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De Larosière High level Group ponders the future of financial supervision in the EU

On February 25th, the High Level Group chaired by Mr de Larosière published its [report](#) on financial supervision in the EU. This document represents a comprehensive assessment of possible policy responses to the crisis related to the regulatory framework, corporate governance, financial supervision, and crisis management both within the EU and, to some extent also at a global level.

The report contains 31 recommendations which hold the prospect of challenging projects over the next few years which might materially change the current EU supervisory and crisis management arrangements.

The key issues highlighted in the report have fed into the [Commission's Communication](#) published on March 4th and which will be further discussed during March by the EFC, the ECOFIN and EU Council. It will provide a basis for the EU position that will be presented at the G20 meeting in London on 2nd April.

Many of the topics included in the report already fall within the EBC's mandate, and have been discussed during previous meetings. These topics will form the basis of the EBC's future workplan.

G20: preparations for the 2nd April Leaders meeting

The 15 November 2008 meeting of G20 Leaders and Finance Ministers was a historic event, bringing together advanced and emerging economies at the highest level to determine how to address the global financial and economic crisis.

All leaders agreed that urgent action was needed in a number of areas, and that this action needed to progress in the next few months, through a process determined and led by G20 Finance Ministers. In light of worsening economic prospects, closer macroeconomic cooperation to restore growth in a broad range of countries, while avoiding negative spillovers, will be a central theme for the next [G20 Leaders in London on April 2nd](#).

Following the November meeting, the following work streams were established: Enhancing sound regulation and strengthening transparency (WG1); Reinforcing international cooperation and promoting integrity in financial markets (WG2); Reforming the IMF (WG3); Reforming the World Bank and multilateral development banks (MDBs) (WG4); macroeconomic policy response and framework (which is being addressed directly by G20 Finance Ministers, Central Bank Governors and Deputies)

The European Commission represents the EU together with the CZ Presidency. A G20 Finance Deputies meeting was held in London on February 1st. Another meeting will take place on March 12th-13th to prepare the G-20 Finance Ministers and Central Bank Governors Meeting, who will discuss the final report before the G20 Leaders meeting on April 2nd.

Prepared by:

Secretariat of the European Banking Committee

Contact:

Tobias Mackie

Secretary to the EBC

Tel. +32 2 296 1661

E-mail:

Tobias.Mackie@ec.europa.eu

Capital Requirements Directive: State of play in the adoption process for an amending Directive

The Commission adopted its proposal to amend the CRD (on large exposures, colleges, hybrid capital, liquidity risk management, and securitisation) in [October 2008](#). After [political agreement](#) was reached in Council in early December 2008, discussions on the CRD review have continued in the early part of 2009 in the European Parliament. On 2nd and 11th February, the ECON Committee discussed 285 EP amendments to the CRD in view of a vote in ECON on 9th March. 5 "Trilogue" meetings (bringing together Commission, Parliament and Council) are due to take place after the vote in ECON, in addition to financial attachés meetings. The final vote in Plenary is expected to take place in April (21 - 23).

Capital Requirements Directive: State of play of the comitology amendments to the Capital Requirements Directive

– Comitology Amendments to Directive 2006/48/EC

By [resolution](#) of 16 December 2008, the European Parliament opposed the draft [comitology Directive](#) amending Directive 2006/48. The resolution states that the EP objects only to a specific provision of the draft Directive which lays down disclosure requirements for the External Credit Assessment Institutions (ECAIs) while it supports the remaining 46 amendments provided by the draft measure.

In its resolution, the EP has requested the Commission to remove this provision from the draft comitology Directive and to shift it either to the proposal for a Regulation on Credit Rating Agencies or to the proposal for a review of Directives 2006/48/EC and 2006/49/EC under the co-decision procedure.

Further to the European Parliament's opposition, the Commission has decided to launch a new Comitology procedure on a new text which takes into account the requests expressed by the European Parliament in its resolution.

On 20th February 2009, the Commission submitted a revised draft Commission Directive amending Directive 2006/48/EC for opinion to the EBC. This new text is identical to the text approved by the EBC on 24 September 2008, except for the provision in Point 3 of the draft directive, laying down the disclosure requirements for the ECAIs, which has been removed.

If the new draft is approved by the EBC, the Commission will re-submit the new draft measure to the European Parliament and Council for their scrutiny in accordance with Decision 1999/468.

The substance of the ECAIs provision has been taken up into an [amendment](#)¹ proposed by J.P. Gauzès, MEP to the pending co-decision proposal for a review of the CRD. This amendment is now part of the package of amendments proposed by the Parliament and currently under the Commission's examination that will be discussed in the pending negotiations.

