delegation of powers in the form of legislation passed by

Parliament and the government should not exercise immediate powers on the supervisory authority and interfere directly in its day-to-day activities. Independence should be balanced and strengthened by proper accountability arrangements and transparency of the regulatory and supervisory process, consistent with confidentiality requirements. National authorities should however relinquish control mechanisms such as having government representatives, chairing or actively participating in the management board of the supervisory authority, or giving the government the right to intervene in the day-to-day operations of the supervisory authority. Their influence should be limited to the possibility of amending the legal framework, imposing long-run strategic goals, and monitoring performance, on the condition that this is done in an open and transparent manner.

188) The ESFS must work with a common set of core harmonized rules and rely on high-quality and consistent information. This means proper, primary, timely information exchange among all supervisors to enable complete assessment – from the national to European to global levels.

189) Finally, the ESFS should be neutral with respect to national supervisory structures: national supervisory structures have been chosen for a variety of reasons and it would be impractical to try to harmonise them – even though it may well be that the current trend could continue towards the emergence of a dual "twin peaks" system (banks, insurance companies and other financial institutions being covered by the same authority and markets/conduct of business by another one).

***Recommendation 18*: A European System of Financial Supervisors (ESFS) should be set-up. This ESFS should be a decentralised network:**

- ***existing national supervisors would continue to carry-out day-to-day supervision;***

- ***three new European Authorities would be set up, replacing CEBS, CEIOPS and CESR, with the role coordinate the application of supervisory standards and guarantee strong cooperation between the national supervisors;***

- ***colleges of supervisors would be set up for all major cross-border institutions.***

The ESFS will need to be independent of the political authorities, but be accountable to them.

It should rely on a common set of core harmonised rules and have access to high-quality information.

IV. THE PROCESS LEADING TO THE CREATION OF A EUROPEAN SYSTEM OF FINANCIAL SUPERVISION

190) The goal set out above is an ambitious one. It will require important institutional, legislative and operational changes. It will also require the emergence of the broadest possible political consensus on the necessity to move in this direction and the steps that must be taken to do so. The Group hopes that all Member States will aspire to these changes. If not, a variable geometry approach based on the mechanisms of Enhanced Cooperation or an inter-governmental agreement provided for in the Treaty may be required.

191) The Group proposes a two stage process, to strengthen the supervision of the European financial sector, thereby rebuilding confidence in the market. The process should be as swift as possible, whilst giving sufficient time to all stakeholders involved to converge towards the goal of a strengthened and more integrated system.

192) Whilst the transformation of current EU supervisory arrangements lie at the very heart of this process, the Group considers that improvements in the organisation of supervision cannot be looked at in isolation from the rules which supervisors have to implement and from the crisis management and resolution arrangements that they have

to implement (together with finance ministries) when needed. Regulation, supervision and crisis management/resolution arrangements are intertwined. They form a continuum. There is no point in converging supervisory practices, if the basic financial regulations remain fragmented. And it will be impossible to revamp the organisation of European supervision, without clarity as to how a crisis, should it break-out, will be managed and resolved by the relevant authorities.

193) The two stage process proposed below therefore brings together regulation, supervision and crisis management/resolution.

A) Stage 1 (2009-2010): Preparing for a European System of Financial Supervision

a) Preparing for the transformation of the level 3 committees into European Authorities.

194) The Commission, the Council and the Parliament should immediately start the necessary legislative work building a consensus to transform the level 3 committees into three European Authorities: a European Banking Authority, a European Insurance Authority and a European Securities Authority. The actual transformation should be completed at the start of the second phase (see below).

Concurrently, work should start in the following areas:

b) Upgrading the quality of supervision

195) The Member States and the level 3 committees should, as a matter of urgency, find practical ways to strengthen the national supervisors. At national level, consideration should be given to the following issues: aligning supervisors' competences and powers on the most comprehensive system in the EU; increasing supervisors' remuneration; facilitating exchanges of personnel between the private sector and supervisory authorities; ensuring that all supervisory authorities implement a modern and attractive personnel policy. At European level, the level 3 committees should intensify their efforts in the areas of training and personnel exchanges to create a strong European supervisory culture.

196) The European Commission should carry-out, in cooperation with the level 3 committees, an examination of the degree of independence of all national supervisors. This examination should lead to concrete recommendations for improvement, including the ways in which national supervisory authorities are funded.

197) The level 3 committees should prepare the modalities with the ESRC for a legally binding mechanism, including for the transfer of information, whereby the identification of risks by the ESRC translates into expeditious regulatory, supervisory or monetary policy examination at EU level.

***Recommendation 19*: In the first stage (2009-2010), national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU.**

- ***Member States should give consideration to the following reforms: aligning supervisors' competences and powers on the most comprehensive system in the EU, increasing supervisors' remuneration, facilitating exchanges of personnel between the private sector and supervisory authorities, ensuring that all supervisory authorities implement a modern and attractive personnel policy.***
- ***The level 3 committees should intensify their efforts in the areas of training and personnel exchanges. They should also work towards the creation of a strong European supervisory culture.***
- ***The European Commission should carry-out, in cooperation with the level 3 committees, an examination of the degree of independence of all national supervisors. This should lead to concrete recommendations, including on the funding of national authorities.***

In this first stage, the European Commission should immediately begin the work to prepare legal proposals to set up the new Authorities.

c) Moving towards harmonised rules, powers and sanctions

198) The European Institutions and the level 3 committees should initiate a determined and concerted effort to equip the EU financial sector with a consistent set of core rules by the beginning of 2013. A process should be set-up, whereby the key-differences in national legislation will be identified and removed.

199) These differences stem from exceptions, derogations, additions made at national level[11], or ambiguities contained in directives which have a material impact on the market; are laxer than the minimum core standards; or which may induce competition distortions or regulatory arbitrage will be identified and removed. In its efforts to remove these differences, the European Commission should concentrate its first efforts on the main problems.

200) This process may not lead to identical rules in every case. However, the core harmonised rules should be sufficiently comprehensive. To that effect, the level 3 committees will examine the differences that exist and propose to the Commission new or further developments of level 1 and level 2 rules (e.g. harmonisation of the sanctions regimes, definition of core capital rules, harmonisation in the areas of short-selling, controls for security settlement systems).

201) The European Institutions should also set in motion a process which will lead to far more consistent sanctioning regimes across the Single Market. Supervision cannot be effective with weak, highly variant sanctioning regimes. It is essential that within the EU and elsewhere, all supervisors are able to deploy sanctions regimes that are sufficiently convergent, strict, resulting in deterrence. This is far from being the case

[11] A practice sometimes referred to as "goldplating".

now. The same exercise should be initiated with respect to supervisory powers. These also differ greatly from one Member State to another[12]. This cannot be conducive to coherent and effective supervision in the Single Market.

<u>Recommendation 20</u>: In the first stage, EU should also develop a more harmonised set of financial regulations, supervisory powers and sanctioning regimes.

- ***The European Institutions and the level 3 committees should initiate a determined effort to equip the EU with a far more consistent set of rules by the beginning of 2013. Key differences in national legislation stemming from exceptions, derogations, additions made at national level or ambiguities contained in current directives should be identified and removed, so a harmonized core set of standards is defined and applied throughout the EU.***
- ***The European Institutions should set in motion a process leading to far stronger and consistent supervisory and sanctioning regimes in the Member States.***

d) Immediate strengthening of the level 3 committees

202) The level 3 committees should be subject to a number of changes which should be implemented rapidly:

i) Reinforcement of the resources of the these committees, to be able to employ more people, with a larger budget;

ii) Development of the presently embryonic peer review processes within each committee, with a view to becoming binding mediation processes;

iii) Redefinition of their work and priorities to become more pro-active in identifying problems and proposing solutions. The use of qualified majority voting should be put into practice;

iv) Cooperation between the level 3 committees should be further intensified and codified.

e) Supervisory colleges

203) The present relatively restricted use of supervisory colleges should be expanded immediately. The Group believes that by the end of 2009 colleges for all major cross-border firms should be established in the EU[13]. By mid-2009, the level 3 committees should make proposals for all major cross border financial firms within the EU to have supervisory colleges and they should define clear supervisory norms for them.

[12] For the time being, for example, only 10 insurance supervisors are empowered to approve internal risk models; only 6 of them can increase capital requirements within firms ; and 2 of them are not empowered to grant licences.

[13] As an order of magnitude, this could encompass at least 50 financial institutions having a significant market share in another Member State.

<u>Recommendation 21</u>: The Group recommends an immediate step-change in the working of the level 3 committees which can be dealt with at once. The level 3 committees should therefore:

- ***benefit from, under the Community budget, a significant reinforcement of their resources;***
- ***upgrade the quality and impact of their peer review processes;***
- ***prepare the ground, including through the adoption of adequate supervisory norms, for the setting-up of supervisory colleges for all major cross-border financial firms in the EU by the end of 2009.***

f) Crisis management and resolution

204) Legislative changes covering in particular aspects of company and insolvency laws (e.g. winding-up, transferability of assets, bankruptcy), should be proposed by the Commission as soon as possible if the EU is to deal with future crises in a more effective and cost-efficient manner (see section VI of chapter 2).

B) Stage 2 (2011-2012): Establishing the European System of Financial Supervision

a) Role of the new European Authorities

205) As early as possible during this second phase, the level 3 committees would be transformed legally into the three Authorities mentioned above.

206) These Authorities would continue to perform all the current functions of the level 3 committees (advising the Commission on regulatory and other issues, defining overall supervisory policies, convergence of supervisory rules and practices, financial stability monitoring, oversight of colleges).

