REPORT

Policy Department
Economic and Scientific Policy

WORKSHOP

CRD Revision in the light of the Financial Crisis

Presentations, Briefing notes and Impact Assessment

IP/A/ECON/RT/2008-20

PE 416.211

This workshop report was requested by the European Parliament's Economic and Monetary Affairs Committee (ECON)

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The opinions expressed in this document do not necessarily represent the official position of the European Parliament.

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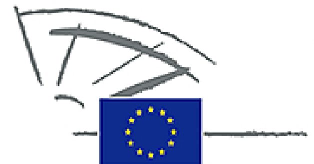

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DIRECTORATE-GENERAL INTERNAL POLICIES OF THE UNION
- DIRECTORATE A -
ECONOMIC AND SCIENTIFIC POLICIES

Workshop: CRD Revision in the light of the financial crisis

05 November 2008
European Parliament, Brussels, Room: **PHS 4 B001 15.00-18.30**
(Interpretation DE, EN, FR)

15.00-15.05 **Introduction by ECON Chairwoman, Ms Pervenche Berés**

15.05-15.10 Introduction by MEP Mr Othmar Karas, Rapporteur CRD

15.10-16.45 **Session 1: Is the current prudential regime for the EU banking sector, based on Basel II, fit for purpose?**

- Is the Basel II/CRD risk management approach appropriate today (e.g. is its reliance on (i) credit rating agencies and (ii) bank's own economic models to determine prudential capital appropriate?) ?
- Is the Commission proposal an adequate response to the crisis?

Guest speakers:

- Dr Rym Ayadi, Head of Financial Institutions and Prudential Policy Unit, CEPS, Belgium
- Dr Hugo Banziger, Chief Risk Officer, Deutsche Bank, Germany
- Ms Barbara Frohn, Global Head of Internal Model Validation, Banco de Santander, Spain
- Mr Gerhard Hofmann, Board Member of the Bundesverband der Deutschen Volksbanken, Germany

16.45-18.30 **Session 2: EU supervision-What is the right approach?**

- Are the CRD changes the right approach for banking?
- Is there consistency with the Solvency II model?
- How to resolve the home/host issue/dilemma? Can colleges of supervisors be a final solution? What should be the future of Level 3 Committees?
- How should the supervision be designed with regard to financial stability and crisis management? Drawing lessons from the current financial crisis and the rescue of xborder banking groups how can a more formal cross border rescue operation be set up? Should the ECB as some argue have a more dominant role?

Guest speakers:

- Mr Nicolas Peligry, Deputy Head International Affairs Division, Banque de France, France
- Mr Thomas Huertas, Banking Sector Director, FSA, UK
- Mr Andreas Ittner, Member of the Governing Board,ONB, Austria
- Mr Mauro Grande, Director, Directorate Financial Stability, ECB
- Mr David Wright, Deputy Director-General, DG Markt, European Commission

Discussants for the two sessions: (co authors, together with Prof. John Eatwell and Mr Avinash Persaud, of the study prepared for the ECON Committee of the European Parliament on "Financial supervision and Crisis Management in the EU"):

- Prof. Kern Alexander, University of London Centre for Commercial Law Studies, and the Centre for Financial Analysis and Policy, Judge Business School, University of Cambridge, UK
- Mr Robert Reoch, New College Capital Ltd; UK

Curricula Vitae

Session I - Speakers

Rym Ayadi

Dr. Rym Ayadi is Senior Research Fellow and Head of Research of the Financial Institutions, Prudential Policy and Tax Unit at the Centre of European Policy Studies. Rym has been working on financial services, financial markets and regulation areas in Europe over the past ten years. She is expert member of FIN-Use forum, an independent expert forum set by the European Commission on financial services matters from users' perspective and invited expert in several research projects on her areas of expertise. She is also "Rapporteur" for several high-level CEPS working parties, which are chaired by senior officials and executives, and attended by business representatives and officials. She holds a PhD in economics and finance at the University Paris Dauphine. She is author of several books, papers and policy briefs on financial regulation (e.g. Basel II, Solvency II), SME financing, banking mergers & acquisitions and European financial markets integration….

Hugo Banziger

Hugo was appointed to the Deutsche Bank Management Board in May 2006 as the Chief Risk Officer. He is responsible for Credit, Market and Operational Risk, as well as Corporate Security & Business Continuity, and Treasury. In May 2007 he also assumed responsibility for Legal and Compliance. In 2000 he became DB's Chief Credit Officer and assumed responsibility for Operational Risk Management in 2004. From 1985 to 1996 Hugo worked at Credit Suisse Group. In 1990, Hugo was appointed Global Head of Credit for Credit Suisse Financial Products, the derivatives house of Credit Suisse Group, based in London. In 1983 he started his career at the Swiss Federal Banking Commission, the Supervisory Agency of Swiss Banks. Hugo has a Doctorate in Economic History from the University of Berne, Switzerland.

Barbara Frohn

As Global Head of the Model Validation group of Banco Santander Barbara Frohn assumes responsibility for the internal validation of Risk Models (Credit, Operational & Market Risk and Economic Capital models) at a corporate level. In addition, Barbara Frohn is deeply involved in the discussions that are taking place between the different industry bodies and the European institutions and other national or supranational governmental organisations in relation to the development of financial regulation and the future of supervision. Preceding her move to Madrid, Barbara fulfilled during 15 years of employment at ABN AMRO various roles in a.o. Global Relationship Management, Energy Finance and Asset Securitisation. Lastly, she headed the Basel II Requirements & Strategic Advisory department within Group Risk Management.

Gerhard Hofmann

Gerhard Hofmann is a board member of the BVR, the Federal Association of German Cooperative Banks, as well as a member of the Executive Committee of the EACB (European Association of Cooperative Banks). Before joining the BVR, he had worked for 21 years for the Deutsche Bundesbank, mainly in the areas of banking supervision and financial stability. At that time he was a member of the Basel Committee, of the BSC and CEBS. Mr Hofmann is the editor of a book on Basel II.

Session II - Speakers

Nicolas Peligry

Nicolas Péligry, 41, is currently Deputy head of international affairs division, at the French banking commission.
He started his career at the French banking Commission in 1996, in the supervision department (off-site and on-site inspection) and joined the French Treasury, Monetary and banking division in 2003 where he contributed *inter alia* to the preliminary discussions, at European Level, on the CRD.
He joined the International affairs division in mid-2005. He is member of several working groups of BCBS CEBS and worked as senior advisor to Mrs. NOUY during the French presidency of the latter committee (2006-2007).

Thomas Huertas

Thomas Huertas is Banking Sector Director of the FSA, a role specifically created to enable the FSA to deliver the Tripartite authorities' initiatives to improve the regulatory architecture of the banking industry. Prior to that, Thomas was acting Managing Director of Wholesale and Institutional Markets at the FSA. Reporting directly to Hector Sants, CEO, Thomas is responsible for improving the depositor and resolution regime for troubled banks, implementing appropriate changes in the liquidity framework for banks, strengthening the FSA's risk identification and mitigation capabilities in the banking sector and improving the FSA's resolution capabilities. He has extensive practical experience in banking and finance from his career with Citigroup, joining in 1975 and holding a number of senior positions. He worked on regulatory issues and corporate strategy in both the United States and Europe as the Chief of Staff for the Vice Chairman. From 2001 to 2003, Thomas was Chief Executive of Orbian, a trade finance and settlement company. More recently, Thomas was Managing Director of Citigroup Global Transaction Services. In addition, he has published and lectured extensively on financial regulation. He holds a PhD in Economics from the University of Chicago.

Andreas Ittner

Member of the Governing Board, Oesterreichische Nationalbank
Professional Activities:

since Sept. 2008	Member of the Governing Board of the Oesterreichische Nationalbank Financial Stability, Banking Supervision and Statistics
since 1983	Oesterreichische Nationalbank: 11 years Director of the Financial Stability and Bank Inspections Department 10 years Head of the Secretariat for the President of the OeNB

Other Functions:
Member of the Committee of European Banking Supervisors (CEBS)
Acting Member of the Banking Supervision Committee of the ESCB (BSC)
Chairman of the Task Force on Liquidity Stress Testing & Contingency Funding
Member of the Supervisory Board of the Austrian Financial Market Authority (FMA)
Member of the Financial Market Committee established under the Austrian Financial Market Supervision Act

Mauro Grande

Born in 1958 in Bolzano (Italy). In 1983 he joined Banca d'Italia and until 1990 he worked in several areas of the Banking Supervision Department of Banca d'Italia. In 1991-92 he was seconded as a national expert at DG XV of the European Commission (Securities Markets Division). At the end of 1994 he was seconded to the European Monetary Institute as Secretary of the Banking Supervisory Sub-Committee. In June 1998, he was appointed Head of the Prudential Supervision Division at the European Central Bank (ECB), in charge of carrying out the tasks of the ECB in the fields of prudential supervision and financial stability. Since February 2003, he is Director and responsible for the area Financial Stability and Supervision of the ECB."

David Wright

David Wright was born in England in 1951. After studying PPE at Oxford, he has been employed by the European Commission since 1977. His career within the Commission has included working in the Statistical Office (1977-1982), the Directorate General For Energy (1982-1987), the Directorate General for Industry and Internal Market Affairs (1987-1989), as Adviser in President Delors' Forward Studies Unit (1989-1992), as a Member of the Cabinet of Sir Leon Brittan Q.C., Commissioner responsible for External and Economic Affairs (1993-1995), as Adviser to Jacques Santer, President of the European Commission (1995-1999), as Director of Financial Services Policy and Financial Markets, and currently as Deputy Director General of DG Internal Market and Services.

Discussants

Kern Alexander

Kern Alexander is Professor of Law and Finance at the University of London Queen Mary College and is Director of Research in Financial Regulation at the Centre for Financial Analysis and Policy, University of Cambridge. Professor Alexander is co-author with Professor John Eatwell of Global Governance of Financial Systems published by Oxford University Press and is a co-author of the European Parliament commissioned report entitled: 'Financial Supervision and Crisis Management in the EU'. He presently is advising the European Commission on the implementation of Basel II in China on the 'EU-China Trade Project.

Robert Reoch

Robert Reoch has over 20 years of experience in finance and has been involved in the credit derivatives market since setting up J.P. Morgan's business in 1994. Reoch Credit Partners was established in 2001 to provide a range of advisory, quantitative, transactional and training services to the market. Robert holds a degree in Chinese Studies and in Law from Cambridge University.

Slides

Session I - Is the current prudential regime for the EU banking sector, based on Basel II, fit for purpose?

Presentation by

Rym Ayadi
CEPS, Belgium

Challenging the New Basel Consensus

Dr. Rym Ayadi, Senior Research Fellow and Head of Financial Institutions and Prudential Policy Unit, CEPS, Brussels

Brussels, November 5, 2008 1

Key Ratios for Top 5 Banks

2007	Top 5 bank assets as % of GNP	Loans to deposits	Core capital ratio	Basel 'tier 1' ratio
Belgium	463	104	4	
France	293	101	3.5	7.4
Germany	165	94	2.6	8
Ireland	404	197	3.6	
Italy	131	161	7.4	6.6
Netherlands	521	125	3.8	10
Spain	184	250	7.2	7.9
UK	313	125	3.9	7.6
EU 27	**237**	**133**	4.3	
Switzerland	756	69	3.2	9.8
USA	**44**	**91**	7.6	8

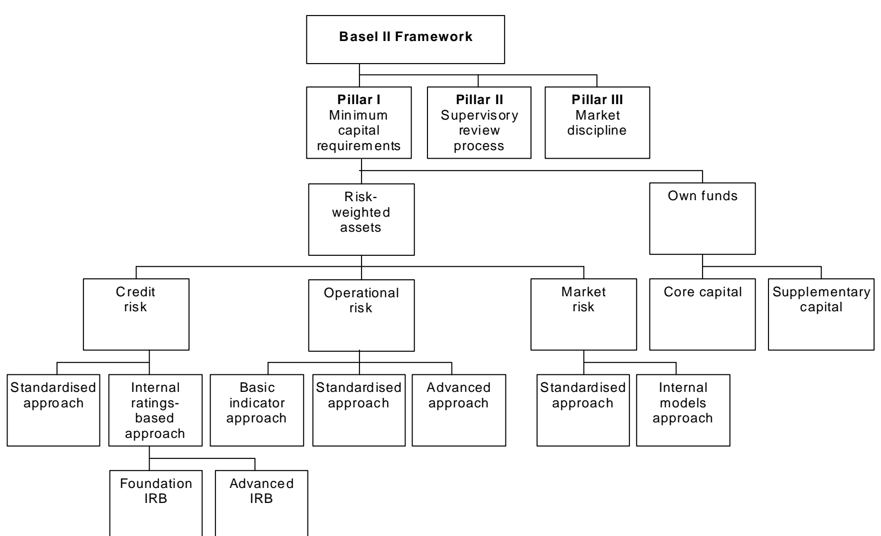
Brussels, November 5, 2008 2

Key Ratios for Top Banks

	Basel Tier 1 ratio		Core capital	
	end 2007	June-08	end 2007	June-08
Fortis	9,5	7,4	3,8	3
Dexia	9,1	11,4	2,4	1,6
ING	7,4	8,4	2,8	2,2

Brussels, November 5, 2008 3

Is the Current Framework of Basel II the Answer?



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Is the Current Framework of Basel II the Answer?

- Does not consider the **interaction between risks**
  - **Limited approach** to regulate today's banking businesses
- Relies on **internal risk assessment and management systems** of major banks and risk assessments of **external rating agencies**:
  - Both have been shown to have **considerable flaws**
  - More **perverse incentives** and **regulatory arbitrage** under Pillar 1
- The revised rules for counterparty credit risk and double default do not reflect credit risk exposures held in the trading book
- Does not reflect **liquidity risk**
- Weakness in risk delimitation
- **Weakness of interaction between 3 pillars**

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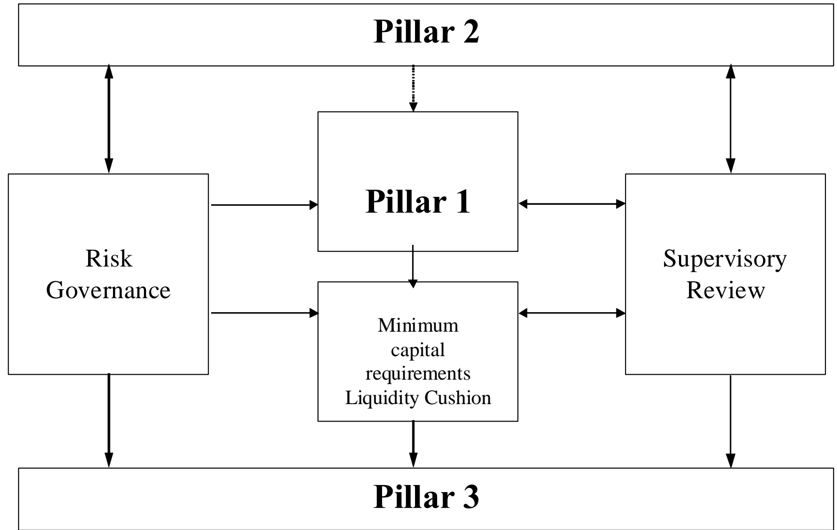
An Integrated Approach of Capital and Liquidity Regulation is Essential



Brussels, November 5, 2008 6

A Regulatory Paradigm Shift is Needed

- Is Pillar 1(as it stands now) the solution? Why should regulators rely on one indicator? Particularly if the calculation is flawed? Is a minimum required of 8% still valid?
- How can Pillar 2 be a remedy? How can it be strengthened?
  - Role of an independent centralized risk management function
  - Role of the Board and role of auditors
  - Dynamic capital management….
  - Strengthening the institutional role of CEBS
- How should Pillars 2 and 3 interact ?

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Presentation by Hugo Banziger CRO, Deutsche Bank, Germany

CRD – Fit for Purpose?

Workshop: CRD revision in the light of the crisis

Brussels, 5 November 2008

Dr. Hugo Banziger

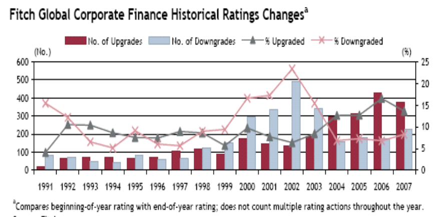
Chief Risk Officer

A Passion to Perform. Deutsche Bank

Question 1: Excessive CRD reliance upon CRA ratings and banks' internal economic capital models?

Benefits of reliance upon CRAs by far outweigh drawbacks:

- External CRA ratings make capital requirements significantly more risk-sensitive than under Basel I
- Under Basel II/CRD, CRA ratings are translated into differentiated risk weightings which are reflective of changes of credit quality over time
- CRA ratings (in particular for European / corporate assets) have reasonably stable track record over time



N.B. As DB uses Internal Ratings Based Approach, external ratings are less relevant

Basel II/CRD pillar 1 capital requirements NOT based upon banks' internal EC models

- Models for calculation of pillar 1 capital requirements are subject to supervisory approval and detailed quantitative and qualitative requirements
- Internal EC models are not - supervisors can impose capital add-ons based upon EC models' output, if EC models are used for pillar 2 Internal Capital Adequacy Assessment Process

Dr Hugo Banziger - Page 2

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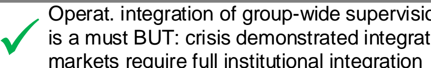
Question 2: Are Commission proposals an adequate response to the crisis?

Supervisory arrangements

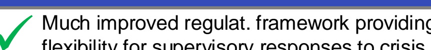
- Colleges of supervisors under strong process leadership of consolidating supervisor with final say on group-wide Pillar 2 and reporting



✓ Operat. integration of group-wide supervision is a must BUT: crisis demonstrated integrated markets require full institutional integration

Liquidity Risk

- CRD implements CEBS and BCBS work - use of sophisticated internal methodologies allowed



✓ Much improved regulat. framework providing flexibility for supervisory responses to crisis

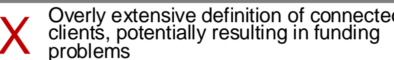
Securitization

- EU-regulated banks cannot invest into a securitization exposure, unless originator/sponsor retains at least 5% “net economic interest”

X Impediment to the re-opening of the securitization market; does not focus on the economic risk in the transaction

Large exposures

- Definition of “connected clients” extended to include common “funding or repayment difficulties”



X Overly extensive definition of connected clients, potentially resulting in funding problems

- Unsecured inter-bank exposures limited to 25% of own funds or an alternative threshold of EUR150m (whichever is higher)

X Puts significant further strain on currently disrupted inter-bank liquidity market

Dr Hugo Banziger - Page 3

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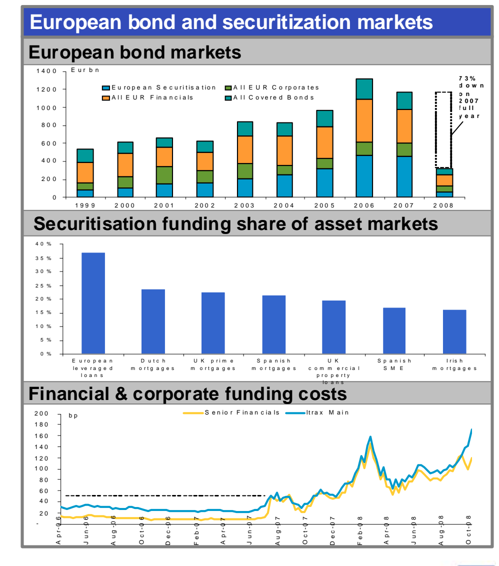
Commission proposal on securitisation is harmful in the current economic environment

- Securitisation plays key role in bringing back liquidity to EU credit markets
- Revival of securitisation will stabilise markets and restore flow of credit to households and corporates
- However, current Commission proposal:
  - Forces banks to retain concentrated risk positions
  - Reduces availability and increases cost of credit in EU
  - Damages EU securitisation markets as a source of funding
  - Impedes EU banks’ ability to compete globally in credit markets
- An appropriate regulatory response is needed to:
  - Prevent past excesses
  - Restore credit liquidity