– Comitology Amendments to Directive 2006/49/EC

The European Parliament's scrutiny period expired on 9 January 2009 and the EP has not made any comment on this draft measure.

Therefore the adoption of this [draft Commission Directive](#) can proceed according to plan. A written procedure for the adoption of this Directive by the Commission will be launched shortly.

Capital Requirements Directive: considering further changes

It is already apparent, as the process to amend the CRD which was initiated last October draws to a successful conclusion, further changes to the CRD will be necessary.

The EBC has been remained attentive to the evolving need for such changes and held further discussions at its March meeting. In particular, consideration is being given to further changes in the context of the trading book, securitisation and national options and discretions. It will be important to ensure consistency with ongoing discussions in European and international fora - in particular with respect to the EBC discussions about supplementary ratios (see below). Changes to the trading book and securitisation rules could be built around recent proposals by the Basel Committee. Capital requirements for the trading book have proved inadequate over the course of the past two years and require strengthening. Capital requirements for complex securitisations of securitisations also need to be strengthened, as these instruments turned out to be particularly sensitive to correlated losses. With regard to national options and discretions, work by CEBS and further discussions in the CRDTG point the way towards substantial progress in this area.

At its meeting, the EBC gave discussed the level of ambition that co-legislators should seek to achieve when narrowing the options and discretions for national implementation.

Regulatory issues: Home/host supervision of branches

In light of the financial crisis, the EBC discussed the robustness of home/host arrangements for the supervision of credit institution with branches established in another Member State. The Commission provided an explanation of the existing CRD requirements regarding information sharing and powers of intervention for host supervisors in emergency situations.

The Commission will perform a transposition check of those provisions to ensure that host authorities are able to exercise the powers currently provided for in the CRD, and that host Member States have sufficient confidence in the robustness of the existing arrangements. In the context of the forthcoming White Paper on early intervention, it is intended to further reflect on the need to entrust authorities with further powers to act at an earlier stage – before emergency situations arise.

Regulatory issues: working towards a Commission report on Procyclicality by end 2009

The Basel II framework (transposed by the Capital Requirement Directive) aims to enhance financial stability by making capital requirements more risk sensitive. As a consequence, capital requirements are broadly expected to vary over time – in line with the economic cycle. The current crisis has prompted questions as to whether and to what extent the variation in regulatory capital exacerbates the economic cycle – or, in other words, whether the new requirements produce "*Pro-cyclical*" effects. CEBS and the BSC have set up a joint task force to pull together empirical analysis and look at long term observation periods.

While there is a clear urgency to devise regulatory responses to improve the financial regulatory framework in order to re-establish confidence, this work is not expected to lead to measures which provide a solution paving the way out of the current crisis. Over the course of this crisis, many banks have remained well above the regulatory minimum capital requirements even though they had to be re-capitalised by governments because of market fears that their capital was not adequate. In the depths of a crisis it is in any case too late to apply counter-procyclical measures, as any such measures would require banks to build up buffers or provisions during the good times and would not be appropriate at this juncture.

At this stage, there may be various ways to mitigate the pro-cyclicality of regulatory capital. Examples include: strengthening the through-the-cycle orientation of minimum capital requirements; basing minimum capital requirements on smoothed outputs of financial institutions' internal risk models; adding a countercyclical "macro-prudential overlay" to the minimum requirements based on measures on the financial cycle. Adjustments could be based on mandatory rules, or else on a more discretionary basis. They could be hardwired to the minima (pillar 1) or encouraged by the supervisory process (pillar 2). Depending on their specific features, the arrangements would impact differently.

The current crisis has also prompted a discussion about the relationship between prudential and accounting rules. The European Council has called for a speeding up of work on the international regulation of capital and for a general consideration of the effects of fair value accounting rules on financial institutions and markets, including their procyclical effects. A special working group set up by the EFC to look at Procyclicality has been paying special attention to the concept of "dynamic provisioning", and to how strong provisioning and flexible counter-cyclical buffers could be achieved, both within the prudential framework and by way of financial reporting. The Working Group believes that these issues deserve an in-depth discussion within the international organisations concerned, mainly the Basel Committee and the IASB.

The ongoing work on pro-cyclicality will feed into the Commission's first biennial report to the Council and the EP on pro-cyclicality (under Art 156 of the CRD), which is due to be delivered by end 2009.

Regulatory issues: considering a new supplementary metric in banking regulation

One of the lessons drawn from the current crisis is that size and leverage of financial firms might be better captured. The European Commission has clearly expressed its view - in the G-20 and in the G-10 Basel Committee, that a new and simple metric should be designed to supplement the present risk-based capital requirements in the Capital Requirements Directive (CRD). This work is part of the programme of measures that are underway to improve the entire capital framework (trading book, securitisation, liquidity, etc).