207) National authorities would continue to remain responsible for the supervision of domestic institutions. Cross-border institutions would continue to be supervised by home and host supervisors. Disputes between home and host supervisors would be subject to decisions by the relevant Authority.

208) But, in addition, the new Authorities would carry-out a number of new, specific tasks which, in full conformity with the principle of subsidiarity, the Group considers would be more effectively carried-out at the European level. These tasks would be the following:

i) <u>In relation to cross-border institutions</u>:

- A legally binding mediation role, allowing the new Authorities to solve disputes between national supervisors. They should be able to, when no agreement can be found between the supervisors of a cross-border institution, take certain supervisory decisions directly applicable to the institution concerned (e.g. approval of risk internal models, capital add-ons, licence withdrawal, resolving disputes about different legal interpretations relating to supervisory obligations…);

- The designation of Group supervisors (in cases where the process laid down in the relevant directives has not led to an agreement on this question);

- The aggregation of all relevant information emanating from national supervisors and pertaining to cross-border institutions;

- Staff from the Authorities could take part in on-site inspections carried out by national supervisors;

- The Authorities would ensure a true level playing-field for all cross-border institutions and facilitate the monitoring of the systemic threats they pose;

- The Authorities would be tasked to ensure the consistency of prudential supervision for all actors (and in particular between cross-border and smaller institutions), thereby avoiding the risk of unfair competition between supervised entities. To guarantee this, any financial institution (including purely domestic ones) should be able to submit complaints to the Authority when they consider that they suffer from any discrimination vis-à-vis a cross-border institution which has its home supervisor in another Member State;

- The prudential assessment of pan-EU mergers and acquisitions (in combination with the assessment made by the relevant Member States).

ii) <u>In relation to specific EU-wide institutions</u>:

- The Authority concerned would be responsible for the licensing and direct supervision of some specific EU-Wide institutions, such as Credit Rating Agencies and post-trading infrastructures.

iii) <u>In the area of regulation</u>:

- The Authorities should play a decisive role in the technical level 3 interpretation of level 1 and level 2 measures and in the development of level 3 technical standards. A legal mechanism should be put in place so as to ensure that, once an Authority has decided on a given interpretation (through guidance, recommendations etc), this interpretation becomes legally valid throughout the EU.

iv) <u>In relation to supervisory standards and practices</u>:

- The Authorities would be responsible for defining common supervisory practices and arrangements for the functioning of the colleges of supervisors;

- The Authorities should evaluate the organisation, processes, competences and independence of the national supervisory authorities through peer reviews. These evaluations should lead to concrete recommendations for improvements and should take place frequently, without any scruples;

- The Authorities would have a significant new responsibility of ensuring that all national supervisors meet necessary standards, by being able to challenge the performance by any national supervisor of its supervisory responsibilities, whether for domestic or cross-border firms, and to issue rulings aimed at ensuring that national supervisors correct the weaknesses that have been identified. In the event of the national supervisor failing to respond to this ruling, a series of graduated sanctions could be applied, including fines and the launch by the Commission of infringement procedures. In exceptional circumstances, where serious issues of financial stability are at stake, the Authorities should be able on a temporary basis to acquire the duties which the national supervisor is failing to discharge.

v) <u>In relation to macro-prudential issues</u>:

- The Authorities would have binding cooperation and information sharing procedures with the ESRC to allow the latter to perform its macro-prudential supervision task;

- The Authorities should create and lead groups of national supervisors to deal with specific events affecting several Member States (e.g. bankruptcy of a third country systemic group).

vi) <u>In the area of crisis management</u>:

- In crisis situations, the Authorities should have a strong coordinating role: they should facilitate cooperation and exchange of information between competent authorities, act as mediator when that is needed, verify the reliability of the information that should be available to all parties and help the relevant authorities to define and implement the right decisions.

- Annex 5 to this chapter shows how supervisory competences could be shared between national supervisors and the Authorities.

vii) <u>In relation to international matters</u>:

- The Authorities would prepare (and in some cases could adopt) equivalence decisions pertaining to the supervisory regimes of third countries;

- They would represent the EU interests in bilateral and multilateral discussions with third countries relating to supervision.

b) Governance and budget of the new Authorities

209) From a governance standpoint, each Authority would have a board structure comprised of the highest-level representatives from national authorities. Their chairpersons and director generals should be full-time independent professionals. These professionals would be chosen and appointed by the board. This should not exclude recruiting an independent external personality of the highest calibre. In addition, the appointment of the chairs should be confirmed by the Commission, the Council of Ministers and the European Parliament and should be valid for a period of 8 years.

210) The Authorities' decisions would be taken collectively, through the board structure composed of the Heads of national supervisors, by qualified-majority. However, other arrangements could be considered when dealing with binding mediation cases (e.g. decisions by the chairpersons and director generals). The Authorities would have their own autonomous budget, which could be financed by the industry and/or contributions from the public sector (including the EU budget). These budgets would have to be commensurate with their responsibilities.

211) The Authorities would have the highest degree of independence vis-à-vis the European institutions, which should in not interfere in the internal processes and decisions of the Authorities. However, the Authorities would be accountable to the Council, the European Parliament and the Commission. They should report formally to these three institutions on a frequent basis.

c) Crisis management and resolution

212) As soon as possible in this second phase, the legislative changes recommended in the previous chapter would need to enter into force. An equal and high level of protection to all depositors, investors and policy-holders should be guaranteed, avoiding competition distortions between institutions and between sectors.

213) The changes recommended above are ambitious and will be complex to implement. It is nevertheless vital to do so in order, in particular, to seriously tackle the issue of confidence that affects the present relationship between home and host countries. Recent developments in this crisis have strengthened this distrust. Fears of most countries have deepened in terms of the ability of their own supervisors to prevent crises, stop withdrawals by parent companies of liquidity held in local subsidiaries or branches. The Group believes that the reforms described above could do a lot to reduce such suspicions and provide effective, practical and legally binding mechanisms to resolve disputes. We believe that this is probably the only way at this stage to combine the efficiency and needs of large groups on the one hand and the necessary safeguards for host countries on the other.

***Recommendation 22*: In the second stage (2011-2012), the EU should establish an integrated European System of Financial Supervision (ESFS).**

- ***The level 3 Committees should be transformed into three European Authorities: a European Banking Authority, a European Insurance Authority and a European Securities Authority.***
- ***The Authorities should be managed by a board comprised of the chairs of the national supervisory authorities. The chairpersons and director generals of the Authorities should be full-time independent professionals. The appointment of the chairpersons should be confirmed by the Commission, the European Parliament and the Council and should be valid for a period of 8 years.***
- ***The Authorities should have their own autonomous budget, commensurate with their responsibilities.***

- In addition to the competences currently exercised by the level 3 committees, the Authorities should have, inter alia, the following key-competences:

- ***i) legally binding mediation between national supervisors;***
- ***ii adoption of binding supervisory standards;***
- ***iii) adoption of binding technical decisions applicable to individual financial institutions;***
- ***iv) oversight and coordination of colleges of supervisors;***
- ***v) designation, where needed, of group supervisors;***
- ***vi) licensing and supervision of specific EU-wide institutions (e.g. Credit Rating Agencies, and post-trading infrastructures);***
- ***vii) binding cooperation with the ESRC to ensure adequate macro-prudential supervision.***

- National supervisory authorities should continue to be fully responsible for the day-to-day supervision of firms.

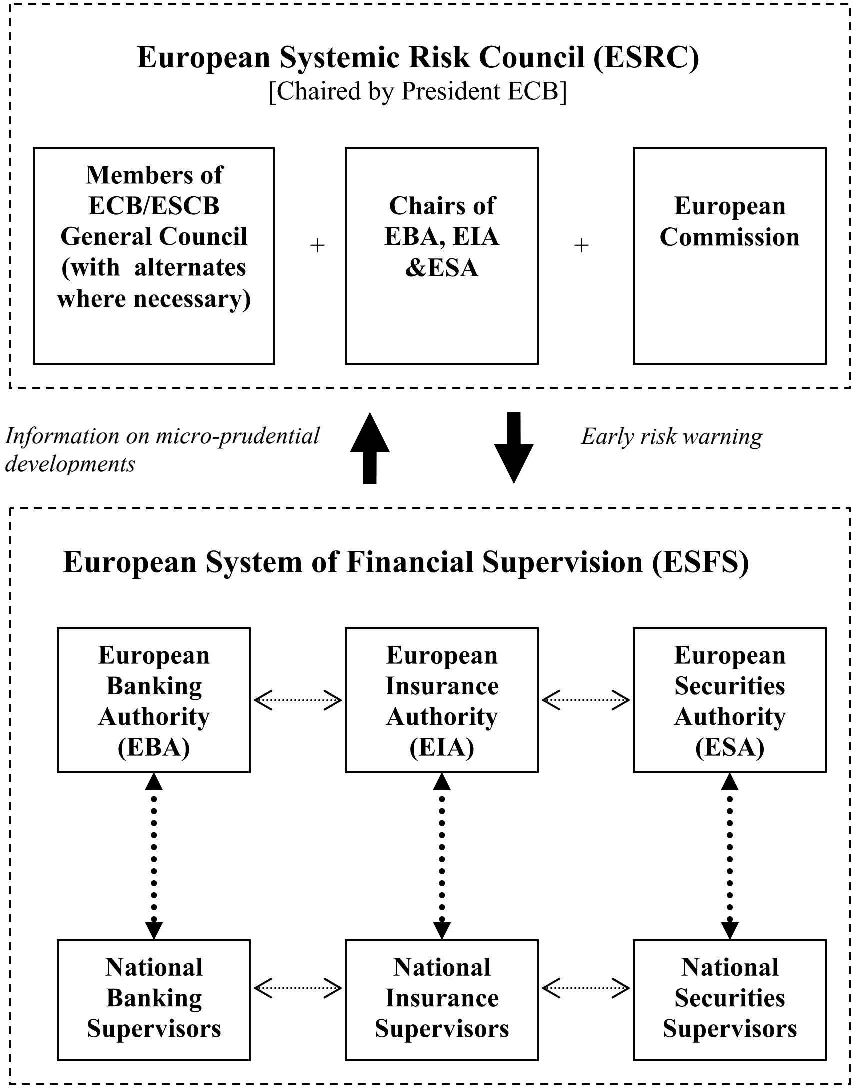
<u>Recommendation 23</u>: The Group recommends that planning for the 2 stages of the new system be started immediately. To this effect, a group of high-level representatives of the Finance Ministries, the European Parliament, the Level 3 Committees, and the ECB to be chaired by the Commission, should come forward before the end of 2009 with a detailed implementation plan.

