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Assessing the implementation challenges of Capital Requirements Directive and the convergence of supervisory practices across Europe

Ladies and Gentlemen,

I would like to thank the Chairman and the organisers of this conference for inviting me today. I am happy to speak to such a distinguished and well informed audience.

As a Chairman of the Committee of European Banking Supervisors and a member of Basel Committee on Banking Supervision, I have met most of the key actors involved in drafting and finalising the Basel II framework and then contributing to the proposed Capital Requirements Directive. I can see many familiar faces also in the audience today. The Directive will soon be submitted to the European Parliament but the work of CEBS towards the implementation measures is still in progress.

As you are aware the Basel II accord is not a legal text. It is a framework for convergence of capital adequacy requirements at a worldwide level. The proposed directive is a legal text and has to be approved by the Parliament. The successful implementation of Basel package in Europe will certainly contribute to the global convergence of practices and help us promote also EU-US dialogue in banking supervision. We at CEBS are a central part in this process.

I shall today assess the challenges the supervisors as well as the banking industry will be facing in the near future. I shall also elaborate on the CEBS' role in promoting the convergence of banking supervisory practices and cooperation among supervisors in Europe. I am proud to announce that CEBS has already made significant progress on many areas in working towards truly integrated financial markets in Europe and there are several areas of work to be covered.

Most of you are probably familiar with CEBS' role, but I would like to share with you some more information regarding its policy and practical approach in many supervisory issues.

Why CEBS matters?

You know as well as I do that Basel II and the new Capital Directive represent a huge exercise and it matters a lot to financial markets in Europe. But sometimes when delivering a speech like this I get the feeling that the picture where and when CEBS comes into play needs further clarification.

In some conversations, people appear to be wondering why they should care about this new committee. The same people keep asking why the Lamfalussy process which gave birth to the new level of committees is so relevant. One could ask aren't there enough committees of "talking shops" in Europe?

Fair enough. A certain degree of scepticism is always welcome but put it bluntly CEBS is here to make your life easier.

Let me give you a very practical example. At the moment banks are facing a fragmented setting of reporting requirements. If they operate across the EU they could be faced with 25 different authorities with 25 different formats of data requirements. It means duplication of work, multitude of technical solutions and unnecessary and maybe considerable compliance costs to institutions.

CEBS is now trying to resolve this problem by introducing common reporting data framework for reporting of the solvency ratio. This means that similar requirements and data settings would be introduced by CEBS' member authorities. The new technical solution would not replace present IT-solutions but would be used to gather financial data from present systems in a common way using XML-based XBRL-language. CEBS will provide the software and all the templates needed to ensure easy and cost-effective installation of this system.

This sounds very technical but let me assure you it will help the industry to get rid of on of their biggest complaints regarding reporting requirements. And this is not designed to help only big banks. Smaller banks are benefiting too because everyone has to make changes in their systems anyway when implementing the Basel II requirements. In this way we can utilise this unique opportunity in the best possible way.

Now I'll come back to other aspects of CEBS work and its position in European supervisory framework. I must admit that the "four-level Lamfalussy approach" to securities, banking and insurance markets is not easy to swallow without a bite or two. But the purpose of it is very clear: It is aimed at establishing faster and more flexible decision-making for legislation and at ensuring uniform application in Member States. It is also calling for transparency and involvement of market participants in the process. We need this approach to achieve the Single Market and level playing field in financial markets.

In Lamfalussy framework - and using EU terminology - CEBS is a "Level 3 committee". This means that we sit under the formal EU legal structures at Levels 1 and 2, and that we largely take the legislation that is handed down to us but we are very much involved in the implementation phase.

One of the key complaints about barriers to integration is that, whatever the formal legislation, the national practices are still rather different. One of the main tasks of CEBS is achieving convergence of supervisory practice within the new rules. CEBS is drafting sets of standards and guidelines for supervisory practice that should be applied consistently by all national authorities. In this way, we can ensure that banks face a more “level playing field”, and that all institutions are subject to a cost-efficient supervisory system.

The Committee is taking a very pragmatic approach to its work and the decisions will touch various fields of banking business from risk management to financial reporting. But before going any deeper into details, let’s stay just a short while within the larger picture.