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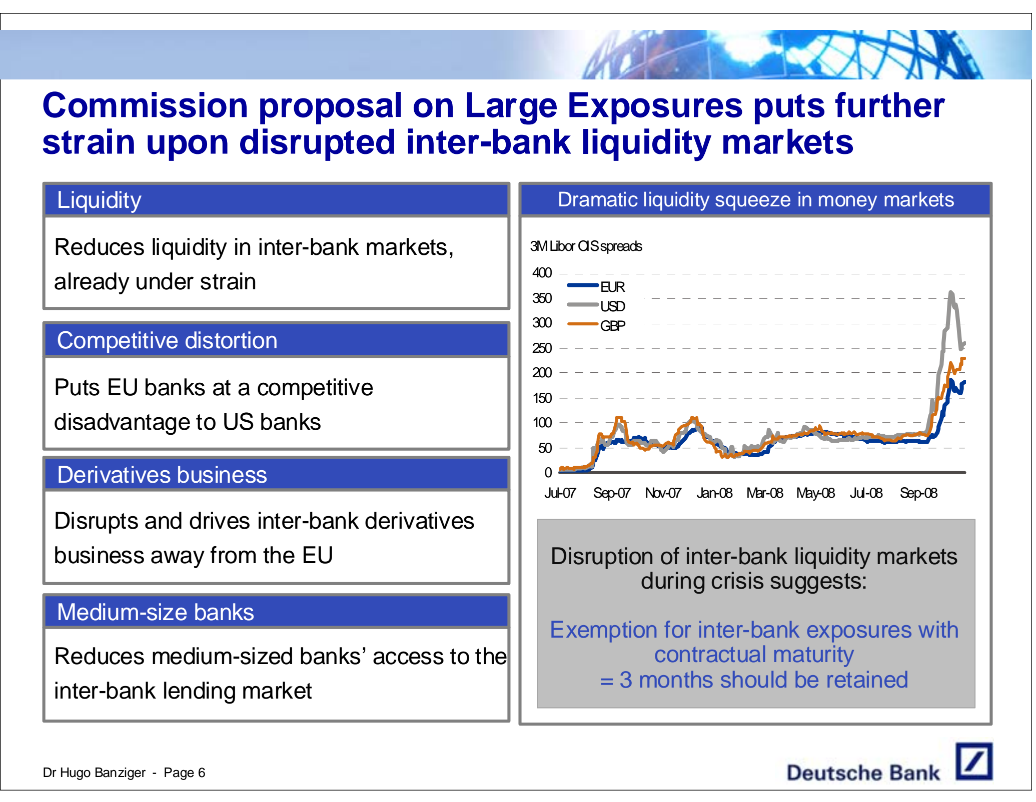
Commission proposal on Large Exposures puts further strain upon disrupted inter-bank liquidity markets
Liquidity
Reduces liquidity in inter-bank markets, already under strain
Competitive distortion
Puts EU banks at a competitive disadvantage to US banks
Derivatives business
Disrupts and drives inter-bank derivatives business away from the EU
Medium-size banks
Reduces medium-sized banks' access to the inter-bank lending market
Dramatic liquidity squeeze in money markets
3M Libor OIS spreads
EUR
USD
GBP
Jul-07
Sep-07
Nov-07
Jan-08
Mar-08
May-08
Jul-08
Sep-08
Disruption of inter-bank liquidity markets during crisis suggests:
Exemption for inter-bank exposures with contractual maturity = 3 months should be retained
Dr Hugo Banziger - Page 6
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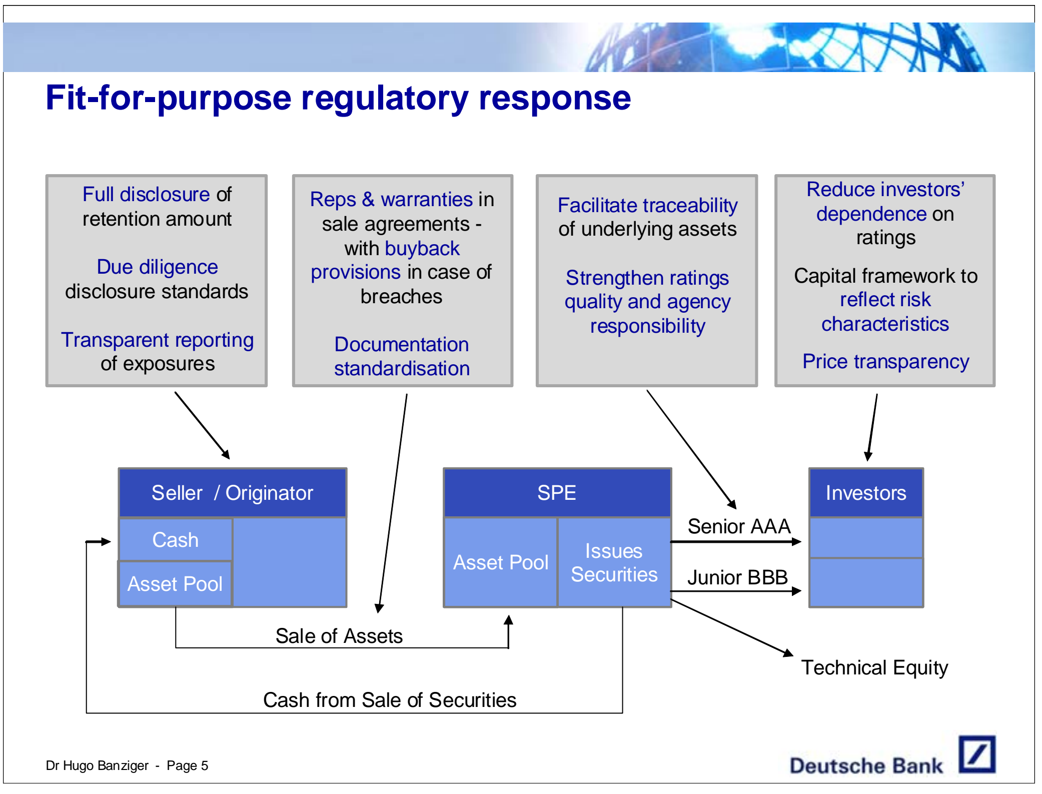

Fit-for-purpose regulatory response
Full disclosure of retention amount
Due diligence disclosure standards
Transparent reporting of exposures
Reps & warranties in sale agreements - with buyback provisions in case of breaches
Documentation standardisation
Facilitate traceability of underlying assets
Strengthen ratings quality and agency responsibility
Reduce investors' dependence on ratings
Capital framework to reflect risk characteristics
Price transparency
Seller / Originator
Cash
Asset Pool
SPE
Asset Pool
Issues Securities
Senior AAA
Junior BBB
Investors
Technical Equity
Sale of Assets
Cash from Sale of Securities
Dr Hugo Banziger - Page 5
Deutsche Bank

Presentation by

Barbara Frohn
Global Head of Internal Model Validation
Banco de Santander, Spain

Workshop: “CRD Revision in the light of the financial crisis”

Session 1.- Is the current prudential regime for the EU banking sector, based on Basel II, fit for purpose? The Santander perspective

Barbara Frohn

European Parliament, Brussels
November 5, 2008

01. In the light of the crisis….

➢ **Systemic risk and contagion effects have been at the forefront of the crisis** → Responses to the crisis should have a global reach but without "*de facto"* killing the financial markets nor penalizing well-performing market players and sound market practices.

➢ **The decisions of today will shape the financial system of tomorrow.** Therefore, we should keep in mind that regulations may solve the current situation but can imply barriers for the future.

➢**The creation of a true level playing field is a pre-requisite for market stability** in the short term (the new state-controlled banks!) and in the medium term (both within and outside the scope of the CRD)

➢The future of bank supervision: a delicate balancing act between
- more focused supervision versus additional layers of regulation
- solvency and consumer protection

02. Is reliance on internal models justified?

➢ **Santander**'s internal rating models capture and signal a client's creditworthiness through the cycle and provide estimates of loan losses at the lowest point in the cycle. Use test requirements ensure business awareness and risk based pricing which is crucial in a recessionary climate.

➢ Economic Capital Models are powerful instruments for portfolio, risk and capital management *provided* its users take full account of model limitations and model risk; they can be deployed for stress testing and scenario analysis and hence support management decision making and management intervention

➢ **EC models are not the panacea. An EC model** is one tool out of a wide range of risk management tools and processes, and represents just one component of a bank's comprehensive ICAAP

03. Will the revised CRD be fit for purpose?

Many changes are deemed positive by the banking community as the amendments align more closely with standing business practice and:

- Tackle issues that were left open (e.g. L.E., Hybrids)
- Remedy inconsistencies (leasing)
- Confront the current financial turbulence

But some issues remain pending. Aiming at market stability and financial institution soundness the CRD will be an effective tool provided these pending issues are properly addressed:

- Full recognition of DIVERSIFICATION in EC models
- Joint IFRS and Basel II effect: procyclicality and capital volatility → dynamic provisioning
- Regulatory and supervisory convergence (National Discretions)
- Limited scope of influence of the CRD

..and with the right focus on Pillar 2:

If used to its full potential, Pillar 2 provides the requisite basis for the bank-supervisor dialogue on a bank´s business model, its resilience in times of stress, its capital strength as well as its capacity to instil confidence in depositors and investors.

CRD revision (1) : Large Exposures

Santander fully acknowledges the need to manage and closely monitor client & other concentrations

However:

- In the current climate, impeding on a free flow of liquidity in the interbank market may prove counterproductive
- The application of the LE regime at subsidiary level poses problems:
    1. esp. for local currencies the number of trusted counterparties may be limited
    2. intragroup: it goes against sound and prudent ALM practices to put excess cash with the parent bank and to issue SBL/Cs ifo subsidiaries. **This defies the objective**!
    3. unlevel playing field between domestic and foreign subsidiaries
- Connected clients (i.e. economic dependence): prudential benefits do not outweigh costs; multiple interpretations lead to confusion

Santander supports:

- A light regime for interbank exposures, exemption for intragroup exposures, however coupled with supervisory scrutiny of a bank´s internal liquidity management practices in Pillar 2
- A two tiered model for interconnectedness: < 20% of own funds: internal notion of client group

  > 20% (reporting) obligation to investigate interconnectedness

CRD revision (2) : Asset Securitisation

6

Securitisation provides a vital funding source for financial and other industries.

Common Goals: Restart of a healthy, fully transparent securitisation market, capitalisation commensurate with securitisation risks incurred

The revised CRD brings about **improvements** in certain areas (e.g. Significant Risk Transfer)

However, **could have negative repercussions in others** (Art 122ª):

More than anything, contagion effects caused the crisis to spread to the EU securitisation and covered bonds markets. Many EU banks kept their first loss position already on their books and had proper lending standards in place for assets to be securitised.

- Is a European solution to a global problem
- Unintentionally impacts on non-securitisation transactions required for sound capital management (e.g. CDS protection)
- Leads to confusion due to lack of clarity (e.g. scope, ´net economic interest´)
- Creates an ongoing obligation which is technically impossible to comply with
- Includes a retention obligation for agents and brokers that have little involvement
- Shies away potential investors, brokers and agents
- Thereby effectively kills the possibility of a re-start of the securitisation markets

CRD revision (2) : Asset Securitisation

7

Santander, even though not directly affected by a retention obligation, still opposes art 122a.

Santander supports industry initiatives aimed at achieving the common goals:

- Alternative solutions (ESF/SIFMA, Dutch initiative) representing a responsible alignment between originator and investor interests

- Additionally, the industry advocates strengthening of the securitisation practice / OTD model: reps & warranties, enhanced disclosure, uniformity of standards and disclosure practices

CRD revision (3) : Supervisory Structures

8

The new supervisory arrangements represent a step in the right direction:

- Enhancement of supervisory convergence and co-ordination
- Further and better understanding of a large bank's overall risk profile and its centralised processes
- Increased efficiency and alignment through the expansion of the scope of art 129 and by the formalisation of the College of Supervisor model

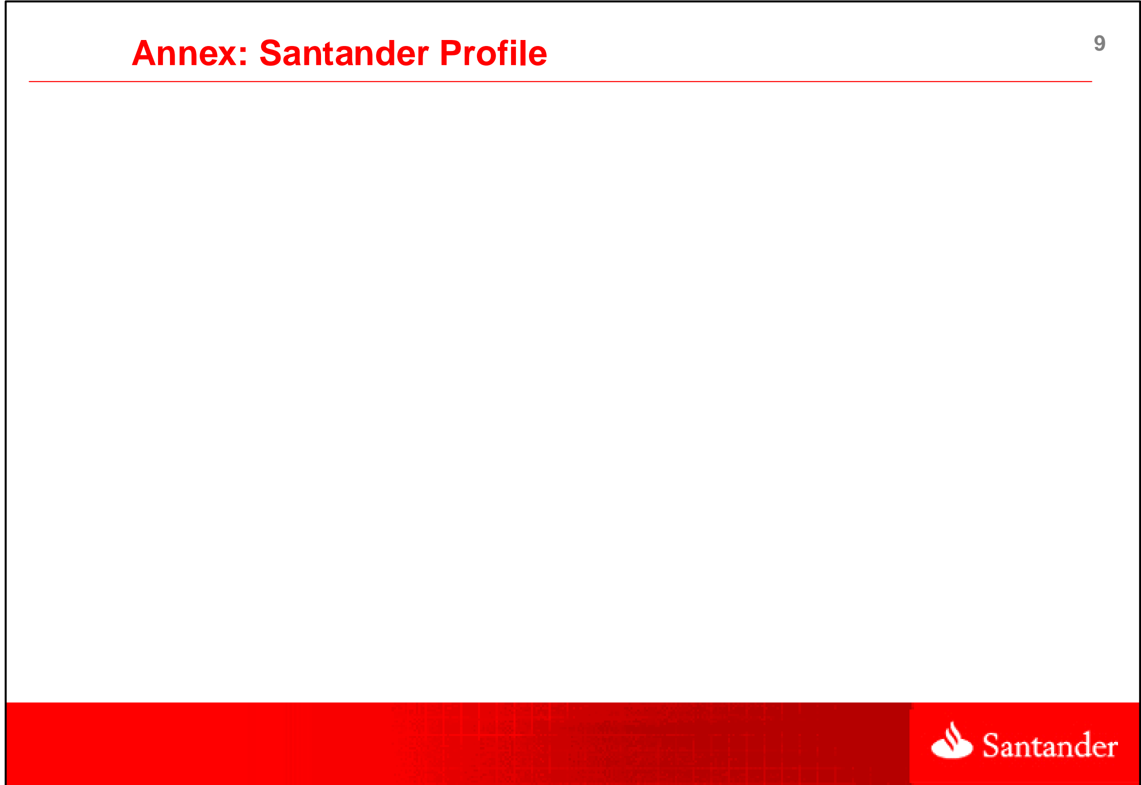
However:

- Currently, supervision is still primarily bilateral. There is **still a long way to go**.
- The introduction of the notion of **systematically relevant branches** and the powers invested in branch supervisors may well prove unworkable, esp. in crisis situations

Santander supports:

- A two-level college model, Core College vs. Full College
- More consideration should be given to supervisory co-operation in stress versus going concern situations
- Strengthening the burden of proof for a claim under art. 42.1

Santander



The crisis has taught us that mechanisms to monitor and evaluate information are as important as transparency among financial institutions.

Santander profile: international

10

International profile

Europe. Santander has presence in:

- Spain
- UK
- Portugal
- Italy
- Germany
- France
- Netherlands
- Switzerland
- Poland
- Czech Republic
- Austria
- Hungary
- Norway
- Sweden
- Finland
- Russia
- Slovakia

Latin America. Santander also conducts businesses in:

- Brazil
- Mexico
- Chile
- Argentina
- Venezuela
- Puerto Rico
- Colombia
- Uruguay

USA. Through Drive Financial

In the past twenty years we went from having 75% of total profit in Spain to a 44%

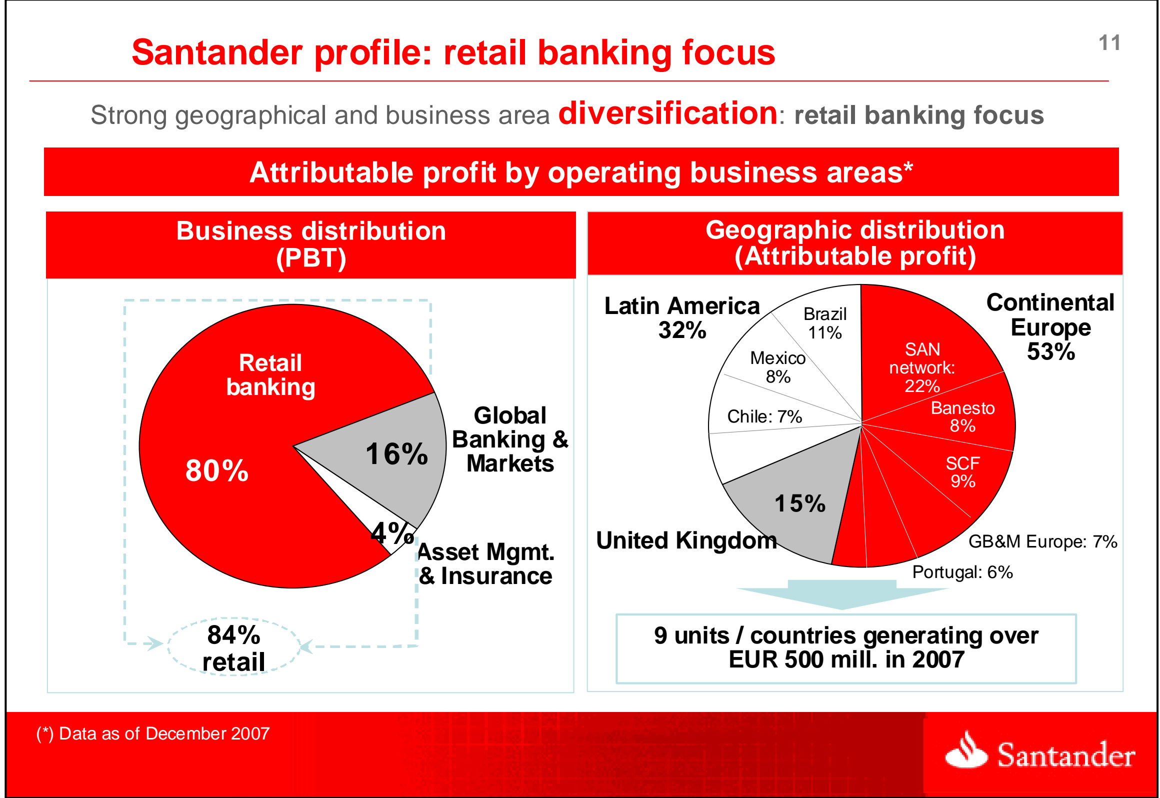
Santander

The global scope achieved by Santander is the result of great international vision, **as shown by the Group's presence in a large number of countries**.

One fact that clearly reflects this international scope is that three of each four employees who today work in the Group do so outside Spain**.**

This international vision **follows a well-defined strategy, which focuses the** Group's activity on Europe and Latin America, **and especially in those** countries and businesses with the greatest growth potential. Drive's acquisition **has positioned us in the biggest consumer market in the world,** USA

Noteworthy is the fact that in the last twenty years we went from having 75% of the total profit in Spain to having the 44%.



2.- HIGH LEVEL of DIVERSIFICATION by both geographic area and business line

By **geographic area**, **Continental Europe** accounted for almost **one half of revenues** in 2007, with **Latin America** generating over **one third** and the United Kingdom (**Abbey**) accounting for **rest**.

By **business**, our group is focused on **retail banking**, where we generate **84% of profit before tax**. We also have **global areas** that generate income and profits either directly in the "**factories**" or indirectly through the **commissions** passed through to the networks.

Lastly I would like to emphasize the substantial diversification by business unit, as **nine of them generated profits of more than EUR 500 million**. This is clearly one of the keys to the **consistency and soundness of our revenues**

Santander
Dow Jones
Sustainability Indexes
FTSE4Good

Presentation by

Gerhard Hofmann
Bundesverband der Deutschen Volksbanken, Germany

Is the current prudential regime for the EU-Banking sector, based on Basel II, fit for purpose?

Gerhard Hofmann

Federal Association
of German Cooperative Banks ?BVR

Co-operative Banks in the EU

- 4.500 Co-operative Banks in Europe
- 45 Million Members and shareholders
- 140 million clients
- Presence in 20 European Countries

Is the Basel II/CRD approach appropriate?

- Hard empirical evidence on effectiveness of CRD/Basel II not yet available:
  - Basel II/CRD has not yet been fully implemented before the financial crisis was unfolding; only few institutions were on Basel II
  - USA are lagging behind
- Overall assessment of CRD:
  - CRD/Basel II are in principle appropriate ways forward
  - Risk sensitive framework is still the best option
  - However, by nature CRD is no panacea
  - Complementary measures in areas outside the core of banking regulation essential (fair value accounting, address shadow banking system, especially CDS, hedge funds, rating agencies, remuneration systems etc)

3 | 05.11.2008 | CRD-Workshop | BVR | Gerhard Hofmann

Is the commission proposal an adequate response to the crisis?

- Securitisation framework: Clear improvements through envisaged CRD amendments
- Originate-to-distribute model problematic
- Obligatory retained portion of securitisation tranches improves incentive structure…
- …should, however, not be set too high as it would make risk transfer in general more difficult
- Moreover, qualitative requirements (i.e. stress testing etc) quite tight → smaller institutions will be constrained in their ability to diversify risk, principle of proportionality as a possible solution
- Scope should be limited to originate-to-distribute models, otherwise networks of co-operative banks and savings banks will loose their instruments to diversify risks within the respective network

4 | 05.11.2008 | CRD-Workshop | BVR | Gerhard Hofmann

Is the commission proposal an adequate response to the crisis?

Proposed rules for large interbank exposures not fully convincing:

- Money markets may suffer
- Timing aspect: Financial crisis not yet over
- 150 million € threshold essential for small institutions to maintain access to money markets; relating this limit to bank internal procedures would create uncertainty
- Impact study recommended, also to ensure consistency with other jurisdictions

5 | 05.11.2008 | CRD-Workshop | BVR | Gerhard Hofmann

Is the Basel II/CRD approach appropriate?

Further improvements necessary:

- Proper implementation of Pillar 2
  - Originate-to-distribute model needs more supervision
  - Avoid unreflected use of external ratings
  - Focus on systemic relevance (difficult to supervise, but most relevant)
  - Focus on off balance sheet exposures outside the radar screen of risk management, supervisory boards and auditors → bring back to balance sheet (Spanish and Italian example)
- Address credit default swaps ($ 55 trillion market), US: central clearing house discussed; EU ?)
- …as well as other forms of shadow banking (US: initiating mortgages without banking license as a root cause of the sub prime crisis)

6 | 05.11.2008 | CRD-Workshop | BVR | Gerhard Hofmann

Is the commission proposal an adequate response to the crisis?

Organisation of supervision in Europe

- Financial crisis not a convincing argument to jump to new institution(s) for overseeing the markets, financial intermediaries and financial infrastructure. Difficult political, legal and practical issues to resolve (after the crisis will be before the crisis)
- Strengthening Lamfalussy II: Cooperation of supervisory authorities in Europe still the optimum to achieve convergence and maintain financial stability
- Differences in national markets remain; avoid discrepancy between supervisory responsibility and accountability for/burden of bail-out
- Networks of cooperative and saving banks, which are among the few stabilising pillars in this crisis, should not be put at a competitive disadvantage by a new institutional structure of supervision

7 | 05.11.2008 | CRD-Workshop | BVR | Gerhard Hofmann

Is the commission proposal an adequate response to the crisis?

Timing and consistency of regulatory responses on a global basis

- 15. Nov. 2008: global financial summit in Washington
- Some politicians propose wide ranging changes (role of IMF, substantive changes?)
- Level playing field must be maintained: Europe to play an important part and provide substantial input in new regulatory agenda, but no „stand alone“-solutions
- Will CRD amendments still make sense against global initiative?

