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CEBS contribution to the Lamfalussy review

Executive summary

Excellent progress has been achieved, and CEBS believes that the current framework can and should be exploited further to deliver more convergence in day-to-day practices and to ensure a more consistent framework for cross-border business in the Single Market.

The Lamfalussy framework has brought about substantial progress in supervisory convergence and cooperation, in a very short span of time. The independent survey launched by CEBS confirms a positive assessment of the progress made in the first years of work, but helps also to identify areas in which further improvements are needed.

In CEBS view the most relevant pressure points in the working of the arrangements are (i) the actual delivery of convergence in day-to-day supervisory practices, and (ii) the conduct of prudential supervision for cross-border groups.

Considering that the Capital Requirements Directive (CRD), on which CEBS focused most of its efforts so far, has just entered into force in 2007, it is understandable that the actual impact of CEBS work on national day-to-day practices is still perceived to be rather limited. However, this may also be partially due to the constraints CEBS faces in its work on supervisory convergence, stemming from differences in national legislation (also outside the banking field) and in national supervisory traditions, which in turn reflect long standing and stratified differences in national banking and financial markets and business practices. This might require a more coordinated action at all levels of the Lamfalussy approach, as well as a reinforcement of the mechanisms deployed at Level 3.

The increasingly integrated measurement and management of risks at the firm-wide level by several cross-border groups represents another challenge for supervisory arrangements focused on legal entities and rooted in legal and administrative instruments developed at the national level. CEBS has developed a pilot project on operational networking and intends to promote an increasingly coordinated approach to supervision of cross-border business.

CEBS intends to actively contribute to the review of the Lamfalussy arrangements by putting forward some concrete proposals to address these pressure points and improve supervisory convergence and cooperation.

Differences in national legislation and regulation represent a significant constraint to the results that CEBS can achieve in fostering supervisory convergence. The number of options and national discretions embodied in the Capital Requirements Directive is the most relevant example. ***Four concrete steps could help stepping up regulatory convergence***, thus paving the way for more effective work at Level 3:

i. *a phasing out of options and national discretions*, through a strong political commitment to limit as much as possible the recourse to such tools and the recourse to sunset clauses allowing for a reconsideration after a certain period of time;

ii. *a proper implementation of the Lamfalussy structure in banking*, which would allow for a greater role of CEBS in proposing technical measures;

iii. *the development of own initiative advice by CEBS*, supported by a structured analysis of the regulatory obstacles to supervisory convergence, to be developed on the basis of the framework for supervisory disclosure set up by CEBS.

iv. *enhanced efforts at Level 4 to ensure consistent implementation of EU law.*

As to supervisory convergence, CEBS' view is that the industry expectations have changed over time. There has been a shift from the original objective of enhanced consistency in national approaches and level playing field, to the request that the same business is subject to exactly the same supervisory treatment throughout the EU, so that country neutral arrangements could allow cross-border groups to operate as if they were subject to a single supervisor. *A clearer articulation of the notion of supervisory convergence could support a better, common understanding ex ante of what CEBS intends to achieve in each specific area of work*. In turn, this would help an effective assessment ex post of the progress made. This paper proposes three different notions of convergence: (i) *convergence in principles*, based on guidelines which leave a certain degree of flexibility in their application at the national level; (ii) *group-specific convergence*, which aims at identifying practical solutions to ensure greater consistency and a risk-based focus for the supervision of the group and its individual legal entities, while respecting level playing field for other institutions active in the same jurisdiction; and (iii) *hard convergence*, which targets country-neutral outcomes throughout the Single Market. On the basis of this classification, ***CEBS proposes three concrete improvements to deliver supervisory convergence***:

i. *a clear ex-ante definition of the convergence target and ex-post assessment of the results*, so as to promote a common understanding of the results that can (and cannot) be achieved in each area of CEBS work;

ii. *the development of new practical convergence tools*, in addition to the high level ones recommended in the Francq report: in particular, CEBS would like to develop at the EU level tools normally used at the national level to ensure consistency in the treatment of different entities (common teams of experts providing support to line supervisors, web-based facilities for implementation questions on CEBS guidelines, joint assessment teams in selected areas; …). CEBS also puts great emphasis on the creation of a common European supervisory culture through training and staff exchanges and supports the establishment of ad hoc cross-sector training structures.

iii. *the pursuance of hard convergence in a few areas*, for instance in the definitions and formats to be used for supervisory reporting.

The efforts on supervisory cooperation should also be stepped up, through an appropriate development of the operational networks. CEBS is committed to take further steps to ensure a smooth functioning of the colleges of supervisors and more consistency in the supervisory approaches applied to cross-border groups in the Single Market. Specific proposals will be further developed at the end of 2007, when the test phase for the pilot project on operational networking launched by CEBS will be completed. But CEBS is also committed to enhance cooperation and exchanges of information at the multilateral level, building upon the positive experience of the confidential discussion on the supervisory concerns spurred by the US subprime crisis. These efforts should develop CEBS into an efficient hub for multilateral cooperation whenever needed, also by more extensive resorting to teleconferencing and web-based facilities. A third area for work on supervisory cooperation is ***crisis management***, where CEBS is further developing the concept of operational network, extended to encompass the relevant authorities and endowed with additional practical tools.

