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The view from Europe

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Ladies and Gentlemen,

I am honoured to present to you a European view on risk management and legislation in the wake of the current crisis.

But given the recent developments in Europe, I should also address the possible changes in the European supervisory landscape. So I will also speak a bit about the changing institutional setting of supervision in Europe.

Since this is most 'hot', I will start with this.

Very recently new proposals have been launched in Europe to strengthen supervision. These proposals are made after a very thorough analysis of what went wrong in the current crisis and what could be improved. The main building blocks of the proposed responses are the following: a stronger European and global macro-prudential analysis; enhancing the Basel II capital requirement process for bank capital; have EU supervision for credit rating agencies; reflect upon mark to market accounting and improve the valuation techniques of complex products; strengthen the supervisory and sanctioning powers for EU supervisors; regulate the parallel banking system – for instance hedge funds; swiftly improve transparency of products, by banks and of markets; and bring about changes in the organisation of macro and micro prudential supervision in Europe and globally.

More specifically, proposals have been launched to create a separate body in Europe for macro-prudential supervision and to gradually develop a European System of Financial Supervisors, that would have rule-making powers throughout the EU on prudential matters and that would be able to take certain supervisory decisions affecting cross border banks.

The day to day supervision would continue to be done by the national supervisors like the UK FSA or the Commission Bancaire, only in case one would not agree, the new European Authority would mediate between the supervisors concerned and would take a binding decision on a cross border banking group.

These proposals have been developed by a group of wise men under the leadership of Mr de Larosiere on request of the EU Commission, the executive arm of the European bodies. At the moment the proposals are being discussed by the 27 EU Member States. My best guess would be that at the latest on 9

June when the Heads of State in Europe will meet, a preliminary decision could be made on the way forward.

But as you can imagine, this is quite a political issue that needs thorough consideration. The reason is that more responsibilities moving towards the centre of Europe will have consequences for the individual EU Member States. A delicate balance has to be struck. But a change is felt necessary, by everyone in Europe. The de Larosiere report has already being named by EU politicians as THE basis for future development.

Our committee – CEBS - has continuously focused on an evolutionary approach to supervision, building upon the current structures in place in Europe. The proposals I have briefly just described, also build upon these current structures. It may not be a total surprise to hear that CEBS welcomes the proposals, although of course very substantive further work needs to be done; and as always, the devil will be in the legal, institutional and practical details.

I will not go further into the details of the more political issues here; but will concentrate on the more technical prudential developments in the remainder of my presentation.

Before I continue, I would like to give you some information about the Committee of European Banking Supervisors.

We have been up and running for 5 years. Our legal status is that of a private company under UK Law. The Committee has been set up by the European Commission to promote convergence between the 27 national supervisory authorities in Europe. Our office is in the City of London.

We have 27 members, both supervisors and central banks from each country in the EU. We also have participants from Iceland, Liechtenstein and Norway, the so-called EEA countries; the EU Commission; and the ECB. Around 55 people are at our table.

Our mandate is to give the EU Commission advice on regulatory issues and promote convergence and cooperation among banking supervisors. Recently, we have been tasked with providing the EU political bodies with regular risk assessments and risk outlooks about the banking sector and need to alert the EU political bodies on adverse market developments affecting EU cross border banks. We, as CEBS, however, do not have a responsibility for the supervision of individual banks; this responsibility rests, at the moment, solely at our individual members.

We have an organisation with three main pillars dealing with

- supervisory practises and supervisory cooperation
- development of new prudential regulation
- Reporting to supervisors, transparency and valuation.

In total more than 200 persons are active within the CEBS structures. During 2008 we had more than 100 meetings organised by CEBS; held hearings on new regulatory developments; and issued much advice on new regulation in the EU. Our meetings are mainly held at our office in London.

On lessons learnt.

The present crisis has clearly showed that there are obstacles in the present framework in the EU when it comes to handling a crisis of a cross border bank.

First, we need a legislative framework that gives supervisors the necessary tools to handle financial markets both under normal conditions, and under stressful situations, like the one we are currently experiencing.

Do we have this?

Let me first start by looking at the regulations in the EU at large.

