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Ensuring Financial Stability through Supervisory Cooperation

What Are the Pre-Conditions for Financial Stability?

Among the necessary conditions for financial stability are: a sound and stable macroeconomic environment, robust payment, clearing and settlement systems and, last but not least, sound financial institutions. Macroeconomic stability and payment system robustness are carefully monitored and discussed in various institutions and committees. Sound financial institutions require efficient banking supervision, convergence of supervisory practices as well as ongoing supervisory cooperation. A disruption or failure of one of these elements may entail market confidence and consumers' trust.

The CEBS has started operating in January 2004, and its structures have been fully up and running in October 2004. According to the Lamfalussy process, the principles of which have been enshrined in the CEBS' charter, it has three main tasks:

- to provide advice to the European Commission;
- to ensure consistent implementation of Community legislation in the banking field and convergence in supervisory practices; and
- to promote supervisory cooperation and exchanges of information.

These three tasks are phrased exactly in the same way as for the sister Lamfalussy Committees, CESR and CEIOPS, but the three committees are in quite different phases of the regulatory cycle. In the insurance field, the major efforts are focused on the technical work supporting the Community legislation on capital adequacy. CEIOPS' main task at this stage is therefore the preparation of advice on what, in the "Lamfalussy jargon", is called Level 1 legislation, i.e. framework legislative principles. CESR became active while the wave of FSAP directives was being finalised, and the main efforts so far have been centred on advice at Level 2, i.e. on technical implementing measures. The CEBS started operating while the proposal for the capital requirements directive (CRD, also called Basel II or CAD III) was being finalised and submitted to the Council and Parliament. For the time being, the CEBS' focus is therefore mainly on the second and third tasks, i.e. on implementation issues: convergence in supervisory practices and networking between authorities. The CEBS is of course also active in the other areas mentioned in the charter. But it is clear that its contribution – in particular to financial stability – will be assessed primarily on the basis of the progress delivered in the implementation of the CRD.

Why do we need enhanced supervisory cooperation and convergence of supervisory practices in Europe? European integration has increased the depth and liquidity of financial markets and has strengthened their resilience against shocks; nevertheless, it has also increased the risk of banking crises spreading across national borders. To reduce this risk, banks supervisors have been improving their cooperation for quite a long time and are now harmonising their supervisory practices. Such convergence is also needed to promote an efficient implementation of new, sophisticated regulations such as Basel II, to disseminate banks' and supervisors' best practices, to improve the level playing field across Europe (which is crucial, as EU is a single market and even a single monetary zone for many countries), to avoid supervisory arbitrage, and to limit administrative burden for banks. All these elements mean better banking supervision and therefore more financial stability in Europe.

In fact, Basel II/CRD provides an unprecedented window of opportunity for delivering concrete results regarding supervisory convergence in Europe. Too often, moving to common standards is costly. Changes must be introduced, which impose to each and every bank to adopt a new reporting framework, to ensure compliance with new requirements and to be scrutinised according to new criteria. But when the whole framework is changing, it makes a lot of sense for supervisors "to converge before they diverge", as stressed by José Maria Roldán, the CEBS' Chair. This is a unique opportunity to promote convergence.

The task is nevertheless daunting: The CEBS has to progress towards common approaches on very complex issues; and it has to do it very quickly, as banks need guidance already by the end of 2005, in order to take decisions early enough for the implementation of the new framework.

Why Is Enhanced Supervisory Cooperation Particularly Needed in Europe?

Basel II represents a paradigm shift in banking supervision. For decades banking supervision consisted of a