As CEBS is expected to play an enhanced role in fostering convergence and cooperation and to have a greater impact on national practices, ***some enhancements to its mandate and status might be considered***. The lack of any reference to CEBS in Community legislation and the predominant focus of the Commission's decisions establishing CEBS on its advisory role do not adequately reflect the very high responsibility entrusted to the Committee in fostering supervisory convergence and cooperation. A reinforced mission statement, endorsed by all EU institutions and coupled with explicit reference to CEBS in Community legislation, would provide a better basis for the Committee's work. A strong political backing and a better policy steer might provide useful support to the process. Accountability should be accordingly enhanced and formally extended to all EU institutions, while respecting the operational independence of supervisors. The possibility of financing CEBS activities from the EU budget might be considered, but such funding should in any case be limited to specific projects requested by Community legislation or recommendations from EU institutions.

The quality of Level 3 tools and their ability to deliver a genuine European benchmark for convergence could benefit from changes in the decision making process. ***CEBS maintains that Level 3 tools should remain not legally binding. However some possibility for qualified majority voting for the adoption of Level 3 tools could be introduced as part of a package with peer review procedures, a "comply or explain" mechanism, mediation and application of impact assessments***. A clear definition (and possibly differentiation) of Level 3 tools (standards, guidelines and recommendation), consistent across sectors, could also be of help. Although none of standards, guidelines and recommendations would be enforceable in legal terms, there could still be some graduation in the degrees of freedom left to national authorities and in the dispersion of the expected results, in relation, for instance, to the notions of convergence mentioned above.

Introduction

CEBS has discussed the working of the Lamfalussy arrangements in banking, including assessing its strengths and weaknesses and intends to contribute to the present debate on the Lamfalussy arrangements with a set of forward-looking proposals, to be considered by the Inter-Institutional Monitoring Group (IIMG) and EU institutions. *This note sets out CEBS' views and proposals along the following lines:*

- Section 1 quickly recalls the progress made so far and the work under way, as we think that before discussing any improvement it is essential to recognise that a huge, genuine effort has been put by EU supervisors in this endeavour, in our view with remarkable results;
- *Section 2 identifies what in CEBS' views are the main pressure points, which require actions* by EU institutions and CEBS;
- Section 3 *puts forward several concrete proposals for improvements*. In particular, it is argued that there is a need to further elaborate on the notion of convergence in order to have a common understanding on which concrete objectives CEBS' efforts are intended to achieve.

CEBS and its sister committees CESR and CEIOPS, place a great deal of emphasis on the need to strengthen supervisory convergence and cooperation also across sectors of financial activity. The present note has to be read in conjunction with the 3L3 medium term work programme that the three Committees have elaborated and which will also be submitted to the IIMG and EU institutions in the coming month.

1. Progress so far and efforts under way

The progress made by CEBS in a very short span of time is indeed very substantial. The amount of work has been daunting: in three years and a half of activity CEBS has published 16 consultation papers. Up to 230 meetings of experts from supervisory authorities took place, and more than 30 meetings with market participants and other interested parties. If these figures, by themselves, cannot be interpreted as evidence of progress, they do indeed provide evidence of effort and commitment to the EU process by all national supervisors.

In order to get a more objective assessment of the progress achieved, CEBS conducted an on-line survey, open to all interested parties. The survey provides a positive general assessment of the progress achieved in the first three years of activity.[1] The survey also highlights areas in which CEBS could and should do better: efforts should be put in striking the right balance between principles and detailed rules; room for improvements exist in the conduct of public consultations; CEBS should also strive to deliver more tangible results for consumers of banking services; last, but not least, the impact on national day-to-day practices is still seen

[1] The survey highlights that:

- all representatives of EU institutions and more than 70% of the industry respondents assessed CEBS' performance in meeting its objectives as very or fairly good;
- more than 70% of the respondents considered that CEBS contributed effectively to the emergence of European good practices;
- around two thirds of market participants praise the quality of CEBS' papers;
- more than 60% of market participants (and all respondents from EU institutions) believe that CEBS contributed a great deal or a fair amount to the goal of building a fully integrated EU financial market;

CEBS is seen as successfully addressing the principle of proportionality, which is key in addressing the diversity of the EU banking sector.

as limited. CEBS is working to follow up on all these points. The next section will elaborate in particular on the last one, which is essential for the actual delivery of supervisory convergence, one of the core tasks of CEBS.

If we consider that the Capital Requirements Directive (CRD), on which CEBS focused most of its efforts so far, has just entered into force in 2007 (and for advanced approaches will only be applied from January 2008 onwards), it is indeed early times to assess the success (or failure) of the arrangements. Besides the concrete results achieved, attention should be paid also to the working of the process, to the interaction with market participants and other interested parties, to the ability to move forward and to generate trust, mutual reliance and networking capabilities of supervisory authorities. On all these grounds, CEBS considers the progress made very significant. In particular CEBS has created a *framework for supervisory disclosure* to facilitate meaningful comparisons of supervisory rules and practices across Europe, as required by the CRD. The framework is intended to increase transparency by making it easier to compare national texts that implement the CRD and related supervisory practices. It also allows comparing the ways in which Member States exercise the options and national discretions available to them in the CRD. In addition, the framework enables institutions to compare the criteria and methods used in the supervisory review process. Finally, it provides aggregate statistical data on key aspects of implementation of the CRD.

CEBS has also initiated a project on operational networking, which is presently in a test phase with a sample of 10 banking groups with significant cross-border business. This project intends to collect and address practical issues emerging in the implementation of the CRD and related CEBS' guidelines It provides an infrastructure supporting enhanced exchange of information and experiences between consolidating and host supervisors of cross-border groups, creating a stable connection between colleges of supervisors and providing a multilateral setting for addressing issues in a more coordinated fashion throughout the EU. In this and other projects a number of tools (web forums, staff exchanges, implementation questions, surveys of good supervisory and market practices, etc.) are being elaborated to promote the emergence of common approaches through time. Although it is early days to assess the contribution the operational networking project could bring to enhancing supervisory cooperation and convergence, CEBS is confident that in the medium to long term it could have a very significant impact on the effective working of the present institutional arrangements.

