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*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](mailto:Tobias.Mackie@ec.europa.eu)

## Financial turbulence: following up the October 2007 Ecofin

The European Banking Committee (EBC) has held further discussions on follow-up work to the [conclusions of the 9<sup>th</sup> October ECOFIN<sup>i</sup>](#), when two separate issues were tabled in relation to crisis management:

- Determination of preliminary policy responses to the recent financial markets situation,
- Adoption of conclusions in light of the completion of the EFC's ad hoc working group report on financial stability (see next article).

As regards the former, the October Ecofin conferred a special role on the Commission to closely follow the different work streams so as to shape its views, ensure consistency, including with its own work programme and formulate and propose appropriate policy responses. Given that the large majority of issues contained in the roadmap concern primarily the banking sector, the EBC also has an important role to monitor progress and provide feedback to the Commission.

The roadmap of actions prepared with the assistance of the Commission in response to the financial turmoil is comprehensive and corresponds to the global agenda of the Financial Stability Forum. The roadmap consists of a working programme, which runs until the end of 2008, aimed at reviewing, along with the EU's international partners, how to further improve: (i) transparency; (ii) valuation standards; (iii) the prudential framework, risk management and supervision, and (iv) market functioning;

A [Commission Communication<sup>ii</sup>](#) on the financial turmoil was adopted on 27 February and will be discussed at the Informal European Council on 13-14 March 2008. A more detailed report will be presented to the ECOFIN in April 2008.

Work is progressing on all areas in a variety of fora, at both international (FSF, BIS, IOSCO, IASB, etc.), and European levels (EFC, EBC, FSC, BSC, CEBS, CESR, CEIOPS, etc.). In general, given the urgency, the work is progressing rapidly but diligently.

On the issue of transparency, the absence of accurate and timely information on exposures to credit risk has been a key factor for the generalised loss of investor confidence in financial markets since August. Questions about the adequacy of transparency have been raised with respect to special purpose vehicles (SPVs), bank disclosure of securitisation operations and exposures to SIVs, the complexity in the structuring, risk measurement and valuation of structured finance products, and the opacity in the functioning of markets for complex financial instruments.

The Commission has requested the Committee of European Banking Supervisors (CEBS) and the industry bodies to formulate a plan to guarantee more granular market information on securitisation exposures by mid 2008. On February 8, 2008, 8 European industry associations<sup>iii</sup> signed and published a [joint position paper](#) that outlines how they plan to respond to the transparency-related issues on the roadmap. This letter covers three fields of work:

- Sound and consistent implementation of the securitisation related CRD disclosure requirements. An assessment of proposed implementation by banks and the information needs the interbank market will be carried out. This work aims at EU good practice guidelines on securitisation disclosures to be published for consultation end June 2008.
- Transparency and the provision of public information on the market. At present, information on the public securitisation markets needs to be collected from a wide variety of sources. In order to assist politicians and policy makers in monitoring the evolution of these markets, the European industry has committed to provide a periodic report on market data, starting in June 2008.
- Finally the European industry is committed to increasing transparency to investors in the securitisation markets. This will involve making initial prospectus and ongoing investor pool reports on term public transactions openly accessible. Lastly, a working group has been formed to develop, to the extent possible, standardised definitions used in various countries for various products, in order to improve consistency and investor understanding.

With regard to valuation standards, while the ultimate responsibility for the valuation and accounting treatment of assets lies with institutions holding the assets, supervisors accounting standard setters and other relevant authorities nonetheless also play an important role from a prudential perspective. Work is underway at the international level aimed at ensuring reliable valuation and auditing of assets, particularly of those assets where markets are potentially illiquid in times of stress, while ensuring compatibility with international financial reporting standards. A report on the accounting valuation of illiquid assets as well as the deployment of sound asset valuation standards by non-bank investors will be submitted to the European Financial Committee (EFC) in June.