The possible introduction of any supplementary metric will need to be properly assessed with respect at least to the three important policy issues: (i) its objectives; (ii) its design and calibration; (iii) its role in supervision and crisis management.

The European Banking Committee is in the process of conducting an overview of the key policy issues at stake and possible options that could be explored for a new metric.

Deposit Guarantee Schemes: Commission considers next steps following the approval of a new Directive

– Proposal amending Directive 94/19/EC:

The European Parliament and Council have now [approved](#) the Commission's [proposal of October 2008](#) to amend the Directive on Deposit Guarantee Schemes. The main changes will be:

- An increase of the minimum coverage level from €20 000 to €50 000 by end of June 2009 (co-insurance to be abandoned)
- A further increase to a fixed level of €100 000 by end 2010 unless the Commission concludes that this would be inappropriate
- A reduction of the time taken to payout to depositors from 3-9 months to 4-6 weeks by end 2010.

The Commission will also be required to prepare a report by end 2009 on a variety of issues (in addition to the increase to €100 000), such as the harmonisation of funding mechanisms, operational issues (such as the payout delay), and the feasibility of a pan-EU Scheme, and to submit legislative proposals if appropriate (see below). The text of [Directive 2009/14/EC](#) was published in the Official Journal on 13 March 2009.

– Commission Report on Deposit Guarantee Schemes

The Commission's report will address the following issues:

- Harmonisation of the funding mechanisms of deposit-guarantee schemes and the benefits and costs of such harmonisation;
- Possible models for introducing risk-based contributions;
- Benefits and costs of a possible introduction of a Community deposit-guarantee scheme.

- The appropriateness of and modalities for providing a full coverage for certain temporarily increased account balances;
- Effectiveness and delays of the payout procedures assessing whether further reduction could be implemented;
- The link between deposit guarantee schemes and alternative means for reimbursing depositors, such as emergency pay out mechanisms;
- The harmonisation of the scope of products and depositors covered, including the specific needs of SMEs and local authorities;
- The impact of diverging legislations as regards set-off, where a depositor's credit is balanced against its debts, on the efficiency of the system and possible distortions, taking into account cross-border winding-up;
- Transparency and information available to depositors (i.e. their awareness about the functioning and the features of existing schemes);
- The effectiveness of cross-border cooperation between deposit guarantee schemes.

In order to help prepare this report, the Commission will be supported by its Joint Research Centre, which has been tasked with obtaining (via a detailed questionnaire which has been sent to national schemes) information and preparing input on specific questions.

A public consultation on these issues will be launched in spring 2009. Additional input will be sought via an expert Working Group which will first meet in July to discuss specific issues with Member States.

Early Intervention: Commission prepares a White Paper

Recent events have provided clear evidence that in cross-border crisis situations the defence of national interests prevails over cooperative solutions - despite the putting in place in 2008 of an EU-wide [Memorandum of Understanding](#) setting out arrangements for cooperation during a crisis. The importance of introducing effective crisis management arrangements and ensuring their interoperability across borders has been recognised both in the [de Larosière report](#) and in the [Commission's response](#).

The Commission has established an expert working group which is helping in the preparation of a White Paper due by June 2009. The White Paper will look at developing an overall EU framework for crisis intervention to deal swiftly and effectively with an ailing bank.

The White Paper will need to consider ways of overcoming national instincts and encouraging win-win cooperative solutions, and will in particular need to consider how to address the current misaligned incentives which impede effective cooperation across borders.

In particular, a new framework will need to deliver in a number of important areas:

- empowering authorities to allow asset transferability (and provide alternative solutions to ring fencing) and create cooperative financing possibilities.



- addressing the need for a common approach to *pre-intervention*, by proposing the development of a common assessment system, enhancement of equivalent and compatible supervisory tools, and empowering supervisors to allow asset transferability subject to certain conditions.
 - seeking to develop a common approach to *intervention*, by ensuring that certain reorganization powers (e.g. bridge banks, partial transfers of banking business, good bank/bad bank, appointment of special administrator,..) are available options in all MS (this may need to entail special rules for dealing with systemic powers which provide derogations from e.g. company law, etc). Such enhanced powers which might impact the rights of certain stakeholders (shareholders, creditors) would need to be offset with appropriate safeguards.
 - addressing coordination between authorities – in particular through the enhancement of the 2008 MoU with legal obligations on alert and consultation between authorities both domestically and cross-border.
 - proposing the development of financing arrangements to underpin cross-border cooperation, by for example converging rules on funding of deposit guarantee schemes and developing their proactive use beyond the paybox function.
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