214) The following diagram illustrates how the ESRC and the ESFS would interact with each other.

A new European Framework for Safeguarding Financial Stability

Macro-prudential supervision

Micro-prudential supervision



<u>Main tasks of the European Systemic Risk Council:</u> *decide on macro-prudential policy, provide early risk warning to EU supervisors, compare observations on macro-economic and prudential developments and give direction on these issues.*

<u>Main tasks of the Authorities:</u> *in addition to the competences of the existing level 3 committees, the Authorities would have the following key-competences: (i) legally binding mediation between national supervisors, (ii) adoption of binding supervisory standards, (iii) adoption of binding technical decisions applicable to individual institutions, (iv) oversight and coordination of colleges of supervisors, (v) licensing and supervision of specific EU-wide institutions (e.g., Credit Rating Agencies and post-trading infrastructures), (vi) binding cooperation with the ESRC to ensure adequate macro-prudential supervision, and (vii) strong coordinating role in crisis situations.*

<u>Main tasks of national supervisors:</u> *continue to be fully responsible for day-to-day supervision of firms.*

V. REVIEWING AND POSSIBLY STRENGTHENING THE EUROPEAN SYSTEM OF FINANCIAL SUPERVISION (ESFS)

215) The implementation of the arrangements described above will have to be monitored, and their effectiveness carefully assessed. A full-review should take place no later than three years after the entry into force of stage 2. Whilst it would be premature at this stage to make detailed recommendations as to how the ESFS could be strengthened beyond stage 2, if stage 2 proves to be insufficient, the following observations can be made.

216) There may be merit, over time, in evolving towards a system which would rely on only two Authorities: The first would be responsible for banking and insurance issues, as well as any other issue which is relevant for financial stability (e.g. systemically important hedge funds, systemically important financial infrastructures). The second Authority would be responsible for conduct of business and market issues, across the three main financial sectors. Combining banking and insurance supervisory issues in the same Authority could result in more effective supervision of financial conglomerates and contribute to a simplification of the current extremely complex institutional landscape.

217) Furthermore, given the speed at which financial markets evolve, it is important to maintain a consistent set of technical rules applying to all financial firms. If it appeared, after the review mentioned above, that wider regulatory powers of horizontal application were needed, such a strengthening of the Authorities should be envisaged.

218) Concerning one idea, that often appears, suggesting the unification of all supervisory activities for cross-border institutions at the pan-EU level, the Group considers that this matter could only be considered if there were irrefutable arguments in favour of such a proposal. The complexities and costs entailed by such a proposal (which would result in a two-tier supervisory system, one for cross-border institutions and one for domestic institutions), its political implications and the difficulty of resolving cross-border burden-sharing are such that the Group has doubts of it being implemented at this juncture. This scenario could become more viable, of course, should the EU decide to move towards greater political integration.

<u>Recommendation 24</u>: The functioning of the ESFS should be reviewed no later than 3 years after its entry into force. In the light of this review, the following additional reforms might be considered:

- ***Moving towards a system which would rely on only two Authorities: the first Authority would be responsible for banking and insurance prudential issues as well as for any other issue relevant for financial stability; the second Authority would be responsible for conduct of business and market issues;***
- ***Granting the Authorities with wider regulatory powers of horizontal application;***
- ***Examining the case for wider supervisory duties at the EU level.***

CHAPTER IV: GLOBAL REPAIR

I. PROMOTING FINANCIAL STABILITY AT THE GLOBAL LEVEL

219) Although Europe was not at the root of the current financial crisis, it has nevertheless both contributed to it and been hit severely by it. Global economic and financial integration has by now reached a level where no country or region can any longer insulate itself from developments elsewhere in the world. This points to the need for a co-ordinated, global policy response not only in the area of financial regulation and supervision, but also in the macroeconomic and crisis management field.

220) Since the financial crisis has started to unfold, the EU has played a pro-active role in international efforts, trying to contain the economic fall-out from the financial crisis and to reform the international financial architecture. The EU was at the origin of the G20 process launched at the Washington Summit in November 2008 and is contributing to the political orientations agreed at that summit. However, beyond managing the current crisis, attention must now be devoted to drawing the lessons from the weaknesses of the current international financial architecture that have been revealed by the recent events.

221) A variety of international institutions and informal groups currently deal with financial regulatory and supervisory issues, often in a segmented way despite the interactions and risk transfers between different parts of the financial system[14]. However, at present there is an evident lack of a coherent framework for designing and enforcing minimum regulatory standards, for identifying risks to financial stability and for coordinating supervisory policies at the global level. Moreover, there are practically no arrangements for cross-border financial crisis management at the global level and for enforcement. What is needed now is a strengthened, more coherent and streamlined international financial regulatory and surveillance system, building on the better use of existing international institutions.

222) A start in addressing the weaknesses of the existing international financial architecture has been made at the G20 Summit in Washington on 15 November 2008. By agreeing on an action plan based on the need to strengthen transparency, to enhance sound regulation, to promote integrity in financial markets and to reinforce international cooperation, G20 leaders have set out the main priorities for the months and years to come. However, international cooperation will not work without a proper representation of the main players and key emerging market economies in each international organisation or body.

223) It is clearly in the EU's interest to try to shape the reform of the international financial architecture. The EU should take the lead by improving its own regulatory and supervisory system, which, necessary in its own right, is also required for international convergence. In other words, international convergence and agreement on high

[14] These include the Basel Committee on Banking Supervision, other Basel-based Committees such as the Committee on the Global Financial System and the Committee on Payment and Settlement Systems, the Bank for International Settlements (BIS), the Financial Stability Forum (FSF) as well as bodies like the International Organisation of Securities Commissions (IOSCO), the International Accounting Standards Board (IASB) and the International Association of Insurance Supervisors (IAIS).

standards needs strong EU enforceability through strong EU institutions. The EU has, after all, a large share of world capital markets. The EU's policy development should dovetail with international developments. Furthermore, convergence in international regulatory and supervisory standards would ensure a level playing field for the highly competitive globally integrated financial services sector.

II. REGULATORY CONSISTENCY

224) Chapter 2 of this report has set out the Group's recommendations for regulatory reform. While some of the required improvements specifically refer to the legislative framework in the EU, most of the recommended reforms either concern existing rules agreed at the international level (Basel 2; international accounting standards) or new initiatives that should preferably be implemented internationally (e.g. the regulation of credit rating agencies, strengthened derivatives market rules or corporate governance rules). The EU has a clear interest in promoting worldwide consistency of regulatory standards towards the high level benchmarks.

225) Such moves towards to international consistency of regulatory standards will also avoid unacceptable regulatory loopholes and regulatory arbitrage which could undermine financial stability. It would moreover reduce the compliance burden associated with cross-border economic activity and avoid distortions of competition. Finally, seen from the point of view of public authorities, enhanced regulatory convergence would avoid regulatory friction between jurisdictions and facilitate the supervision of globally active firms.

226) International regulatory convergence towards a consistent set of rules could be promoted by pursuing two parallel avenues. Firstly, a strengthening and broadening of bilateral regulatory dialogues between the main financial centres. Secondly, a clear mandate, including precise objectives and timetables, for international standard-setters as currently discussed in the G20 context.

227) Who should be in charge of coordinating the international standard setting process? Given its experience and track record as a standard-setter in the field of banking, the Basel Committee would seem well placed to play an important role in developing adequate standards in some of the above-mentioned areas. However, as a number of international standard setters other than central banks are concerned by the regulation of the different aspects of financial activity, the Group considers that a reformed FSF would, in view of the broader range of its participants and expertise, be in the best position for coordinating the work of the various international standard setters in achieving international regulatory consistency.

228) However, the FSF in its current form would not be able to fulfil this task. It is therefore proposed to strengthen the FSF by providing it with more resources and a stronger governance structure (including a full-time chairperson). Moreover, the FSF should become more accountable by reporting to the IMF and, like other international standard-setters (e.g. Basel Committee) should swiftly enlarge its membership to all systemically important countries. Clearly, all international standard-setters will need to combine independence from political interference with political accountability. Furthermore, it will be essential to prepare such international financial standards transparently and in

close cooperation with market participants in order to be sufficiently close to market realities.

229) It would also be important to report regularly (at least once or twice a year) to the IMF's International Monetary and Finance Committee (IMFC) in order to maintain the political momentum and to ensure accountability. In this context, it would be advisable to activate the Articles of Agreement of the IMF in order to transform the IMFC into a decision making Council.

230) Over the medium term, thought might be given to establishing a full international standard-setting authority, established by a treaty. The objective should be to put in place an international standard setting process which would be binding on jurisdictions and which would ensure implementation and enforcement of international standards. This would have to be supplemented by providing the IMF with the tasks of surveying (in the framework of Article IV Reviews) the enforcement of these standards.