8 | 05.11.2008 | CRD-Workshop | BVR | Gerhard Hofmann

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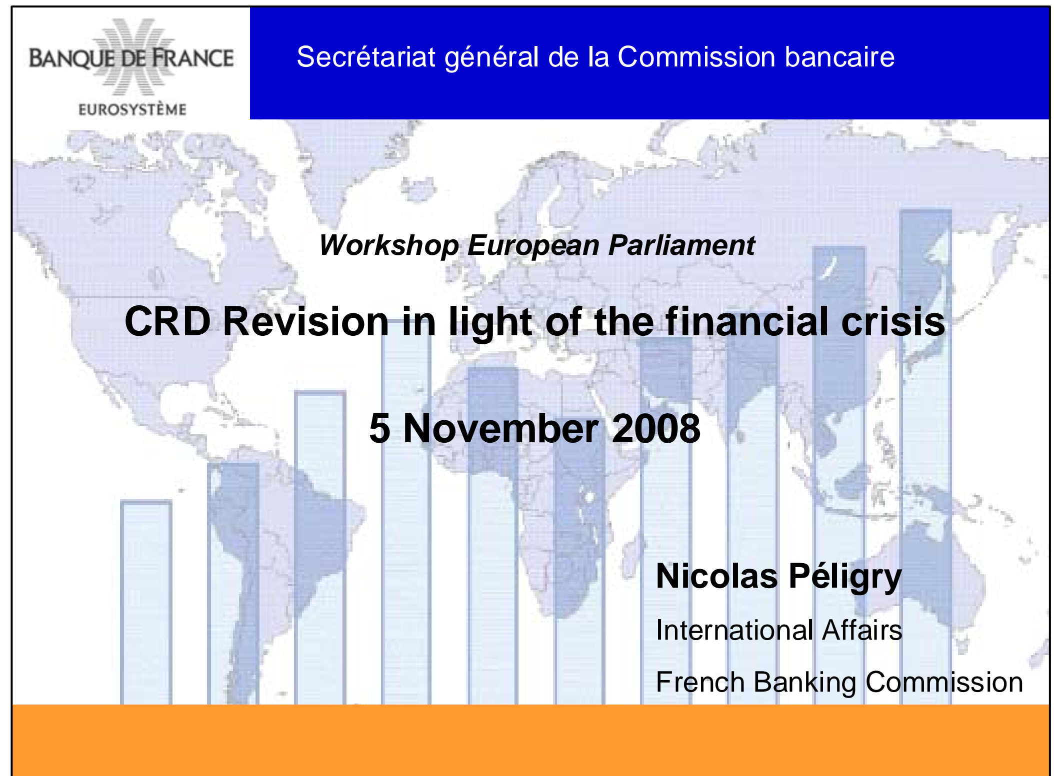
Session II - EU supervision-What is the right approach?

Presentation by

Nicolas Peligry
Deputy Head International Affairs Division, Banque de France, France



Outline

1) Are the CRD changes the right approach for banking?

2) What should be the future of Level 3 Committees?

3) How should the supervision be designed with regard to financial stability and crisis management?

2

SGCB

Nicolas Péligry
French Banking Commission
Workshop at the European Parliament, 5 November 2008
CRD revision in light of the financial crisis

1) Are the CRD changes the right approach for banking?

➔ **An enhancement of the regulatory framework on a number of key areas**

a) Tier one capital :
- The current lack of precision is prejudicial to the level playing field and to financial soundness
- Clear eligibility criteria should lead to upgrade the quality of the numerator of the solvency ratio
- The sooner, the better

b) Securitization
- Incentives of investors and originators have to be rebalanced
- Importance of qualitative, more than purely quantitative criteria, such as sound management of risk, whoever bears it

3

SGCB

Nicolas Péligry
French Banking Commission
Workshop at the European Parliament, 5 November 2008
CRD revision in light of the financial crisis

1) Are the CRD changes the right approach for banking?

d) Liquidity risk management
- Enhanced requirements, designed to promote best practices ("Pillar 2" type approach)
- For larger banks, key importance of developing robust internal methodologies
- Framework under which supervisors, at national level, will carry out in-depth assessment of the liquidity profile of each bank, both from a quantitative and a qualitative perspective

c) Large exposures
- Current rules have to be simplified and designed to address the issues raised by excessive concentration on a single counterparty
- The proposal is on the right track but its effects on inter-bank markets need to be carefully assessed

4

SGCB

Nicolas Péligry
French Banking Commission
Workshop at the European Parliament, 5 November 2008
CRD revision in light of the financial crisis

1) Are the CRD changes the right approach for banking?

➔ **an up-grading of supervisory arrangements for the supervision of cross-border groups**

- In a number of key areas : the principle of article 129-2 proved to be a success for the validation of internal models, it should be extent to other topics: pillar 2 and reporting
- A leading role for the home supervisor with strong involvement of host, including host of significant branches
- The home should be granted with the"last say" for strategic decision at group level, but this prerogative should be used in exceptional circumstances, after mediation by CEBS

5

SGCB

Nicolas Péligry
French Banking Commission
Workshop at the European Parliament, 5 November 2008
CRD revision in light of the financial crisis

1) Are the CRD changes the right approach for banking?

➔ **the comparison with Solvency II for insurance companies**
Three key differences:

a) The group support
b) Coupled with the former point, the taking into account of full diversification benefits, at group level
c) The wider used of full-fair value, including for equities

- Would a convergence between insurance and banking sector, on such basis, be appropriate?

- To which extent these regulatory differences reflect the differences of "business model" ?

6

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Nicolas Péligry
French Banking Commission
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CRD revision in light of the financial crisis

2) What should be the future of Level 3 Committees?

➔ **A central role to play in promoting convergence of practices**

a) Between Member States: the same EU rules should apply equally to all banking actors wherever they are located, taking into account the proportionality.

➢ Need for the development of a real "European supervisory culture" : learning to work together

➢ The Level 3 should be granted with adequate ressources

b) Between colleges of supervisors ("horizontal convergence"):

➢ while colleges should be conducive for enhanced consistency of approaches between concerned home and host supervisors, there is a critical need to ensure a consistency between colleges

➢ However, each of them should be left a certain leeway to adapt to the specificities of each group

7

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French Banking Commission
Workshop at the European Parliament, 5 November 2008
CRD revision in light of the financial crisis

2) What should be the future of Level 3 Committees?

➔ **Should the current architecture be adapated?**

a) There is a clear need to speed-up the evolution currently ongoing so as to make the supervision of cross-border group more efficient and in line with the increase integration of financial activities in the European landscape

b) However, the principle of a decentralized organization should not be challenged in itself

c) The ECOFIN Council Roadmap and beyond

8

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French Banking Commission
Workshop at the European Parliament, 5 November 2008
CRD revision in light of the financial crisis

3) How should the supervision be designed with regard to financial stability and crisis management?

➔ **An increased role of CEBS in the assessment of risk, in particular in the context of colleges of supervisors (in a "bottom-up" approach)**

a) The CEBS in the best placed to monitor micro-prudential risks

b) Bottom-up approach : the information collected and analyzed in the framework of the supervision of banking group provide a precious material to carry out risk assessment

c) A common data-base?

➔ **Strong coordination with ECB, through the BSC**

a) The complementarity between micro and macro analysis

b) How should CEBS and BSC should interact

➔ **The advantages in having banking supervision close to central bank.**

9

SGCB

Nicolas Péligry
French Banking Commission
Workshop at the European Parliament, 5 November 2008
CRD revision in light of the financial crisis

Presentation by

Thomas Huertas
Banking Sector Director, FSA

EU Supervision – What is the right approach?

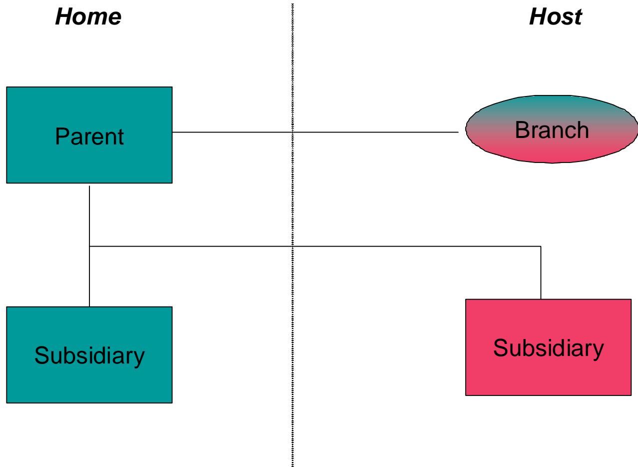
Presentation before the
European Parliament Workshop:
CRD revision in the light of the financial crisis

Brussels

5 November 2008

Dr. Thomas F. Huertas
Chair, Expert Group on Prudential Requirements, CEBS
and
Director, Banking Sector, Financial Services Authority (UK)

The structure of multinational groups



The framework for supervision in the EU

Regulation	*Liquidity*	*Resolution*
Single market Freedom of establishment Primacy of home country supervision	ESCB, but not a single central bank or a single currency Lender of last resort: National responsibility subject to ECB and COM review	Solvency assistance is national matter subject to EU review (state aid) Fiscal authority is national Compensation schemes are national

Supervision has to operate within the above framework but also recognise that EU firms operate globally and that global firms operate in the EU.

Progress toward common supervision

- Colleges of supervisors implemented and making a difference
- 3L3 committees
- Promotion of convergence
  - Guidance for supervisors in implementing directives
  - Training
  - Forum for dialogue to assure common response to problems/crises
- Advice with respect to new legislative/regulatory proposals
  - Responses to CfA from Commission
    - Hybrid capital
    - Large exposures
    - Liquidity
  - Own initiative advice

Two approaches

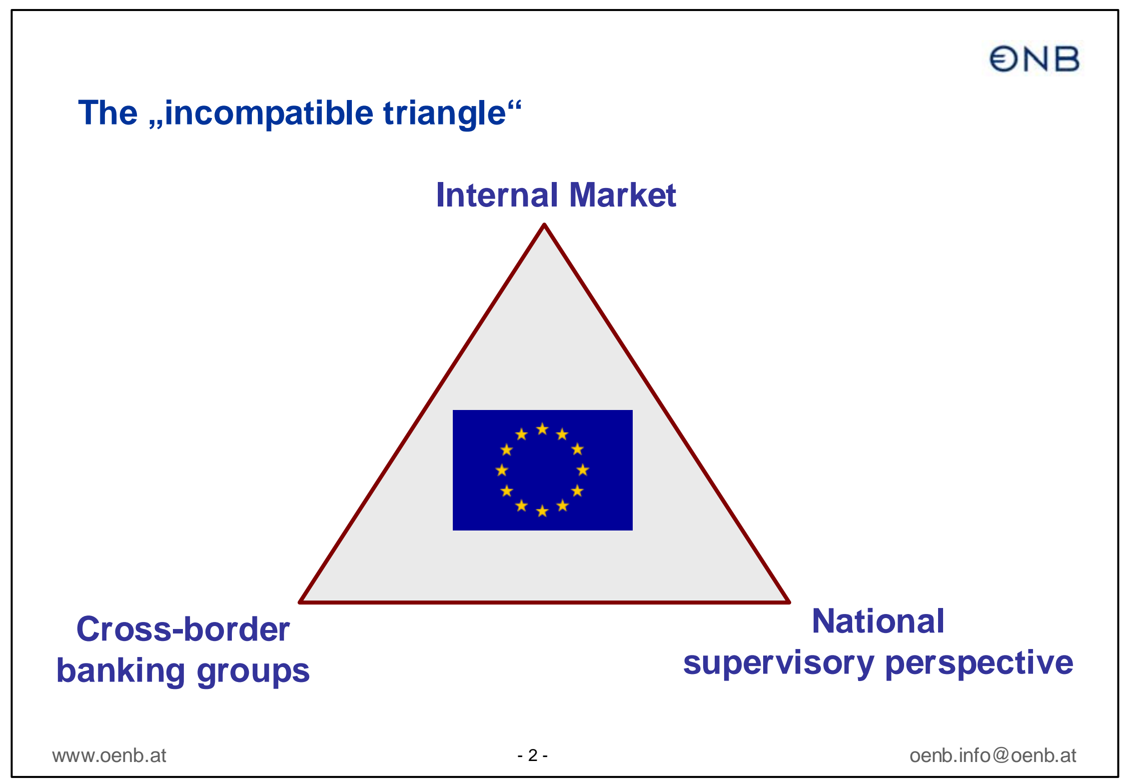
	Insurance (Solvency 2)	***Banking (CRD and other directives)***
Group responsibility/ Group support	Home country exercises group supervision and assures solvency of subsidiaries	Home country approves models for capital adequacy but does not assure solvency of subsidiaries
Compensation scheme	No directive in place	Home country responsibility for parent bank but possibility of top-up into host country scheme of branch. Host has liability but limited influence. Subs are treated as if they were a parent bank in host country.
Liquidity	Not considered	Host country responsibility. CEBS work on good practices.
Solvency assistance/ resolution	Home country responsibility, including ultimately responsibility for subs of parent	Home country responsibility for parent, but not necessarily for subsidiaries.

CRD amendments

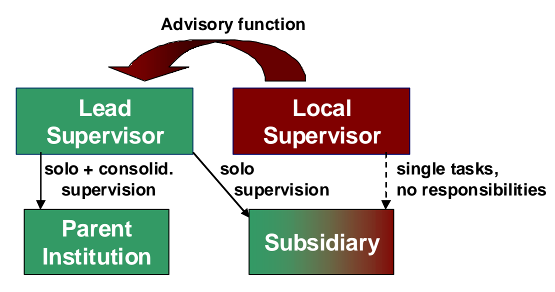
- ✓ Include reference to EU obligations in national mandates for supervision
- ✓ Colleges to include significant/systemically relevant branches
- ✓ CEBS to provide operational guidelines and evaluate overall progress of colleges
- ✗ Securitisation “skin in the game” requirement

Presentation by

Andreas Ittner
Member of the Governing Board,ONB, Austria



The „lead supervisor“ is NOT the right answer, neither short-term nor long-term



- level playing field problems: group specific rules versus internal market concept
- Local supervisors‘ interests not appropriately reflected
- Split btw supervisory and financial stability/bailing-out responsibility → renders crisis management more difficult (who pays?)
- No incentives for enhanced two-way info exchange
- Legal issues

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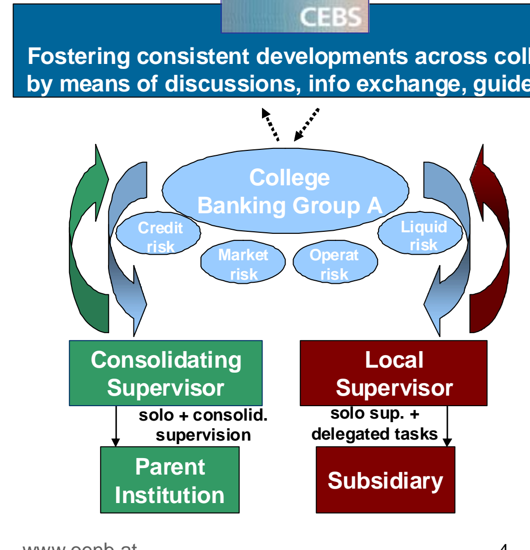
ONB

Short term: Further step up supervisory cooperation



- further intensification of colleges-work
- expert teams within colleges
- delegation of tasks
- linking participation to the commitment to contribute in crisis resolution?
- in parallel: work on further regulatory harmonisation

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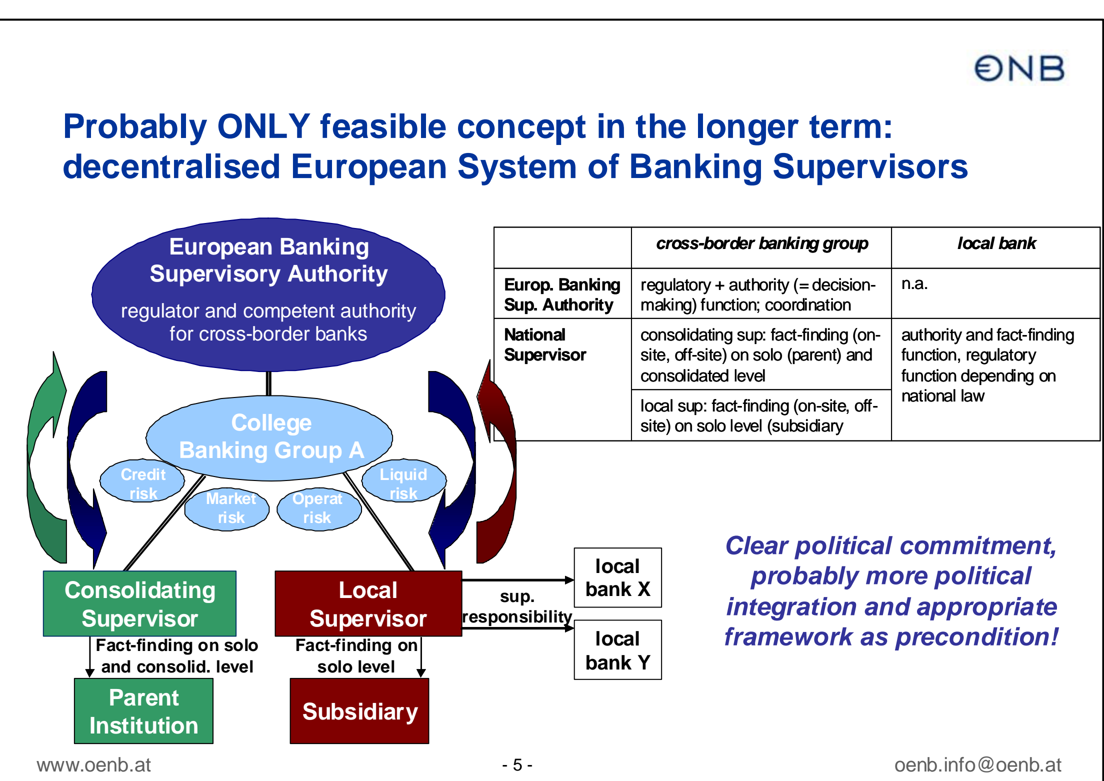

	cross-border banking group	*local bank*
Europ. Banking Sup. Authority	regulatory + authority (= decision-making) function; coordination	n.a.
National Supervisor	consolidating sup: fact-finding (on-site, off-site) on solo (parent) and consolidated level local sup: fact-finding (on-site, off-site) on solo level (subsidiary	authority and fact-finding function, regulatory function depending on national law

ONB

Procedural way forward: Masterplan

Agreement on a Roadmap with milestones and timelines

- **Harmonisation or (if not sufficiently possible) 28th regime of supervisory requirements**
  - **licensing, requirements for banks, reporting scheme, supervisory powers and approaches etc**
- **Administrative procedures**
- **Winding-up and deposit guarantee**
- **Adequate provisions for crisis resolution incl. bailing-out (tax payers‘ money); who is contact from the MoF‘s side?**
- **…**

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Regulatory requirements: Lessons from the current crisis

Scope:
Global standards espec. for credit granting

Content:
- level of capital/own funds to be increased
- off-balance sheet activitites to be covered by risk management
- enhanced focus on liquidity
- stronger micro/macro-link in supervision

But: NO overregulation ? focus on banks' incentive structure!

ONB

Conclusion with regard to proposed CRD amendments

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels,
COM(2008) 602/3

2008/xxxx (COD)

Proposal for a

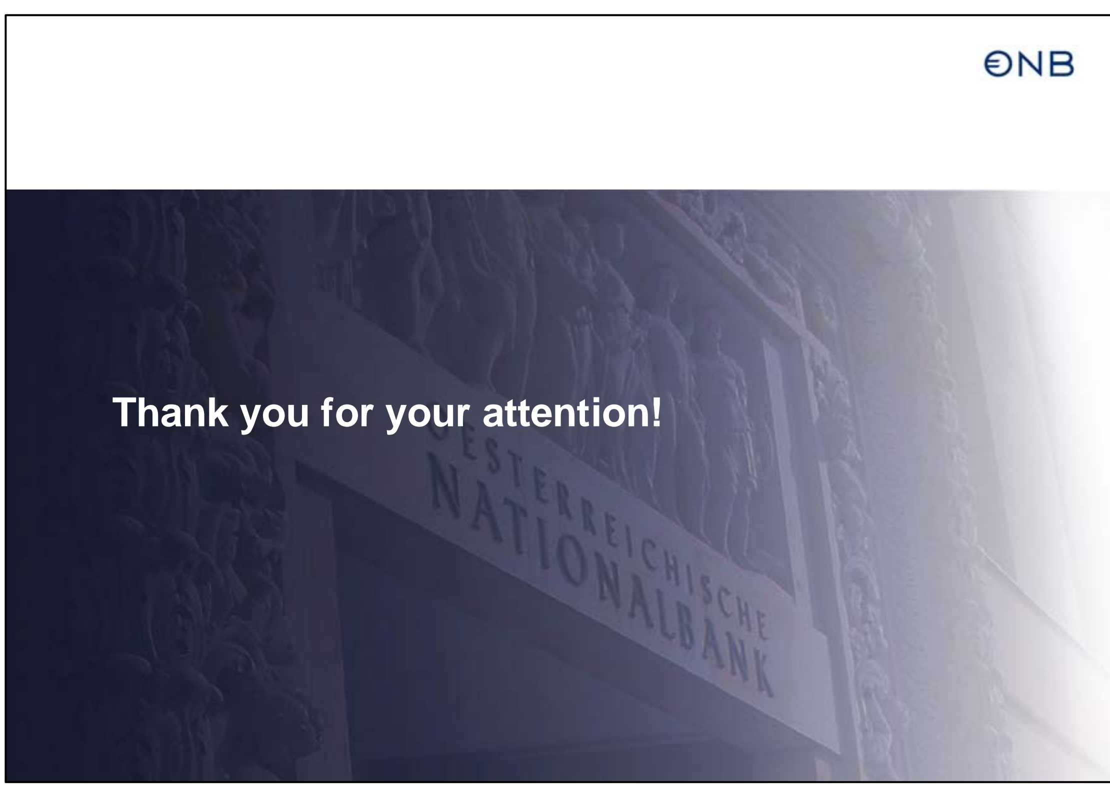
DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management

(SEC(2008) 2532)
(SEC(2008) 2533)

EN EN

- Some lessons of the current crisis are already taken on board
- No legal barriers for information exchange between supervisors and central banks to allow for more effective cooperation
- Move towards the lead supervisor to be avoided, i.e. no transfer of additional powers to the consolidating supervisor
- Instead: Masterplan towards a European System of Banking Supervisors


ONB
Thank you for your attention!
OESTERREICHISCHE
NATIONALBANK

Presentation by

Mauro Grande
Director, Directorate Financial Stability, ECB

Workshop: CRD Revision in the light of the financial crisis

Some lessons from and responses to the financial crisis

Mauro Grande
Brussels, 5 November 2008

EUROPEAN CENTRAL BANK 1

Outline

Some lessons from and possible responses to the financial crisis with regard to:

- Financial stability assessment
- Prudential supervision
- Financial crisis management

Financial stability assessment

Some lessons

- **In terms of financial stability monitoring and assessment, central banks and other authorities:**
  - were able to identify in *broad terms* the main risks and vulnerabilities (e.g. under-estimation of risks)
  - could not identify the specific *propagation* mechanisms of the crisis (e.g. complex structured products, SPVs)
- **Public warnings on risks stemming from financial stability assessments did not affect *market participants' behaviour***
- **The identification of risks and vulnerabilities for the financial system was not translated into *supervisory action***