More generally, the scope and intensity of bilateral and multilateral cooperation between EU supervisors dealing with major cross-border groups increased substantially under the guidelines issued by CEBS, and facilitated by the improvement in mutual understanding favoured by CEBS structures.

Finally, there is a lot of work under way in implementing the recommendations of the report of the Financial Services Committee on financial supervision (the so-called Francq report). For example, CEBS has been working on developing a mediation mechanism, which should assist, inter alia, in help addressing differences in the application of Level 3 tools. *CEBS supports the analysis and the recommendations of the Francq report and considers that their implementation could have far reaching effects on the ability of the Lamfalussy arrangements to meet expectations*. Any new requests on Level 3 Committees should carefully avoid imposing a diversion of resources from the fulfilment of the tasks identified by the Francq report.

2. Pressure points

The positive assessment of the progress made thus far does not imply that CEBS is content with the status quo. The experience of the first three and a half year of work highlights that improvements are warranted and indeed possible.

As the arrangements have started to produce results, key stakeholders (industry, EU institutions and supervisors themselves) have developed increasingly ambitious expectations on what the process is expected to deliver. The Lamfalussy review provides a unique opportunity to refocus and sharpen the objectives and achieve a shared view amongst all interested parties on the concrete outcomes the present arrangements should deliver in the medium term.

The starting point should be an in-depth analysis of the pressure points in the working of the arrangements. In banking, the attention should focus on

- *the actual delivery of convergence in day-to-day supervisory practices, and*
- *the conduct of prudential supervision for cross-border groups.*

2.1 The actual delivery of convergence in day-to-day supervisory practices

The CEBS' survey shows that the quality of CEBS' guidelines is praised and the approach adopted to achieve convergence is appropriate. Yet, *the actual impact on national day-to-day practices is still perceived to be rather limited*. A number of factors may be at work, which explain the view expressed in the survey:

- First, national regulations – including differences in the implementation of Community legislation - can impose significant constraints on the possibility of changing national practices. Differences in national legislation are beyond the reach of CEBS and call for activity at Level 4 of the Lamfalussy framework. In several instances, regulatory differences reflect more fundamental differences in company law and tax regimes, which affect the way in which banks operate.
- Second, there are significant and stratified differences in national banking sectors, financial markets and supervisory traditions, which impinge on the approach adopted by each authority in a number of areas: the dividing line between prudential legislation, administrative rules and supervisory practices varies across Member States; different modalities of interaction with supervised entities are relied upon (e.g., informal tools based on dialogue vs. more formal administrative tools); principles-based vs. rules-based approaches; combination of off-site surveillance and on-site inspections; reliance on external auditors or on-site examiners from the supervisory authority; reliance on quantitative early warning tools, peer groups analyses and statistical techniques, with the related implications in terms of data requirements from supervised entities; policies for corrective action; attitude towards bailing out ailing institutions; integration between prudential and conduct of business supervision; etc.

The use of Level 3 guidelines to foster convergence in supervisory practices, if not accompanied by additional efforts and mechanisms, may not be always sufficient in achieving a satisfactory reduction in this dispersion of outcomes, at least in the very short term. Supported by the unanimous position expressed by industry bodies in the consultation processes, CEBS has relied mostly on principles-based guidelines, which leave room for national variation. Guidelines adopted by consensus may be constructed so as to embrace a wide spectrum of national practices, acknowledging the present variety in banking structures, financial markets and supervisory approaches. This may not result in the development of a truly European benchmark.

In some areas, more market driven process of convergence could prevail, with pressure on national authorities to remove certain competitive disadvantages for national players. It cannot be ruled out that the result might be a convergence to lower standards.

2.2 The conduct of prudential supervision for cross-border groups.

One of the challenges for supervisors is to keep pace with the increasingly integrated risk management practices at several cross-border groups. The issue is well known: some banking groups tend to operate as unitary organisations and to blur the distinction between branches and subsidiaries, by centralising some functions at the parent level and outsourcing other tasks to subsidiaries (or even outside the group). In normal business conditions, where groups are well capitalised and possess abundant liquidity, this poses few, if any, problems. If liquidity is scarce, or if capital may become inadequate, the distinction between branches and subsidiaries matters – both to the holders of liabilities, such as deposits, issued by the specific entity, as well as to the regulators and supervisors of the subsidiaries and the group as a whole.

The misalignment between legal and operational structures raises potential concerns in terms of both effectiveness (i.e., ability to identify and address prudential concerns) and efficiency (i.e., administrative costs for both supervisors and supervised entities) of the supervisory arrangements. Community legislation already acknowledges and addresses this issue: the requirements on home-host cooperation and the coordination responsibilities of the consolidating supervisors have been significantly reinforced by the CRD. CEBS further fleshed out these provisions in its guidelines, aiming at a well structured and integrated process for the supervision of cross-border groups. In order to ensure that the CRD provisions and CEBS' guidelines deliver the expected results, CEBS has recently launched the project on operational networking mentioned above, aimed at identifying and addressing practical implementation issues in this area, focusing its attention on a sample of banking groups with significant cross-border business within the EU.