The Ecofin roadmap also identified a series of issues relating to the prudential framework which needed to be addressed. The Commission services were already in the process of preparing amendments to banking rules (see below) prior to the current financial turbulence, but recent events have injected an added sense of urgency. In particular ECOFIN has highlighted the need for further clearer rules on: (i) large exposures, (ii) banks' trading book exposures, (iii) enhanced cooperation between supervisors, (iv) improvement of risk management standards by non-bank investors and (v) banks' liquidity requirements. This latter issue is currently being discussed by the Basel Committee, CEBS and the Banking Supervision Committee. At Basel, the work on preliminary lessons to be drawn from the crisis<sup>1</sup> was published on 21st February, and work on supervisory principles for bank's liquidity risk management (LRM) is planned for delivery in July. At its next meeting in March, the BCBS will discuss possible additional substantial work – e.g. developing an international framework for LRM regimes. The Commission is awaiting finalisation of the work in Basel before considering possible implementation of new rules into the CRD.

Finally the Ecofin roadmap endorsed a series of initiatives concerning market functioning – in particular picking up on key issues which arose in the context of the US subprime crisis. With regard to credit Rating Agencies (CRAs), the Commission has requested the Committee of European Securities Regulators (CESR) and the European Securities Market Expert Group (ESME) to come forward with their assessment of CRAs' activities and in particular the rating process<sup>1</sup>. CESR is expected to produce a report at the end of April this year, whereas ESME have been asked to present their report by the end of May.

In the meantime, the Commission has made clear that it expects rating agencies to improve their practices with respect to dealing with conflicts of interest, ensuring transparency of ratings/methodology and improving quality of ratings. Moreover, the IOSCO Task Force on CRAs is currently discussing possible amendments of IOSCO's code of conduct for CRAs, focusing on three main areas: (i) quality and integrity of the rating process, (ii) independence and avoidance of conflicts of interest and (iii) responsibilities of the CRAs to the investing public and issuers. The outcome of these discussions will be published in May and a report will be submitted to the EFC in June.

The current market turmoil has highlighted the possible deterioration of underwriting standards for originators with regard to the so-called the "originate and distribute" model, due to the subsequent transfer of underlying exposures and lack of proper understanding by end investors of their actual risk profiles. The Ecofin called for an examination into the

incentive structures in credit markets and the implications of the 'originate and distribute' models of banks for credit markets. At the end of February, the BIS/FSF organised a workshop with market participants and academics on the subject. The ECB's Banking Supervision Committee is also in the process of constituting a task force with the objective of assessing the use of securitisation in the EU banking landscape and analysing the risks this model might pose for financial stability.

In light of the problems which have arisen in the US, and which lie at the root of the financial turbulence, the ECOFIN roadmap also called for an examination of rules covering the origination and (mis-) selling of mortgage credit. Last December, the Commission adopted a [White Paper](#)<sup>iv</sup> on the integration of EU mortgage credit markets, in which the Commission announced its intention to examine the costs and benefits of the different policy options for responsible lending. A study is due to be launched in March.

Finally, the ECOFIN called for a thorough examination of the treatment of so-called 'non-organised debt markets' by the Financial Services Committee (FSC). The complexity of some OTC structured products has raised concerns over investor protection and credit risk. In Europe, both the participants and the instruments are regulated under MiFID. However, other Directives (such as Prospectus Directive, Transparency Directive and the Market Abuse Directive) may not always apply due to the relevant exemptions. In February, the Commission provided input to discussions at the Financial Services Committee, and the issue was subsequently discussed by the EFC. At this stage, emphasis is on encouraging market participants and industry bodies to seek improvements in the organisation of these markets, inter alia through some degree of standardisation of instruments; better management systems for counterparty risk; and improved transparency.

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## Crisis Management: responding to the Ecofin roadmap

Further to the finalisation of a report by an ad hoc working group of the EFC, the October 2007 Ecofin endorsed a second roadmap of 12 issues designed to develop EU financial stability arrangements.