I would like to point out that CEBS is unique body in many respects. There are four good reasons for this:

First, our members have a powerful voice in Europe

Second, we are part of the legal framework

Third, CEBS work has an effect on the way banking business is run

Fourth, transparent consultation process guarantees that market participants and end users have a say in our work

Let me elaborate a little on these four points. Firstly, CEBS is the only institutional committee that brings together all of the banking supervisory authorities and central banks of the 25 EU countries supported by three EEA countries as observers. Our members include also other institutions such as the European Commission and European Central Bank. Because of this high level representation CEBS has a powerful voice.

Secondly, you should remember that CEBS is part of the legal framework and it is the only committee that is formally charged with promoting convergence of banking supervisory practices and supervisory co-operation in Europe. This task has been assigned to us by a Commission Decision, on the basis of an agreement among European finance ministers. And it is not only the Commission that will check up on whether we are meeting this objective. We are accountable to the Council and European Parliament; our work will be closely monitored by the Inter-institutional Monitoring Group, by the industry and by other market participants.

Thirdly, CEBS is the one banking supervisory body which will be asked by the Commission to provide advice on fleshing out the technical detail of European banking directives. This detail can have a real impact in the way banking business is run in Europe. Our decisions may have an effect on the compliance costs or capital needs of the industry but that said I must emphasize what I said a moment ago - we are trying to minimise the unnecessary administrative burden on banks and aim for cost-efficient supervisory system across Europe. Our true aim is to make you save money but we have to remember that prudential supervision is becoming increasingly technical and complex. We are relying on the best practices developed by market participants and the importance of CEBS is selecting the best supervisory practices to be applied throughout the EU on the basis of open dialogue with the industry.

The new Capital Requirements Directive and changes in international accounting standards will affect the industry in several ways and CEBS will be involved when the details will be fleshed out.

The fourth point on the special character of CEBS is that it is the only committee working in the banking field which is required to be transparent and to consult the industry and end-users – therefore you have a chance to work with us and influence the outcome of our deliberations. Our consultative panel consists of 19 members who have respectable experience of banking – either working for the industry or representing the customers.

CEBS work will make a difference to the way banks are currently supervised, whether you are internationally or domestically focused. And now I'll turn to more practical level of Committee's work.

CEBS' work in practice

Implementing a new legislation in 28 different jurisdictions at the same time is a huge task. Add convergence and harmonization to it and the task becomes ever more challenging. In this complex environment, CEBS will issue standards, guidelines and recommendations that will change the way banks and investment firms are supervised, because each member authority within CEBS commits itself to implement our best practices within its own country.

The consultative documents that are published on our website have been agreed by CEBS members – so you can see already what your supervisors are likely to expect in some specific areas. And after each consultation process the responses will be analysed providing feedback to the comments received.

If you do business on a cross-sector basis, European banking legislation will be important to you. But at least as important will be the implementation and day-to-day application of this legislation, and the supervisory practices that are employed by national authorities. CEBS is working towards the promotion of a system that allows supervisors to fulfil their prudential objectives without hindering grater integration and at the same time minimising the level of bureaucracy on cross-border institutions.

CEBS affects both international and domestic banks. Even if you do not have any cross-border operations or business, CEBS will help to ensure a more level playing field in relation to your domestic competitors, including entities from other countries, through promoting consistency in supervisory practices. At the same time, CEBS is fully aware of the need to take account of the diversity across Europe.

So, we are expected to deliver results but how are we going to succeed? That question has been put to me several times. I have also met a few sceptics who are questioning our work and don't have great faith in our tools. But I must disappoint you if you happen to be a sceptic. During its short lifetime, CEBS has already proved that it can deliver and that the tools available can make a difference.

And CEBS is already making a difference. We have proposed the deletion of more than 20 national discretions in the Capital Requirements Directive. We are working towards a common reporting system for the solvency ratio under Basel II and are looking for a common framework for financial reporting altogether. We have published draft principles on Pillar two and on outsourcing. Both of these consultation processes are ongoing and feedback on the forst round of comments is being prepared. It is envisaged in the CEBS' work programme that guidelines for Pillar II and outsourcing would be published next year. Consultation for common reporting is starting during the first quarter of 2005. This is to give you a sneak preview of future work of CEBS. I'll come back to the work programme later on in my speech.