***Recommendation 25*: The Group recommends that, based on clear objectives and timetables, the Financial Stability Forum (FSF), in conjunction with international standard setters like the Basel Committee of Banking Supervisors, is put in charge of promoting the convergence of international financial regulation to the highest level benchmarks.**

In view of the heightened role proposed in this report for the FSF, it is important that the FSF is enlarged to include all systemically important countries and the European Commission. It should receive more resources and its accountability and governance should be reformed by more closely linking it to the IMF.

The FSF should regularly report to the IMF's International Monetary and Financial Committee (IMFC) about the progress made in regulatory reform implementing the lessons from the current financial crisis.

The IMFC should be transformed into a decision-making Council, in line with the Articles of the IMF agreement.

III. ENHANCING COOPERATION AMONG SUPERVISORS

231) In order to address the serious supervisory failures experienced in the past, strengthened international collaboration in the supervision of large complex cross-border financial groups is of crucial importance. For this purpose, international colleges of supervisors should be set up before summer 2009 for all the largest financial institutions along the lines prepared by the FSF. Pragmatic solutions must be found on host supervisor involvement, striking the right balance between efficiency and adequate representations and information. As agreed by the G20 summit, major global banks should meet regularly and at least once per year with their supervisory college for comprehensive discussions on the assessment of their risks.

232) With a view to ensuring consistency and to identify potential systemic risks, in addition to the participation of macro- and micro-prudential authorities, the participation of an

official from an international body like the Basel Committee in these colleges would be highly desirable. On this basis, best practices could also be identified and promoted and coherence could be ensured.

233) The emergence over the last few years of financial conglomerates who are very large in size and active in many different business segments (including in proprietary trading) throughout the world represents a particular supervisory challenge. There is a risk that this trend will intensify as a result of the crisis (e.g. the merger between commercial banks and investment banks), as ailing institutions are being acquired by others. If the system is not going to move towards a clear separation between pure commercial banking activities (and some investment activities carried-out for the clients) and banks that basically act like an investment fund, then the world is moving towards a more complex setting where both activities will be mingled.

234) Such complex institutions, as well as conglomerates combining banking and insurance, pose indeed specific challenges both for their managers and their supervisors: most frequently, increasing size goes hand in hand with increased complexity and increased cross-border activity. Such financial giants are so vast and complex that it is a huge challenge to assess in an adequate way the risks to which they are exposed or the risks that they may represent for the wider economy. Given their size and the structural function they have for the financial system as a whole, they are, to some extent, "*too big to manage*" and *"too big to fail"* – which means that they can expose the rest of society to major costs and are subject to acute moral hazard; in some instances, these institutions can even be "*too big to save*", for example when they are head-quartered in a relatively small country or when the organisation of a rescue package is simply too complex to implement. However, although this may be desirable in instances of excessive market dominance under anti-trust law, it is unlikely that large financial institutions will be broken up into component parts.

235) All this calls for a particularly stringent supervision of these institutions. Supervisors should be particularly attentive to them, step up international cooperation to ensure the best possible oversight and carry-out robust comprehensive risk assessments. The extent to which these institutions are leveraged and how they are funded should in particular be closely scrutinised on an on-going basis. The way in which they allocate and price capital within the firm is crucial to their risk management. Anti-trust authorities will also have to enhance their vigilance in relation to these institutions and be ready to take any appropriate measure.

236) Faulty risk management has played a key role in the run-up to the current crisis. International firm supervisors should therefore pay greater attention to banks' internal risk management practices and insist on proper stress tests.

237) In the light of the corporate governance weaknesses witnessed over the past few years, supervisors will also need to pay greater attention to the incentive effects of corporate remuneration schemes. Here as well, a common global approach would be optimal in order to avoid regulatory arbitrage. Supervisors should therefore agree on a common assessment of incentive alignment in financial institutions and apply such common criteria under pillar 2 of Basel 2.

238) The IMF should play a significant role in surveying (in the framework of Article IV assessments) the enforcement by member countries of international standards.

***Recommendation 26:* Barring a fundamental change in the ways that banks operate, the Group recommends that the colleges of supervisors for large complex cross-border financial groups currently being set up at the international level should carry out robust comprehensive risk assessments, should pay greater attention to banks' internal risk management practices and should agree on a common approach to promoting incentive alignment in private sector remuneration schemes via pillar 2 of Basel 2.**

The Financial Stability Forum (FSF), working closely with other relevant international bodies, should ensure coherent global supervisory practice between the various colleges and promote best practice.

IV. MACROECONOMIC SURVEILLANCE AND CRISIS PREVENTION

239) As has been described in chapter 1 of this report, international macroeconomic developments and global imbalances have played a major role in leading to the current crisis. While many were observing the emergence of at least some of these developments and imbalances, only few rang the alarm bells. While the lack of relevant aggregate data of a reliable nature admittedly rendered any such warnings less precise and thus less effective, this is no excuse for the fact that, where concerns were actually voiced, corrective action has been totally inadequate. Macroeconomic surveillance therefore needs to be significantly improved and needs to get more teeth.

240) The experience of the last few years has highlighted the importance of establishing a more robust macroeconomic framework for the global economy. To this end, the surveillance of macroeconomic policies, exchange rates and global imbalances needs to be reinforced. Central banks, on their side, should more closely monitor the growth in monetary and credit aggregates.

241) Beyond the strengthening of the IMF's existing macroeconomic surveillance mechanisms one of the priorities in crisis prevention should be the strengthening of international early warning mechanisms building on the swift identification of systemic vulnerabilities. A comprehensive early warning system, jointly run by the IMF and the FSF, could build on the existing analytical framework for bilateral and multilateral macroeconomic surveillance, but would have to give greater emphasis to macro-prudential concerns. The existing financial reviews are not designed to provide an assessment on macro-prudential risks or vulnerabilities ahead of crises. Drawing the lessons from the past, it will moreover be important to ensure that any effective early warning system is able to deliver clear and unambiguous messages to policymakers and recommend pre-emptive policy responses. The key failure in the past was not so much a lack of surveillance, although the messages emerging from the surveillance could have been sharpened, but a lack of policy action. Thus, the follow-up to any such financial system assessments needs to be strengthened significantly.

242) A comprehensive early warning system could also usefully be complemented by the creation of an international risk map and an international credit register. The purpose of such a risk map would be to build up a common data base containing relevant information on risk exposures of financial institutions and markets, both at the national and the international level. The risk map should contain all the information needed for

identifying systemic risks on a global scale. Clearly, in order to be effective, the risk map should go beyond the banking sector and include major other financial institutions like insurance companies and hedge funds. It should also include all major financial products. Subject to suitable rules for protecting confidentiality of firm-level data, such a risk map would close the information gap revealed in the current crisis and could become an essential tool for everybody interested in assessing risks to financial stability.

243) An international credit register could be instrumental when preparing, on a regular basis, a global financial risk map. Such a credit register, to be set up by the BIS in cooperation with other relevant bodies like national central banks and the IMF, would consist of a database compiling a coherent set of interbank and customer-specific credit data (above a certain threshold and collected at regular intervals) for the major creditors. It would therefore allow to better assess the risk exposure of key financial players. Complementing existing national credit registers, an international credit register, accompanied by a comparable securities register, would be a useful tool for all bodies concerned about assessing risks to financial stability – provided this can be achieved without excessive bureaucracy.

244) The International Monetary Fund (IMF) is in principle uniquely placed for playing an over-arching role in ensuring high-quality macroeconomic and macro-prudential surveillance even if it may need to further deepen its analysis of financial market developments. The IMF has already, in collaboration with the FSF, undertaken substantial work on setting up an early warning system (including a possible early warning list) and on procedures for a future Early Warning Exercise (EWE). The purpose of such a EWE should be to increase peer pressure in order to trigger timely corrective action. The IMF, in cooperation notably with central banks, would also seem to be the international institution best suited for preparing a global risk map.

245) In addition, the IMF/World Bank Financial Sector Assessment Programmes (FSAP) should in the future become compulsory for all IMF member countries, based on a fixed schedule particularly for systemically important countries. It should be at the same level as macroeconomic surveillance and be fully integrated into the Art. IV consultation process. Furthermore, the FSAP results should be published and countries should be obliged to set out their reasons for not following IMF recommendations, similar to the "comply or explain" procedure now used in the EU's level 3 committees.

246) When reinforcing global early warning mechanisms concerning risks to financial stability, close cooperation between the IMF with its expertise in macro-prudential matters, the FSF and the BIS/Basel Committee with their knowledge of micro-prudential supervision will be required. These different tasks and warnings would be regularly reported to the IMFC or to the IMF Council as suggested above. Moreover, in order to build up an international credit risk map and credit register, market participants and national regulators will need to be involved.

247) However, allowing the IMF to play its full role in addressing global macroeconomic imbalances and in promoting financial stability will require a strong political will to accept its independent professional advice. Too often in the past, the IMF was hindered by the (large) member countries concerned either from undertaking the necessary analysis (e.g. Financial Sector Assessment Programme, FSAP) or from voicing publicly its concerns. It is therefore particularly important that the IMF reinforces its surveillance over systemically important countries in an even-handed manner and that member

countries increase their commitment to implementing the IMF's precise policy recommendations. Even acknowledging that there may always remain legitimate intellectual disagreements, the objective must be to effectively address domestic policies in systemically important member countries of the IMF which present a serious risk to the stability of the international economic and financial system. The IMF's recommendations – discussed and endorsed by the IMFC – should therefore become internationally shared macroeconomic policy objectives. In this context, the IMF could also usefully resume its multilateral consultations with key member countries.