series of wide-ranging and intrusive administrative constraints, coupled with large discretionary powers attributed to the supervisory authority. Until the early 1980s product and geographic markets were segmented by law or administrative provisions, the opening of branches had to be authorised in order to avoid excessive competition, price controls and quantitative constraints to credit growth were often in place, large loans had to be authorised on a case-by-case basis, etc. Basel I was the first major breakthrough. The Accord brought us to a different stage, in which level playing field was sought on a new key tool for prudential supervision, the solvency ratio. The international layer of banking supervision was quite simple: all banks had to calculate this ratio and stay above it. Wide discretion was left to national authorities to determine other components of the supervisory toolbox, including the concrete actions to be taken in relation to the capital ratio. For instance, in some countries a prompt corrective action framework was built up, which envisaged the activation of some supervisory interference when certain trigger levels of the ratio were hit. In some countries, authorities could impose additional capital requirements, while in others this was not legally feasible. In the EU, of course, a much higher degree of harmonisation was achieved with the second banking coordination directive and the creation of the Single Market, but supervisory practices remained, to a large extent, diversified across Member States. First, with the amendment on market risk, and now on a much wider scale with Basel II, supervisory requirements have moved towards a growing reliance on the internal measures and safeguards developed by the banks themselves for controlling risks. The new framework is risk-focused. It cannot be treated as a compliance exercise; it is intended as an integral part of the management and governance of the banks. The most remarkable feature of Basel II is that it does not put forward a rigid framework, a straightjacket of requirements superimposed on bank practices. The new capital adequacy framework is expected to evolve with best industry practices; it provides incentives for improving, refining and innovating in

risk management. More than a static framework, it represents an evolutionary approach to banking supervision.

This change was mostly brought about by the shortcomings of the previous approaches. More intrusive approaches to supervision, by dictating the areas of business in which banks could and could not expand, and by constraining a sound pricing and, in some cases, hedging of risks, showed all its weaknesses with the developments of international banking and with the crises of the 1980s. The approach based on broad-brush requirements led to an easier and easier circumvention of the rules, as information technology and financial innovation supported a growing ability of banks to unbundle and repackage risks in such a way to minimise the regulatory capital.

Now the supervisory framework is much more in line with industry practices, and it was very reassuring to see that, after extensive rounds of

consultations, the proposed directive received support from banks of all types and sizes. Nonetheless, some parts of the framework are complex and there are growing concerns about its implementation.

In a cross-border environment, there is indeed a concern that such a complex package could be implemented into national legislations and then into operational supervisory practices that may differ across countries. If this were to occur, the compliance burden for cross-border groups would be increased, as they would have to report to a number of different authorities, convince them of the adequacy of their capital, satisfy at the same time somewhat different criteria.

Under Basel I, the international dimension of cooperation was mainly focused on the exchange of information and on agreements between supervisors on the division of tasks in the monitoring of international banks. The simple structure of the capital requirements did not leave space for much interpretation. Now for the first time supervisory practices are at the core of the new framework: consistent implementation has to be addressed at two levels, the transposition of the Accord into national legislation and the supervisory practices that will translate the new rules into day-to-day supervision. At the global level, beyond EU, the Accord Implementation Group of the Basel Committee is extremely active in supporting an affective and consistent implementation of Basel II.

What Is the Role of the Committee of European Banking Supervisors in Promoting Financial Stability?

As far as the CEBS is concerned, the main challenge is consistent implementation. As the adoption of the directive is coming closer to an end, the attention starts focusing on the transposition of the new framework into national legislations. The CRD is still a pre-Lamfalussy directive: Although it will be possible to revise extensive parts of the directive, in particular the technical annexes, via "comitology procedures" (thus enhancing the ability of the regulatory framework to adapt to changes in market structures and practices), there is no distinction between framework principles and technical rules, between Level 1 and Level 2 measures. This means that there is no room for assessing whether, for some technical measures, regulations – directly binding in all Member States – would be a more suitable legislative tool than directives – which need to be implemented in national legislation in all Member States. As the Lamfalussy report noted, reliance on directives rather than regulations "*… leaves more latitude for Member States to implement Community Law but too often leads to uneven transposition and different interpretations*". There is in fact a widespread perception that notwithstanding the huge effort in harmonisation, common rules have been often implemented in slightly different ways in national rulebooks and this may have prevented the Single Market to deliver its full benefits. Institutions operating on a cross-border basis have to comply with a set of slightly different requirements on supposedly harmonised supervisory tools, with the result that compliance costs increase – and

are perceived by regulated entities as dead-weight, useless costs.

Besides differences in the transposition of common provisions, there is also the concern that Member States could adopt layers of regulatory additions that go beyond the provisions of the directive, so that the benefits of a harmonisation become less evident and the costs of cross-border compliance increase.

Finally, there is the issue of visibility of the EU layer of common rules and practices. There is quite a lot of attention devoted to Community legislation when it is being discussed and finalised. But after this stage, the set of rules banks have to comply with in the Single Market remains a collection of national rulebooks. In particular, the visibility of a common EU regulatory framework vanishes as soon as banks move into the concrete provisions they have to comply with.