Our work is based on consensus which – of course – is not always the easiest way to proceed but in our case it has been very productive. Once a decision has been passed in the CEBS meeting, the members have committed themselves to see it through on national level. Our tools could be described as soft law but so far they seem to stand on hard ground.

Therefore: Please ensure you are and stay well-informed about CEBS: Keep up to date with our work – read our website to view publications, consultation papers, press releases, speeches and subscribe for news updates.

You can also have a direct impact if you get involved. You can contribute to our consultations, ask questions, interact with your national supervisors about CEBS' work and contact members of the consultative panel if you want your views to be better heard.

This was all I wanted tell you generally about CEBS and why it matters to you.

Supervisory Review Process

Now it's time to take a closer look at one of the central pieces of our present work – the Supervisory Review Process under Pillar two in Basel II framework. As I just mentioned the first round of consultation has ended and the analysis of the responses is under way. It seems that a second round of consultation will be conducted during the spring of 2005.

It has been a long process and a very important one. Our first consultation paper was developed over several years, during which EU supervisors talked to their national industries to get a clear understanding of what banks and investment firms wanted. We decided to release the paper already before the text of the Directive was finalised because we considered it important to consult interested parties at an early stage in order to encourage dialogue and to promote transparency between supervisors and financial institutions.

CEBS is working hard towards the development of common guidelines for the implementation of the supervisory review process. We are aware of the industry's desire to see EU-wide implementation of this important piece of the supervisory framework. Our intention is to get the consistent approach that would be suitable for all of us.

Our consultation paper sets out principles for the overall Supervisory Review Process and its two main complementary elements: the Internal Capital Adequacy Assessment Process – which is the firms' own evaluation of their capital needs - and the Supervisory Review and Evaluation Process - the supervisors' process to evaluate firms. The paper describes in high level principles what supervisors will expect from institutions in their assessment of the adequacy of their financial resources. It also contains principles on the supervisory authority's obligations under Supervisory Review and how these might be performed.

We received sixteen responses to the paper, all of them very supportive of the approach undertaken by the Committee. There are still a few areas where we need some additional work and especially clarification of terminology and better definition of scope.

From the responses I can see that we all agree that the Capital Adequacy Assessment Process should be owned by the financial institution itself. And that it is for the institution to define, develop, and manage its process. We support also the concept of proportionality and the general view that the principles set out in the paper are intended to enhance the level playing field in the EU under the new capital regime.

All of us agree on the importance of risk based framework and capital planning. The new Basel framework emphasises the importance of capital planning, the importance of management responsibility and other qualitative aspects of risk management.

We are moving towards an agreement on the key issues but there are still differences remaining in our views. Our consultation paper recognises that the firms' process and the supervisory review and evaluation are separate processes. The first is yours and the second is ours. We are also proposing that the two processes should work within a wider Supervisory Review Process. In practice they are closely intertwined and there will be a close interaction between them. It will then generate an important and necessary dialogue and feedback mechanism, which quite rightly still needs some more clarification and guidance.

In addition there are some other areas we need to revisit and look at more closely. For instance, the definition of risks - especially reference to non-material risks - will need clarification. The industry has also expressed some concern about the possible encouragement to make greater public disclosures of the internal process of the banks. From their perspective this could include competitively sensitive information – so it should not be applied. I guess this is a valid argument and has to be assessed accordingly.

The last but not the least area of - sometimes heated - discussion and debate concerns the home-host issue. As you know the subsidiaries of credit institutions are supervised by host supervisors and the branches by the home supervisor of the whole group. The new Capital Directive will have some implications on home-host issues that we have to look into carefully.

Home-host

The industry has quite strongly stressed the view that the cross-border groups would like to have only one single authority or access point to deal with and not 25 when they have operating network of branches across the EU. In Pillar two terms, this means that the big groups should not face different, conflicting or even incompatible obligations when performing their duties under Pillar two. That is why there is the demand to see the supervisory review and institution's own capital adequacy assessment process applied only on consolidated group level. The basic argument behind this is to avoid inconsistent supervisory treatment and double counting of risks.

This is also our view, we want to avoid inconsistency and that's why we have adopted the concept of consolidated supervisor in regard to home-host debate. We believe that we can answer to industry's wishes by enhancing the role of consolidating supervisor in co-operation with the host supervisor. This is a very pragmatic and practical approach. Co-operation of supervisors has been tested for years in our main working group, the Group de Contact, but now we are preparing even more practical guidelines to cover the complexity of home-host relation in constantly changing financial environment.