248) As the experience of the last few years has demonstrated, analysis alone is not enough. Corrective action is required. Although a high-level ex ante political commitment to the implementation of IMF recommendations would help, more ambitious steps should be taken. In particular, when thrashing out the early warning system, thought should be given to the possibility of identifying "danger zones" for key variables, the entry of which would be to trigger the presumption of the need for intervention, thus reversing the "burden of proof".

<u>Recommendation 27</u>: The Group recommends that the IMF, in close cooperation with other interested bodies, notably the FSF, the BIS, central banks and the European Systemic Risk Council (ESRC), is put in charge of developing and operating a financial stability early warning system, accompanied by an international risk map and credit register.

The early warning system should aim to deliver clear messages to policy makers and to recommend pre-emptive policy responses, possibly triggered by pre-defined "danger zones".

All IMF member countries should commit themselves to support the IMF in undertaking its independent analysis (incl. the Financial Sector Assessment Programme). Member countries should publicly provide reasons whenever they do not follow these recommendations.

The IMFC/Council should receive a report, one or twice a year, on this matter.

249) Any efforts to reduce the risks to financial stability are in danger of being undermined by systemically relevant jurisdictions that refuse to use internationally agreed standards. The international community therefore has to deal with jurisdictions that have weak regulatory and governance standards, lack transparency or are not cooperating in exchanging information, like certain offshore financial centres. Leaving aside money laundering and tax issues, and focusing only on financial regulation, offshore financial centres can pose a risk to financial stability and also create a substantial level playing field problem: registration of financial institutions can be weak; initial capital requirements (for services to non-residents) are low; and supervision substandard or even inexistent.

250) In order to correct the associated risks to the global financial system, different measures have been proposed. These range from added financial statement disclosure rules (requiring the disclosure of off-balance sheet structures on a jurisdiction by jurisdiction basis in a separate annex to the financial statement, accompanied by a risk statement for assets held in poorly regulated, and in some cases, "uncooperative" financial centres) to

more far-reaching rules prohibiting regulated financial institutions from transacting with entities located in these jurisdictions.

251) Without judging the merits of these proposals at this time, which should be examined in more detail, the Group considers that, already today, group supervisors have the possibility of increasing capital requirements for those financial institutions that take higher risks by holding assets in poorly regulated financial centres or where supervisors feel hindered in getting pertinent information. Where necessary, these existing powers should be used to the full.

252) The effectiveness of these arrangements should be monitored on a regular basis under the auspices of the IMF. More generally, a transparent evaluation and benchmarking process should be set up by the IMF and the FSF, in cooperation with the World Bank, the Financial Action Task Force (FATF) and the OECD, in order to regularly assess the regulatory framework in off-shore centres and other financial centres, the results of which would be made public.

***Recommendation 28*: The Group recommends intensifying co-ordinated efforts to encourage currently poorly regulated or "uncooperative" jurisdictions to adhere to the highest level international standards and to exchange information among supervisors.**

In any event, in order to account for the increased risks, group supervisors should increase capital requirements for those financial institutions investing in or doing business with poorly regulated or supervised financial centres whenever they are not satisfied by the due diligence performed or where they are unable to obtain or exchange pertinent information from supervisors in these offshore jurisdictions.

The IMF and the FSF, in cooperation with other relevant international bodies, should assess the existing regulatory standards in financial centres, monitor the effectiveness of existing mechanisms of enforcing international standards and recommend more restrictive measures where the existing applied standards are considered to be insufficient.

V. CRISIS MANAGEMENT AND RESOLUTION

253) Even improved crisis prevention will not completely avoid crises from happening. However, the current crisis has revealed a lack of effective crisis management and coordination framework at the international level. There are no clear multilateral arrangements for coordinating national responses to financial crises. Furthermore, the difficulties in separating liquidity from solvency crises have again become apparent.

254) The experiences of the last twelve month have demonstrated the need for close coordination between supervisory, monetary and fiscal authorities. Effective information sharing and close cooperation are essential not only for efficient crisis management, but they are also indispensable for avoiding negative spillovers, distortions to competition and regulatory arbitrage.

255) In this context, strengthening the IMF's capacity to support countries facing balance of payment problems in a financial crisis is critical. The Fund currently has insufficient resources for assisting its members. EU Member States should therefore show their readiness to contribute to increasing IMF resources.

***Recommendation 29*: The Group recommends that EU Member States should show their support for strengthening the role of the IMF in macroeconomic surveillance and to contribute towards increasing the IMF's resources in order to strengthen its capacity to support member countries facing acute financial or balance of payment distress.**

VI. EUROPEAN GOVERNANCE AT THE INTERNATIONAL LEVEL

256) While the European Union is one of the key international players, its representation in international organisations and other international bodies is fragmented and lacks coherence and continuity. In some cases, the EU's representation is incomplete (e.g. the FSF or G20 at Ministerial level), while in other cases the EU as a whole – i.e. including its Member States - is even perceived as being over-represented, to the detriment of emerging market economies. This weakens the possibility of the EU speaking with a single voice, and it is something that is also increasingly criticised by the EU's international partners. It is therefore essential to organise a coherent European representation in the new global economic and financial architecture. In the context of a more ambitious institutional (and quota) reform of the IMF, this could imply re-arranging constituencies and reducing the number of Executive Board members for the EU to not more than two. A similar consolidation of the EU's representation should be installed for other multilateral fora.

***Recommendation 30*: The Group recommends that a coherent EU representation in the new global economic and financial architecture be organised.**

In the context of a more ambitious institutional reform, this could imply a consolidation of the EU's representation in the IMF and other multilateral fora.

VII. DEEPENING THE EU'S BILATERAL FINANCIAL RELATIONS

257) The EU has every interest in leading and developing its relations with the major financial powers of the world. Over the past years, good technical work has been carried out with the United States on complex regulatory and supervisory issues and these efforts should be intensified with the new US administration to find the broadest and deepest common ground. Likewise, with Japan and China, Brazil, India, Russia, Saudi Arabia, and other emerging countries the EU should work to develop common understanding on the global financial reforms that are needed. The EU has a unique opportunity to strengthen its global influence and to promulgate its ideas and approaches. But for this to happen – the EU's own supervisory and regulatory model must not just be fit for purpose but a global example of effectiveness, utility, fairness, cooperation, consistency and solidarity.

***Recommendation 31*: In its bilateral relations, the EU should intensify its financial regulatory dialogue with key partners.**

***

This report sets out the regulatory, supervisory and global reforms that the Group considers are needed.

Work must begin immediately.

ANNEX I: Mandate for the High-Level Expert Group on financial supervision in the EU

The current financial crisis has highlighted the weaknesses in the EU's supervisory framework, which remains fragmented along national lines despite the substantial progress achieved in financial market integration and the increased importance of cross border entities. If financial integration is to be efficient in terms of safeguarding systemic stability as well as in delivering lower costs and increased competition, it is essential to accelerate the ongoing reform of supervision.

Supervisory reform has so far relied on an evolutionary approach, whereby the so-called Level 3 Committees in the Lamfalussy framework are expected to achieve significant convergence in supervisory practices and procedures across member states. While certain progress in convergence has been achieved, this progress has not allowed the EU to identify and/or deal with the causes of the current financial crisis. The current national-based organisation of EU supervision lacks a framework for delivering supervisory convergence and limits the scope for effective macro-prudential oversight based on a comprehensive view of developments in financial markets and institutions.

The Group is therefore requested to make proposals to strengthen European supervisory arrangements covering all financial sectors, with the objective to establish a more efficient, integrated and sustainable European system of supervision.

In particular the group should consider:

- how the supervision of European financial institutions and markets should best be organised to ensure the prudential soundness of institutions, the orderly functioning of markets and thereby the protection of depositors, policy-holders and investors;

- how to strengthen European cooperation on financial stability oversight, early warning mechanisms and crisis management, including the management of cross border and cross sectoral risks;

- how supervisors in the EU's competent authorities should cooperate with other major jurisdictions to help safeguard financial stability at the global level.

The Group will examine the allocation of tasks and responsibilities between the national and European levels.

The Group should present a report to the European Commission in view of the Council of Spring 2009.

The Group will conduct hearings and organize a consultation as appropriate.

ANNEX II: Meetings of the Group and Hearings in 2008 - 2009

The Group began its work in mid-November and held 11 full day meetings. It received oral evidence from the following personalities and representatives of European financial services associations and international institutions:

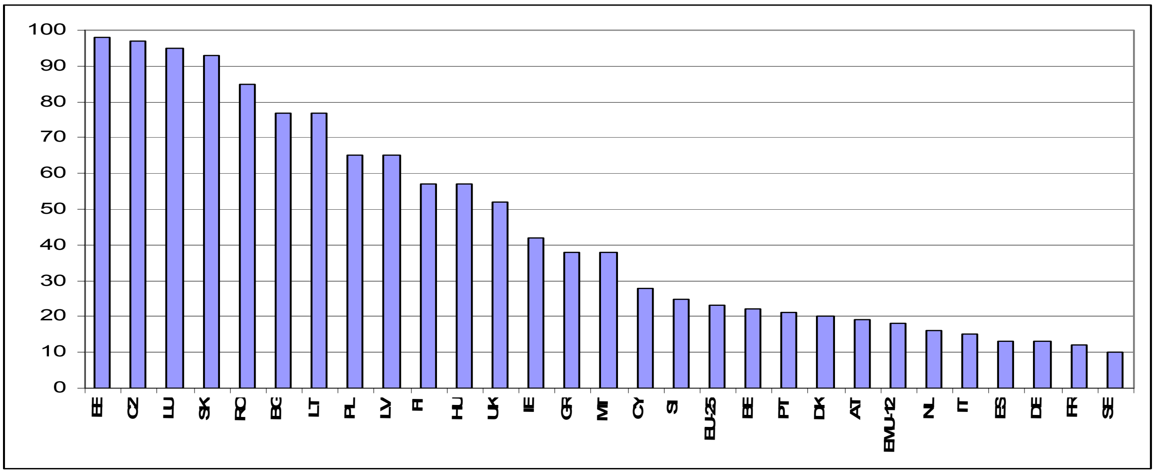
- The Chairs of the 3 Level 3 Committees (CEBS, CEIOPS, CESR);
- European Commissioners Charlie McCreevy and Joaquin Almunia;
- Dr A.H.E.M. Wellink, Chairman of the Basle Committee and President of the Netherlands Central Bank;
- Mr Jean-Claude Trichet, President of the ECB;
- Mr Mario Draghi, Chairman of Financial Stability Forum and Governor of the Bank of Italy;
- Mr Marek Belka, Head of the European Desk of the IMF;
- Mr Xavier Musca, Chairman of the Economic and Finance Committee;
- Mr Peter Praet, Chairman of the Banking Supervisory Committee at the ECB and Executive Director at the National Bank of Belgium;
- Baron Alexander Lamfalussy;
- The CEA (Comité Européen des Assurances) and AMICE (Association of Mutual Insurers and Insurance Cooperatives in Europe);
- The EBF (European Banking Federation), ESBG (European Savings Banks Group) and EACB (European Association of Co-operative Banks);
- The Federation of European Securities Exchanges (FESE), ICMA (International Capital Market Association), EFAMA (European Fund and Asset Managers Association), ISDA (International Swaps and Derivatives Association), FOA (Future and Options Association), AMAFI (French Association of Financial Markets), LIBA (London Investment Banking Association), European Issuers and ISCS (Investicni společnost Ceske sporitelny);
- Representatives of large insurance companies (AXA, Munich Reinsurance Company, Aegon and AVIVA plc.).

ANNEX III: An increasingly integrated single European financial market

Looking ahead, it is important to ensure that the way in which supervision is organised in the Single Market allows supervisors to meet the objective of maintaining financial stability (in both normal and crisis conditions), while allowing to the greatest extent possible financial institutions and customers to benefit from the advantages of the Single Market as set out in the Treaty.

EU financial markets are increasingly integrated, especially in the wholesale markets. The banking and insurance markets are dominated by pan-European groups, whose risk management functions are centralised in the group's headquarters. There has been an increase in cross-border M&A transactions in terms of value since 2003. This trend was particularly strong in 2005, when several large-value transactions were conducted, amounting to over 50% of the total M&A value in the euro area banking system. EU banks have become more international than ever, expanding into foreign markets both in Europe and beyond. Currently around 70% of EU banking assets is in the hands of 43 banking groups with substantial cross-border activities. Especially in the Central and Eastern European countries, the banking sectors are dominated by foreign (mostly Western European) financial groups (see figure 1). The present crisis is likely to lead to further consolidation across borders, although the economic slow-down may limit consolidation in the short to mid-term.

Figure 1. Market share of foreign-owned banks (% of total assets)



As for financial markets, the available evidence suggests that the integration has progressed considerably, but varies depending on the market segment, and is to a large extent correlated with the degree of integration of the underlying financial infrastructure. Table 1 provides an overview of the level of integration of the various segments. It should be noted that due to intensive cross-border consolidation of stock exchanges, concentration of the underlying infrastructures is increasing (i.e. the market share of the five largest stock exchanges in Europe exceeded 90% in 2006).

Table 1. Integration of various market segments

Market segment	Degree of integration
Money market	High degree
Bond markets • government bonds • corporate bonds	 Considerable degree Considerable degree
Equity markets	Increasing integration
Banking markets • interbank/wholesale activities • capital market related activities • retail banking activities	 Increasing integration Increasing integration Fragmented

This evolution towards large cross-border groups does not imply any judgement on the benefits or the possible drawbacks (the last global chapter will touch on the concept of 'too big too fail') of this phenomenon. But it is important that any reflection on the EU supervision framework should take into account these trends.

The emergence of an increasingly integrated financial market in the EU is indeed a major challenge for financial supervision – a challenge which goes to the heart of the objective of supervision: integration increases contagion risks, and thereby jeopardises financial stability; integration makes it more difficult to ensure a level playing-field if rules and supervisory practices differ; integration means the development of large cross-border groups, which will require more streamlined and cost-effective supervisory organisation.

At the current juncture, the supervision of EU firms remains largely based on national, home state supervision – but where cross border firms have set up subsidiaries under local law these subsidiaries are regulated finally at host state level. Cross border branches of firms are regulated by the home country – but safeguards have been provided in EU law for host state supervisors to act for example in emergency situations to protect depositors (Article 33 CRD). In the case of investment services, host state supervisors have significant areas of control - including the right to examine branch arrangements (Article 32 MIFID). Host supervisors retain control of liquidity in branches as well and should be informed of all relevant information about the group (Article 42 CRD and its recent strengthening).

This organisation is a very complex one, leading to multiple reporting lines between supervisors and supervised entities and to complex mechanisms of cooperation between home and host supervisors. Some argue that the present arrangements should be preserved because, in certain cases, it could be better to handle complex financial institutions with different supervisors holding different views on a number of issues. However, such a view would have to be backed by a precise and convincing analysis. In any case, such an approach has the potential of leading to cross border and cross-sectoral risk and distrust between supervisors.

Be that as it may, what seems difficult to contest is that fragmentation in supervision has shown to be the source of major dangers. The case of AIG in the US is noteworthy. No one in the US and elsewhere denies that the collapse of that major institution was the result of a weak state-by-state insurance regulatory system and of the absence of a single responsible supervisory body at the Federal level. More generally, the US authorities are likely to restructure what most consider as a too fragmented supervisory system. The EU must obviously avoid such pitfalls.

Some argue that there is, at the moment, insufficient mechanisms allowing for real and effective collaboration between home and host supervisors:

- host supervisors do not have comprehensive means to challenge the home state supervision of a group which has branching activities in its territories;

- there is no binding mediation mechanism arbitrating between home and host supervisors, whether for banks, insurance companies or investment firms;

- if a national supervisor fails to take a necessary measure, there is no quick mechanism allowing for a collaborative decision to be taken in relation, for example, to the liquidity or solvency position of a group;

- there are no effective cross border crisis management arrangements, as illustrated by the table below.

1. Cross-border institutions operating in a branch structure:

Responsibility, information and tools are asymmetrically distributed and concentrated in the home country. In a crisis situation where the institution is *systemically important both in the home and the host country* authorities have incentives to find a solution since a branch cannot fail or be reconstructed on its own. However, problems may arise if both authorities seek to rely on the incentive and willingness of the other authority to contribute to a solution for the group. The host country, even though having a clear economic interest in a solution, may try to avoid or limit any contribution to sharing the burden and point to information and supervisory responsibilities in the home country. The home country may comparably try to shift the largest possible burden to the host country and argue that the crisis is not due to regulatory failure and/or that actions of their independent supervisors do not entail fiscal responsibility.

If the institution is *only systemically important in the home country* the host country will be reluctant to contribute in crisis management when a financial burden is involved. The home authorities have the incentives, instruments and access to information to ensure a solution. The *Icelandic cases* provide tangible examples.

Turning to the opposite case where the institution is *only systemically important in the host countries* significant conflicts of interests may arise. Host authorities lack the information and tools to act (except for the corner solution where the host country intervenes to rescue the entire group). Moreover, in case of a failure of a group with a large branch, the burden on the home country deposit guarantee scheme (DGS) may be substantial.

2. Cross-border institutions operating in a subsidiary structure:

Responsibility, information and tools are shared between the countries where the institution operates. Both home and host competent authorities should have access to information and tools to use in a crisis situation, if necessary. If an institution is *systemically important both in the home and the host country* both authorities have incentives to ensure a solution. In theory, the problems can either be solved individually or jointly. However, host authorities may have an incentive to ring-fence the subsidiary in some cases (and almost all Member States may be legally obliged to do this), while home authorities may have an incentive to seek the centralization of a bank's assets and keep liabilities decentralized. The functional, managerial and operational structure of the group and mismatch between the distribution of assets and liabilities could result in difficulties in restarting the subsidiary on its own and more generally in restructuring the group. Both authorities may need to rely on the incentives and willingness of the other authority – which will often not have legal flexibility - to provide a solution as the home and host country authorities are not accountable to each other in the event of insolvency. The management of *Fortis-group* serves as a real example of this case.

As in the case with branches, for an institution that is *only systemically important in the home country,* the host country will be reluctant to contribute in crisis management when a financial burden is involved.

If the subsidiary is *only systemically important in the host country* host authorities in principle have the adequate tools and sufficient information to act independently in a crisis situation, but may in practice find it difficult to restart the subsidiary on its own due to the ownership structure of the bank.

It is important to note that consolidated group structures vary from among Member States as well as their legal obligations. Missing as well at EU level are early intervention tools, common winding up procedures, rules on transferability of assets and common approaches to bankruptcy.

Given the above, the current supervisory arrangements are not optimal to contribute to a high degree of financial stability in the Single Market. Host Member States, in particular, largely depend on the effectiveness of supervision carried-out in the home Member States. And one supervisory mistake can have major consequences throughout the Single Market.

The appropriateness of current arrangements also fails from an efficiency standpoint. Currently, financial institutions operating in different markets have to cope with different national supervisory rules and practices. They have to commit extensive resources to deal with numerous supervisors and differing supervisory requirements, for example in the area of reporting. This entails administrative costs without any added value[15].