Notwithstanding these efforts, there is still a gap between the expectations of some market participants and the progress actually achieved by CEBS in delivering a more unified supervisory process for cross-border groups. Certain industry representatives appear to expect that CEBS should deliver a supervisory process that eliminates the distinction between branches and subsidiaries. Such a result is outside CEBS' reach, as it would require a fundamental rewriting of banking legislation, as well as insolvency law, which would in fact make subsidiaries equivalent to branches and modify the allocation of responsibilities accordingly. Also calls for a single supervisory review process at the group level are not consistent with the present legal setting, as established in the CRD, which envisages a more coordinated approach within supervisory colleges. More generally, proposals to establish a lead supervisor model raise serious concerns of a possible disconnect between the jurisdiction of supervisory responsibilities and the area in which a banking failure would impact, which might generate incentive problems and conflicts of interests and raise legal liability issues and level playing field concerns. However, different views on the optimal model should not prevent achieving concrete progress on practical issues. CEBS has engaged in a dialogue with the platform of banks involved in the operational networking project and believes that mechanisms to clearly identify, prioritise and address practical issues should be further developed, with a constructive effort from all interested parties.

There is also agreement that *the arrangements for preventing and managing crises with potential cross-border effects have to be enhanced*. In close cooperation with the Banking Supervision Committee of the ESCB, CEBS has further elaborated on the Memorandums of Understanding (MoUs) between banking supervisors, central banks and finance ministries with a view to tightening the arrangements for cooperation and information exchange, with a special focus on cross-border groups. And, during the recent turbulent market conditions, home and host country supervisors have effectively worked to develop together appropriate supervisory measures within short time frames – in many cases within the same day. In addition, there has been effective and close cooperation between the supervisory authorities, central banks and finance ministries within and across Member States as well as with third countries, such as the United States and Switzerland. The EFC has suggested means for further enhancement of supervisory coordination and cooperation in a crisis situation, which will require further work.

3. CEBS' proposals

In order to address the pressure points identified in the previous section CEBS is of the view that *it is necessary to elaborate further on the notion of convergence*. First, it is important to distinguish between *regulatory and supervisory convergence*. Second, all CEBS stakeholders should have a clear view of the outcome that could be expected from CEBS work on supervisory convergence.

The following step consists of elaborating concrete proposals to enhance *supervisory cooperation*.

Finally, if CEBS work has to be enhanced, some consideration should be given to the *need to reinforce CEBS' role* in the Lamfalussy architecture and to *improve CEBS' working processes*.

3.1 Regulatory convergence

The whole debate on the Lamfalussy arrangements seems to be focused on Level 3, while the other levels are assumed to be achieving their main objectives and performing optimally. While this assumption is probably right with reference to the ability of the Lamfalussy approach to increase the quality of Community legislation and the transparency of the rule-making process, with extensive consultations and engagement of interested parties, it is not evident that the degree of consistency achieved across Member States is completely satisfactory. As already highlighted by CEBS and its sister committees, inconsistencies in the national rulebooks can still represent a significant constraint on what can be achieved at Level 3. Differences in national legal implementation are beyond CEBS` reach and call for activity at Level 4.

Furthermore, in some cases Level 3 might be asked to address inconsistencies or options that have been consciously inserted in Level 1 or Level 2 measures (e.g., national discretions). This could possibly generate a misplaced allocation of responsibilities for the failure of the Lamfalussy approach to deliver a fully consistent regulatory and supervisory framework. The lack of regulatory convergence may represent a serious constraint on the ability of CEBS to deliver supervisory convergence in day-to-day practices.

Concrete proposals to strengthen regulatory convergence

(i) <u>*Phasing out of options and national discretions*</u>: the Commission has already agreed on the need for further work on the options and national discretions included in the CRD and has mandated CEBS to work in this area. While CEBS is actively contributing to this exercise, some medium term solutions should also be considered. For instance, a strong policy commitment to introduce options and national discretions only when absolutely needed to smooth the transition to the new regulatory setting should be considered. It might also be considered *introducing options and national discretions in Community legislation only through provisions subject to a standard sunset clause*, which would allow for a reconsideration and possible elimination after a relatively limited period of time (e.g., three years).

(ii) <u>*Properly implementing the Lamfalussy structure in banking*</u>: Community legislation in banking is still pre-Lamfalussy, although a distinction between Level 1 and Level 2 is implicitly adopted through the list of articles subject to comitology procedures. The lack of a clear Lamfalussy structure creates some difficulties, for instance in implementing the better regulation agenda in banking. Several areas of legislation on which CEBS has been mandated to work (e.g., large exposures rules), contain both general policy principles and very detailed technical rules. Under the present arrangements it is not always clear how the consultation process should be best organised and how an impact assessment should be structured, with a confused division of labour between the Commission and CEBS. Frequently, CEBS has worked under very tight deadlines, which have not allowed for proper consultation. This has also affected the not entirely positive feedback received by CEBS on consultation practices. A *short term solution*, which CEBS proposed in a letter to the Commission, would be to come to a *clear ex ante agreement in each Call for Advice on the dividing line between policy principles and technical details*. On the former, CEBS should be requested to provide supervisory input, while the responsibility for public consultation and impact assessment would primarily lay with the Commission. On technical details, on the contrary, CEBS should be left enough time and scope to conduct extensive consultations and conduct cost-benefit analyses and impact assessments as appropriate. *In the longer term, a cost-benefit analysis should be conducted to assess the need for a comprehensive reshuffling of banking legislation according to the Lamfalussy framework*.

(iii) <u>*Developing own initiative advice*</u>: CEBS intends also to develop in the future own initiative advice, indicating to the Commission possible areas in which the degree of regulatory convergence is not satisfactory and impedes progress in the pursuance of convergence in supervisory practices. The information collected through the supervisory disclosure framework, coupled with a structured dialogued with interested parties, could support CEBS' effort.