Consistency of application and level playing field across Europe are our common targets. But it should be weighted against the functioning of the national market. That is to say that there are still differences in local markets that have to be taken into account. When making changes we have to ensure that they will not lead to market distortions as local banks and branches of larger groups can be supervised by different authorities. In this respect the concept of lead or sole supervisor of big banking groups doesn't give us the right answer.

The CEBS view is that the way forward is to further promote supervisory convergence, cooperation and information exchange so that home and host supervisor come together and closely co-ordinate their actions. As this is currently the case, proximity still matters. It matters in retail banking. It matters in supervision as well. Local knowledge is an important asset.

Supervisors should be able to inspect and assess the banks that operate under their jurisdiction. The host supervisor is best placed to take an informed look at subsidiaries in its territory, and possibly actively contribute in the supervision of systemically important branches too. The home supervisor might even consider this being a better solution if it decides to delegate some supervisory tasks to the host. Some supervisors could find it also practical to delegate tasks to consolidated supervisor.

What ever the outcome of this home-host exercise is, we must respect the subsidiarity principle. Some tasks are best done centrally, some are best done regionally, some are best done locally and some are certainly done best together. It is highly unlikely that full centralisation of all tasks is ever optimal.

There are already systemic branches in the Member States and the number is likely to increase over time. One driver could be the European Company Statue. I find it hard to believe that supervisors, central banks or finance ministries could accept that they might not play any role in the supervision of truly systemic or significant institutions operating in their economies.

What then is the role of CEBS in all this? The Committee is neither a home or host authority. But our members are all the home and host authorities in the EU and EEA. We see the issue from all sides and are working hard to come to solutions that would be acceptable to everyone.

And this is the work now in progress. We are preparing common guidelines on home-host issue and preparing a consultation paper to be published in spring 2005. The market participants have already commented on home-host related matters in our previous consultations and at this time we are hoping to wrap the whole package up. Here again I stress the importance of dialogue between different players - we as supervisors, the banking industry, other market participants and the end users.

Now coming back to Pillar II the scope of application will be decided together with the analysis on home-host issue. I should tell you that we are also aiming to move faster with our work. We are fleshing out Pillar II to see how the central dialogue between the internal process and supervisory review will operate in practise. I want to know how they will interact to achieve an effectively functioning Supervisory Review Process before we publish the final guidelines which can then act as a common base or guidebook the industry and for supervisors.

You'll be hearing more from us early next year.

Future work

Talking about next year I have already mentioned some of the work streams currently undertaken by the CEBS. I will now give you some insights into CEBS future work programme.

CEBS has initiated several strands of work during this year – the first operational year of the committee. The workload has been impressive due to the great demand for convergence in banking supervisory practices and in relation to the finalisation of the proposed Capital Requirements Directive.

The basic outline of our future work programme has been endorsed by the CEBS and it will be published on our website in due course. The publication of the work programme will allow all interested parties to know in which areas progress is expected and within which time frame.

The work programme will also allow European institutions to form a view on the way in which the Lamfalussy framework is being operationally implemented in the banking sector. This should also facilitate the accountability vis-à-vis the European Parliament, the European Council and the Commission.

Future work areas of CEBS can be described under three main headings:

- Co-operation and information exchange related issues;
- Convergence of supervisory practice;
- Externally driven work streams.

Under co-operation and information exchange the most important issue is of course home-host where the goal is enhancing the two-ways flow of information between home and host authorities, clarifying the operational arrangements allowing the consolidated supervisor to fulfil its tasks.

Another area of work is crisis management. A crisis management exercise conducted by the BSC highlighted some areas for further work, in particular principles for co-operation and exchanges of information in cases of crises of large and complex financial organisations. Jointly with the BSC, CEBS will work for the development of an effective operational network mechanism in this area and for organisation of simulation exercises.

Information exchange itself requires specific attention. Exchanges of confidential information are already taking place under the main working group of CEBS, the Groupe de Contact, which regularly reports to CEBS. CEBS will consider further how to develop its framework for information exchange to ensure the pursuance of supervisory objectives in increasingly integrated markets.