There are eight main streams of work that have been activated by the CEBS to tackle these issues and, as a result, improve financial stability in Europe.

Common Reporting (COREP)

A common framework for the reporting of the solvency ratio (Basel II or CRD) has already been submitted to public consultation and the CEBS is working on assessing and incorporating the comments received. This COREP common reporting framework covers credit risk, market risk and operational risk as defined in the CRD. It is applicable to all EU credit institutions and investment firms. The "COREP package" consists of common templates as well as a common XML/XBRL-based technology platform, inclusive of a taxonomy to be used as a reference library. The proposal pursues the highest level of standardisation across the EU, leaving each supervisor free to decide the scope and the level of aggregation required within the common framework. Moreover, in order to increase standardisation, the number of templates has been minimised. As a result, it is expected that banking groups operating on a cross-border basis will face a lower administrative burden, while small, local banks will not be imposed additional costs as the reporting framework had to be updated in any case. Also the exchanges of information between supervisors should be facilitated, with increased cross-border comparability.

Common Financial Reporting (FINREP)

The CEBS has prepared a common EU response to the new accounting standards (IFRS). The so-called common "prudential filters" (i.e. special prudential treatment of certain items as well as certain latent profits or losses) have been developed in order to limit the volatility of prudential own funds resulting from the IFRS introduction. Moreover, the CEBS has developed an EU harmonised financial reporting framework that includes a balance sheet, a profit and loss account as well as annexes adapted to the IFRS.

Supervisory Disclosure

The CEBS has no enforcement powers and can only make use of soft tools crafted via consensus between national competent authorities. But the disclosure of supervisory information will allow for a proper discussion of differences. It will provide market participants with information as to the scope for divergent implementations and with a tool for exercising pressure towards more consistent choices, if they are considered necessary. As disclosure of information by banks is

expected to support market discipline, supervisory disclosure is expected to act as a disciplinary device towards consistent implementation.

Article 144 of CRD requires that competent authorities disclose a set of information related to the directive implementation. The disclosure framework must provide a comprehensive set of supervisory rules, tools and guidance and permit meaningful comparisons in four specific areas:

- any kind of national rules and guidance;
- the ways national discretions are exercised;
- the supervisory review, (namely the criteria and methodologies used by national authorities in the Supervisory Review and Evaluation Process (SREP) and the Individual Capital Assessment Process (ICAAP); and
- some aggregate statistical data on key aspects of the implementation in each Member State.

The framework proposed by CEBS will be based on a set of tables, containing both qualitative and quantitative information, and organised around the four sections corresponding to the four areas indicated in Article 144 of the CRD. It adopts a user-friendly approach using the same ways to disclose, via the Internet, as it is the best way forward to avoid unnecessary administrative burden for supervisors. The CEBS website will be the point of entry, giving an overview at European level and will provide links to national websites where the detailed information will be accessible. This two tier structure should allow for easy comparability and for access to detailed information at the national level, in "clones websites", with similar structure in order to favour easy consultation and navigation. The reliance on common formats and the use of a common language, English, should support meaningful comparisons.

Allowing for cross-border comparisons is not only positive in order to track and foster progress towards consistent implementation. It also provides for a clearer visibility of the EU layer of rules, as the common elements will be visible, together with the country specific ones. Supervised entities should gradually become more aware of the tiered structure of the rulebook they have to comply with: common framework principles, (embodied in directives) common technical rules and supervisory guidance, (enshrined in the more flexible components of the CRD and in CEBS' guidelines) as well as the national component, which should reflect specific aspects and practices of local markets and banking sectors.

The Reduction of the National Discretion Options

With reference to national discretions, the CEBS has conducted an attempt to cut down the number of options and discretions in the directive text.

Following a request for advice, CEBS proposed to delete 23 discretions and almost all the proposals were accepted in the text approved by the Council. The tight timeline did not allow however for a careful review and for extensive consultation with the industry. Therefore, as a second step, the CEBS asked its Consultation Panel to help identifying those options and national discretions that could have a significant impact on the conduct of cross-border business and on the level playing field. In fact, there might well be discretions that reflect a specific feature of some local markets and do not have any material effect on institutions operating throughout

the Single Market. For instance, several discretions refer to transitional periods, needed to adapt national legislation and move to the new setting. This exercise should allow the CEBS to identify priority areas for further work.