Finally, one can question whether the current arrangements provide for a level playing-field between financial institutions. Cross-border institutions have different home supervisors, depending on the Member State where they have established their headquarters. These various supervisors may have different views on major supervisory issues, such as for example the validation of internal risk models. The Colleges of Supervisors may also take different views in equal situations, leading to different supervisory outcomes for groups who compete with each other.

[15] The ongoing compliance cost as a percentage of operating expenses for large banks and financial conglomerates is on average around 1%. Large pan-EU institutions could save at least several million euros every year, if they could benefit from a more streamlined supervisory structure.

ANNEX IV: Recent attempts to strengthen supervision in the EU

Over the last few years, a number of attempts have been made to introduce greater coherence between the reality of an integrated market and the organisation of supervision. The EU has tried to increase cooperation and coordination between national supervisory authorities, including for crisis management. This applies especially to the implementation of the Lamfalussy process across the banking, securities and insurance sectors and the recent MOU on crisis management.

The first aim of the Lamfalussy report in 2000 was to speed up the adoption of EU financial services law – providing a framework and mechanism for timely decision making based on the technical expertise of the level 3 committees, open consultation, transparency and political accountability. Good results have been achieved in this respect. The Lamfalussy process did not deal with strengthening prudential oversight – but the report warned: *"While the committee strongly believes that large deep, liquid and innovative financial markets will result in substantial efficiency gains and will therefore bring individual benefits to European citizens; it also believes that greater efficiency does not necessarily go hand in hand with enhanced financial stability"*.

Another aim of the Lamfalussy process was to converge supervisory practices; agree common day to day interpretations and applications of EU rules with non-binding guidelines; foster greater trust among supervisors. These tasks have proven to be very difficult.

Without recourse to qualified majority decision making until very recently, and without legal powers the level 3 committees have been unable to converge their activities sufficiently. Some of this is due to the fact that some directives in levels 1 / 2 of the Lamfalussy process allowed for optionality and gold plating – so level 3 could not resolve the problems left over from levels 1 and 2. But in other cases, national supervisors did not cooperate sufficiently to converge either supervisory practices or interpretations – whether the reason is to protect a national champion, restrict competition, preserve a national practice viewed as a competitive supervisory or regulatory advantage or just sheer bureaucratic inertia.

Some recent examples of supervisory difficulties within the Lamfalussy framework[16]:

- No common reporting formats have been agreed, and are unlikely before 2012.
- Lengthy blockages resulting in no agreement on CESR-ESCB standards for clearing and settlement.
- Unified registration and supervision of credit rating agencies at EU level cannot be granted to CESR because it lacks the legal powers resulting in the Commission proposing complex national registration with non-binding coordination by CESR.

Over the past decade, the Commission, supported by the level 3 committees, has worked hard to try and further reinforce supervisory cooperation in the EU. The latest attempt has been in its recent proposals for the revisions of the CRD and its proposal for a home country based

[16] A number of examples on regulatory divergences are provided in the chapter on regulation.

group support regime for Solvency 2. The aim in both cases was to move towards stronger group wide supervision.

For the CRD, the Commission proposed:

- Installing colleges of supervisors for major cross border groups and ensure an effective decision-making process within the colleges.
- Strengthening home country control for capital add-ons in subsidiaries in other Member States;
- Strengthening host state branch supervisory with more information.

For Solvency 2 – the group support regime proposed by the Commission, inter alia, would:

- Install colleges of supervisors for cross-border groups and ensure an effective decision-making process within the colleges;
- Allow the home based firm to allocate capital throughout the group in an efficient way, subject to safeguards to protect the financial soundness of all the legal entities belonging to the group.

In both cases a strong number of countries - including all new Member States for Solvency 2 and Member States unanimously in the case of the CRD – have decisively rejected changing the current balance of home and host state regulation.

At the heart of this, are three major problems:

(i) A perceived lack of adequate processes and guarantees in the case things go wrong for host country depositors and policy-holders that do business with foreign branches and subsidiaries, linked to local requirements for all supervisors to protect local interests and apply local laws first.

(ii) Lack of a sufficiently clear framework agreement on at the EU level on burden sharing principles in rescue operations with a cross-border character.

(iii) A lack of trust among EU supervisors, which recent events have accentuated further.

The majority of Member States are not confident that, should a cross-border crisis occur, it will be managed and resolved in an optimal way for their citizens. And indeed, some recent examples, highlighted in hearings organised by the Group, have shown that the division of responsibilities between home and host supervisors have been far from satisfactory which has complicated the coordination of crisis management. Many Member States, therefore, object to major modifications in the allocation between home and host authorities. They will not, in particular, accept that the level of regulatory capital to be held by the subsidiaries established in their territories is decided by a competent authority in another Member State.

The absence, therefore, of a sound framework for crisis management and resolution (with sufficiently clear principles on burden sharing, customers' protection, assets transferability and winding up) complicates the introduction of an effective and efficient supervisory system to avoid financial crises in the first place. Any proposals to modify the organisation of supervision in the EU therefore have to be accompanied by the setting up of a more convincing framework for crisis management in the EU.

Furthermore there could be cases where Member States disagree with the monetary policy choices made elsewhere in the EU, seeing them as too lax and jeopardising the stability of the financial system. Given the impact of excessive credit expansion, especially in some host countries, safeguards for such countries could be justified. If a host supervisor detects such deviations, it should be able to act by tightening credit conditions or increasing reserve requirements. The following safeguards should be considered:

- if there were to be significant mismatches in terms of borrowing in foreign currencies, the host supervisor should have the leeway through appropriate regulations to curb those currency mismatches in both subsidiaries and branches;

- particular attention should be dedicated to the appropriate degree of liquidity of branches and subsidiaries in host countries.

If the implementation of such safeguards were to create a problem with the group supervisor, it would be useful if the host supervisor could bring the case to an independent body for arbitration and decision.

The Commission's proposal for mandatory colleges of supervisors for cross-border firms has fared better politically, although there are no clear decision-making processes in case of disagreements among supervisors in colleges nor mechanisms for dealing with disputes. And some have estimated there will need to be up to 123 colleges which will make the application of consistent supervisory practice essential, but very difficult to achieve.

Against this background, the Group considers that it is crucial that in the future EU supervisors exercise their competences in a more effective, collaborative and coordinated way than today. The existing level 3 committees have clearly reached their limits in terms of informal cooperation methods.

The fact that EU supervisory arrangements may not have been one of the major causes of the crisis, and that the supervisory systems of some third countries have not performed better, cannot be excuses for inaction. Given their complexity and fragmented nature, EU supervisory arrangements have, in the context of an increasingly integrated EU market, the potential of being inadequately prepared for a future crisis. This pertains to the future and cannot be demonstrated. It nevertheless appears that it would be wise for Europe to organise itself in order to limit further damage if new crisis were to appear. Making recommendations to facilitate this is the very essence of the mandate that has been given to the group. The aspirations of global G20 convergence – important though it is – cannot be delivered without effective supervision in the biggest capital market in the world, the EU.

The Group considers it is now pressing to establish a more effective supervisory system in the EU. One which will better meet the objective of financial stability. Ensure a level playing-field. Be as cost-effective and underpin real European capital market integration.

ANNEX V: Indicative allocation of competences between national supervisors and the Authorities in the ESFS

BANKING SUPERVISION

Stage 1

SUPERVISORY TASKS	NATIONAL LEVEL	EU LEVEL
Licensing of banks, e.g., fit and proper test, business plan, and minimum capital.	**X**	
Compliance with CRD minimal capital requirements (Pillar 1)	**X**	
Review of bank's internal capital assessment and supervisory review process of bank's adequacy of capital (Pillar 2)	**X**	
On-site inspections	**X**	
Review of banks' disclosure framework (Pillar 3)	**X**	
Enforcement and sanctions	**X**	
Internal governance/control	**X**	
Supervisory assessments of mergers and acquisitions.	**X**	
Hybrid funds, i.e., compliance with eligibility requirements	**X**	
Large exposures requirements	**X**	
Qualified holdings	**X**	
Reporting	**X**	
Know your customer rules	**X**	
Provisioning policy	**X**	
Anti-money laundering rules	**X**	
Imposition of a conservator and possible revocation of licences	**X**	
Complaints	**X**	
Development and implementation of harmonised technical EU prudential regulations and requirements, including advice to the Commission	**X**	**X** (see § 206)
Defining overall supervisory policies		**X** (see § 206)
Convergence of supervisory rules and practices		**X** (see § 206)
Financial stability monitoring		**X** (see § 206)
Oversight on colleges		**X** (see § 206)
Crisis management/resolution	**X**	

Stage 2

SUPERVISORY TASKS	NATIONAL LEVEL	EU LEVEL
Licensing of banks, e.g., fit and proper test, business plan, and minimum capital.	**X**	
Compliance with CRD minimal capital requirements (Pillar 1)	**X**	
Review of bank's internal capital		

assessment and supervisory review process of bank's adequacy of capital (Pillar 2)	**X**	
On-site inspections	**X**	**X** (see §208)
Review of banks' disclosure framework (Pillar 3)	**X**	
Enforcement and sanctions	**X**	
Internal governance/control	**X**	
Supervisory assessments of mergers and acquisitions.	**X** (National)	**X** (pan-EU, in combination with national assessments, see §208)
Hybrid funds, i.e., compliance with eligibility requirements	**X**	
Large exposures requirements	**X**	
Qualified holdings	**X**	
Reporting	**X** (To be included in an EU database)	
Know your customer rules	**X**	
Provisioning policy	**X**	
Anti-money laundering rules	**X**	
Imposition of a conservator and possible revocation of licences	**X**	
Development and implementation of harmonised technical EU prudential regulations and requirements, including advice to the Commission	**X**	**X** (incl. binding technical interpretation of level 1 and level 2 measures, see §208)
Defining overall supervisory policies		**X** (see § 206)
Ensure consistent supervision, e.g., defining common supervisory standards and practices as well as arrangements for the functioning of colleges		**X** (incl. binding supervisory standards, see §208)
Binding mediation, e.g., in case of disagreement between national supervisors		**X** (see §208)
Designation of group supervisor		**X** (see §208)
Complaints	**X**	**X** (e.g., on discrimination by national supervisors, see §208)
Financial stability monitoring		**X** (see §208)
Binding cooperation and information sharing procedures with the ESRC for macro-surveillance		**X** (see §208)
Evaluate supervisory processes though peer review		**X** (see §208)
Aggregate all relevant information pertaining to cross-border institutions		**X** (see §208)
Prepare and/or adopt of 3rd country equivalence decisions		**X** (see §208)
Represent EU interests in bilateral and multilateral discussions with third countries on supervision		**X** (see §208)
Crisis management	**X**	**X** (Coordinate national efforts, e.g., create and lead groups of national supervisors, see §208)
Crisis resolution	**X**	**X**