Financial stability assessment

Possible responses

- *Combine* more effectively macro-prudential analysis of central banks with micro-prudential assessment of supervisors at the EU level (recent involvement of Level 3 Committees in risk assessment is a positive step)
- Central banks, including the Eurosystem, should have *wide access* to supervisory information on major banks for the purpose of their own financial stability assessment
- Set up a *systematic dialogue* at the EU level between competent authorities and market participants on risk developments
- Pursue stronger coordination at the EU level on policy responses to identified risks and enhanced capability of EU supervisors to react to *systemic risk* concerns

EUROPEAN CENTRAL BANK 4

Prudential supervision

Some lessons

- It is too early to assess the *performance* of colleges of supervisors (CoS) since they are still in the process of being established
- The crisis *shifted the focus* of attention from the efficiency to the financial stability dimension of CoS
- The financial crisis highlighted the need for supervisors to better understand:
  - the interplay between the structural changes in the *funding activity* of banks and *market liquidity*
  - the extent to which *credit risk transfer* allows banks to pass on risks effectively

EUROPEAN CENTRAL BANK 5

Prudential supervision

Possible responses

- **The ability of CoS to ensure - not only the efficiency of supervision - but also the *stability* of the major cross-border banking groups will depend on:**
  - effective interplay between home and host supervisors within the CoS to reach a full understanding of the risk profile of the group and ability to take decisions, whenever needed, for the group as a whole
  - the degree to which Level 3 Committees will exert strong and effective coordination role towards best practices of supervision
- **In any case, *mechanisms should be in place* for a smooth flow of information between the Eurosystem and the relevant supervisory colleges in both directions**
- **Review by supervisors of *internal mechanisms* to allocate and prioritise resources and of existing *expertise***

EUROPEAN CENTRAL BANK 6

Financial crisis management

Some lessons

- **For *central banks,* the current crisis highlighted:**
  - the need for strong coordination in money market interventions and the expansion of liquidity facilities
  - the usefulness of supervisory information for the performance of key functions in crisis situations (monetary policy operations, financial stability assessment, provision of ELA)
- **For *ministries of finance*, the crisis indicated the need for strong coordination on the definition of rescue packages also involving central banks and supervisory actions**
- **The arrangements for crisis management set out in the *2008 MoU* have been tested to a limited extent**
- **Need for a comprehensive view over developments in a cross-border *systemic crisis* across countries and authorities**

EUROPEAN CENTRAL BANK 7

Financial crisis management

Possible responses

- **Increased *convergence* can be expected in the tools used by central banks to intervene in money markets in crises**
- ***CRD amendments* on the flow of information are welcome but a key aspect will be implementation**
- **In order for CoS to be effective in crisis management of a major cross-border banking group:**
  - the supervisory tools for crisis management should be consistent across home and host countries
  - the decision-making process in the CoS should be reinforced in crisis situations with appropriate accountability safeguards
  - central banks and ministries should be involved in the CoS, whenever required
- **Enhanced EU-wide mechanisms for pooling information and assessing developments in systemic crises**

EUROPEAN CENTRAL BANK 8

Summary

- **In normal times:**
  - Strengthen the interplay between central banks and supervisors for the identification and assessment of risks to financial stability
  - Enhance the coordination at the EU level of policy responses to the identified risks to financial stability
  - Promote the effective functioning of CoS in going concern
  - Reinforce the coordination role of Level 3 Committees over CoS
- **In crisis situations:**
  - Ensure that CoS are effective also in a crisis, by also involving other competent authorities
  - Enhance mechanisms for monitoring and assessing the systemic inter-linkages between markets, institutions and market infrastructures in the single market

EUROPEAN CENTRAL BANK 9

Presentation by

David Wright
Deputy Director-General, DG Markt, European Commission

CRD: prudential supervision
The right approach?

David Wright
Deputy Director General
Internal Market DG

What do we need?

- More cooperation
- More coordination
- More convergence

More cooperation

- Host supervisors of branches *42a*
- Colleges of supervisors *129, 131a*
- European 'mandate' *rec 6, 42b*

More coordination

- Crisis management *129,130*
- 'Pillar 2' local capital add ons *129*
- Reporting *129*

More convergence

- Participation in CEBS obligatory *42b*
- CEBS needs to deliver on
  - Reporting *129*
  - Hybrids *63a*
  - Securitisation *122a*
  - Mediation *129*
  - Colleges 131a

Solvency II vs CRD

Home, 'group' supervision vs Host 'solo' supervision

	Solvency II	**CRD**
Risk assessments & model validations	*Both*	*Both*
How much capital	*Home*	*Host*
Group support	*Home*	---
Cooperation	*Both*	*Both*
Pillar 2 assessments	*Both*	*Both*
local capital add-on	*Home*	*Home*

Financial stability

- Macro vs micro supervison – add central banks' insights to supervision
- Early intervention in ailing banks – remove current legal barriers to cross border solutions

Next steps

- De Larosiere Group
- Global dimension
- Commission report to European Parliament and Council on banking group supervision

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Presentation of Prof. Kern Alexander

Presentation by

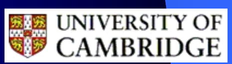
Kern Alexander
University of London Centre for Commercial Law Studies, and the Centre for Financial Analysis and Policy, Judge Business School, University of Cambridge

Main points

- CRD and Basel II
- European Regulatory institutions
- EU Crisis Management

Financial Innovation

- Technical developments in data analysis, statistical theory and in the theory of finance have transformed risk management, pricing, and the range of financial products.
- Credit risk transfer/securitization led to the originate, rate & relocate model (ORR)
- Financial regulation and crisis management have not kept pace with these changes.



Financial Stability Forum

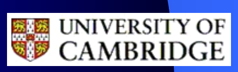
"A striking aspect of the turmoil has been the extent of risk management weaknesses and failings at regulated and sophisticated firms"

Basel II & CRD

- Credit risk exposure of individual bank

But does not adequately address

- Systemic risk – an externality
- Liquidity risk

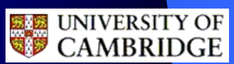


CRD & Basel II

- Credit risk models seek to align regulatory capital with economic capital
- Pillar 2 fails to incentivise bank management to take account of systemic risk
- An excessive reliance on markets to deliver systemic stability
- Far reaching re-appraisal of the analysis underpinning prudential regulation required

Regulatory incentives

- In the run up to the credit crunch banks appeared to have an increasingly healthy ratio of regulatory capital to risk.
- Regulators applauded the growth of securitization as spreading risk
- Market discipline (the stock market) rewarded Northern Rock's & HBOS management and risk-return strategy
- In sum: banks were incentivised by regulators to earn fees for originating risk and for relocating the debt elsewhere.

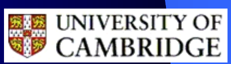


Liquidity

- Liquidity a function not of size but of diversity
- In the face of extreme events
  - Risk *absorbers* will tend to buy assets when they fall in price
  - Risk *traders* will tend to sell assets when they fall in price
- Efficient markets require a balance of both, but regulators have focussed on incentivising risk traders rather than risk absorbers.

The ORR model was the outcome of the incentives facing financial institutions

- Regulatory requirements incentivised banks to originate and relocate loans
- Investors were incentivised to hold (and trade) illiquid, high return assets that appeared to be of low risk
- Investors that could hold illiquid assets were discouraged from doing so by an emphasis on mark to market accounting and the required responses to changes in asset prices
- The size and concentration of the flow to risk traders proved destabilising – and the risk-sensitive models are an important part of the problem



Market gridlock

- Crises in the provision of liquidity no longer take the form of bank runs
- Market gridlock
- Northern Rock & Fortis not "bank runs"

The Response

- from the FSF and from the G7 Finance ministers:
  - more transparency
  - more disclosure
  - more effective risk management by firms.
- More of the Same: "The New Basel Consensus"

The Response

- Improving risk management by firms is valuable in itself, but, in the light of current events, fails on two counts:
  - (1) it fails to address the dilemma that more disclosure & transparency may actually increase systemic risk by increasing herding;
  - (2) it does not confront the externality of systemic risk.

Revising CRD

- Urgent re-appraisal of the underlying philosophy of risk management – regulators should not rely on economic capital models.
- More effective liquidity management
- Role of rating agencies in CRD?
- Emphasis on systemic risks to be a fundamental component of all supervisory activity

A systemic approach

- Fair value accounting
- Counter-cyclical liquidity ‘reserving’. Estimate a future need, not a liability now.
- No ‘secret reserves’, transparent reserve amount based on regulator’s estimate & approval.
- Tax deduction for liquidity reserves in good times, and transfer it to profit/loss during downturn.

A systemic approach

- Contra-cyclical “reserving” – a buffer, not a charge.
- Retention of risk by the Arranger (20%).
- Common stress testing based on the stresses reported to the regulator.
- The negative systemic impact of mark-to-market needs to be mitigated. Mark-to-market for tradable assets
- Need to de-incentivise risk traders in favour of risk absorbers

A systemic approach

- Transform the relationship of the central bank to the market from an institutional approach to a functional approach.
- Target leverage – wherever it may be found!

EU regulatory practice

- Home country control
- Mutual recognition
- Minimum standards

Home country determined where financial firm is incorporated and/or principal place of business

EU institutions have no competence to exercise supervisory practices (only member states)

European banking groups

- Growing differences between the operational and legal structures of the banking group
- More difficult for supervisor to attribute risk to the legal entity (ie., subsidiary)
- Creates suboptimal regulatory incentive to focus on the subsidiary, and not on where risk-taking occurs

Enhancing EU Financial Supervision

- Group of lead regulators from jurisdictions where financial institution's main risk-taking occurs
- Involve host regulators where financial institution has substantial assets and/or liabilities
- EU supervisory body with legal competence to monitor cross-border banks
- Capital measurement models should be adopted by the supervisor in the country where the bank has the most assets and liabilities booked, not necessarily where it has legal status (ie., incorporation), but approved by host supervisors. EU Supervisors Committee resolve disputes

Reforming EU crisis management

- Eliminating national obstacles to the transfer of assets within a banking/financial group during a crisis or to forestall a crisis
- Single set of rules to apply to the reorganisation and insolvency of cross-border financial groups
- EU prompt corrective action mechanism, must override shareholder rights under company law
- Greater deposit protection at EU level

Conclusion

- Recent crisis shows that systemic risk can arise from a general drying-up of liquidity in capital markets
- CRD fails to focus adequately on liquidity risks of bank's whole sale funding model, and too much deference given to bank's internal credit risk models.
- CRD calculation based on individual bank risk factors, rather than on aggregate level of leverage in the system.

Conclusion

- Should there be an EU-wide supervisor for cross-border financial groups? Or other market activities?
- EU bank reorganisation regime and deposit protection scheme

Financial Supervision and Crisis Management in the EU

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Kern Alexander
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Briefing notes

Topic I

The proposed capital retention charge of 5% is a watered down version of the original 15% proposed by the Commission. Is the 5% sufficient to prevent misuse of structured products as happened previously? Does the Commission's Impact Assessment analyse in sufficient depth whether the proposed reduction is justified?

Briefing Paper on Proposed Changes to Capital Requirements Directive in the Area of Securitization[1]

Briefing Paper for the Financial experts panel of December 2008 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Dr Alfred Bieć

Executive Summary

The more securitized assets in originators'/sponsors' portfolio, the more attention to the quality of origination process is applied. That's the main idea underpinning EC's proposal to the Capital Requirements Directive (CRD) amendment in its part devoted to securitization.

Unfortunately, the Impact Assessment document does not support in any way the proposed 15%, 10%, and finally at least 5% of risk retention by originator or securitization sponsor.

Especially that such mechanism already exists in the market practice and is visible when no investor wants to buy certain risk transfer products when risk is too elevated. As a consequence the sponsor or originator is forced to retain certain portion of the risk on their books. To illustrate that mechanism, notice that 84% of the European securitization issuance in the first quarter of 2008 and 75% of the issuance in the fourth quarter of 2007 were retained rather than distributed to investors2. Similar mechanisms one could easily find in the US market. On the other hand, isn't it true that it doesn't matter if originator needs to keep even as little as 5% of risk since the originator is interested in the good performance of the underlying assets due to his reputation and ultimately financing costs in the future? The idea to force all the originators to keep portion of risk on theirs books penalizes those originators or sponsors who operate according with good industry standards.

Keeping in mind what was said above, one should stress that adding a legal obligation to retain a portion of risk on originator's/sponsor's books means costly overregulation, unnecessary and artificial constrain to the European financial market, and it would be ineffective as well.

The key issue here is how to reduce information asymmetry between the buyer and the seller of a security in the presence of inclination to moral hazard by originators, investors, rating agencies supervisors and regulators. All those parties should be affected to some extend by the regulation. Proposed regulation implicitly blames mostly the originators and sponsors of securitizations for the current turmoil. There is no assessment of how a portion of risk retained on originator's books would influence market liquidity, credit costs, and competitiveness of the European financial industry. There is no assessment of how Basel II agreement, fully in force since the beginning of 2008, would prevent from misuse of structured products. There is no assessment of whether extremely risky subprime mortgage securitization experience in the US market forms a good ground to formulate a general regulation for all other assets classes in the European financial market.

[1] Prepared on the request of the European Parliament's Committee on Economic and Monetary Affairs, Commitment number 511/15393(2008)
[2] See: Impact assessment p.142

Rating agencies play an important role in securitizations. They are supposed to reduce information asymmetry between buyers and sellers of the securities. Impact Assessment does not address this issue.

The possibility to keep a certain portion of securitized assets for a certain period of time on the books of originator or sponsor should be an option left to them rather then an obligation imposed on them by law. It would allow markets for more flexibility to adapt to new circumstances.

1. Introduction

The central challenge of the proposed changes to the Capital Requirements Directive (CRD), in part dedicated to securitization, is the answer to the question: who is responsible for the risk on the books of the investor; the investor himself i.e. the buyer of the securities or the seller (originator, sponsor), both of them or maybe the regulator or the supervisor? The answer to that question is an obvious one to me. It is the investor who is responsible for his books and risk attributed to the assets he buys. Question is whether he has access to and is in a position to use all necessary information needed for the proper assessment of the risk of the security under consideration. Economic theory points out the real problem, which needs to be solved here; it is the information asymmetry between the buyer and the seller of the security alongside with moral hazard. The first person, who introduced the concept of information asymmetry to economics, was George Akerlof in his article The Market for Lemons[3] (1970). In 2001 George Akerlof and two other economists working on similar issues (Michael Spence – signaling, Joseph E. Stiglitz – screening) received a Nobel Prize for this concept and for the study on how the market participants behave when they approach to deal with information asymmetry. Signaling describes a situation when one party of a transaction informs other parties about important parameters of the transaction. Screening describes a situation when one party of a transaction screens the market and other participants for more information relevant to the transaction. The information asymmetry and moral hazard create distrust between the parties of a transaction. In extreme situations, information asymmetry may damage the market. We witness such damage currently in the financial markets. The lack of trust between banks and other financial institutions has broken financial liquidity in the market. The banks, and others usually active in financial markets, simply have stopped transacting. The consequence to the economy is a credit crunch, bankruptcies, unemployment, slower growth and recession in certain markets.

What was presented above constitutes a theoretical perspective to which I will refer on the subject being examined here.

The central issue here is how to remove information asymmetry between the seller and the buyer of a security and how to deal with moral hazard.

The CRD change proposal[4] raises several issues. Those issues are:

- Large inter-bank exposures
- Hybrid capital instruments
- Capital Requirements for Securitization
- Colleges of Supervisors
- Home-host issues and crisis management arrangements
- Derogations for bank networks from certain prudential requirements
- Treatment of Collective Investment Undertakings (CIUs) under the Internal Ratings Based (IRB) Approach

[3] Akerlof, George A. (1970). "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism". *Quarterly Journal of Economics* 84 (3): 488–500.
[4] http://ec.europa.eu/internal_market/bank/docs/regcapital/crd_proposal_en.pdf

Out of those seven issues, I will concentrate here on the capital requirements for securitization. And more precisely, as has been requested by the Committee on Economic and Monetary Affairs of the European Parliament, I will pay special attention to answer the following questions:

"The proposed capital retention charge of 5% is a watered down version of the original 15% proposed by the Commission.

- *Is the 5% sufficient to prevent misuse of structured products as happened previously?*
- *Does the Commission's Impact assessment analyse is sufficient depth whether the proposed reduction is justified?"*

3. Impact assessment

In this section, I will make a formal characteristic of the Impact Assessment in terms of its contents structure. And then, I will compose some questions which should have been answered by Impact Assessment but, unfortunately, were not.

3.1. Formal characteristic

The Impact Assessment document5, in its part devoted to securitization, seems to be prepared under shortage of time. The entire document consists of 147 pages including Annexes of 105 pages. There is an Annex of 5 pages devoted to the issue of securitization, as compared, for example, to the Annex of about 40 pages devoted to Large Exposures. Out of those 5 pages, 3 pages were devoted to technical presentation of three general policy options (first option: do nothing, second: prepare targeted changes, third option: complete review of existing requirements), remaining 2 pages characterize the size and tendency of the market, definition of the problem and the public consultation outcome.

Under the second policy option, a proposal was presented to force the originator or sponsor of the securitization to retain at least 15%, and after consultation with industry and Member States watered down to 10% and 5% of the risk of any given securitization. When a bank wants to invest in the securitization it is obligated to investigate whether the corresponding risk exists on the originator's books – irrespective of whether they are EU banks or not.

3.2. Unanswered questions

There is no answer or assessment of such important questions as the following:

- Do we really understand who is responsible for current crisis?
    - Is it the originators'/sponsors' fault?
    - Is it the investors' fault?
    - Is it the rating agencies' fault?
    - Is it the market supervisors' fault?
    - Is it the regulators' fault?
    - It is somebody else's fault?

The answer given in the CRD proposal blames mostly the originators. Is this right?

[5] http://ec.europa.eu/internal_market/bank/docs/regcapital/impact_assessment_en.pdf
http://ec.europa.eu/internal_market/bank/docs/regcapital/resume_impact_assessment_en.pdf

What about other parties involved directly or indirectly in the transactions? Especially investors, rating agencies, financial market supervisors and finally regulators. Did they complete their job correctly?

Unfortunately, the Impact Assessment does not provide answers to those questions. Maybe it is too soon to have an answer. Further and deeper analyzes are needed.

Other unanswered questions by Impact Assessment are:

- What was the default rate of the European securitizations versus the US securitizations in the same risk category?
- Is the subprime mortgage lending (extremely risky) a good foundation to create capital requirements regulation and extend it to other risk categories?
- What was the Special Purpose Vehicles (SPV's) role in the crisis?
    - Should those structures be allowed to finance long assets (loans) with short liabilities exposing themselves to liquidity risk and the markets to instability?
    - Should those structures be off balance items, not affecting the balance sheets and capital of the sponsors?
    - Do they need to be regulated?
- What about other subprime lending securitizations, for example in the auto-loan markets?
    - Do that market (auto) and securitizations in that market have similar default characteristics? Is it truth that borrower would stop paying his auto-loan obligation first and then only later would stop paying his mortgage obligation?
    - Does originate to distribute models in the autos' markets create similar problems to the investors and securitization industry? Are the default rates the same? Is the severity to investors the same?
    - Are there any parallels between subprime housing markets and subprime autos markets?
- What about the quality of the ratings made to the securitization issuances by rating agencies?
    - Were those ratings realistic?
    - Do any independent assessments of those rating exist?
- How would the Basel II accord in force since the beginning of 2008 influence misuse of structured product?
- Why was there a proposal of at least 15%, then 10% and currently 5% of the risk to retain? What was the underlying principle behind those numbers?
    - What impact would it have on risk mitigation of a given investor,
    - What impact would it have on competitiveness of EU banks and financial sector,
    - What impact would it have on liquidity of the EU financial sector,
    - What impact would it have on cost of credit,

- What mechanisms would be in place to make sure that the originator really holds10% of risk,
- What would happen if investors would find out that originator is not holding at lest 10% portion of the risk of the product under consideration? How it would impact prices of those assets if investor would be forced to fire sells?
- For how long should the originator keep its portion of risk?

At the same time, it is understandable that if some originators or sponsors would be required to hold certain portion of securitized risk, then there would be more attention on their part to maintain better underwriting/originating standards. How large should that portion be to make sure that they would maintain proper underwriting standards and who are those originators or sponsors? The answer is not easy but the Impact Assessment does not discuss that issue. On the other hand, isn't it true that it doesn't matter if originator needs to keep even as little as 5% of risk since the originator is interested in the good performance of the underlying assets due to his financing costs in the future?

If so, it seems to me that, the idea to force all the originators to keep portion of risk on theirs books penalizes those originators or sponsors who operate according with good industry standards.

That is why it seems that qualitative approach on the originator, investor, supervisor and rating agencies side would be more appropriate.

4. Proposal discussion

In this section, I will discuss issues directly related to the question posed be the Committee.