(iv) *enhanced efforts at Level 4 to ensure consistent implementation of EU law*: as pointed out by the Inter-Institutional Monitoring Group (IIMG) the enforcement of Community legislation is essential to make sure that the desired degree of harmonisation has been achieved.

Proposals (i), (ii) and (iv) would require actions from EU institutions, while proposal (iii) could be autonomously adopted by CEBS.

3.2 Supervisory convergence

CEBS' view is that the expectations about the desired degree of convergence have changed over time. There has been a shift from the original objective of enhanced consistency in national approaches and level playing field, to the request of some market participants that the same business is subject to exactly the same supervisory treatment throughout the EU, so that country neutral arrangements could allow cross-border groups to operate as if they were subject to a single supervisor.

In fact, *more work should be done to better define the desirable degree of convergence, which may vary across different supervisory practices*. We propose a three-pronged approach:

- *Convergence in principle*. This is and would remain the main approach applied by CEBS for implementation of Community legislation. It is based on the issuance of guidelines which allow national authorities some discretion in application, so as to tailor the supervisory approaches to the specific features of local markets, business practices and supervisory traditions. The approaches adopted by national authorities would be subject to supervisory disclosure, so as to allow for cross-country comparisons and identification of remaining convergence issues. Peer review would be the main tool to review the practical application of the guidelines. National authorities would be expected to "comply or explain".
- *Group-specific convergence*. Convergence in principles might need to be reinforced in specific areas by "group-specific" convergence, aimed at identifying practical solutions to ensure greater consistency and a risk-based focus for the supervision of the group and its individual legal entities. This convergence should be pursued within supervisory colleges, through multilateral and bilateral efforts, under the coordination of the consolidating supervisor. Operational networking should enable CEBS to compare experiences across different cross-border groups and to address possible consistency issues. The scope of such convergence should be carefully calibrated in order not to generate level playing field issues for banks operating in the same jurisdiction.
- *Hard convergence*. In a few areas anything short of completely country-neutral approaches would fail to deliver the necessary degree of convergence. In such areas Level 3 work should aim at developing standards that are consistently adopted by all national supervisors, or even develop mechanisms for joint supervisory assessments (as it has been done for instance for the recognitions of External Credit Assessment Institutions – ECAIs – under the CRD).

CEBS believes that the assessment of the progress achieved by the Lamfalussy arrangement would greatly benefit by a clear common understanding of which type of convergence is desirable in different areas of work. It is important to stress that achieving convergence is costly and might require distraction of scarce resources from the pursuance of other tasks. The three different notions of convergence imply a different amount and distribution of adjustment costs. Hard convergence, or complete standardisation, would imply very high adjustment costs, especially for supervisory authorities. While for cross-border groups in most cases the benefits would probably outweigh the costs, this would not be the case for more local players. Group-specific convergence would in all likelihood leave some additional administrative costs for cross-border groups to bear, while imposing lower adjustment costs on supervisors; it would have an ambiguous indirect impact on local players, who would not be directly affected but might have to compete with cross-border players subject to somewhat different treatments. Convergence in principle would produce more gradual results and dilute adjustment costs through time, but might preserve a rather complex and potentially costly compliance process for cross-border business.

The policy choice on the desirable degree of convergence is also going to affect the pace and direction of change towards developing a more coherent and integrated approach to banking supervision, thus *<u>addressing differences in national supervisory traditions</u>*. For instance in the late 1970s the US decided to achieve "hard convergence" in the supervisory practices of their various banking agencies in a limited number of areas: the Federal Financial Institutions Examinations Council (FFIEC), composed of all the Federal agencies, was allocated the responsibility of directly organising the training for examiners and prescribing uniform principles, standards, and reporting forms for the federal examination of financial institutions. The agencies also closely cooperate in the supervision of groups under their joint responsibility, for instance by conducting joint examinations. Convergence in other areas was left to the cooperation between authorities, which do issue through the FFIEC joint guidance when needed.

CEBS is committed to continue and intensify its efforts to create a common European supervisory culture, by supporting common training and exchanges of staff. A common platform for training is being established together with CESR and CEIOPS. This could require dedicated structures.

Concrete proposals to enhance supervisory convergence

(i) *<u>Ex-ante definition of the convergence target and ex-post assessment of the results</u>*: in its work programme, and then in each product, *CEBS should state clearly the desired degree of convergence it intends to achieve*. Reference to the definitions of convergence put forward in the previous section might help in this respect. Dialogue with the industry and formal consultation processes, together with regular reporting to EU institutions, should help in making sure that there is enough agreement on the desired outcome of each product in terms of convergence. Ex post, CEBS should rely on peer review to conduct rigorous assessments and make sure that the original target has been achieved. Accountability exercises should also reinforce the external monitoring on the results achieved. In some cases, measurable target could be of help.