A set of commonly agreed principles on financial crisis management, including a principle on burden sharing, was part of the endorsed package. Agreement on an **extended MoU on crisis cooperation**, incorporating the common principles, practical guidelines and voluntary specific cooperation agreements is in the process of being finalised. This should also include an agreement to employ a common analytical framework for assessment of the systemic nature of a financial crisis and its cross-border implications.



The intention is to present the new MoU to the informal ECOFIN on 4-5<sup>th</sup> March for endorsement, further to which it is intended that the extended MoU be signed at the level of Finance Ministers, Central Bank Governors and Heads of Competent Financial Supervisory Authority. The agreement is due to enter into force on 1st July 2008.

The roadmap also advocated a decision by end 2007 on whether to include an **EU-dimension in the national mandates of supervisory authorities**, i.e. a requirement to cooperate and to take into account financial stability concerns in all Member States. In December 2007, while reviewing the Lamfalussy process, the Council underlined the importance of this issue and invited the FSC and EFC to further examine this issue and to report to the informal ECOFIN in April. In the context of the CRD review, possible amendments currently under discussion ([see below](#)) would introduce an obligation to take into account the potential impact of competent authorities' decisions on the stability of the financial system in all Member States concerned. In particular this would further clarify the purpose of existing cooperation obligations in emergency situations, although it would not be a directly applicable measure creating rights for individuals.

The roadmap also recommended further work on ensuring the availability and functionality of **tools for crisis management and resolution** (e.g. emergency liquidity arrangements, interaction of national deposit guarantee schemes). The Commission has been asked to prepare a report to the FSC by the final quarter of 2008. In addition to this, as part of the Lamfalussy review the Commission is requested to report back on supervisory powers in all three financial services sectors. In this context, the Commission has addressed a letter to CEBS requesting a stocktake to be carried out on supervisory powers, which include powers in relation to re-organisation measures and other supervisory tools in crisis situations. This will complement the information already gathered by the Commission services in its consultation on the review of the Winding Up Directive.

This work is closely linked to another project included in the roadmap, looking at how to reduce barriers to **cross-border asset transferability** while retaining appropriate safeguards and possibly extending the scope of the **winding up Directive** to include insolvent subsidiaries ([see below](#)).

The EFC AHWG's report argued that as there were no specific provisions in the **State aid** or all other competition rules with respect to a crisis originating in the financial sector, a suitable, efficient and fast procedure was needed to enable the Commission to assess potential State aid measures proposed by a Member State. The report also requested clarification of when a banking crisis could be considered by the Commission to be a "serious disturbance to the economy" under the Treaty and State aid rules. In response to this request, the Competition

Directorate General submitted a paper to the EBC in February. Further discussions are planned for the next informal Ecofin.

Finally the Ecofin roadmap requested the Commission to **"improve interoperability of DGS, by removing the inconveniences in the current arrangements, and clarify the practical implications of DGS to absorb and share any financial burdens"** and report to the EBC by mid 2008. In particular, the Commission was asked to clarify the EU Deposit Guarantee Schemes Directive, especially: practical agreement and clarification of the scope of the Directive and tasks of DGS, 'topping-up', information exchange between schemes, reducing pay-out delays and improving depositor information. The Commission is working closely with the European Forum of Deposit Insurers (EFDI) on a number of issues ([see below for more details](#)).

## Review of the Winding up Directive 2001/24/EC

As a follow-up to the October 2007 ECOFIN, the Commission is requested to prepare by mid 2008 a feasibility study and by mid-2009 proposals on how to reduce barriers to asset transferability within cross border banking groups and how to further improve EU banking groups' crisis resolution and management arrangements.