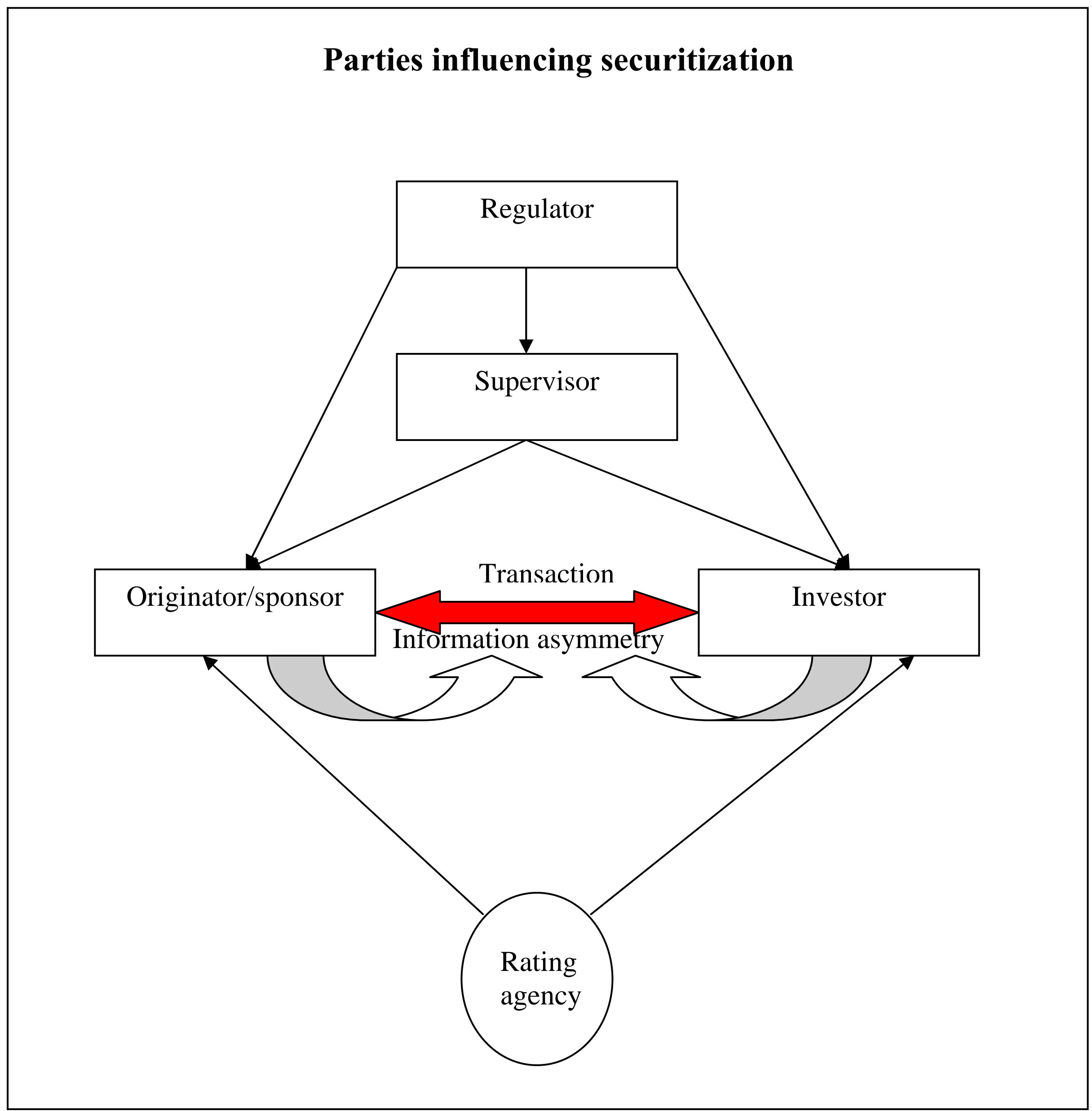
Is some portion of risk (5% for example) left on the originator books sufficient to prevent misuse of structured products as happened previously?

4.1. Parities to the transaction

First let's define parties involved in the process of securitization directly and indirectly.

As we can see in the figure below, there are usually five parties involved in securitization process: (1) originator/sponsor, (2) investor, (3) supervisor (for example banking supervisor, capital market supervisor, insurance market supervisor, etc.) (4) rating agency and (5) regulator.

Figure 1



4.2.How much risk left prevents from default

Let's assume that originator knows that 100% of risk of a given loan portfolio will be seating on originator's books up to maturity, as it used to be in the banking practice in the past. Does this fact prevent him from experiencing default on some number of loans in his portfolio? Everybody who knows the lending business would answer: NO. Then, it proves that the risk left on originator's loan portfolio does not, per se, prevents any portion of the portfolio from defaulting. This is because credit portfolio performance depends not only on underwriting standards but also on market conditions. If so, then 15%, 10% or 5% capital retention charge alone is not enough to prevent securitized assets from underperformance. This is the first clarification which says: one should not expect to invent such a retained portion of securitized assets, which would eliminate risk from financial assets. Always, there will be risk of default.

4.3. Misuse of product and moral hazard

Would maintaining some portion of securitized assets be enough to prevent from misuse of structured products?

The word "misuse" suggests that there is an intention to use the product in the way that it excessively threatens other market participants' interests. In other words, there is inclination to moral hazard. Each case would be different. Because it would depend on to what extent market participants; investor, supervisors, rating agencies, originator or sponsor would be affected by moral hazard and to what extend market reputation would be important to them. Probably, there is no such amount of risk remaining on the originators books that would prevent from moral hazard. In some cases, probably even if 100% of risk would be seating on originators books, they would be inclined to moral hazard. In practice, inclination to moral hazard depends on the organizational culture. More precisely, it depends on the balance of power (influence) in organizational (financial institution) structure between people responsible for sale and the people responsible for risk management. Going deeper, it depends on performance based incentive structure of top management. The more their salaries, bonuses and other incentives depend on short or mid term performance, the more they would be inclined to moral hazard.

4.4. Special securitization standards for high risk assets

Going back to the current financial crisis it is worth asking: to what extent it was a misuse of a financial instrument and to what extent it was a natural development in the market. It is well known that from time to time some assets performing under the stress lose their value. We have already shown that there is nothing unnatural that in some market circumstances loan portfolio may be in default.

Keeping in mind that current crisis has been triggered by subprime mortgage securities which were very risky assets6 maybe we should review a securitization scheme for such risky assets. Maybe the most junior trench (so called toxic) was too thin in those securitizations? As it is well known the toxic trenches are very difficult to sell. So, the thinner the trench, the easier it is to get relieved of it. That's why most senior trenches have not been safe enough. It is because triple A does not really mean triple A in a stress situation. If so, the problem would not be loan underwriting standards but securitization scheme standards under given originating/underwriting standards (in case of extremely risky borrowers). Another issue is that other subprime lending securitizations such as, auto loans may not have similar to mortgage lending destructive characteristic. Then, forcing European financial market to retain some portion of securitized risk on their balance sheets regardless of what assets class and what kind of risk those assets represent looks like using hammer instead of chirurgical scalpel.

[6] In forth quarter 2007 in the US default rate of subprime mortgage loans was 6 times greater then normal mortgage loans. See. Gary B. Gorton (2008)

4.5. Size matters

Another issue of subprime mortgage loans and their securitization in the US is the size of the market. According to Gary B. Gorton[7] in 2007Q1 the subprime type mortgage loans market amounted to 1,5 trillion US dollars. This is around 1% of word's financial assets[8]. Out of those subprime loans 80% were securitized. The total US mortgage loans market amounts to 6 trillion US dollars. Those numbers can be compared for example to the total net equity and debt flow to developing countries up to 2007, which amounted to $1.03 trillion[9]. If one compares the US subprime mortgage outstanding to the assets of EU banking sector (~30 trillion EUR in 2007) then it is close to 4% of total asset of EU banking sector, and this is more then 50% of the Deutsche Bank's assets at the end of 2007.

Substantial size of subprime mortgage securitization and its spread all over the entire financial word made it dangerous to the financial sector stability. Because the US and European financial centers are the largest in the World and are closely cooperating, with strong financial ties to each other, then the financial crisis would strike the US and European financial institutions first.

4.6. Level of risk retention

The level of risk retention on the balance sheet of originator or sponsor should be reexamined. The Impact Assessment did not support any of the numbers (15%, 10%, 5%) proposed. It seems that it was simply guessing.

It is important to say, that risk retention on the books of the originator does not prevent financial markets from misuse of structured products. It is because moral hazard is always present in the real world. The originators, investors, rating agencies, supervisors and regulators – are all affected by moral hazard.

But it is worth to say that risk retention may slightly diminish misuse of structured products in case of some originators and sponsors; those who are extremely inclined to moral hazard. On the other hand it should be taken into account how the risk retention would influence the competitiveness of the European financial sector and cost of credit in Europe. And it should be taken into account that different risk categories may need different treatment.

5. Quick reaction to crisis symptoms

This part of the Briefing Paper does not correspond to the main topic of the Paper, which is the CRD amendment.

This is to propose a worldwide system of quick identification of those financial institutions that have on their books assets being under stress. The main issue of the current financial crisis, and earlier ones, is the lack of trust between market participants and as a consequence the lack of liquidity in the market. If the world financial system were in the position to identify quickly who and how much of affected assets keeps on his balance sheets then it would be easer to maintain confidence and, as a consequence, liquidity between market players. What is needed to create such a system? First, worldwide consensus is needed on the scope and the functioning of the system.

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[7] Gary B. Gorton, *THE PANIC OF 2007*, NBER WORKING PAPER SERIES, Working Paper 14358, September 2008, p. 8

[8] See McKenzie

[9] Global Development Finance. The Role of International Banking. The World Bank, 2008 p. 34

The main idea is that the financial institutions being supervised should be obligated under the regulation to report how much of affected assets they have on their books. Second, a model of the system is needed including parties' rights and obligations, timing, interdependencies and several reaction scenarios. Third, worldwide unified software is needed, which would allow automatic data collection from financial institutions and pooling those data. Fourth, a governing body is needed which would trigger the system initiation and be responsible for its maintenance and development.

Report on the treatment of securitisation in the Capital Requirements Directive (CRD)

Briefing Paper for the Financial experts panel of December 2008 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Didier Davydoff

Executive Summary

The European Commission proposed amendments to the Capital Requirements Directive (CRD), including provisions concerning the exposure of credit institutions to securitised credit risk. Among others, the amendment would require the originator or the sponsor of any credit transferred to a European credit institution to issue an explicit commitment to maintain at least 5% (the "retention ratio") in positions having the same risk profile as the transferred credit. This proposal came after a previous one that foresaw a 10% retention ratio.

This proposal is intended to reduce the conflict of incentives between the originator of the credit and the final bearer of the risk that appeared in the "originate-to-distribute" model. However the current crisis should not be attributed to all kinds of securitisations. The origin of the current financial turmoil was the irresponsible provision of loans to American households (the sub-prime crisis) and the wrong models used by rating agencies to evaluate the risk of defaults of the complex financial products based on those loans.

The alignment of incentives of originators and investors is desirable but not sufficient if it leads to hold positions enabling originators to provide irresponsible lending. Financial institutions, ministries of finance and market authorities took part in the public consultations but key stakeholders did not participate in the public debate: individuals who are at risk of overindebtedness because of the OTD model.

A second consideration is that the regulation should not prevent the development of securitisation of sustainable mortgage or commercial credit in Europe. Securitisation plays a significant role in the refinancing of credits in some European countries (mainly the United Kingdom, Spain and the Netherlands).

A third consideration is that the alignment of incentives will be weak when the sponsor, rather the originator of the credit will retain positions in its books: a major aspect of the alignment of incentives concerns credits on an ongoing basis, when difficulties of reimbursement appear. But sponsor have no direct relationship with the debtor.

Concerning the level of the ratio, rough simulations show that the retention ratio does worsen the risk profile of the originator and that in some cases the impact of the 10% ratio would be significantly bigger than the one of the 5% ratio. However, in-depth analysis should be run in order to evaluate the impact of different levels of ratio. Such analysis should also aim at measuring potential collateral effects of the retention ratio, including higher costs of borrowing and smaller supply of credit to households and corporations. This analysis was not run within the impact assessment released by the European Commission.

In any case, one cannot expect that the retention ratio will restore confidence in the background of the current financial turmoil: it will only apply to exposures incurred by credit institutions after 1 January 2011.

The European Parliament has asked me to answer the following questions:

"**The proposed capital retention charge of 5% is a watered down version of the original 15% proposed by the Commission. Is the 5% sufficient to prevent misuse of structured products as happened previously ? Does the Commission's Impact assessment analyse in sufficient depth whether the proposed reduction is justified ?**"

A. Background of the Commission's proposal

The European Commission proposed to amend the Capital Requirements Directive of June 2006 (2006/48/EC and 2006/49/EC) in order to reinforce its effectiveness. Among others, the proposal includes provisions concerning the exposure of credit institutions to transferred credit risk. The new article 122a added to Directive 2006/48/EC foresees that the originator or the sponsor of such risk should issue "an explicit commitment to the credit institution to maintain, on an ongoing basis, a material net economic interest and in any event not less than 5 per cent in positions having the same risk profile as the one the credit institution is exposed to". Credit institutions should be able to produce this commitment to the competent authorities.

The original proposal of the Commission required originators of securitisations to hold capital for at least 15% of the securitised exposures. As responses to a first public consultation were very critical to this approach, a new proposal was published by the Commission and submitted to public consultation in June 2008: Credit institutions would be allowed to invest in credit risk transfer products only if the originators of the credit retain in their own books at least 10% of the transferred exposures in position having the same risk profile. This proposal was intended to align the incentives of originator of loans and the ones of the final bearer of the risk.

Responses to the second public consultation were as critical as the first ones. Respondents – financial institutions, ministries of finance and national market authorities – considered that the "originate-to-distribute" (OTD) model could be sufficiently improved by enhanced transparency and strict due diligence requirements. Respondents considered that the retention ratio would be ineffective and could be contravened by financial innovation. However the Commission maintained its position in favour of a quantitative requirement applying to originators or sponsors, even though it lowered the proposed minimum retained positions from 10% to 5%. Syndicated loans and credit default swaps, which were included in the first proposal, were finally excluded from the retention requirement if "there are not used to package and/or hedge an obligation" to which the retention would otherwise apply. Furthermore, more flexibility is given in the new proposal, as it would be left either to the originator, or alternatively to the sponsor to retain exposure, whichever would be easier to implement. Among other, the Commission justified this new flexibility by the case of securitised products based on loans granted by several originators, for which the retention ratio would have been difficult to implement.

Credit institutions should also be able to demonstrate to their national regulators that they have an understanding of their securitisation positions and have a performance monitoring system in place. Furthermore, originators and sponsors would be required to comply with new disclosure rules to make their loans eligible to securitised products acquired by European credit institutions. Originators of credits would also be required to align their lending criteria for lending exposures with loans they keep in their books.

B. Which wrong practices should be forbidden by regulation?

The origin of the problem: irresponsible lending by US banks

The origin of the current financial turmoil was the irresponsible provision of loans to American individuals, leading to a massive overindebtedness of poor households in the US. The credit burden (including monthly interest and repayment of the credit) was unbearable by many households when compared with their disposable income. It was clear that lenders could get their money back only by using the dwelling itself as a guarantee for the mortgage.

This statement raises two issues:

- Firstly the securitisation of corporate debt worked well. Hence, it is important to be sure that regulatory measures do not hamper the development of this market which contributes to the provision of credit to corporations for financing their investments.
- Secondly, the idea of the retention obligation was conceived as a clever trick to avoid conflicts of interest in the "originate to distribute" model and to align the incentives of the originator of the credit and the ones of its final bearer. However, would irresponsible lending be acceptable if there was no conflict of interest between the originator and the final investor ? For example, if the prices of US dwellings had not fallen down and had permitted the lenders to avoid loses by selling the dwelling of insolvent households, would investment by European banks in such instruments be acceptable, or should social responsibility principles have prevented them to do so?

The transmission of the problem: wrong models to measure risks

Rating agencies underestimated to probability of default associated to securitisation products because they did not run sufficiently strong stress scenarios. This proves that transparency is not sufficient to avoid wrong evaluations: rating agencies access confidential information that does not necessary reach investors. However their ratings underestimated the probabilities of default.

This is an argument in favour of quantitative rules complementing the enhancement of transparency and stricter due diligence requirements.

Final losses of investors

Portfolio managers relied on ratings to invest in structured products. They are often constrained to buy only AAA products. As many structured products benefited from that rating, they were investible. Enhancing transparency would increase the responsibility of portfolio managers.

C. What can be expected from the principle of the retain ratio?

Requiring the originators of credits to retain a minimum percentage of their securitised credits should contribute to align their incentives with the final investor's interest.

- This alignment should operate when the credit is granted to the investor.
- It should also operate on an ongoing basis, when difficulties of reimbursement appear: a bank is able to negotiate with a debtor. For example, the bank can re-schedule the credit rather than just writing-off the credit when there is an arrear of payment by the debtor. However, if it is the sponsor which retained a percentage of the securitised position, it will not be able to do so, as it is not in direct contact with the debtor.

Most practitioners from the industry raised practical issues of implementation and cost considerations. They fear the issuance of securitised products would be considerably diminished. As securitisation is a refinancing instrument for banks, respondents to the consultation believe that the provision of credit to households and corporations would be diminished. This consequence of the new regulation would be unfortunate in a period of economic recession.

This argument should be taken into consideration, although securitisation plays a much smaller role in financing the economy in Europe than in the United States: at end of the third quarter of 2008, the total amount of securitisation was almost five times higher in the United States (6.960 billion euros) than in Europe (1.488 billion euros).

In fact, amounts at stake are very different from one country to another. Table 1 compares outstandings of Residential Mortgage Backed Securities (RMBS) broken down by country to outstanding loans to households for house purchasing. It shows that securitisation is barely used as a refinancing tool of dwelling loans in France and Germany. On the contrary, it accounts for one third of dwelling loans in the Netherlands and for around one fifth in other countries.

Table 1: Outstandings at end of 2008-Q3 (in billion euros)

	(1)	(2)	(1)/(2)
	Outstanding Residential Mortgage Backed Securities (RMBS)	**Outstanding loans for house purchasing**	**Share of RMBS**
Germany	6,5	963,1	0,7%
France	13,7	686,7	2,0%
Belgium	21,6	106,0	20,4%
Italy	55,0	261,7	21,0%
Spain	136,8	649,5	21,1%
Ireland	28,1	124,4	22,6%
Portugal	23,8	105,1	22,6%
United Kingdom	350,9	1 534,3	22,9%
Netherlands	137,1	406,5	33,7%

Sources: ESF, ECB, Bank of England

Table 2 relates outstandings in ABS with collateral including consumer loans to outstandings of consumer loans in various countries. ABS figures are in average lower than RMBS, but consumer credit is also less important than credits for house purchasing. ABS collaterals are the highest in Italy, in the United Kingdom and in Germany.

Table 2: Outstandings at end of 2008-Q3 (in billion euros)			
	(1)	**(2)**	**(1)/(2)**
	ABS with collateral including auto loans, credit card, loans (consumer and student) and other	**Outstanding consumer loans**	**Share of ABS**
Ireland	-	21,9	0,0%
Belgium	0,3	9,7	3,1%
France	9,2	156,9	5,9%
Netherlands	2,7	24,0	11,2%
Portugal	2,0	15,3	13,1%
Spain	18,4	103,9	17,7%
Germany	32,6	171,7	19,0%
United Kingdom	43,7	188,6	23,2%
Italy	49,7	55,4	89,6%

Sources: ESF, ECB, Bank of England

Table 3 relates total outstandings in CDOs and Commercial Mortgage Backed Securities to outstandings of credit to non-financial corporations in various countries. This segment of the securitisation market with collateral including claims on corporations is smaller than the other segments, except in the UK, where it represents 11% of total outstanding loans to non-financial corporations.

Table 2: Outstandings at end of 2008-Q3 (in billion euros)			
	(1)	**(2)**	**(1)/(2)**
	Sum of CDOs and CMBS	**Outstanding consumer loans**	**Share of ABS**
Belgium	0,1	120,7	0,1%
France	4,4	824,5	0,5%
Italy	8,0	868,3	0,9%
Portugal	1,4	114,8	1,2%
Ireland	4,9	192,3	2,5%
Germany	31,5	927,8	3,4%
Spain	44,8	961,5	4,7%
Netherlands	19,1	334,4	5,7%
United Kingdom	78,1	711,1	11,0%

Sources: ESF, ECB, Bank of England

In its impact assessment, the Commission considers that a dramatic fall of securitisation issuance already happened in 2008 and that no regulation could have a worse effect on the market than the current lack of confidence. It believes that the retention ratio will restore confidence and allow for a restart of the issuance. However, it should be noted that the retention ratio will only apply to exposures incurred by credit institutions after 1 January 2011. But there is an urgent need for restoring confidence. Regulatory action should be efficient much more rapidly in the background of the current financial turmoil.

Furthermore, the proposed new article also foresees that "competent authorities may decide to temporarily suspend the requirements during periods of general market liquidity stress". This latter provision appears to be contradictory with the argument that the retention ratio will restore confidence: if it were the case, it would be all the more necessary in periods of liquidity stress. In fact the current liquidity crisis shows that credit institutions tend to retain almost all issuance to bring them as collateral in the framework of Central Banks liquidity schemes.

D. 10% or 5%: what does it change ?

Today, the level of the retention ratio would not change anything as the greatest part of current securitisations are retained for repo purposes in Central Banks liquidity schemes. In particular, the ECB changed its liquidity framework and now accepts securities with lower ratings (BBB- from A-) as collateral.

However the question has to be raised for the future, when securitisation will play a role again in terms of transfer of risks, not only in terms of refinancing.

The impact assessment published by the Commission does not deal with this issue: it only discuses the opportunity of having a retention ratio, not the desirable level of this ratio. It mentions the 10% ratio, not the 5% one.

We propose a rough numerical example comparing the risk profile of a bank which would retain 10% (or alternatively 5%) of the risk exposure related to a credit it granted on the one hand, and the risk profile of an investor who would bear 90% (or alternatively 95%) of the same risk exposure.

Let's assume that the originator granted loans of 1 million euros to 100 corporations. Rating agencies calculate default rates according to the ratings. We use Standard and Poor's descriptive statics:

Rating of the corporate debt	Weighted long-term average one-year default rates (in %)
AAA	0.00
AA	0.01
A	0.06
BBB	0.23
BB	1.00
B	4.57
CCC/C	25.59

We assume that the expected loss is equal to the nominal amount of the loan multiplied by the corresponding default rate. We know that this is an over simplistic assumption, as a default is recorded on the first occurrence of a payment default (the debt can be totally or partially reimbursed in the future). We propose this numerical example for illustrative purpose only to get a rough measure of incentives.

Then we consider the risk profile of the portfolio of the originator on the one hand, of the investor on the other. For example, the originator of 100 loans of 1 million euros rated B would have the following exposure if it retains 10% of the credits in its books and exchanges the remaining 90% against assets without risk (deposits at the Central Bank for example):

(4.57%x10)+(0x90)= 0.457 million euros.

The rating which is the closest to this profile is a credit BBB (expected loss for a portfolio of 100 credits of 1 million euros: 0.230 million euros).

The risk profile of the investor is:

(4.57%x90)+(0x10)= 4.113 million euros

The rating which is the closest to this risk profile is B, like the original credit.

The overall output of this calculation is as follows:

Rating of the debt	Risk profile of the holder of the securitised debt	Risk profile of the originator (without any retention ratio)	Risk profile of the originator (in case of a 10% retention ratio)	Risk profile of the originator (in case of a 5% retention ratio)
AAA	AAA	AAA	AAA	AAA
AA	AA	AAA	AAA	AAA
A	A	AAA	**AA**	**AAA**
BBB	BBB	AAA	AA	AA
BB	A	AAA	A	A
B	B	AAA	BBB	BBB
CCC/C	CCC/C	AAA	BB	BB

The table shows that the retention ratio does worsen the risk profile of the originator. But there is only one difference between the impact of the 10% and the one of the 5% ratio. Only if the debt is rated A (upper medium grade), the originator has a portfolio AA (high grade) with a 10% ratio, and AAA (prime) with a 5% ratio. This difference is significant, as A ratings account for approximately one third of outstanding European ratings other than AAA (source: Moddy's) and one fifth of the US ones.