(ii) *Development of new practical convergence tools*: *new practical tools, in addition to the high level ones already identified in the Francq report, should be developed to support day-to-day supervisory convergence*. CEBS is already devoting a lot of efforts in this direction and would appreciate wider support. These practical convergence tools should be based on processes already in place at the national level, to ensure similar treatment and equivalence of outcomes in the application to different entities of supervisory instruments requiring some degree of discretion and judgement. Networks of national supervisory experts in different areas of expertise (*convergence networks*, in CEBS' jargon) should ensure continuous dialogue on technical issues and ability to provide common responses to similar practical supervisory issues. *Good practices papers* should be developed to complement CEBS' guidelines. These papers could be coupled with web-based facilities for *implementation questions*, so that a response given to a bank on the suitability of a certain business approach would be visible also to other banks and ensure a common understanding on the appropriate reading of CEBS' supervisory guidance. In some areas, *joint assessments* by teams composed of supervisors from different national authorities could also help in ensuring convergence. This has been already tested in the assessment of rating agencies' applications for recognition of their ratings under the CRD in various EU countries. Similar approaches are being discussed for the analysis of economic capital models. All these tools should gradually develop CEBS into a sort of "*virtual organisation"*, fully decentralised but able to perform some functions in a more joined up fashion, and through common structures and processes, whenever needed. Particular attention should be devoted to common training and staff exchanges, to foster a common European supervisory culture. *CEBS would support dedicated structures for training at 3L3 level.*

(iii) *Aiming at hard convergence in selected areas*: so far CEBS has worked mainly through guidelines, to achieve "convergence in principles". In some areas, these efforts have produced tangible progress, but CEBS acknowledges that in some cases the convergence objectives have been only imperfectly achieved. For instance, supervisory reporting is one area in which more progress should be made, and one in which CEBS commits itself to make progress. Cross-border groups have rightly complained that national authorities define data elements differently and do not coordinate their data submission deadlines. This raises costs for cross-border groups and hampers authorities' ability to amalgamate data and/or draw cross-border comparisons among banks. CEBS commits itself to rectify these deficiencies by implementing uniform reporting for credit institutions, in the sense that data elements shall have the same definition in each Member State. Any new proposal in this area will be subject to Impact Assessment according to the methodology currently under development by all three Level 3 committees.

All these proposals could be implemented by CEBS, but some form of support from EU institutions and acknowledgement in a revised mandate for the Committee would provide enhanced impetus. The proposal for a common 3L3 training platform might have financial implications, for which financing from the EU budget might be considered.

3.3 Supervisory cooperation

The CRD contains many provisions that require a great deal of supervisory cooperation among supervisors. CEBS has set up a general framework for enhancing bilateral and multilateral supervisory cooperation in EU, which is being extensively tested in the application of CRD provisions. Several structures have been working to assist in ensuring smooth home-host cooperation and discuss issues of common interest, with a view to identify consistent ways forward. To some extent, CEBS' operational networks represent the farthest reaching cooperation exercise between supervisors. The project provides an infrastructure that supports an enhanced exchange of information and experiences between consolidating and host supervisors of a sample of cross-border banking groups. It intends to create a stable connection between colleges of supervisors, thus providing a multilateral setting for identifying concrete issues in a more coordinated fashion throughout the EU. The operational networks are in the test phase and a final assessment will be made in December 2007. This assessment might lead to an extension of the project to a wider sample of banks and to the strengthening of the process, with the identification of more specific deliverables within a given timeline. At this stage, it is difficult to elaborate further on the possible development of the project, which has to be based on clear evidence collected during the test phase.

Cooperation arrangements between supervisors in charge of a specific cross-border group are only one aspect of the efforts CEBS has to put in place. Multilateral cooperation and exchange of information within the Committee and its working structures are at least as important. The recent turmoil in money and financial markets spurred by the US subprime crisis has been an important test. Intense bilateral exchanges of information have been coupled for the first time with a detailed confidential discussion at the multilateral level. The sharing of quantitative and qualitative information in this case provides a useful starting point on which the Committee should build further.

Concrete proposals to strengthen supervisory cooperation

(i) *Further developing operational networks*: the operational networking project so far has been in a test phase, focused on a limited sample of groups and exclusively on issues arising in the implementation of the CRD and CEBS' guidelines to cross-border groups. It is common understanding among CEBS members that the project has an enormous potential and needs to be further developed with a view to achieving broadly congruent supervisory outcomes for cross-border groups, in a cost effective, risk based and proportionate manner. The numbers of groups could be extended; the focus could shift to the joint assessment of risks and to a more structured and regular exchange of information. Specific suggestions will be put forward by the end of 2007.

(ii) *Reinforcing cooperation for crisis management*: CEBS and the BSC are proposing to adopt a "variable geometry" setting for the operational networks, which would envisage a selected group of relevant supervisory authorities and central banks to address regularly in an ad hoc format financial stability issues. In accordance with the work of the Economic and Financial Committee, such groups should be extended to representatives of relevant finance ministries as appropriate.

(iii) *Developing CEBS' role as a hub for multilateral information exchange*: in the past, the Groupe de Contact has developed confidential exchanges of information on supervisory issues. This function has been downsized recently, due to the focus of the CEBS and all its substructures on the implementation of the CRD. Such function should be further developed in the future, also by resorting to teleconferencing and web-based tools.

All these proposals could be implemented by CEBS, but some form of support from EU institutions and acknowledgement in a revised mandate for the Committee would provide enhanced impetus.

3.4 A strengthened role for CEBS within the Lamfalussy architecture

CEBS has been entrusted with significant tasks and the degree of ambition on what it is requested to deliver is always increasing. At the same time, CEBS is a private company limited by guarantee under English law and it is even questionable whether CEBS could be mentioned in Community legislation: for instance, the framework for supervisory disclosure is definitely an accomplishment of CEBS, but it is based on a CRD requirement imposed on Member States, as the legal services of the Commission maintained that Community legislation cannot impose requirements on a private company resident in one country of the Union.