		(Coordinate national efforts, e.g., facilitate cooperation and exchange of information, act as mediator and help to define and implement the right decisions, see §208)

INSURANCE SUPERVISION

Stage 1

SUPERVISORY TASKS	NATIONAL LEVEL	EU LEVEL
Licensing of insurance firms, e.g., fit and proper test, business plan and minimum capital.	**X**	
Checking the calculation of the Minimum Capital Requirement (MCR) and the Solvency Capital Requirement (SCR)	**X**	
Impose capital add-ons	**X**	
Evaluate the level of eligible own funds	**X**	
Evaluate the quality of eligible own funds	**X**	
On-site inspections	**X**	
Asses technical provisions	**X**	
Assess investment rules	**X**	
Assess the system of governance	**X**	
Asses internal models	**X**	
Approve ancillary own funds	**X**	
Authorise hybrid capital items	**X**	
Enforcement and sanctions	**X**	
Supervisory assessments of mergers and acquisitions.	**X**	
Reporting, including decisions on public disclosure by insurance undertakings	**X**	
Know your customer rules	**X**	
Anti-money laundering rules	**X**	
Revocation of licences	**X**	
Complaints	**X**	
Development and implementation of harmonised technical EU prudential regulations and requirements, including advice to the Commission	**X**	**X** (see § 206)
Defining overall supervisory policies		**X** (see § 206)
Convergence of supervisory rules and practices		**X** (see § 206)
Financial stability monitoring		**X** (see § 206)
Oversight on colleges		**X** (see § 206)
Crisis management, including assessing the viability of recovery plans and/or financing scheme	**X**	
Crisis resolution and insolvency proceedings	**X**	

Stage 2

SUPERVISORY TASKS	NATIONAL LEVEL	EU LEVEL
Licensing of insurance firms, e.g., fit and proper test, business plan and minimum capital.	**X**	
Checking the calculation of the Minimum Capital Requirement (MCR) and the Solvency Capital Requirement (SCR)	**X**	
Impose capital add-ons	**X**	
Evaluate the level of eligible own funds	**X**	
Evaluate the quality of eligible own funds	**X**	
On-site inspections	**X**	**X** (see §208)
Asses technical provisions	**X**	
Assess investment rules	**X**	
Assess the system of governance	**X**	
Asses internal models	**X**	
Approve ancillary own funds	**X**	
Authorise hybrid capital items	**X**	
Enforcement and sanctions	**X**	
Supervisory assessments of mergers and acquisitions.	**X** (National)	**X** (pan-EU, in combination with national assessments, see §208)
Reporting, including decisions on public disclosure by insurance undertakings	**X** (To be included in an EU database)	
Know your customer rules	**X**	
Anti-money laundering rules	**X**	
Revocation of licences	**X**	
Development and implementation of harmonised technical EU prudential regulations and requirements, including advice to the Commission	**X**	**X** (incl. binding technical interpretation of level 1 and level 2 measures, see §208)
Defining overall supervisory policies		**X** (see § 206)
Ensure consistent supervision, e.g., defining common supervisory standards and practices as well as arrangements for supervisory colleges		**X** (incl. binding supervisory standards, see §208)
Binding mediation, e.g., in case of disagreement between national supervisors		**X** (see §208)
Designation of group supervisor		**X** (see §208)
Complaints	**X**	**X** (e.g., on discrimination by national supervisors, see §208)
Financial stability monitoring		**X** (see §206)
Binding cooperation and information sharing with the ESRC for macro-surveillance		**X** (see §208)
Evaluate supervisory processes through peer reviews		**X** (see §208)
Aggregate all relevant information pertaining to cross-border institutions supervisors		**X** (see §208)
Prepare and/or adopt of 3rd country		**X** (see §208)

equivalence decisions		
Represent EU interests in bilateral and multilateral discussions with third countries on supervision		**X** (see §208)
Crisis management, including assessing the viability of recovery plans and/or financing scheme	**X**	**X** (Coordinate national efforts, e.g., create and lead groups of national supervisors, see §208)
Crisis resolution and insolvency proceedings	**X**	**X** (Coordinate national efforts, e.g., facilitate cooperation and exchange of information, act as mediator and help to define and implement the right decisions, see §208)

SECURITIES SUPERVISION

Stage 1

SUPERVISORY TASKS	NATIONAL LEVEL	EU LEVEL
MiFID		
Authorisation		
- Investment Firms	**X**	
- Regulated Markets and Multilateral Trading Facilities	**X**	
Calculations	**X**	
Suspense of trading	**X**	
Compliance conduct of business	**X**	
Inspections	**X**	
Reporting	**X**	
Enforcement	**X**	
Post-Trading		
Authorisation	**X**	
Supervision	**X**	
Enforcement	**X**	
Access to other systems	**X**	
Credit Rating Agencies		
Authorisation	**X**	
Supervision	**X**	
Enforcement	**X**	
Prospectus		
Authorisation	**X**	
Transparency		
Officially Appointed Mechanisms	**X**	
Notification shareholders	**X**	
Market Abuse		
Market supervision	**X**	
Enforcement	**X**	
Emergency powers	**X**	

EU investigations	**X**	
Accounting		
Mandatory recommendations	**X**	
Enforcement	**X**	
UCITS		
Authorisation	**X**	
Enforcement	**X**	
Others		
Compliance conduct of business by other financial institutions, e.g., banks and insurance firms	**X**	
Supervisory assessment of mergers and acquisitions	**X**	
Development and implementation of harmonised technical EU prudential regulations and requirements, including advice to the Commission	**X**	**X** (§ 206)
Defining overall supervisory policies		**X** (see § 206)
Convergence of supervisory rules and practices		**X** (§ 206)
Financial stability monitoring		**X** (§ 206)
Oversight on colleges		**X** (§ 206)
Crisis management/resolution	**X**	

Stage 2

SUPERVISORY TASKS	NATIONAL LEVEL	EU LEVEL
MiFID		
Authorisation		
- Investment Firms	**X**	
- Regulated Markets and Multilateral Trading Facilities	**X**	
Calculations	**X**	
Suspense of trading	**X**	
Compliance conduct of business	**X**	
Inspections	**X**	
Reporting	**X**	
Enforcement	**X**	
Post-Trading		
Authorisation	**X** (national)	**X** (pan-EU, see §208)
Supervision	**X** (national)	**X** (pan-EU, see §208)
Enforcement	**X** (national)	**X** (pan-EU, see §208)
Access to other systems	**X** (national)	**X** (pan-EU, see §208)

Credit Rating Agencies		
Authorisation		**X** (see §208)
Supervision		**X** (see §208)
Enforcement		**X** (see §208)
Prospectus		
Authorisation	**X**	
Transparency		
Officially Appointed Mechanisms	**X**	
Notification shareholders	**X**	
Market Abuse		
Market supervision	**X**	
Enforcement	**X**	
Emergency powers	**X**	**X** (Coordinate national efforts, see §208)
Investigations	**X**	
Accounting		
Mandatory recommendations		**X** (see §208)
Enforcement	**X**	
UCITS		
Authorisation	**X**	
Enforcement	**X**	
Others		
Compliance conduct of business by other financial institutions, e.g., banks and insurance firms	**X**	
Supervisory assessment of mergers and acquisitions	**X** (National)	**X** (pan-EU, in combination with national assessments, see §208)
Development and implementation of harmonised technical EU regulations and requirements, including advice to the Commission	**X**	**X** (incl. binding technical interpretation of level 1 and level 2 measures, §208)
Defining overall supervisory policies		**X** (see § 206)
Ensure consistent supervision, e.g., defining common supervisory standards and practices as well as arrangements for the functioning of colleges		**X** (incl. binding supervisory standards, see §208)
Binding mediation, e.g., in case of disagreement between national supervisors		**X** (see §208)
Complaints	**X**	**X** (e.g., on discrimination by national supervisors, see §208)
Financial stability monitoring		**X** (see §208)
Binding cooperation and information sharing procedures with the ESRC for macro-surveillance		**X** (see §208)
Evaluate supervisory processes through peer review		**X** (see §208)

Collect and make available all relevant information pertaining to cross-border institutions		**X** (see §208)
Prepare and/or adopt of 3rd country equivalence decisions		**X** (see §208)
Represent EU interests in bilateral and multilateral discussions with third countries on supervision		**X** (see §208)
Crisis management	**X**	**X** (Coordinate national efforts, e.g., create and lead groups of national supervisors, see §208)
Crisis resolution	**X**	**X** (Coordinate national efforts, e.g., facilitate cooperation and exchange of information, act as mediator and help to define and implement the right decisions, see §208)