The level of the retention ratio may have a triple collateral impact:

- An impact on the diligence managed by the originator of the credit. This is the goal of the ratio but it raises the cost of securitisation from the originator's viewpoint. Originators might be incited to rather sell their securities to non-European investors, especially if the retention ratio requirement is extended to securities bought by European UCITS.
- An impact on the cost of credit for the borrower and finally on the flows of new credits granted to households and corporations.

- An impact on the return of securitised credits for final investors.

Being obliged to retain a portion of its credit in its own books, it is possible that the originator of the credit or the sponsor retains a higher percentage of the credit to help the sale of the securitised product to the investor. Indeed, keeping a position implies fixed costs for the originator for maintaining and managing the file of individual borrowers. The more the originator appears to be ready to keep a position in its books, the more the investor confidence will be increased.

All actors will run a costs-benefits analysis, in which the proportion of the credit retained by the originator will be a key parameter.

Conclusion

Respondents to public consultations were financial institutions and financial public authorities only. They oppose the retention ratio for practical reasons of implementation. However, not all stakeholders took part in the consultations related to this draft amendment of the CRD. The OTD model started with irresponsible lending by American credit institutions leading to massive overindebtedness of households.

It is necessary, not only to align the interest of the final bearer of securitised products, but also to be sure that those interests are consistent with the general obligation of social responsibility credit institutions should comply with. Distributing 90% or 95% of irresponsible loans does not make much difference: both are contradictory with social responsibility.

As far as responsible loans are concerned, an in-depth analysis should be run in order to assess all effects of a retention ratio and to determine the best level for such a ratio.

Capital Resources Directive: amendments regarding securitisation

Briefing Paper for the Financial experts panel of December 2008 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Richard Pratt

Executive Summary

Developing global trade and financial imbalances that developed this century created unstable conditions in the world's financial markets. These conditions included cheap and easily available credit, the use of complex financial instruments and a willingness on the part of financial institutions to buy products they did not fully understand, whose risks they did not properly assess, manage or price.

One manifestation of this tendency was the extension of mortgage credit to borrowers in the US who would not normally have been considered adequately credit worthy ("sub prime borrowers"). The mortgages were incorporated within complex financial instruments according to a business model known as "originate to distribute". The financial instruments were sold to investors, hedge funds, insurance companies and other banks. When mortgage defaults began to arise, the effect spread rapidly through financial markets and this was the trigger for the turmoil recently experienced as the unstable conditions resulted in the sharp correction that was, in any case, inevitable.

Banks using the "originate to distribute" model have an incentive to earn fees by granting large numbers of mortgages but do not suffer the consequences if credit standards decline. The Commission proposals address this conflict of interest and include requirements for increased due diligence by banks when buying these instruments and a rule that banks should only buy securities based on pooled risks when the originator or sponsor retains an interest in at least 5 per cent of the risks.

The conflict of interest is important and should be addressed but is not substantially different from other conflicts of interest between intermediaries and investors throughout the financial services business. Moreover, unravelling of "sub prime" mortgages was the trigger but not the fundamental cause of the turbulence.

The Commission impact assessment does not provide sufficient justification for the proposal. It provides no data on whether those banks that operated the "originate to distribute" model extended credit on worse terms than those operating on the traditional model (and there is evidence that, in fact, they did not). It does not explain why this conflict of interest cannot be adequately addressed through the more normal regulatory requirements for a code of conduct and for disclosure (enhanced requirements for which are, very properly, included amongst other proposals made by the Commission). It does not address other fundamental objections to the proposals, particularly that it may create a perverse incentive on investors to continue to fail to undertake adequate due diligence.

The conclusion of this paper is that the proposal is not sufficiently justified and the impact assessment does not adequately address the fundamental objections to the proposal. The most appropriate solutions relating to capital disclosure, enhanced due diligence and strengthened supervision are also included within the Commission's proposed amendments and are the appropriate way forward.

1. Introduction

1.1. The European Parliament has commissioned a briefing paper on the following questions:

> *The proposed capital retention charge of 5% is a watered down version of the original 15% proposed by the Commission. Is the 5%sufficient to prevent misuse of structured products as happened previously? Does the Commission's Impact assessment analyse in sufficient depth whether the proposed reduction is justified?*

1.2. The argument put forward in this paper is that the new proposal is rather different from the original Commission proposal, is not, on its own, either necessary or sufficient to prevent misuse of structured products and is not analysed in sufficient depth in the Commission's impact assessment. The Commission does not explain why this proposal is necessary when its other proposals adequately address the problems on their own.

1.3. This proposal is one of a series that amend the Capital Resources Directive (CRD – 2006(48)EC). Overall, the proposals are designed to address the weaknesses in financial institutions' behaviour that have led to the recent turmoil in financial markets, the freezing of the credit markets and the consequential effects on the real economy. To put the Commission's proposal in context, it is therefore necessary to examine first the key underlying causes of the financial turbulence that are relevant to the proposal.

2. The Background to the Market Turbulence

2.1. Throughout the early years of this century, severe global imbalances in global trade and financial flows began to build up, reinforcing and accelerating trends that had begun in the late 1990s. Emerging markets, particularly China and India, liberalised their trading policies and began to experience substantial economic growth as they were able to manufacture products at prices that were very attractive to consumers in developed markets. In such circumstances, it might be expected that the new investment opportunities in the emerging markets would result in substantial financial flows from developed to developing markets.

2.2. In fact, the reverse happened. The increasing level of exports to the developed countries resulted in trade surpluses that might have been offset to some extent by inflows of foreign direct investment but might also have been expected to have resulted in an appreciation of the exchange rates of the emerging economies. There were market pressures in that direction. However, for policy reasons, emerging markets policymakers intervened to prevent their exchange rates rising. They did so by buying (mostly) US assets (especially US Treasury bonds) in very large quantities. The financial flows represented by these purchases more than offset the inward direct investment in emerging markets. In effect, the emerging economies lent money to the developed world, to finance consumption rather than borrowing from the developed world to finance investment [1] [2].

2.3. Moreover, because of the effect of cheap imports (reinforced, in the case of EU countries by the availability of plentiful labour from new accession countries), inflationary pressures appeared to recede in developed countries and authorities' policy interest rates remained low in the US and elsewhere. Moreover, the risk spreads between traditionally low risk assets and other assets, normally regarded as being of much higher risk, fell to very low levels [3].

2.4. The effect of these factors was that cheap credit was increasingly freely available in developed countries. Investors were keen to enhance investment returns in a low interest rate environment and looked to the financial markets to supply financial instruments that increased yield. The period was one of substantial market innovation as financial institutions responded to the demand for new instruments. There was particular demand for instruments that had some similar characteristics to bonds but which generated higher returns (at a time when interest rates on conventional bonds were low).

2.5. These instruments included those designed to transfer credit risk. One example was the mortgage backed security (MBS). A number of individual mortgages would be bundled together by the originator (usually a bank) and sold to a structured investment vehicle (SIV). The SIV would then issue different classes (or tranches) of bonds with different risk/return characteristics. In normal course, a relatively small (and reasonably predictable) proportion of mortgagors default on their repayments. The SIV would therefore issue, typically, three classes of instrument. The first (equity) tranche would give the highest return but would be the first to absorb any losses from defaulting mortgagors. The next (mezzanine) tranche would absorb any losses that were not absorbed by the equity tranche. The most senior tranche would not suffer any losses unless the first two tranches were completely wiped out. The return on the senior tranche would be lowest but was still higher than that achievable, at the time, from conventional bonds. Investors in senior tranches considered that there was a very low chance that mortgage defaults would be so extensive that they would not be absorbed by the lower tranches. In many instances, such senior tranches were rated as AAA by the credit rating agencies.

2.6. Other forms of asset backed securities (ABS) were also issued. In addition, financial intermediaries bundled together MBSs and other ABSs into new SIVs, which then issued further tranches of securities – with equity, mezzanine and senior tranches as before. Securities of this kind were sold to hedge funds, insurance companies, and individual investors as well as to commercial and investment banks.

2.7. The availability of the MBSs and easily available cheap credit encouraged banks to alter their business models. Traditionally, banks would have accepted deposits from the public and used the funds to lend. The availability of cheap credit meant that they could borrow from the wholesale money markets at cheaper rates than those they would have to pay retail depositors. Those that specialised in mortgages would borrow on the wholesale markets, lend to mortgagors and then package the mortgages to be sold as MBSs. The latter practice became known as the "originate to distribute" business model.

2.8. In principle, this extensive risk transfer should have been a good thing for financial stability because it removed risk from banks' balance sheets and spread them throughout the financial markets. However, the benign effect of this was offset by a number of other factors:

2.8.1. Financial markets became much more interconnected and so problems in the banking sector were quickly transmitted to other sectors;

2.8.2; Banks made loans to investors to purchase the ABSs they were selling, so in the event of a loss of value of the securities, the bank found that it was exposed to the risk of default by the purchasing investor;

2.8.3. Financial institutions that created SIVs to buy ABSs and then re-issue new securities, considered that they could not accept the reputational risk that would arise from a default by the SIVs they had created and therefore felt obliged to take the risks back onto their balance sheet when the value fell;

2.8.4. The complexity of the instruments that were created by this process of repackaging, slicing and reselling in new tranches meant that it was very difficult for investors to assess the underlying risk, so that many investors did not make serious efforts to assess risk, value the assets and manage the risk but instead relied heavily on the ratings of credit rating agencies;

2.8.5. Those ratings, although reasonable as regards the credit quality of the tranches (especially the senior or low risk tranches), did not necessarily reflect the risks associated with the likely volatility of the price of the securities, particularly in stress conditions.

2.9. One striking aspect of the general tendency to relax lending standards and to under-price risk was that those specialising in mortgages extended mortgage loans to those who might not otherwise have qualified. Mortgages were given to "sub prime" borrowers who may not have had sufficient, or sufficiently secure, income to service the debt. Although, in the light of recent events, this was the most glaring example of the lax credit standards, in fact this laxity was evident in many other areas, including loans to households and businesses. Financial institutions misjudged the risks involved in this lending [4].

2.10. Once the benign credit conditions began to change, the effect was sudden and dramatic as has now been seen. Defaults on mortgages began to rise and the price of the corresponding MBSs fell sharply. Investors refused to buy the more complex instruments because it was not clear to what extent they were also affected by the increased level of default. The falling price of these securities meant that financial institutions holding them had to write down their value (according to accounting rules requiring them to "mark to market") and the sheer size of their holdings meant that their losses substantially eroded their underlying capital. Where the investors were banks, they were forced to sell assets in order to restore their capital to the levels demanded by regulatory authorities (and the market).

2.11. Where the investors were insurance companies, the credit rating agencies began to consider downgrading their ratings and this, in turn, reduced the value of some of the insurance contracts they had written (in areas of the markets totally removed from mortgages). In some cases, they had underwritten the value of securities and those holding the securities began to sell them. Sometimes the investors were forced to sell because they were regulated institutions such as pension funds and regulatory requirements forbade them from holding such securities unless they were guaranteed by a highly rated insurer. Other participants, who had relied too heavily on the protection given by credit insurance had to reassess the quality of the counterparty (the insurer) in the light of market developments [5]. This prompted some to add to selling pressure. Where the investors were hedge funds, they found that their own investors, who became concerned about the value of their investments, sought to redeem their holdings, forcing the hedge funds to sell asset to realise cash for redemptions [6].

2.12. The effect of this selling pressure in all parts of the market was to reduce the value of a wide range of assets (not just the more complex credit transfer instruments discussed in this paper). Where the assets were held by financial institutions, the falling prices created further losses according to the "mark to market" accounting rules. This in turn forced further selling and a downward spiral of sales pushing prices down and creating further losses and further asset sales [1]. When major institutions were no longer able to sustain the losses and household names were either forced to merge (Bear Sterns), allowed to collapse (Lehman Brothers) or forced to seek Government help (AIG), fear mounted in the marketplace that no one could be sure of the creditworthiness of any counterparty.

2.13. One particular effect took most players in the financial markets by surprise. Those who bought the more junior or equity tranches of the ABSs and other credit transfer instruments were prepared for losses. They knew they had bought a high risk investment and were prepared that it might reduce in value. However, those who had bought the more senior tranches did not understand their performance characteristics at times of severe system wide stress and were not prepared for their dramatic fall in value [6]. This fall was caused partly by the growing awareness that the precise composition of the assets underlying these instruments was unknown. However, when regulated institutions holding ABSs were forced to sell securities to restore capital, they were forced to sell the more senior tranches. By this time, there was no market for the more risky or equity tranches. As a result of the forced sales, the prices of the senior tranches of securities fell substantially.

2.14 In practice, substantial amounts of these senior tranche securities were held by major commercial and investment banks. This was partly out of choice. It was also because, during the benign credit conditions that had applied before 2007, there was a stronger market for the higher yielding equity tranches. The originating institutions found that they retained the securities from the senior tranches on their own books. In addition, many of the banks that were originating mortgages and selling them as MBSs had packages of securitised mortgages, held in their own subsidiaries, ready in the pipeline for subsequent onward sale [6]. The financial turbulence meant there was no longer a market for them.

2.15. In summary, the global imbalances in trade and finance led to cheap and easily available credit in the developed world. This resulted in a search by investors to increase investment returns. The sheer quantity of investment funds available for lending prompted banks and other lenders to relax their due diligence standards, to take on substantial amounts of debt and to place too low a price on the risks they were taking on. Their willingness to relax standards in this way meant that they were prepared to buy more complex financial instruments, the true risk of which they did not fully understand. Banks adopted business models that depended upon their ability to borrow substantially in the wholesale money markets and to sell bundles of securitised assets.

2.16. When the conditions changed, the effect was dramatic. The total marked to market losses on credit assets in the US and Europe have been estimated at $2.8 trillion [7], equivalent to about 85 per cent of banks pre crisis "Tier 1" regulatory core capital [1]. Moreover, the fall in the value of other assets (for example prime UK MBSs) is far greater than would be expected by any plausible projection of possible losses arising from such instruments, thus demonstrating the market's general retreat from such instruments. [1]

3. The Commission Proposal

3.1. A bank that arranges mortgages and then sells the mortgages on to other investors may be affected by perverse incentives. The bank earns fees based on the number of mortgages it can arrange and then sell as MBSs to investors. However, it does not expect to retain the mortgage on its balance sheet and therefore may be less concerned about the creditworthiness of the borrowers to whom it is lending. Indeed, it could be argued to have an incentive to reduce lending standards so as to increase the number of mortgages it grants and thereby increase its fees. This tendency could be reinforced by the remuneration structure of the institution itself. The banks may behave in this way to increase the quantity of mortgages, believing that it would not suffer the consequences of decreased quality in terms of higher defaults.

3.2. This is one example of the conflict of interest that exists throughout the financial services sector. Those selling investments to investors frequently have interests, in terms of obtaining the benefits of increased sales, which are at odds with the interests of the investors themselves. This sometimes manifests itself in the sale of unsuitable investments. In the case of the “originate to distribute” model, it may have manifested itself in the form of a lower quality of investment.

3.3. The Commission has proposed rules designed to alter the incentive structure. Originally it proposed that institutions that engaged in the “originate to distribute” model should be required to hold capital equal to 15 per cent of the value of the assets, even after the assets were securitised and no longer on the originators’ balance sheet. The Commission withdrew this proposal in the light of adverse comments.

3.4. The Commission has now introduced a rather different proposal. There is no longer any requirement on the originator to hold capital against the risks of an ABS or similar instrument. Instead, the obligation is transferred to a bank, which, under the proposal, must not make an investment in certain credit risk transfer instruments, unless the originator has retained exposure to at least 5 per cent of the risk (the Commission impact assessment suggested a figure of 10 per cent but this has been reduced in the published proposed amendment to 5 per cent).

3.5. In addition, the Commission is proposing that banks should be required to undertake sufficient due diligence to ensure that they understand the risks of the investments they make. Banks providing enhanced liquidity for securitisations will be required to manage the liquidity risks.

3.6. Those banks originating or sponsoring securitisations are to be required to make further disclosures, including their economic interest in the assets.

4 The Commission’s Impact Assessment

4.1. The impact assessment does not cover in detail the proposals relating to the enhanced due diligence requirements and the liquidity management. It asserts that such proposals have attracted general support. This paper also does not focus on these measures (which are beyond the terms of the question addressed) but notes that the due diligence and liquidity proposals appear to be sensible and well founded.

4.2. In respect of the proposals to address the perverse incentives in the "originate to distribute" model, the Commission’s impact assessment canvasses three options:

4.2.1. to retain the current provisions in the CRD;
4.2.2. to make targeted changes (its favoured proposal); and
4.2.3. to start a wholesale review of existing requirements.

4.3. The Commission acknowledges that the full requirements of the CRD only came into effect in February 2008, after the damage to financial markets had been done. However, the Commission suggests that to rely on the existing CRD would be to fail to learn the lessons of recent history. The wholesale review is dismissed on the grounds that the CRD is based on the Basel II accord (which itself took several years to conclude) and that a review would mean a departure from Basel II and it would be too long before any measures could have effect. These options are dismissed fairly summarily and the attention is focused on the Commission’s favoured option of targeted measures.

4.4. The Commission acknowledges that its original proposal (the 15 per cent capital charge) would have put EU institutions at a disadvantage and would have been ineffective in that it could be easily circumvented [8]. The Commission states that the new proposal seeks to avoid these problems by being applied to all banks acting as investors within the EU and is written in broad terms to reduce the risk of financial engineering being used to avoid the impact.

4.5. The Commission further acknowledges that its 5 per cent risk retention proposal has also attracted opposition on the grounds that:

4.5.1. it would have unintended consequences in terms of reduced liquidity and increased cost of credit;

4.5.2. there would be a loss of competitiveness for EU regulated institutions in view of the fact that no other regulatory body outside of the EU has announced any similar regulatory intentions;

4.5.3. there would be implementation and monitoring difficulties; and

4.5.4. the approach would be inconsistent with the risk-based approach underpinning the CRD.

4.6. The Commission dismisses these criticisms on the basis that the financial market turbulence has demonstrated the inadequacy of the qualitative approach. The fear of a reduction in liquidity of securitisation markets is also rejected on the grounds that such liquidity has reduced anyway and that there is a need for new measures to restore investor confidence.

5. The Adequacy of the Commission's Impact Assessment

5.1. The analysis in this paper of the underlying reasons for the abuse (that is the inadequate credit assessment arrangements in originating banks) suggests that the causes of the abuse lie far deeper than the perverse incentives inherent in the "originate to distribute" model. The real causes lie in the general tendency (in conditions of easily available and cheap credit) of many financial institutions in many different parts of the financial markets to fail to assess correctly the risk they were taking on and to fail to price it appropriately. There were also failures in risk management and weaknesses in the amount of capital held.

5.2. The increasing defaults from subprime mortgages were the trigger that started the turbulence. However, the fundamental imbalances were creating an unsustainable position in the financial markets. If it had not been the subprime mortgage problem, it would have been something else. It is therefore not appropriate to focus attention solely, or even primarily on the subprime market. Instead, most attention should be focussed on the deeper underlying causes – namely the willingness of financial institutions to depart from proper risk management when provided with cheap and easily available credit. This paper returns to this topic below.

5.3. The Commission is correct in pointing out that the "originate to distribute" model creates incentives on the originating bank to reduce the quality of credit assessments when allocating mortgages. However, if these incentives were a critical factor in reducing credit assessment standards, it might be expected that banks that adopted the "originate to distribute" model would have experienced worse defaults than other players in the subprime mortgage market that adopted the more traditional "originate and hold" model. Some commentators have suggested that, in fact, "originate to hold" lenders were no better off than "originate to distribute" lenders.

5.4. There are a number of reasons why the effect of the perverse incentives may be offset by other factors which mean that the originator retains an interest in minimising defaults:

5.4.1. The "originate to distribute" lender may retain administration rights to service the mortgages and the profits from this will be substantially reduced if there are more defaults;

5.4.2. At any one time, the "originate to distribute" lender will have mortgage backed securities in the pipeline waiting to be sold and will therefore be exposed to the risk of default on these mortgages;

5.4.3. The originator would also be subject to losses arising from early defaulters because of the way the securitisations are constructed and these would be high if credit standards were lax.

5.5. To justify the proposal for a risk retention requirement at all, the Commission should provide some data demonstrating the effect of the perverse incentives by comparing the performance of banks that adopted different business models. In fact it does not. Some other commentators have suggested that there is no difference in performance [3] [9].

5.6. Moreover, if the Commission had provided a detailed justification for the 5 per cent retention rule, it would need to provide data justifying the level. It is not clear how a retention level of 5 per cent would impact the behaviour of banks engaged in the originate to distribute model, when compared with the other incentives and exposures to which they were subject. To be justified, the quantitative approach favoured by the Commission would need to be justified by a quantitative analysis of its likely effect, so that the market could determine if 5 percent were the right figure, or whether some other figure would be preferable. There is no such analysis in the impact assessment. There is no justification of the 5 per cent as compared with the assumed effect of the original 15 per cent capital charge.

5.7. The Commission also does not address more fundamental objections that have been raised in respect of the proposal.

5.8. It acknowledges that financial engineering would have been likely to result in the original 15 per cent capital charge being ineffective. However, it does not show how this problem is addressed by its new proposal. If banks wished to invest in securities without the 5 per cent retention charge, it would not be long before the market developed a suitable instrument (perhaps a synthetic instrument that did not involve pooled assets as such but which mirrored the performance characteristics of pooled assets). Much depends on the drafting of the regulation. However, the more detailed it is, the more likely it is that financial engineering can find a way around the precise rules, because it will never be possible to devise a detailed rule that covers all conceivable circumstances. The more high level the drafting, the more implementation will depend on different national regulatory authorities. Either way there may be the same doubts about effectiveness that were raised in respect of the Commission's original proposal..

5.9. The proposal requires the 5 per cent interest to be retained by the originator <u>or</u> the sponsor. This will result in different practices for different originators and sponsors. Where ABSs from different originators and sponsors are then bundled together and repackaged, it will be increasingly complex to assess which of the securities is retained by whom. This adds to the complexity and, as noted above, it was the failure to see through the complexity of financial instruments and assess the underlying risks that exacerbated the problem in recent months. The Commission proposal for a retention charge may therefore make the problem worse.

5.10. The 5 per cent retention proposal assumes that the risk appetite of the originator and that of the investor will be aligned so that the retention of risk will ensure that credit standards are maintained at the level assumed by the investor. In practice, this is unlikely to be so. The originator may well be quite comfortable to accept a high level of risk arising from the 5 per cent interest in the securitised assets, in return for a higher reward, given the significance of that 5 per cent retention in the overall portfolio of assets held by the originator. For the investor, on the other hand, the investment may represent a larger element of the portfolio and the overall risk management may be such that the risk appetite is low. Because the risk appetite of originator and investor are not aligned, the 5 per cent retention will not provide any protection to the investor.