In a third step, the CEBS will then try to develop a consensus on possible further reductions of such discretions. As most national discretions are contained in the annexes to the CRD, this would still be possible without burdensome legislative revisions via c-decision, as changes could be introduced via comitology procedure. If deleting significant options or discretions would not be possible, efforts should be made to reduce their impact via convergence in the practices adopted in exercising it.

It is not as much as it was expected when the CEBS started this work; but it is not un-significant, and national options will probably go more easily after the implementation of the CRD. Hopefully supervisory disclosure will exercise further pressure in this direction.

The Validation of Internal Approaches for Credit and Operational Risk (IRB and AMA)

Regarding validation, the work is being focused on the definition of common quantitative and qualitative criteria for discrimination and calibration of rating systems, estimates of the probabilities of default, losses given default, exposures at default and AMA parameters. Furthermore, the CEBS is developing minimum standards for the review of the methodologies applied by credit institutions and investment firms. The CEBS is not aiming at detailed guidance, de facto setting up new requirements: The objective is to clarify what the supervisor expects.

The Implementation of Pillar 2

This is the area in which more leeway is left to discretional evaluations of supervisory authorities, thus opening room for potential different approaches adopted by national supervisors. As to Pillar 2, the CEBS has already issued a first consultation paper in 2004, receiving a rather positive feedback. The three core principles developed in that paper were:

– a clear statement that the ICAAP is the responsibility of the supervised

institution;
– he definition of the SREP as a challenge to the internal assessment put forward by the bank, thus starting a necessary dialogue between the institution and the supervisory authority; and
– the principle of proportionality, according to which the intensity and depth of the dialogue should be proportionate to the systemic importance, nature, scale and complexity of the institution.

Following the comments received in the consultation, the CEBS has developed further work and intends to submit soon to public consultation a second version of the paper. The new paper will further flesh out the respective responsibilities of supervisory authorities and institutions, and the interaction between the ICAAP and the SREP. Further work is being started on specific risk factors, such as concentration risk and interest rate risk in the banking book, also with a view

to developing common principles. In general, the approach adopted is not prescriptive and focus on processes; it aims at reaching more clarity and commonality in the approaches that will be used by supervisors, without putting forward too specific requirements.

The Home/Host Issue

The CEBS is preparing the issuance of principles governing the cooperation and the two-ways exchange of information between home and host authorities. These guidelines are being prepared with the objective of providing a framework which would deliver an easy and straightforward division of labour between all the authorities involved, with a common understanding of:

- Who should activate a process?
- Which information should, as a rule, be channelled? And when?
- How different steps in a risk assessment process should be shaped?

The restructuring of large groups has produced an increased misalignment between the legal and operational structures; organisational choices are often made at the firm level. The legal entity is not anymore a self-contained body performing all the functions connected to the services provided in that jurisdiction and directly controlling all the related risks. This creates a serious challenge for a risk-focused supervision, as supervisory responsibilities are allocated on the basis of the country of residence of the legal entity, although the monitoring of the risks incurred by such entity may well require access to information available outside the jurisdiction of the supervisor. This aspect could give rise to higher compliance costs, if in order to reconcile the legal entity approach with the functional one controls end up to be duplicated by several authorities involved in the supervision of a cross-border group. In the absence of convergence in supervisory practices, this might even determine conflicting supervisory requirements.

The provisions introduced in the proposed CRD reflect awareness of this issue. It enhances the tasks of the consolidated supervisor and creates a coordination mechanism between competent authorities, which should minimise the scope for duplications and additional compliance costs. But all these provisions, and in particular those asking for a joint decision for the validation of IRB and AMA approaches, call for the definition of supervisory guidelines, which better define the respective tasks of all the parties involved.

There is therefore a need for principles governing the cooperation and the two-ways exchange of information between home and host authorities. Such guidelines are being prepared with the objective of defining a clear framework of the basis of which more specific, tailor-made agreements could be defined by the authorities involved in the supervision of specific cross-border groups. The intention is to provide a framework which should articulate a clear division of labour between all the authorities involved, with a common understanding of who should activate a process; which information should, as a rule, be channelled and when; how different steps in a risk assessment process should be shaped; etc.