A change in the legal status of CEBS, for instance its transformation into an EU agency, would not fit within the present structure of the Lamfalussy-framework and the non legally binding nature of Level 3 products. In addition, it would raise several concerns in terms of operational independence of supervisory authorities. But *CEBS would welcome some form of enhancement of its role. This could be accomplished for instance through the issuance of a new mandate, rebalanced to acknowledge the relevance of Level 3 work and endorsed by all EU institutions, and via express reference to CEBS' tasks in Community legislation.*

The Commission decision of 5 November 2003 establishes CEBS as an independent advisory group. Notwithstanding references to the Committee's tasks of fostering convergence in supervisory practices and enhancing supervisory cooperation and exchanges of information, the advisory task is predominant. Accordingly, the accountability framework refers only to the Commission, although CEBS regularly reports on the progress achieved to the Committee on Economic and Monetary Affairs (ECON) of the European Parliament and to the Council's Financial Services Committee.

Similarly, Community legislation in banking contains a number of requirements on supervisory cooperation, but CEBS is never mentioned as a relevant party. Specific reference to CEIOPS has been included in the recent Commission proposal on Solvency II. The EFC report "Developing EU Financial Stability Arrangements", recently approved by the ECOFIN Council, recommends to clarify the existing obligations to coordination and information sharing and to examine possible improvements. This review could provide an opportunity to flesh out a precise role for CEBS in Community legislation, for instance by mentioning its role in supporting the development of operational networks and in fostering consistency in approaches for the supervision of cross-border business.

If CEBS' role were to be enhanced along these lines, *it would be important to ensure that accountability mechanisms are put in place vis-à-vis all EU institutions*. High level political statements supporting the progress and putting pressure on Lamfalussy structure to meet expectations would be useful. CEBS is presently receiving recommendations for progress in Level 3 work from several sources: some rationalisation of the process would be welcome. The coordination of EU institutions in setting high level political priorities for CEBS should be coupled with more formal accountability mechanisms, allowing for a rigorous and open process to assess the ability of the Committee to achieve its objectives. At the same time, CEBS would like to stress that its operational independence should be fully recognised, so as to avoid any undue interference from the political sphere or the supervised entities. If external bodies were in a position to dictate detailed work programmes and operational priorities, there would be a risk of biasing the ability of supervisors to identify what is needed for the effective conduct of their tasks.

CEBS is presently funded by its members and so far this has not resulted in any major constraint to CEBS' activities. However, if in the future CEBS will be requested by Community legislation or recommendations of EU institutions to initiate projects with considerable funding implications, the possibility of funding such projects out of EU budget might be carefully considered.

CEBS understands that the requests to upgrade Level 3 tools by making them legally binding are aimed at ensuring a more direct impact of CEBS' work in day-to-day national practices. However, such a development would create serious concerns: it would *de facto* generate an additional layer of rules, conveying the impression that the Lamfalussy process increases regulatory burden instead of streamlining supervisory processes; CEBS would be transformed into a rule-making body, thus raising complex issues of accountability; thorny enforcement questions would arise. *CEBS favours that Level 3 tools remain in the realm of soft law and draw their force from the reputation of the Committee, the technical quality of its work and the commitment of members to implement CEBS' guidance. Compliance should be assessed through a transparent peer review process, coupled with a "comply or explain" mechanism.* Interested parties would, therefore, be in a position to assess the reasons for non implementation and, where appropriate, bring pressure to bear on the supervisory authority concerned. Such tools should be explicitly mentioned in CEBS' Charter.

At the same time, it is possible and maybe desirable to distinguish between CEBS' products that are *inward* and *outward* oriented. It would definitely be inappropriate to attribute binding character to CEBS' guidance addressed to market participants; as such obligations could be created only with enforceable tools. But CEBS' work dealing with supervisory processes is directly addressed to CEBS members and could therefore be accompanied by a stronger expectation that each member sticks to the "club rules". Such inward oriented guidance could be more detailed and explicit in imposing behaviour that members commit to adhere to.

If these tools proved unable to ensure sufficient compliance with CEBS' guidance to achieve the desired level of convergence, the Commission could consider whether other tools, including Community legislation, should be used to ensure greater consistency of outcomes within the Single Market.

The Lamfalussy report and the related wording in CEBS' Charter refer to three types of Level 3 tools: *standards, guidelines and recommendations*. It might be useful to further elaborate on, and maybe differentiate amongst, these instruments, with a view to distinguishing the type of "implementation" that is expected by members and the effects the tool is expected to generate. Although none of them would be enforceable in legal terms, there could still be some graduation in the degrees of freedom left to national authorities and in the dispersion of the expected results, in relation, for instance, to the notions of convergence developed above. A clearer and more standardised structure for Level 3 tools should be defined. For example, each product should clearly state to whom it is addressed, the core objective to be achieved and the proposed mechanisms to do so. This should assist external parties to better understand CEBS' products (and their limits).

Concrete proposals on CEBS' role, tasks and tools

(i) *Enhancing CEBS' role*: the mandate of CEBS could be revised through appropriate decisions from all EU institutions spelling out in greater detail the Committee's role and task. The Committee's role should be mentioned also in Community legislation, for instance where cooperation obligations and supervisory disclosure requirements are set out. Political statements from EU institutions could define clear high level priorities for CEBS' work, thus facilitating a transparent process for assessing the progress made.

(ii) *Strengthening the accountability mechanisms*: the enhancing of CEBS' role and the specification of its tasks should be coupled with accountability mechanisms vis-à-vis all EU institutions. Reinforced accountability should be respectful of the operational independence of supervisors.

(iii) *Opening the possibility of funding from EU budget for specific projects*: when CEBS is requested to initiate resource intensive projects in Community legislation or by recommendations of EU institutions, the possibility to rely on EU budgetary support should be considered.

(iv) *Better focusing Level 3 tools*: Level 3 tools should not become legally biding. The decisions sharpening the Level 3 tasks of CEBS could differentiate between the three types of tools defined in the Lamfalussy report (standards, guidelines and recommendations), better clarifying what they are expected to achieve and associating different tools to different notions of convergence.