5.11. It is an inherent feature of ABSs, that the securities issued have different risk return characteristics. It is generally understood that the intention is that the 5 per cent retention should be applied to each tranche in a securitisation [10] but is not clear how this is to be achieved. The Commission proposals does not explain how it can be ensured that the 5 per cent retained by the originator will be representatives of the risks of the security as a whole, rather than, say, that associated with the more senior tranches.

5.12. Perhaps even more dangerously, the investor may take too much comfort from the 5 per cent retention and fail to undertake a proper assessment of the risks and reward of the investment in the securitised instrument [11]. It was the failure properly to assess such risks that led to the current turbulence and it would be perverse for the Commission to introduce a proposal that decreased the incentives to undertake that due diligence and perhaps makes the problem worse.

5.13. Finally, the Commission has not addressed the problem that the proposal could undermine the competitiveness of EU firms and decrease the liquidity of the markets in credit instruments. The Commission response that the market itself has suffered a loss in liquidity is hardly sufficient, since it must be expected that this proposal is intended to be maintained even when markets have recovered their liquidity.

6. Conclusion

6.1. The terms of reference for this briefing paper seek comment on whether the Commission has justified the change from the 15 per cent capital charge on originators to the requirement that investors (where they are credit institutions) only invest where there is a 5 per cent retention of risk by the originator or sponsor. It also asks if the 5 per cent will be sufficient to prevent abuse.

6.2. This paper has sought to demonstrate that the poor credit assessments of the players in the sub prime market were just one (particularly acute) manifestation of the general tendency towards inadequate risk assessment and management that resulted from the cheap and easily available credit. The conflicts of interest inherent in the “originate to distribute” business model are just one manifestation of conflicts of interest between intermediaries and investors that occur throughout financial services business.

6.3. The correct response to these problems would include proposals as follows:

6.3.1. To strengthen capital requirements;

6.3.2. To enhance banks’ risk management and insist that it addresses liquidity and other risks as well as credit risk;

6.3.3. To require full disclosure of the risks inherent in MBSs;

6.3.4. To require banks to undertake proper due diligence when purchasing MBSs, ABSs and other credit transfer instruments and to have stronger valuation methodologies;

6.3.5. To enhance supervision of regulated institutions' risk management [4]

6.4. The first of these solutions is, essentially, put in place by the CRD itself, which is modelled on the Basel II accord. This reinforces a risk based approach to capital and management. As the Commission has pointed out, the CRD was not fully implemented until February 2008, by which time much of the damage had been done in terms of poor risk management. The Financial Stability Forum has suggested that supervisors look for ways to strengthen capital requirements and notes that the Basel Committee for Banking Supervision is proposing increased capital requirements for the more complex securitisation instruments [4]. Others are suggesting a development of more growth related capital requirements [1][7].

6.5. The remaining approaches are, very properly included within the Commission's proposed amendment to the CRD. There are detailed provisions on each of these topics. These are the most appropriate solutions to the problems identified by the Commission and they should be allowed to work. Other measures, outside the scope of the Commission proposal are also important, such as the International Accounting Standard Board's enhancement of accounting and disclosure standards for off balance sheet vehicles [13].

6.6. The conclusion of this paper is that the Commission has not fully addressed the objections to any proposal that relies on the retention of a quantified level of risk by the originators of mortgages. Those objections suggest that the proposal may not only be ineffective but may even create perverse incentives on its own. Moreover, the analysis in this paper suggests that the retention charge only addresses matters that were the trigger for the financial turmoil in recent months and does not address the other underlying causes. On that basis it is unlikely to be sufficient. The appropriate response can be found amongst the other proposals put forward in the Commission amendment to the CRD, as noted above.

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Topic II: Regarding the proposed changes on hybrid capital, do these strengthen the bank's capital in the light of recent events?

Eligibility of hybrid instruments issued by credit institutions for regulatory original own funds under European financial law

Briefing Paper for the Financial experts panel of December 2008 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Dr. Christos Vl. Gortsos

Executive summary

Directive 2006/48/EC *of the European Parliament and of the Council is the main source of Community financial law pertaining to the definition of "own funds" for credit institutions. It established a distinction between "original" and "additional" own funds, with the former being treated, for supervisory purposes, as items of a higher quality (see below,* ***Section A 1*** *of the present paper).*

The Directive ***does not contain any provision on the regulatory treatment of credit institutions' "hybrid instruments".*** *In light, however, of the significant level of outstanding volumes in such issues and the fact that several member states are treating them as eligible, under divergent though conditions, for original own funds, the Commission submitted a* ***proposal for a Directive*** *to amend Directive 2006/48/EC. Its objective is to achieve a common regulatory treatment of hybrid instrument issued by credit institutions, and in particular to* ***set out common criteria for their eligibility for original own funds of credit institutions****. The proposed provisions draw heavily on the advice submitted to the Commission by CEBS. This is, to our opinion, totally adequate and justified, taking into account the significant technical expertise of the members of CEBS on the relevant issues (below,* ***Section A 2****).*

The main provision in this respect is that of the ***new point (ca) of article 57****. According to this, for hybrid instruments to be eligible for original own funds they have to meet three (3) conditions: not qualify as "subscribed capital" (under the Directive, as amended), meet the majority of the requirements applying to securities of indeterminate securities (under the Directive in force), and meet the specific requirements laid down in the* ***new article 63a****. The latter are addressing the essential economic characteristics of hybrid instruments, which must be met cumulatively:*

- *permanence of the sources assigned to the issuing credit institution,*
- *ability of their issuers to suspend (not just defer) payments, and*
- *ability of hybrid instruments to absorb losses both on a going concern basis and in the case of bankruptcy or liquidation (below,* ***Section B****).*

Taking into account the above, and the considerations further developed in this paper, ***it can be assessed that the proposed provisions of the Directive constitute a solid basis****, in full conformity with the highest available international supervisory standards, for the adoption of a common Community approach toward the inclusion of hybrid instruments issued by credit institutions in their original own funds:*

- *the latter will continue to be able to issue such instruments in order to enhance their capital basis, especially under the conditions prevailing currently in international financial and credit markets, while*

- *the competent authorities will be satisfied that, especially in stress situations, the hybrid instruments will be available to absorb losses and contribute to the protection of depositors and the stability of the financial system (below,* ***Section C 1****).*

The paper concludes with a summary of some proposals for minor amendments made throughout Section B of the paper (below, ***Section C 2****).*

A. The general framework

1. The system of the Community legislation in force on credit institutions' own funds: a brief overview

1.1 Directive 2006/48/EC of the European Parliament and of the Council

1.1.1 Introductory remarks

Based on the work adopted at the international level by the Basel Committee on Banking Supervision in 1988,[10] the Council adopted, one year later, the so-called Own Funds Directive (89/299/EEC),[11] which laid down minimum criteria with regard to the calculation of the own funds of Community-based credit institutions (hereinafter the "credit institutions").[12] The provisions of this Directive, as subsequently amended with regard to several technical aspects, were taken over in the codifying Directive 2000/12/EC of the European Parliament and of the Council,[13] and then, almost *verbatim*, in Directive 2006/48/EC of the European Parliament and of the Council *"relating to the taking up and pursuit of the business of credit institutions (recast)"*.[14]

Hence, Directive 2006/48/EC is currently the main source of Community financial law pertaining to the definition and calculation of credit institutions' own funds. Its provisions apply also to Community-based investment firms by virtue of article 13 (para. 1) of Directive 2006/49/EC of the European Parliament and of the Council *"on the capital adequacy of investment firms and credit institutions"*.[15]

For reasons of competitive equality, the adoption of a common definition of own funds[16] is of particular importance within the Community regulatory framework applying to credit institutions, and in particular to their prudential supervision, since own funds, among others:

- constitute the numerator of the solvency ratio of credit institutions,[17] and
- are taken as the benchmark for the calculation of credit institutions' large exposures[18] and qualifying holdings in non-financial sector undertakings.[19]

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[10] Basel Capital Accord (1998), available at the following website of the Basel Committee: www.bis.org/publ/bcbsc111.htm.

[11] EE L 124, 5.5.1989, p. 16 ff.

[12] For a comparative study of the provisions of the Basel Capital Accord and the Community regulatory framework of that period on own funds, see **Hausmann, Y. (1995):** *Die Eigenmittelvorschriften des schweizerischen Bankengesetzes im Vergleich zu den Bestimmungen der Europäischen Union und des Basler Ausschusses für Bankenbestimmungen und -überwachung*, Schweizer Schriften zum Bankrecht, Band 31, Schulthess Polygraphischer Verlag, Zürich, pages 118-152, and **Norton, J.J. (1995):** *Devising International Bank Supervisory Standards*, International Banking, Finance and Economic Law Series, Graham & Trotman / Martinus Nijhoff, London-Dordrecht-Boston, pages 99-200.

[13] EE L 126, 26.5.2000, p. 1 ff.

[14] EE L 177, 30.6.2006, p. 1 ff.

[15] EE L 177, 30.6.2006, 201 ff.

[16] The provisions of both Directives with regard to own funds (as in general) are based on the principle of minimum harmonisation, leaving the member states the discretion to apply more stringent rules (see, for example, para. 1 of article 61 of Directive 2006/48/EC).

[17] Directive 2006/48/EC, article 75.

[18] *Ibid*, article 108.

[19] *Ibid*, article 120.

1.1.2 The provisions in force of Directive 2006/48/EC

The provisions in force of Directive 2006/48/EC on credit institutions' own funds can be summarised as follows.

(a) Categories of own funds

Firstly, a distinction has been established between **"original"** and **"additional"** own funds. These terms are not used in the relevant articles of Directive 2006/48/EC, but only in recital 29 thereof. The distinction, also embedded in theory and in the work of the Basel Committee, is derived from the application of the provisions of article 57 in conjunction with article 66, para. 1, of the Directive.[20] *The distinction is of particular importance in the context of the treatment of hybrid instruments (see in particular below, under A 2.2.2 and B 1).*

In particular:

(aa) The items eligible for original own funds (also called in the terminology of the Basel Committee "core capital" or "Tier 1 capital") include:[21]

- capital within the meaning of article 22 of Directive 86/635/EEC of the Council *"on the annual accounts and consolidated accounts of banks and other financial institutions"*,[22] in so far as it has been paid up,[23] plus share premium accounts, but excluding cumulative preferential shares,
- reserves within the meaning of article 23 of Directive 86/635/EEC,
- profits and losses brought forward as a result of the application of the final profit or loss, and

(ab) The additional own funds (also called in the terminology of the Basel Committee "Tier 2 capital") consist of the following items:[24]

- revaluation reserves within the meaning of article 33 of the Fourth Company Directive of the Council on annual accounts (78/660/EEC),[25]
- value adjustments (*i.e.*, hidden reserves) within the meaning of para. 2 of article 37 of Directive 86/635/EEC,
- "other items" meeting the conditions set out in para. 1 of article 63 of Directive 2006/48/EC, including securities of indeterminate duration and other instruments, as well as cumulative preferential shares, meeting the conditions set out in para. 2 of article 63,[26]
- fixed-term cumulative preferential shares and paid-up subordinated loan capital under the conditions laid down in para. 3 of article 64 of Directive 2006/48/EC, and
- the commitments of the members of credit institutions set up as cooperative societies, and the joint and several commitments of the borrowers of institutions organised as funds, under the conditions laid down in para. 1 of article 64 of Directive 2006/48/EC.

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[20] See just below, under (b).

[21] Directive 2006/48/EC, article 57, items (a) to (c).

[22] EE L 372, 32.12.1986, p. 1 ff.

[23] On this item see in detail below, under B 1.2.

[24] Directive 2006/48/EC, article 57, items (d) to (h).

[25] EE L 222, 14.8.1978, p. 11 ff.

[26] On the conditions that must be met for securities of indeterminate duration to qualify as additional own funds, see in detail below, under B 1.3.

(ac) Finally, a separate category constitute the "funds for general banking risks" within the meaning of article 38 of Directive 86/635/EEC, which for the needs of calculating the quantitative limitations imposed (see just below, under (b)) are being equalised to original own funds.

It is interesting to note that all items included in original own funds, the funds for general banking risks", and the first two items included in additional own funds must be available to credit institutions for unrestricted and immediate use to cover risks or losses as soon as these occur.[27]

(b) Quantitative limitations

The total amount of a credit institution's own funds is calculated as the sum of its original and additional own funds and the funds for general banking risks minus the elements deducted from them (partly from original own funds and partly from the overall own funds),[28] subject to specific quantitative limitations. The limitations have been introduced because, for supervisory purposes, original own funds are considered to be of a higher quality. *These provisions are also of particular importance in the context of the treatment of hybrid instruments (see in particular below, under A 2.2.3 and B 1.1.2).*

In particular:

(ba) The total of additional own funds may not be higher than the sum of "net" original own funds.[29] **That means that at least 50% of a credit institution's capital base has to consist of net original own funds**.

The term "net" original own funds means:

- *the total original own funds, as defined above, and funds for general banking risks*
- *minus own shares at book value, intangible assets, and material losses of the current financial year.* [30]

(bb) The sum of certain elements of additional own funds, and in particular commitments, fixed-term cumulative preferential shares and paid-up subordinated loan capital, may not exceed 50% of "net" original own funds.[31] Based on this provision, it has been established in practice to distinguish between:

- "upper" additional own funds (or "upper" Tier 2 capital), a term which comprises the items of additional own funds which are not included in the numerator of this ratio (i.e., revaluation reserves, value adjustments, and "other items", as defined above, and
- "lower" additional own funds (or "lower" Tier 2 capital), a term which comprises the abovementioned items included in the numerator of the ratio.

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[27] Directive 2006/48/EC, article 61, para. 2.

[28] *Ibid*, article 66, para. 2.

[29] *Ibid*, article 66, para. 1, point (a).

[30] *Ibid*.

[31] *Ibid*, article 66, para. 1, point (b). These items are considered to be of a lower quality to qualify as credit institutios' own funds due to their contractual characteristics.

(c) Calculation of own funds on a consolidated basis

The abovementioned provisions refer to the unconsolidated own funds of credit institutions. Directive 2006/48/EC contains also specific provisions on the calculation of own funds on a consolidated basis.[32]

1.2 Directive 2006/49/EC of the European Parliament and of the Council

Credit institutions (and investment firms[33]) are required to use the abovementioned (under 1.1) "basic" definition of own funds in order to meet the capital requirements set out in article 75 of Directive 2006/48/EC against exposure to three categories of risks:

- credit (including country) risk according to the provisions of articles 76-101 of Directive 2006/48/EC,
- operational risk (firstly introduced in 2006) according to the provisions of articles 102-105 of that Directive, and
- market risks, according to the provisions of articles 18-21 of Directive 2006/49/EC.

In addition, according to articles 13-17 of Directive 2006/49/EC, credit institutions (and investment firms as well) may also use the so-called **ancillary own funds** (also known as "Tier 3 capital"). This "alternative" definition of own funds, firstly introduced by Directive 93/6/EEC of the Council (known as "the Capital Adequacy Directive", or "CAD"[34]) again in line with the work of the Basel Committee,[35] can only be used to meet the capital requirements against exposure to market risks.[36]

The provisions of this Directive are not of relevance for the subject-matter of the present paper, it is not proposed to be amended, and hence they will not be discussed further.

[32] *Ibid*, article 65.

[33] By way of application of article 13, para. 1, of Directive 2006/49/EC.

[34] EE L 141, 11.6.1993, p. 1 ff.

[35] Amendment to the Basel Capital Accord to incorporate market risks (1996), available at the same website of the Basel Committee as the initial Basel capital Accord.

[36] Directive 2006/49/EC, article 13, para. 2.

2. The proposal for a Directive of the European Parliament and the Council amending Directives 2006/48/EC and 2006/49/EC: the provisions on hybrid instruments

2.1 The objective of the proposal and the progress of the legislative procedure

2.1.1 The objective of the proposal

The abovementioned (under 1) Community legislation in force does not contain any provision with regard the treatment of the so-called "hybrid instruments" issued by credit institutions, i.e., instruments combining features of debt and equity.[37] Nevertheless, experience suggested that during the last years:

- several credit institutions have issued such instruments in amounts of a very significant extent, and

- in addition, these instruments are being recognised by several member states and their competent authorities as eligible, under quite divergent conditions, for original own funds of the credit institutions incorporated under their jurisdiction.

In light of these developments, the European Commission requested CEBS to submit an advice containing an analysis of these instruments and a review of their use throughout the member states of the European Economic Area. The results of this review were submitted by CEBS in 2006[38] and 2007[39] and triggered initiatives to identify a Community-wide common approach for the inclusion of hybrid instruments in credit institutions' original own funds. This task has been assigned to CEBS which submitted to the Commission a new advice on March 26, 2008.[40]

2.1.2 The progress of the legislative procedure

The abovementioned initiatives were coronated in 2008 with the submission by the Commission of a proposal for a Directive of the European Parliament and of the Council *"amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposure, supervisory arrangements, and crisis management"*.[41] With regard to hybrid instruments, recital 2 of the Commission's proposal acknowledges that

"hybrid capital instruments play an important role in the ongoing capital management of credit institutions" and they *"allow credit institutions to achieve a diversified capital structure and to access a wide range of financial investors"*.

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[37] For an analysis of the characteristics, development and legal features (under continental law) of hybrid instruments, see, among others, the recent article of **René Bösch (2008)**: Hybride Finanzinstrumente, in Reuter, T.U. and Th. Werlen (editors): *Kapitalmarkttransaktionen III*, Europa Institut Zürich, Schulthess Juristische Medien, Zürich-Basel-Genf, pages 39-68.

[38] *"First part of CEBS technical advice to the European Commission on own funds: analysis of the capital instruments recently created by the industry"*, 23 June 2006 (hereinafter CEBS (2006)), available at the following website of the Committee: www.c-ebs.org/Publications/Advice/2006.aspx.

[39] *"Report on the quantitative analysis of the characteristics of hybrids in the European Economic Area"*, 13 March 2007 (hereinafter CEBS (2007)), available at the following website of the Committee: www.c-ebs.org/Publications/Advice/2007.aspx.

[40] *"Proposal for a common EU definition of Tier 1 hybrids"*, 26 March 2008, available at the following website of CEBS: www.c-ebs.org/Publications/Advice/2007.aspx.
This document takes full account of the historical developments that led to the submission of the proposal for a Directive by the Commission. It also refers extensively to the relevant work that has been undertaken by the Basel Committee on Banking Supervision, which has laid down the conditions for hybrid instruments to be eligible as "Tier 1 capital" and quantitative limitations on their inclusion. These guidelines of 1988 have not been formally incorporated in the abovementioned Basel Capital Accord (they are known as the "Sydney Press Release") and are available at the following website: http://www.bis.org/press/p981027.htm.

[41] COM(2008) 602 final, 1.10.2008.

Taking up, recital 3 states that

"therefore, it is important to lay down criteria for those capital instruments to be eligible for original own funds of credit institutions and to align the provisions in Directive 2006/48/EC to that agreement".

The proposed provisions on the regulatory treatment of hybrid instruments issued by credit institutions draw heavily on the work of CEBS, and do not abstain in any material aspect from the proposals submitted by CEBS in its 2008 advice. ***This is, to our opinion, totally adequate and justified, taking into account the significant technical expertise of the members of CEBS on bank supervisory and regulatory issues such as the one discussed herein.***[42]

The European Parliament submitted its draft Report on this proposal, which is confined to one but of major importance modification-addition to the wording of the abovementioned recital 3 thereof.[43] The French Presidency of the Council, on its part, inserted some additional provisions, of a clarifying nature, in the text of the proposal, while also redrafting recital 3 in line with the European Parliament's Report.[44]

The rest of the present paper is based on the text of the French Presidency, while taking also into account the proposal submitted by the European Parliament in its Draft Report.[45]

2.2 A detailed overview of the proposed provisions

2.2.1 Introductory remarks

In order to achieve the goal of establishing a common Community definition of hybrid instruments issued by credit institutions (and to a lesser extent by investment firms) for prudential supervisory purposes, it is proposed to modify certain provisions in force of Directive 2006/48/EC pertaining to the own funds of credit institutions (and investment firms) and to insert some new provisions. These proposed modifications and new provisions can be classified in two categories:

- provisions on the eligibility of hybrid instruments for original own funds (see below, under 2.2.1), and
- other (more technical) provisions (under 2.2.2).

It is worth noting at this point that, despite the fact that the proposed provisions of the Directive are clear in substance, they do not even mention the words "hybrid instruments" or "hybrids", but in recital 2.[46] *Accordingly, recourse is made to the work of CEBS, which is consistently using the term "hybrids" to comprise three (3) broad categories of instruments:*[47]

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[42] As evidence of this consideration, see in detail below, under B 2-4.

In these sub-sections of the present paper reference will be made to the Executive Summary of the abovementioned advisory paper, cited as "CEBS (2008)".

[43] Committee on Economic and Monetary Affairs, 2008/0191(COD), 27.11.2008 (unpublished).

[44] Document 15434/1/08/ REV 1 (unpublished).

[45] On the latter, see in particular below, under B 1.1.

[46] See above, under 2.1.

[47] CEBS (2008), para. 9. For a detailed analysis of the characteristics of hybrid instruments in the member states of the European Economic Area, see the abovementioned studies conducted by CEBS (CEBS (2006) and (2007)).

(a) *The first category refers to the so-called "innovative" instruments. These are hybrid instruments with "incentives to redeem" for the issuing credit institutions.*[48]

(b) *The second category includes the "non-innovative" instruments, i.e., instruments which do not have incentives to redeem.*

(c) *Finally, the third category is made up of the non-cumulative perpetual preferential shares.*[49]

According to CEBS (2007, para. 29), the most commonly hybrid instruments issued by credit institutions in the European Economic Area, even though with significant differences among member states, are the following:

- *non-cumulative trust preferred securities (30%),*
- *undated deeply subordinated non-cumulative notes (22%), and*
- *non-cumulative perpetual preferential shares issued by credit institutions themselves and not though SPVs (16%).*

2.2.2 The provisions on the eligibility of hybrid instruments for original own funds

(a) Article 57, point (a) (modified)

Point (a) of article 57 is being modified to provide that the unconsolidated own funds of credit institutions shall consist, among others, of capital meeting more stringent requirements than those already in force. Accordingly, it is required that capital, within the meaning of Article 22 of Directive 86/635/EEC, must not only have been paid up, but it has also to be able to fully absorb losses in going concern situations, and in the event of bankruptcy or liquidation to rank after all other claims.