Let's now turn to the second heading of priorities – the convergence of supervisory practice. As already mentioned, CEBS has published a consultation paper on general principles for Pillar II, the Supervisory Review Process. Following the analysis of input received in the consultation, these principles will be developed to guidelines.

One new and very important area of convergence is common reporting as already emphasised earlier in my speech. Banking sector is truly concerned about the potential costs of a setting with fragmented reporting requirements and we are trying to address these concerns by developing a common framework for the reporting of the capital ratio. This framework should minimise the reporting burden on credit institutions and investment firms while improving the co-operation between supervisors. CEBS' answer is an XML-based solution as a basis for a common reporting framework. We are defining taxonomy of financial and supervisory reporting-related data and CEBS will propose a complete package for the implementation of the new solvency ratio. Consultation on common reporting is envisaged to start early next year and our members are currently discussing this issue at national level with the local industry.

There is also a need to develop commonly accepted minimum criteria for the validation of models used for calculating institution's credit and operational risks. The new framework for capital adequacy envisages a recognition process for external credit assessment institutions. CEBS is developing guidelines for the recognition of these rating agencies. The guidelines will define a common approach to the ongoing assessment of rating agencies' compliance with the requirements and a common approach towards cases of non-compliance.

The proposed Capital Requirements Directive requires competent authorities to disclose information on the implementation of the Directive itself, the exercise of options and discretions and other relevant information. This will be an important element in the process aimed at ensuring consistent implementation of the Directive. CEBS is currently delineating the elements of supervisory information at stake, building a framework designed to enable a meaningful comparison of approaches and defining its own role in the implementation of the framework for supervisory disclosure.

In the area of accounting and auditing the adoption of International Accounting Standards (IAS) within the EU is a major reform. It will affect significantly the way of conducting business, also contributing to increasing financial market integration. The issuance of the new International Financial Reporting Standards (IFRS) raises several issues from a supervisory perspective and is a very relevant strand of work for CEBS.

Finally, the third heading of priorities was externally driven issues. These include the advice to the Commission. The Commission has indicated that CEBS will receive requests for advice on several new issues. The areas that may call for CEBS advice include possible obstacles to cross-border mergers in banking, supervision of liquidity risk and the definition of regulatory capital.

Apart from these priorities CEBS is conducting other work as well. Cross-sectoral issues are becoming quite dominant in our work. CEBS, together with the other Level 3 Committees for securities and insurance - CESR and CEIOPS - is developing an intense exchange of information and experiences. We are discussing how to conduct practical work on supervision of financial conglomerates and off-shore centres.

In regard to off-shore centres the need is felt to review at the EU level whether there are still problems with non-cooperative jurisdictions and, if so, whether common EU principles for dealing with such problems should be developed.

As you can see the work load of CEBS is quite respectable. And as I told you earlier we are not alone in this business. We need dialogue, interaction and partnership.

I can not stress enough the importance of our consultation process. It gives you all a direct access to our work and it will have an impact if you get involved.

CEBS work is governed by the principle of transparency. It has been stated already in the Commission decision establishing CEBS that we should consult market participants, consumers and end-users in an open and transparent manner. All our consultative papers have and will be published on our website and the Consultative Panel will be kept constantly informed of our work in progress.

Transforming Basel II to new Capital Requirements Directive has already proved to be a great challenge for the supervisors and the banking industry. But normally challenge goes hand in hand with an opportunity for change and improvement. As mentioned, the new set of rules that will be introduced will enhance the risk measurement and management of banks, which not only will foster the solidity and soundness of individual institutions, but also strengthen the stability of the whole banking system.

At the same time, the new capital requirements also provide a unique window of opportunity to achieve increased convergence of national rules and practices when implementing the Directive.

CEBS' objective is to actively contribute to this process. However, we have to recognise that this is not an easy task: cross-country differences in legal and administrative systems still exist meaning that supervisory practices will not converge over night. We should also keep in mind that much bank activity in Europe is still conducted on a domestic basis by domestic banks, and we have to ensure that our approaches reflect the realities of the system. We can therefore only go step by step in order to avoid major disruptions, but I can assure you that we aim to do this in a consequent and straightforward way, and that we are completely committed to the task ahead.

This is all I want to say to you today. Thank you for your attention.