To support the requested work by reviewing the Winding Up Directive (2001/24/EC), the Commission carried out a public consultation to clarify the existing treatment of cross border banking groups in a crisis situation or under reorganisation or liquidation. The consultation also took stock of legislations in the different Member States relating to obstacles to asset transfers between entities of cross border banking groups. The results of the public consultation are available on the Commission's website:

[http://ec.europa.eu/internal\\_market/bank/windingup/index\\_en.htm](http://ec.europa.eu/internal_market/bank/windingup/index_en.htm)

In the context of Commission's work on asset transferability, the European Banking Federation has set up a working group to provide further insight into possible difficulties that European cross-border groups might face in crisis situations.

A call for tender was published in February 2008 in order to involve insolvency specialist in the work. More details can be accessed on the following website:

[http://ec.europa.eu/dgs/internal\\_market/calls\\_en.htm](http://ec.europa.eu/dgs/internal_market/calls_en.htm)

The EBC will discuss this issue in depth at its next meeting in June.



## Amendments to the Capital Requirements Directive

On March 14<sup>th</sup>, the EBC met to discuss planned changes to the Capital Requirements Directive (CRD). Extensive work has been carried out in the special Commission working group (CRDWG) of Member State representatives which has made significant advances on all of the subjects under consideration, with extensive prior work having been carried out by CEBS.

There are 6 distinct areas where amendments to the CRD are envisaged:

- clarification of crisis management 'home/host' issues ([see below](#));
- adjustments to the large exposures regime ([see below](#));
- Hybrid capital instruments ([see below](#));
- trading book;
- technical changes to CRD to reduce administrative burdens;
- co-operative banks in certain member states (Article 3).

The preparation of the draft legislative texts will be based on two different legislative instruments and adopted under two different legal procedures:

1. An amending Directive, to be adopted by the Council and European Parliament through the co-decision procedure, should propose amendments on: crisis management 'home/host' issues, large exposures, hybrids, cooperative banks in certain Member States and a small part of the technical changes to the annexes (those in Annex III to which the comitology provisions do not apply);
2. An amending Directive to be adopted by the Commission under the comitology procedure, which would incorporate the trading book rules and technical changes to the CRD to reduce administrative burdens. The EBC has an important part to play in the adoption of this piece of legislation and the Draft proposals will need to be submitted to the EBC at forthcoming meetings.

Two procedures are necessary because some of the planned amendments concern the essential rules of Directives 2006/48/EC and 2006/49/EC which have to be amended by the legislative process, whereas others concern implementing measures of the essential rules, which the Commission is empowered to adopt under Article 251 of Directive 2006/48/EC and Article 41 of Directive 2006/49/EC. The procedures are summarised in the following table:

#### Procedures for the amendment of the Capital Requirements Directive

Subject	Legal instrument	Timing
Hybrid capital instruments Large exposures Cooperative banks Crisis Management' home/host' issues	EP/Council Directive in <u>co-decision</u> ('level 1')	Commission proposal October 2008.  Common position EP/Council spring 2009 Adoption 2009
Trading book Technical changes to CRD to reduce administrative burdens	Commission Directive through <u>comitology</u> ('level 2')	EBC draft text June 2008  EBC decision Sept 2008  EP/Council scrutiny Oct-Dec 2008  Commission adoption Dec 2008

#### Strengthening cooperation and coordination between supervisors

During its previous meeting on 13<sup>th</sup> November, the EBC came to the conclusion that progress in terms of asset transferability coupled with a joint responsibility and accountability framework would be key to progress on other areas of work, including deposit guarantee schemes, work on converging supervisory powers and improving the EU crisis resolution framework.

As part of the 2008 CRD review, the Commission services have suggested to underpin this joint responsibility and accountability framework in colleges of supervisors both in going concern and in crisis situations. The composition, role, tasks, and the decision-making process within colleges would be specified in the CRD. This proposal would not result in the re-allocation of responsibilities and powers between home and host authorities. Colleges would be in place to ensure that supervisors came to commonly agreed decisions in some key areas (Pillar 2, reporting). As in the Solvency II proposal, CEBS would act as a 'mediation' body in case of disagreement between home and host authorities.