As you know we have implemented Basel II in the EU. This has been done by means of an EU directive. This directive however is implemented to some extent by every Member State a bit differently. These differences are really a problem in the supervision of a cross border bank. Last year, CEBS urged to the EU legislative bodies to eliminate about 80% of all the national discretions and options presently available in the EU equivalent of Basel II, of which there are over100. This initiative has now been picked up and will lead to legislative changes in due course.

The crisis showed also that it is obvious today, that the present legal framework in the EU, does not give supervisors enough powers to intervene early and if necessary in a coordinated and prompt fashion, especially for a bank that operates cross border. As there are around 40 of those banking groups in Europe with several, and for some many, EU supervisors supervising different legal entities of these groups, we have to make sure that supervisors, when needed, have a sufficient legal basis to take action based upon sufficiently converged supervisory and sanctioning powers across the EU countries. To accomplish this, will not be an easy task. This point has been taken up by the EU Commission. Later this year they will come out with a White Paper on their proposals for the way forward. If you would be interested in a detailed analysis of the current sanctioning and supervisory powers for each of the supervisors within the EU, just have a look at our report analysing these, available on our website.

A second issue that is being dealt with at the moment, is a more common deposit guarantee system. As the crisis emerged, we have seen deposit outflows from banks in EU countries with low guaranteed amounts to banks in countries with high guaranteed amounts. As an emergency measure across the EU, the level of deposit guarantee has, in a coordinated effort, been raised to a more uniform level. But again here, further legislative action, aimed at a more harmonised approach, is underway.

A third topic that needs more focus, is the organisation of the "lender of last resort" function and the cooperation between central banks, supervisors and ministries. For crisis situations, we set up a very interesting framework of MoUs between the stakeholders I just mentioned. When the crisis hit the markets, we learnt that these MoUs, in some cases were not put into practice, and when they were used, they didn't really show their value or were not followed up. At the moment we are evaluating the way forward.

A fourth issue that we learnt from the crisis as being very important is how to organise the burden sharing between the EU Member States involved when money is required for an orderly resolution in a cross-border situation, for a problem bank.

This topic is very much related to the fiscal policies of the different Member States in the EU, which are not coordinated within the EU right now (and will probably not be coordinated in the near future). So the set up is, that who pays, makes the decision.

So let me now turn to the CEBS work that we feel is very important in the current crisis.

Firstly I want to mention disclosures.

Committee of European Banking Supervisors

Good disclosures are key. From the moment the crisis was evolving, CEBS has emphasised continuously the need for good disclosures. The reason for this is that in our view good disclosures can contribute to <u>increased trust</u> amongst banks and towards banks, which of course is very important at the moment, given the situation, for example, at the interbank market.

More specifically, CEBS has carried out several assessments of the adequacy of banks' public disclosures on <u>securitisation operations</u>, <u>structured products</u> and <u>illiquid assets</u> affected by the crisis and has recently assessed other stressed assets as well.

The benchmark for doing these assessments was based upon a set of <u>observed good practices for disclosures</u> on activities affected by the crisis. We developed these observed good practices based upon actual disclosures by banks globally during the first half year of 2008 and presented them in the middle of this year to the market.

These observed good practices cover disclosures on the <u>business model</u>, <u>risk management</u>, <u>exposures and their impact</u> as well as <u>accounting policies and valuation issues</u>.

In CEBS' view, these good disclosure practices provide institutions with clear guidance on:

- comprehensive information on the business model and risk management;
- meaningful information on exposures and their impacts, with appropriate levels of granularity;
- useful disclosures on accounting policies; and
- improved presentation of the disclosures.

CEBS is of the opinion that the use of these practices will contribute considerably to the improvement of disclosures on exposures and activities affected by the crisis.

The practices CEBS has identified have, in essence, a global scope. They are in line with the recommendations made in the last year's report of the Financial Stability Forum (FSF) on 'Enhancing market and institutional resilience' and consistent with the 'Leading practice disclosures' as identified by the Senior Supervisors Group. In a number of areas CEBS' practices supplement the FSF and SSG efforts and are meant to put some more practical guidance and flesh on the bones.

In fact we aimed for a more holistic approach and promote disclosures that 'tell a coherent story' to help understanding the background to an activity, its impact and importance, as well as its management.