All these proposals would require initiatives from EU institutions. The latter - proposal (iv) – could be adopted by joint decisions of all of the Level 3 Committees, but a clearer definition of Level 3 tools in a revised mission statement issued by EU institutions would give greater strength and focus to the tools.

3.5 An improvement of CEBS' working processes

A greater contribution to supervisory cooperation and convergence might stem also from improved working processes at CEBS, touching upon decision making mechanisms, the commitment of national authorities to the EU objectives and the dialogue with interested parties.

3.5.1. Decision making mechanisms

So far CEBS has always strived to endorse its work by consensus. This has proved very valuable, as it has ensured strong involvement and sense of ownership by all members, which has been essential in the start up phase of the Committee. However, it is acknowledged that working by consensus may sometimes constrain the ability to achieve a true European benchmark.

With reference to the advisory function, there is agreement that CEBS should *issue regulatory advice based on qualified majority voting (QMV), giving proper account also of the minority positions expressed*. This is already possible in the present setting and is already done in CESR. Reliance on QMV for advice would not raise any enforceability concern, as the Commission would be provided with the reasoning of the majority and the minority of CEBS members and the usual decision making mechanisms for approving Community legislation could be relied upon.

The recourse to QMV for Level 3 tools is less straightforward, as Level 3 tools would still remain not enforceable and national authorities would still have the possibility to implement them partially or not at all. CEBS intends to continue to work by consensus as far as possible, but supports introducing some possibility for QMV decision making at Level 3. Strengthened decision making mechanisms should be in a package with peer pressure mechanisms, such as peer review and "comply or explain". The possibility to activate a mediation mechanism should also help addressing differences in the application of Level 3 tools. The adoption by QMV would not alter the non-legally binding nature of Level 3 tools.

3.5.2. EU statement in national mandates

It might prove difficult to achieve convergence and enhanced cooperation by acting only at the EU level: the remit of national authorities should also be considered, with a view to achieving a better interlocking of European and national objectives. *The proposal to introduce EU-wide objectives in the mission statements of national supervisors could therefore be considered, albeit the decision to implement this goes beyond CEBS' remit*. This could help bridging the gap between national authorities' and CEBS' objectives. The statements should refer to the objectives of supporting convergence of supervisory practices and cooperation at the EU level. A specific reference could be introduced also to the cooperation and exchange of information in the prevention and management of crisis with potential cross-border effects. However, before deciding on possible extensions of the mission statements of national supervisors, a careful analysis of the practical and legal consequences, in particular with reference to the liabilities of supervisory authorities, should be carried out. *At the same time, a revised CEBS mandate could say expressly that the Committee is requested to contribute to the pursuance of the safety and soundness of the local banking sector by national authorities.*

3.5.3. Coordinated definition of priorities and possibility to "opt in"

Further initiatives could contribute to generating a closer interconnection between the work of the Committee and that of its member organisations. For instance, ad hoc meeting could be established before the drafting of CEBS work programme to exchange information on national agendas for the coming year and the medium term. This should allow a better coordination of CEBS agenda with that if its members. This request was raised by CEBS Consultative Panel. Moreover, also during the year, CEBS members could be requested to open up their national initiatives to other members, who could for instance comment on consultation papers and then "opt in" to the new tools, thus producing reinforced convergence also on a strictly voluntary basis

3.5.4. Dialogue with interested parties

CEBS is putting a great effort in enhancing the dialogue with all interested parties. So far it has been rather difficult to engage consumers in contributing to CEBS' work, due to the predominant focus on prudential matters, which are mostly of indirect relevance for end-users of financial services (although this could well become very direct in case of stress). It is crucial that all interested parties contribute to highlight relevant practical issues and signal their preferred prioritisation of CEBS' work, so that the Committee could take these into consideration when deciding on its work programme. Improvements have been made, especially through the project on operational networking. But the process could be further formalised, through regular hearings and open questionnaires. This should also satisfy the request of the European Banking Federation and other industry representatives to have channels to flag practical issues to CEBS. Such solution is preferable to granting market participants direct access to mediation mechanisms, as the latter approach could open a questionable EU redress procedure without an appropriate legal basis.

CEBS is also committed to enhancing the dialogue with supervisors outside the EU, as it is aware that the call for cooperation and convergence in supervisory practices does not stop at the borders of the Union. Greater coordination between the dialogue on financial services at the political and at the technical level would be desirable.

Concrete proposals on CEBS' working processes

(i) **Relying more extensively on majority voting**. CEBS intends to continue to work by consensus, but considers that the possibility to resort to majority voting at Level 3 could contribute to improving the quality of its work and the Committee's ability to deliver convergence in supervisory practices. As discussed above, the adoption by QMV would not alter the non-legally binding nature of Level 3 tools. Strengthened decision making mechanisms could be adopted as part of a package with peer pressure mechanisms (peer review and "comply or explain", mediation and impact assessment).

(ii) **Better interconnecting EU and national objectives.** CEBS could support proposals to introduce EU objectives in the mission statement of national authorities and, conversely, the objective to support the pursuit of prudential objectives at the national level in CEBS' mandate. Such high level interlocking could be further supported by coordination in the definition of work programmes and specific projects.

(iii) **Improving the dialogue with interested parties.** CEBS supports further developing existing facilities to allow interested parties to highlight relevant issues CEBS should address and to assist in prioritising among different tasks.

The first two proposals would require support from EU institutions and commitment from Member States, while the improvement of the dialogue is an objective CEBS is committed to pursue.