To ensure that supervisors act collectively and develop common approaches across colleges, the Commission services are suggesting that the consolidating supervisor should keep CEBS informed about the activities of colleges, including in crisis situations.



To keep pace with current market developments, supervisors of systemically important branches will be involved in colleges, depending on the relevance of the issue to be discussed. Access to specific information, in particular in crisis situation, will be required by the CRD. By associating host supervisors in colleges, the Commission services do not intend to change the allocation of responsibility between home and host supervisors (of branches), but to further enhance host supervisors' access to information which may be of relevance for the financial stability.

### Large Exposures

The current CRD provisions are based on the general assumption that banks spread their exposures. However despite, this banks could be still be exposed to the same client or a group of connected clients, which could, in extreme situations, lead to the loss of the full exposure. This is referred to as a "traumatic loss" and it is the reason why existing prudential rules are complemented by a rule that limits the so-called "large exposures" to a percentage of the own funds of a bank: in effect this is a back stop regime.

The current large exposures (LE) rules are 15 years old and need to be updated. The existing LE regime has been identified as a priority area within the Commission's Action programme for reducing administrative burdens in the EU.

The Commission requested CEBS to deliver advice on the review of the Large Exposures regime in 2005-2006. CEBS consulted the industry and is due to submit and publish its advice in the near future by the end of March (<http://www.c-ebs.org/Advice/advice.htm>). On 14 March 2008 the EBC discussed the current inclusion of branches of credit institutions from third countries in the regime, the exemption of exposures to or guaranteed by government bodies, the treatment of interbank exposures and the treatment of intra group exposures.

The Commission's proposal, scheduled for October 2008, should further cover the simplification and clarification of amendments regarding the scope, the application of credit risk mitigation and the deletion of several national discretions.

### Hybrids

At its meeting on 5<sup>th</sup> March 2008, CEBS endorsed the final advice to the European Commission with respect to the treatment of hybrid instruments.

The Commission is not intending to propose a brand new definition for hybrid instruments which are eligible in banks' original own funds, but, rather, to provide guidelines for a common and clear EU-wide interpretation and implementation of eligibility criteria that hybrids must meet.

There remains only one issue on which CEBS has not been able to reach agreement: the **limits** for including hybrid instruments into banks' original own funds. CEBS has confirmed that **regulatory capital ratios should be met without undue reliance on hybrid instruments** and that 'common' shareholder funds (common shares and disclosed reserves or retained earnings) are the key elements of capital.

CEBS has put forward two options for the limits for consideration. The objective of both options is to strengthen an institution's Tier 1 capital.

The Commission Services are keen to achieve consensus on the most appropriate option, and at the meeting on 14<sup>th</sup> March requested the views of EBC members. The Commission services are still reflecting on this issue and would be ready to investigate any other option which would try to (i) take the current market structure into proper consideration, such as for example the fact that hybrid characteristics indeed influence or appeal to different groups of investors i.e. fixed-income and equity investors, while also (ii) providing the public sector comfort that common shareholders' funds should represent the key elements of capital.

## Deposit Guarantee Schemes: Work on self-regulatory issues advances

As outlined in previous newsletters, the Commission has identified six areas where further self-regulatory action needs to be developed. The European Forum of Deposit Insurers (EFDI) has achieved progress in the areas of work that has been entrusted to them.