An important point is the recognition that the degree of involvement and cooperation should be defined according to the significance of an entity, with respect both to the group business and to the local markets in which it operates.

A very important chapter of this guidance will concern the specific issues that need to be addressed to ensure a smooth approval process for the validation of IRB and AMA approaches. Following the innovative provisions that have been introduced in the proposed CRD, all the authorities are required to come to a joint determination and, if within a certain time frame this does not happen, the consolidating supervisor has to take the final decision.

Before submitting this delicate piece of work to public consultation, the CEBS has "road tested" it with reference to some specific cross-border groups, in order to identify possible unresolved issues and further refine the criteria.

An interesting question concerns the possibility, envisaged in the directive, to delegate supervisory responsibilities to the home/consolidating supervisor. This provision was already present in the consolidated banking directive, but it has not been activated very often (mostly for the supervision of liquidity risk, for which there was already a large contrast between the old supervisory framework and the increasingly centralised treasury management of banks). Here a distinction should be made between delegating responsibilities and tasks. While delegation of tasks seems to be easily workable, provided that there is the appropriate trust between authorities and a sufficient commonality of approaches, delegation of responsibilities may raise some difficult legal issues. For instance, in case the consolidated supervisor is delegated the responsibility of supervising a subsidiary in another Member State, how would the enforcement of some hard supervisory measures take place? According to which legal framework such supervisory procedures could be initiated?

Moreover, there might be cases in which home and host authorities maintain different views, for instance with reference to the significance of a group component, or to the optimal distribution of capital within a group. Different views are more likely when home-host issues are addressed at a general and abstract level, while when concrete issues are addressed it is probably easier to come to a shared view, especially when there is a habit to cooperate and rely on each other's assessment. However, the possibility cannot be ruled out that in some cases different positions have to be reconciled. In such cases, it is the legal attribution of responsibilities that has to determine the final decision.

Crisis Management

The CEBS is, and will increasingly be, a leading actor in crisis prevention and management. It has been working to define guidelines regarding cooperation between supervisors in emergency situations according to the CRD:

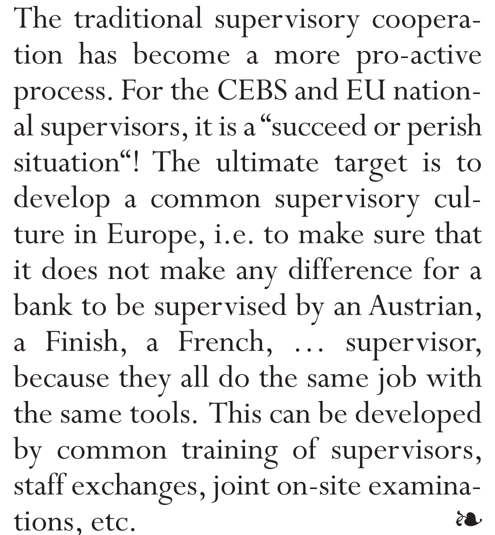
"C*ompetent authority responsible for the exercise of supervision on a consolidated basis of EU parent credit institutions shall carry out the following tasks (...) planning and coordination of supervisory activities in going concern as well as in emergency situations.*" (Article 129)

In such circumstances, the distribution of responsibilities is less precisely defined, in light of the constructive ambiguity that dominates the arrangements for crisis management and the

role exercised by other authorities, including central banks, deposit guarantee schemes and, in extreme cases, ministries of finance.

This new guidance is being incorporated in bilateral Memoranda of Understanding (MoUs) between supervisors, allowing better crisis management through an increased role of the consolidated supervisor.

The CEBS takes part in the High Level Working Group on Crisis Management; its work is focused on the definition of a joint MoU with national ministries of finance, with the objective of crisis resolution. It will be a MoU distinct from the 2003 Supervisors MoU on Crisis Management and Resolution (not to increase moral hazard), that will complement the supervisors' MoU.



Conclusion

The traditional supervisory cooperation has become a more pro-active process. For the CEBS and EU national supervisors, it is a "succeed or perish situation"! The ultimate target is to develop a common supervisory culture in Europe, i.e. to make sure that it does not make any difference for a bank to be supervised by an Austrian, a Finish, a French, … supervisor, because they all do the same job with the same tools. This can be developed by common training of supervisors, staff exchanges, joint on-site examinations, etc. ❧

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