The main focus now, is on good practices as observed as of end 2008. Assessments have been done by CEBS for around 20 major banks in the EU in 3 rounds (mid 2008, 3rd Quarter of

2008 and 4th Quarter of 2008). CEBS analysed the information that institutions provided, not only on quantitative exposures to stressed and illiquid instruments, but also on their impact, link with the business model, risk management practices and accounting and valuation practices.

The most recent findings – finished yesterday – show that on average, the quantitative disclosures on impact and exposure levels are satisfactory, and that the more qualitative disclosures on business model, risk management and accounting, leave room for improvement. Mid this year, CEBS will perform an assessment on the 2008 annual accounts of EU banks and on their first Pillar 3 disclosures, and will then come up with policy recommendations to the EU political bodies, if necessary.

A second important topic is colleges.

Let's go back for a minute to 1992. This was the year in the EU when we started the internal banking market. No separate licences were necessary any more when a bank wanted to branch out within the Union. A notification by the home to the host supervisor was sufficient. Since then, there has been a clear trend towards more cross border banking, both through branches and through subsidiaries. We now have about 40 banks with major EU cross border banking business. However, in the light of the current crisis, it is becoming increasingly more evident, that the EU banking legislation has been developed when cross border banking was on a very light scale.

When the legislation was developed, it was not foreseen that we would have branches of foreign banks that are systemically important and that many cross border banking groups would have, as they now do, centralised treasury functions and centralised liquidity management. This makes supervision more complicated, not the least for the host supervisors. In CEBS' view, supervisory colleges can play an important role in bridging information gaps and spreading knowledge in cases where the host or home authority, on a standalone basis, doesn't have enough insight or technical competence.

But colleges are more than just this. They are a tool to coordinate the practical supervision of a cross border group. Topics that could be discussed, include the identification of the main risks facing a banking group, the assessment of a bank's business model, its risk management framework, and the supervisory work plan for the group as a whole.

There is a special role for the home country supervisor in establishing such a college and in making it work.

The biggest added value of the college approach is that the supervisory authorities who participate in a college can now take decisions on a more informed basis. Especially now, in the current crisis, this is a very important feature. But still, it is not a guarantee for getting consistent decisions by all supervisors, since the college of supervisors does not change the division of responsibilities between home and host supervisors. Every supervisor and Member State retains its own decision making powers in respect of that part of the group to which it has given a licence to operate.

In the recent proposals for changing the supervisory structures in Europe, the colleges of supervisors have been given a very prominent role. And it has been proposed that members of the CEBS organisation would participate in colleges, to see whether they operate adequately and to assess that the colleges operate in a sufficiently converged way and that there no major differences on supervisory practices between different banks.

Furthermore, CEBS has been tasked to develop, by end 2010 at the latest, a joint risk assessment process for home and host supervisors under Pillar 2 of Basel II. This should lead to one joint risk assessment for one cross border banking group, and lead to coordinated Pillar 2 add-ons under Basel II, for the different legal entities of that group.

In addition, CEBS is been asked to develop detailed operational guidelines on the adequate functioning of colleges, also by end 2010. In principle, these guidelines should also be suitable for a global group, so there is a genuine interest for us to develop this effort on a globally coordinated way.

I'm heading towards the end of my presentation.

So I would like to highlight a few more topics that are on the EU agenda. Some work had started prior to the crisis, but some of the actions are being taken now in response to the financial crisis and in response to political demands.

- Firstly Liquidity risk management. The work on improved regulation and supervision already started before the crisis, but has been intensified. All in all, the approach in the EU is comparable to the BCBS approach, although more emphasis in the EU is placed on supervisory practices.

- Secondly, Remuneration schemes. CEBS has launched a consultation its principles on remuneration. It tries to put the right incentives in for banks and focuses on an adequate bonus policy, as part of adequate internal governance. Most probably the EU Commission will propose legislative proposals on remuneration in the second half of this year;

- Thirdly, the non-risk based metric. Together with the EU Commission, CEBS is analysing the various possibilities to develop one or more parameters that could be used, together with the risk based BII capital ratio.

- Pro-cyclicality should also be mentioned. Various alternatives are being looked at here, amongst others, the measurement of credit risk through the cycle, the use of countercyclical buffers etc.

I know for sure that I could easily mention a number of other topics as well. As these too are quite important to take up as soon as possible, but I do not want to overrun my timeslot!

Thanks for your attention!