- On the range of products and liquidity covered under national Deposit Guarantee Schemes (DGS) and on the enhancement of depositor information about schemes, EFDI's reports are being finalised.
- Regarding the possible decrease of payment delays to depositors, the Joint Research Centre gathered substantial and important data on the handling of payouts in practice throughout the EU. This information has been forwarded to EFDI, and should serve as a quantitative basis for their considerations.
- On possible shortcomings concerning the information DGS need to fulfil their tasks, an inventory of problems that have occurred and a report on which information DGS need is expected to be received by the Commission in March.
- On these issues, reports will be adopted by EFDI mid-April. Final versions of the reports are expected to be published before the summer break.
- On topping up arrangements, EFDI has carried out an inventory of existing arrangements and has been working on a list of issues that could (or could not) be improved via a voluntary model arrangement. A first draft of such a model arrangement has already been developed.



- On possible common voluntary approaches to risk-based contributions to DGS, the Commission's Joint Research Centre (JRC) has drafted a report containing factual descriptions of current approaches in Member States, which will soon be finalised. This report will then serve as a basis for EFDI to identify possible models later this year.

The JRC has also analysed the current efficiency of the schemes, and will analyse DGS processes, ranging from the initial decision about the event that triggers reimbursement to possible refinancing after an event. This work encompasses an analysis of the cost impact of banking crises and will be complemented by a scenario analysis to evaluate the efficiency of funds in case of a financial crisis. Key figures of the 2007 report on the cost impact of a possible harmonization of funding mechanisms have also been updated. The report will soon be available on the Commission's web site [http://ec.europa.eu/internal\\_market/bank/guarantee/index\\_en.htm](http://ec.europa.eu/internal_market/bank/guarantee/index_en.htm).

## Lamfalussy: clarifying and strengthening the role of Level 3 Committees

On 20 November 2007, the European Commission published a [Communication](#)<sup>v</sup> on the Review of the Lamfalussy Process. Although the process has broadly met its overall objectives, in the Commission's view some important changes are required in order to make it more efficient, in particular with regard to the functioning of the Level 3 Committees.

The Commission has suggested that the Level 3 committees should better contribute to supervisory cooperation and convergence in the EU. To this end, the Commission proposed a series of changes to the way in which the level 3 committees operate. The political accountability of the level 3 committees towards EU institutions should be reinforced. Their internal decision-making procedures should be improved by introducing qualified-majority voting. These improvements should be combined with financial assistance from the Community budget for specific EU wide regulatory projects and cross-sectoral training programmes for supervisors. The overarching need for deeper supervisory convergence and cooperation was endorsed by the Ecofin Council in its [conclusions of 4 December 2007](#)<sup>vi</sup>. The conclusions set out a roadmap that describes the actions which have been identified to improve the Lamfalussy process, including detailed timetables. Most of the actions should be implemented by 2008.

The Commission is working on clarifying and strengthening the role of the Level 3 Committees with a view to setting out concrete options to be discussed at the informal ECOFIN in April. The main objective will be to reinforce the contribution that the Level 3 Committees should make to supervisory cooperation, supervisory convergence and, possibly, to crisis prevention and management.

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[http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ecofin/96375.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/96375.pdf)

ii [http://ec.europa.eu/commission\\_barroso/president/pdf/COM2008\\_122\\_en.pdf](http://ec.europa.eu/commission_barroso/president/pdf/COM2008_122_en.pdf)

iii The European Banking Federation (EBF), the Commercial Mortgage Securities Association (CMSA), the International Capital Markets Association (ICMA), the European Association of Co-operative Banks (EACB), the European Savings Banks Group (ESBG), the Securities Industry and Financial Markets Association (SIFMA), the London Investment Banking Association (LIBA) and the European Securitisation Forum (ESF).

iv [http://ec.europa.eu/internal\\_market/finservices-retail/home-loans/integration\\_en.htm#whitepaper](http://ec.europa.eu/internal_market/finservices-retail/home-loans/integration_en.htm#whitepaper)

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[http://ec.europa.eu/internal\\_market/finances/docs/committees/071120\\_final\\_report\\_en.pdf](http://ec.europa.eu/internal_market/finances/docs/committees/071120_final_report_en.pdf)

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[http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/en/ecofin/97420.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ecofin/97420.pdf)