(b) Article 57, new point (ca)

A new point (ca) is being inserted in article 57 to provide for hybrid instruments as items eligible for original own funds: *"instruments other than those referred to in point (a), which meet the requirements set out in points (a), (c), (d) and (e) of Article 63 (2) and in Article 63a."*

(c) Article 63, para. 2, new subparagraph

In para. 2 of article 63 a new (final) subparagraph is being added as follows: *"Instruments referred to in point (ca) of article 57 shall comply with the requirements set out in points (a), (c), (d) and (e) of Article".*

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[48] On this category of instruments, and the meaning of the term "incentives to redeem", see in detail below, under B 2.3.

According to CEBS (2007, para. 34), 42% of all hybrid instruments in the European Economic Area do have "incentives to redeem" in the form of step-ups.

[49] As mentioned above, under 1.1.2 (ab), cumulative preferential shares, both fixed-term and perpetual, are treated as additional own funds, provided that in addition they meet the conditions set out in article 57 of Directive 2006/48/EC.

(d) New article 63a

The (new) article 63a lays down the specific criteria to be met (in addition to the general criteria set out in article 63, para. 2) for hybrid instruments to be eligible for original own funds.

All these provisions are discussed in detail below, under section B of the present briefing paper.

2.2.3 Other provisions

(a) Consolidated calculation of own funds (article 65, para.1, point (a)) (modified)

Point (a) in para. 1 of article 65 (on the consolidated calculation of own funds) is being modified to take account of the existence of hybrid instruments giving rise to minority interests.

(b) Quantitative limitations (article 66, paras. 1, 2 and 4 (modified) - new para. 1a)

Paras. 1 (on the quantitative limitations in the use of the various items of own funds), 2 (on the deduction of items from own funds) and 4 (on the conditions for exceeding the quantitative limitations) of article 66 are being modified to take into account the inclusion of hybrid instruments into original own funds. In addition, the (new) para. 1a of article 66 is introducing additional quantitative limitations in the use of hybrid instruments.

In particular:

(a) The provisions of para. 1 of article 66 are being modified only in the sense that in both quantitative limitations introduced therein[50] the denominator of the relevant quotas will contain also, alongside the other categories of original own funds, the hybrid instruments issued by the credit institution.[51]

(b) The provisions of para. 2 of article 66, on the deduction of items from original own funds and from total own funds, are being modified accordingly *mutatis mutandis.*

(c) According to the provisions of the new para. 1a of article 66, the total of hybrid instruments will be subject to the following quantitative limitations:[52]

(i) Hybrid instruments that must be converted during emergency situations and may be converted at the initiative of the component authorities, at any time, based on the solvency situation of the issuing credit institution may in total not exceed a maximum of 50% of the “net” original own funds, this term including also hybrid instruments.

(ii) Within the above limit, all other hybrid instruments may not exceed a maximum of 35% of the total of “net” original own funds.

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[50] See above, under A 1.1.2 (b).

[51] On this provision, see also below, under B 1.1.2.

[52] See also CEBS (2008), paras. 54-59.

(iii) Within both the above limits, dated hybrid instruments and any hybrid instrument whose provisions include "an incentive to redeem"[53] for the credit institution may not exceed a maximum of 15% of the total of "net" original own funds.

(iv) Finally, the amount of items exceeding the abovementioned limitations, will be subject to the limitations laid down in para. 1 of article 66.

Accordingly, hybrid instruments are used to be named in practice as "lower" original own funds (or "lower" Tier 1 capital).

(d) According to the (modified) provision of para. 4 of article 66, the competent authorities may authorise credit institutions to exceed the limits laid down not only in para. 1 (as already in force) but also those set out in para. 1a. In both cases, limits may be exceeded only *"temporarily during emergency situations"*.

(c) Grandfathering clauses (article 154, new paras. 8 and 9)

Article 154 (on the Directive's transitional provisions) is introducing, in its paras. 8 and 9, grandfathering clauses with regard to the use of hybrid instruments. In particular:

(a) According to para. 8, credit institutions which do not comply by 31 December 2010 with the limits set out in para. 1a of article 66 (see just above, under (b)), will have to develop strategies and processes on the necessary measures to resolve this situation before the dates set out in para. 9 (see just below, under b). These measures will have to be reviewed under the provisions of article 124 of Directive 2006/48/EC.

(b) According now to para. 9, hybrid instruments that by 31 December 2010, according to national law, are to be deemed equivalent to the items included in original own funds, but either do not fall within the meaning of "capital" (under point (a) of article 57) or do not comply with the criteria set out in article 63a, will also be deemed to be hybrid instruments until 31 December 2040, subject to two (2) limitations:

- up to 20% of the sum of original own funds minus the items deducted from them between 10 and 20 years after 31 December 2010, and
- up to 10% of the sum of these items between 20 and 30 years after 31 December 2010.

CEBS is being assigned with the task of monitoring, until 31 December 2010, the issuance of these instruments by credit institutions.

(d) Application of Pillar III

(Annex II, part 2, points 3 (a) and (b)) (modified)

Finally, points 3 (a) and (b) in part 2 of Annex XII (on the Pillar III requirements of the Directive) are being modified to impose on issuing credit institutions the obligation to disclose specific information about their hybrid instruments.

[53] On this term, see below, under B 2.3.

B. Criteria for the eligibility of hybrid instruments for original own funds under the provisions of the proposal for a Directive: a systematic presentation

Some amendments to the provisions of the proposal for a Directive suggested by the author are denoted below in footnotes, in bold letters and blue colour, and then summarised in Section C 2 of the present paper.

1. The main provision: the new point (ca) of article 57

1.1 Introductory remarks

1.1.1 The conditions laid down in point (ca) of article 57: an overview

The main provision of the proposal for a Directive under discussion on the eligibility of hybrid instruments for original own funds of credit institutions is set out in the new point (ca) inserted in article 57. It states that the unconsolidated own funds of credit institutions may also include *"instruments other than those referred to in point (a), which meet the requirements set out in points (a), (c), (d) and (e) of Article 63 (2) and in Article 63a."*

According to this provision, in order for hybrid instruments to be eligible for original own funds they have to meet, as a condition *sine qua non*, the following three (3) conditions, one negative and two positives:

- not qualify as "capital" (see below, under 1.2),
- meet the requirements applying to securities of indeterminate securities (under 1.3), and
- meet the specific requirements laid down in the new article 63a (under 1.4).

1.1.2 Application in conjunction with para. 1 of article 66

That hybrid instruments issued by credit institutions, to the extent that they meet the above mentioned requirements, will be eligible for their original own funds is derived from the joint application of article 57, point (ca) in conjunction with the provision of the modified para. 1 of article 66. According to the latter:

"The items referred to in points (d) to (h) of article 57 shall be subject to the following limits:

(a) *the total of the items in points (d) to (h) of article 57 may not exceed a maximum of 100 % of the items in points (a) to* ***(ca)*** *minus (i), (j) and (k) that article; and*

(b) *the total of the items in points (g) to (h) of article 57 may not exceed a maximum of 50 % of the items in points (a) to* ***(ca)*** *minus (i), (j) and (k) of that article."*

Hence, as already mentioned,[54] in both these quantitative limitations the denominator of the two quotas, which constitutes the amount of "net" original own funds, will contain, in addition to the other categories of original own funds and the funds for general banking risks, also the hybrid instruments issued by the credit institution, provided that they meet the conditions laid down in the Directive (see just above, under.1.1.1).

[54] See just above, under A 2.2.3.

1.2 Hybrid instruments must not qualify as "capital"

1.2.1 General considerations

Firstly, hybrid instruments must not qualify as "capital", as this item is defined in point (a) of article 57. As already mentioned (see above, under A 2.2.1), point (a) of article 57 is being modified to provide that for "capital" to be eligible for inclusion in the unconsolidated original own funds of credit institutions it has to meet more stringent requirements than those already in force. In particular, "capital" has to meet three requirements:

(a) It must fall within the meaning of article 22 of Directive 86/635/EEC. According to this article, the item "subscribed capital" (liabilities: item 9) comprises *"all amounts, regardless of their actual designations, which, in accordance with the legal structure of the institution concerned, are regarded under national law as equity capital subscribed by the shareholders or other proprietors"*.

(b) It must have been paid-up.

(c) In addition – the new element – it must be able to fulfil two (2) conditions:

- fully absorb losses in going concern situations, and
- in the event of bankruptcy or liquidation rank after all other claims.

1.2.2 The amendment proposed by the European Parliament

In this respect, and in line with the last provision of the new point (a) of article 57, the European Parliament considers that recital 3 should draw a clear line in the division between subscribed capital and hybrid instruments and, also, to clarify which categories of non-cumulative preferential shares can be eligible for "capital", the rest qualifying as "hybrid instruments". Accordingly, it is proposing the insertion of following considerations:

(a) Subscribed capital should include all instruments that are regarded under national law as equity capital, rank after all other claims during liquidation and fully absorb losses *pari passu* with ordinary shares on a going concern basis. These instruments may include:

- *instruments providing preferential rights for dividend payment on a non cumulative basis, provided that they are included in article 22 of Directive 86/635/EEC, rank after all other claims during liquidation and fully absorb losses on a going concern basis pari passu with ordinary shares*, and
- any other instrument under credit institutions' statutory terms taking into account the specific constitution of mutuals, co-operative societies and similar institutions and which are deemed broadly equivalent to ordinary shares in terms of their capital qualities.

(b) As a consequence, the following should be included in the category of hybrid instruments, provided, in addition, that they meet the requirements laid down in (new) point (ca) of article 57:

- instruments that do not absorb losses on a going concern basis pari passu with ordinary shares, and
- instruments that do not rank after all other claims during liquidation.[55]

[55] **To our opinion, in consistency with the wording in articles 57, point (a) and 63a, recital 3 should make reference to events of *"bankruptcy or liquidation"*.**

To our opinion, if the new element in the definition of "capital" is to be accepted, and it should so, the proposal of the European Parliament (accepted also by the French Presidency) is justified. *It is also consistent with the work of CEBS, which is treating non-cumulative perpetual preferential shares issued by credit institutions as hybrid instruments (see above, under A 2.2.1). This is due to the following findings:*[56]

(a) *Their terms usually do not contain mechanisms, such as writing-down of capital (only 3% of non-cumulative perpetual preferential shares) or conversion into ordinary shares, which are deemed necessary to achieve recapitalisation if the issuing credit institution has occurred losses. Hence, they do not fully meet the criterion of being able to absorb losses on a going concern basis.*[57]

(b) *Only 5% of all categories of outstanding hybrid instruments rank pari passu with ordinary share capital in the event of liquidation, even though they all provide for "deep subordination" vis-à-vis other categories of bondholders.*[58]

Accordingly, non-cumulative perpetual preferential shares can be eligible for "capital" only in the cases (rare up to the present, as evidence suggests) when both the abovementioned conditions are met cumulatively.

1.3 Hybrid instruments must meet certain requirements applying to securities of indeterminate duration

In addition, hybrid instruments have to meet the requirements set out in points (a), (c), (d) and (e) of article 63, para. 2, which already apply (in addition to point (b) thereof) to securities of indeterminate duration and other instruments, including cumulative preferential shares of indeterminate duration, that are included in additional own funds.[59] In particular:

- the instruments must have been issued and the amounts they represent be fully paid-up,[60]
- they may not be reimbursed either on the bearer's initiative or without the prior agreement of the competent authorities,
- the lender's claims on the credit institution shall be wholly subordinated to those of all non-subordinated creditors, and
- the documents governing the issue of the securities provide for debt and unpaid interest to be such as to absorb losses, while leaving the issuing credit institution in a position to continue trading.

Point (b) of this paragraph, which is omitted, states that "the debt agreement shall provide for the credit institution to have the option of deferring the payment of interest on the debt". This omission is justified by the fact that the provisions of article 63a are definitively more stringent, in the sense that they require the ability of the issuer not only to defer interest payments, but also to cancel them.[61]

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[56] See CEBS (2007), para. 35-36.

[57] On this criterion, see in detail below, under B 4.1.

[58] On this criterion, see in detail below, under B 4.2.

[59] See above, under A 1.1.2 (ab).

The same provision is repeated in the new, final subparagraph inserted in para. 2 of article 63.

[60] See also CEBS (2008), paras. 27-28.

[61] See below, under B 3.

1.4 Hybrid instruments must meet the specific requirements laid down in article 63a

Finally, hybrid instruments have to meet the requirements laid down in the new article 63a. The provision of para. 1 thereof is stating that for hybrid instruments to be eligible for original own funds they must comply with the requirements set out in paras. 2 to 5. These requirements are further specifying those applying to indeterminate securities in general (as mentioned above, under (1.3)), as necessary in order for the hybrid instruments to qualify as original and not as additional own funds, and are addressing the three essential economic characteristics of hybrid instruments, which have to be met cumulatively:

- the permanence of the financial sources assigned to the issuing credit institution (see below, under 2),
- the ability of their issuers to suspend payments (under 3), and
- the ability of hybrid instruments to absorb losses both in going concern situations (para. 4) and in case of bankruptcy or liquidation (under 4).[62]

2. Requirements on the permanence of hybrid instruments

The detailed provisions relating to the permanence of hybrid instruments are laid down in para. 2 of article 63a. They broadly reflect existing market and (national) regulatory practices and try to strike a balance between market efficiency and incentives for innovation, on the one hand, and the need to ensure that hybrid instruments are able to absorb losses.[63]

2.1 Forms of hybrid instruments depending on their duration

According to the first provision, credit institutions are allowed to issue hybrid instruments eligible for original own funds in two different forms:

- either as "undated instruments", i.e., as instruments of an indeterminate duration (the so-called "perpetuals"), or
- as "dated instruments", in which case, however, the original maturity must be at least thirty (30) years.

2.2 General restriction in the exercise of embedded call options

The proposal for a Directive takes account of the fact that both these categories of hybrid instruments usually include one or more call options. It is provided, however, that these options, may be exercised only at the discretion of the issuer. Hence, the holders of the instruments are deprived of their right for termination.

2.3 Time limitations on the right of redemption

Concrete time limitations are being imposed with regard to the right of redemption of hybrid instruments by the issuing credit institution. In particular:

(a) As a general rule, **all hybrid instruments** may not be redeemed before five (5) years after the date of their issue.[64]

[62] See also CEBS (2008), para. 30.

[63] See below, under 2.4.

[64] *Ibid*, para. 40. On the exception to this rule and the right for early redemption, see below, under 2.5

(b) Specific rules are established for hybrid instruments whose terms (or provisions in the terminology of the article)[65] include so-called "incentives to redeem" for the credit institution.[66] The following distinction is of importance in this respect:

(i) Undated hybrid instruments: if the terms of this category of instruments provide for an incentive to redeem, then:

- the incentive to redeem must be "moderate",[67] as determined by the competent authorities, and
- the incentive may not occur before ten (10) years after the date of issue.[68]

(ii) Dated hybrid instruments: the terms of this category of instruments should not allow for any incentive to redeem other than the maturity date.

2.4 Powers of the competent authorities

In principle, all hybrid instruments may be called or redeemed by the issuing credit institutions only with the prior consent of their competent authorities. The latter are entitled to grant permission only if two conditions are met:

- the request is made at the initiative of the credit institution, and
- at their discretion, either financial or solvency conditions of the credit institution are not unduly affected.

In this respect, the competent authorities are given as well the following powers:

(a) They are entitled to require credit institutions to replace the redeemed hybrid instrument by subscribed capital or by other hybrid instruments of the same or better quality.

(b) They are obliged to require the suspension of the redemption for dated hybrid instruments, if the issuing credit institution does not comply with the capital requirements set out in article 75.[69]

(c) Finally, they may require the suspension of the redemption, at other times, based on the financial and solvency situation[70] of the credit institutions concerned.

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[65] The provisions governing the instruments may be either statutory or contractual.

[66] According to CEBS (2008, para. 41), as "incentives to redeem" are considered step ups and principal stock settlement mechanisms, when combined with a call option. In this respect, CEBS is suggesting that:

- the terms of the instrument must provide for no more than one rate step-up over its life (*ibid*, para. 43),
- principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution (*ibid*, para. 44).

[67] According to CEBS (*ibid*, para. 42), a step up should be considered as "moderate" if it results in an increase over the initial rate that is no greater than either:

- 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or
- 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis.

The swap spread, which is fixed at the pricing date, reflects the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate (*ibid*, para. 43).

[68] See also CEBS (2008), para. 40.

[69] See above, under A 1.1.2.

2.5 Right of early redemption

The Directive stipulates that the competent authorities may, exceptionally, grant permission "at any time", i.e., even before the lapse of the standard five-year period (see just above, under B 2.2), for an early redemption of hybrid instruments. Nevertheless, this early redemption may only take place if two conditions are met:

- there is a change in the applicable tax treatment ("tax event") or regulatory classification ("regulatory event") of these instruments,[71] and
- this change was unforeseen at the date of issue.[72]

3. Requirements on the ability of issuers to suspend payments

According to para. 3 of article 63a, the provisions governing a hybrid instrument must contain a clause allowing the issuing credit institution to cancel (alongside its right to defer), when necessary, the payment of interest or dividends for an unlimited period of time, and this on a non-cumulative basis.[73] In this respect, the following provisions have also been proposed:

(a) The credit institution will be required by its competent authorities to cancel such payments if it does not comply with the capital requirements set out in article 75.[74]

(b) In addition, the competent authorities may require the cancellation of such payments based on the financial and solvency situation[75] of the credit institution.[76]

(c) It is also stipulated that any such cancellation should not prejudice the right of the credit institution to substitute the payment of interest or dividend by a payment in the form of subscribed capital, by making use of the so-called "Alternative Coupon Satisfaction Mechanisms" (ACSMs).[77] This is conditioned on two factors:

- the mechanism must allow the credit institution to "preserve financial resources",[78] and

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[70] **To our opinion, in the third sub-para of para. 2 of article 63a the term *"financial and solvency situation"* should be replaced, for reasons of accuracy and consistency, with the term *"financial and solvency conditions"*, which is used in the second sub-para (second sentence) of para. 2.**

[71] **"Accounting events" may also occur. In this respect, to our opinion the provision of article 63a, para. 2, last sub-para. should be amended as follows:**

"The competent authorities may grant permission at any time for an early redemption of dated and undated instruments ~~in the event that~~ in particular if there is a change (…)."

This is consistent with CEBS (2008, para. 45), which stresses the indicative nature of these events (*"(…) by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments (…)"*).

[72] See also CEBS (2008), para. 45.

[73] *Ibid*, para. 46 and 49-51.

As mentioned above (under B 1.3), in the case of securities of indeterminate duration, which do not qualify for hybrid instruments and hence can only be eligible for additional own funds, the debt agreement must provide for the credit institution to be able simply to defer, and not cancel, payments.

[74] *Ibid*, para. 47.

[75] **In line with the remark in footnote no. 61 above, the term *"financial and solvency situation"* should, to our opinion, also be replaced, for reasons of accuracy and consistency, with the term *"financial and solvency conditions"*.**

[76] See also CEBS (2008), para. 48.

[77] *Ibid*, para. 52.

[78] **To our opinion, the term "preserve financial resources" is very imprecise. One alternative to overcome this shortcoming is to expect that CEBS will issue a relevant guideline based on its 2008 paper (*ibid*, para. 52). A second is to replace this term with the following text in the second sentence of the last sub-para of para. 3:**

- the substitution may be subject to specific conditions established by the competent authorities.

4. Requirements on the ability of hybrid instruments to absorb losses

Paras. 4 and 5 of article 63a contain provisions aiming to ensure, to the largest extent possible, that hybrid instruments are able to absorb losses both on a going concern basis, in particular in stress situations (see below, under (4.1), and in the case of a credit institution's bankruptcy or liquidation (under 4.2).

4.1 Going concern situations

According to the provisions of para. 4, the terms of a hybrid instrument must provide that principal, unpaid interest or dividend must meet the following two (2) conditions in order for the instruments to be able to absorb losses within the credit institution on a going-concern basis:

(a) Firstly, the funds raised by the issuing credit institution through the hybrid instruments must able to "absorb losses". This is required for circumstances when the credit institution has been exposed to risks (but has not yet occurred losses), in order to prevent its insolvency.

According to CEBS (2008, para. 34), a hybrid instrument can contribute to the prevention of insolvency if the following four (4) conditions are met:

- the hybrid instrument is permanent,
- the issuer has the flexibility to cancel coupon/dividend payment,[79]
- the instrument would not be taken into account for the purposes of determining whether the institution is insolvent or not, and
- the holder of the instrument cannot be in a position to submit a petition for insolvency of the credit institution.

(b) In addition, the terms of the instruments should not "hinder the recapitalisation" of the issuing credit institution, evidently if it has occurred losses causing a breach of its capital requirements. The appropriate mechanisms deemed necessary to achieve the recapitalisation, by eliminating the possibility of potential future outflows to the holders of hybrid instruments, will have to be elaborated by CEBS,[80] which, according to para. 6 of article 63a, will be required, in general, to elaborate guidelines for the convergence of supervisory practices with regard to hybrid instruments and to monitor their application.[81]

CEBS has already indicated its position towards this end. In its 2008 advice it is stating that such mechanisms should include:

"(…) provided that any such mechanism allows the credit institution <u>to have full discretion over the payment of coupons or dividends and does not lead to a decrease in the credit institution's capital."</u>

[79] These two conditions are satisfied by the previously mentioned provisions of article 63a.

[80] According to CEBS (2008, para. 35), these mechanisms are necessary to ensure that, if the issuer has incurred losses and may need to be recapitalized, the new capital would not be used directly to benefit existing holders of hybrid instruments.

[81] **To our opinion, the proposed provision of para. 6 is superfluous and could be deleted, since the issuance of guidelines on such issues and the monitoring of their application is an integral and essential part of the tasks that have assigned to CEBS according the legal instruments governing its operation (Commission Decision 2004/5/EC and its own Charter) as a so-called "level 3" committee under the "Lamfalussy procedure".**

- the possibility of writing-down the principal, permanently or temporarily, at a certain trigger point,
- the conversion of hybrid instruments into ordinary shares at a certain trigger point, or
- any other mechanisms, provided that the issuer can demonstrate to the satisfaction of the competent authorities that the mechanism is capable of achieving the objective of facilitating the recapitalisation.[82]

In addition, any such mechanism must be legally certain (based on appropriate legal opinions), be disclosed and transparent to the market and, in the case of a principal write-down, be on the credit institution's balance sheet (in conformity with accounting rules).[83]

4.2 Bankruptcy or liquidation of a credit institution

The provision of para. 5 of article 63a stipulates that, in the case of bankruptcy or liquidation of a credit institution, the hybrid instruments it has issued should rank even after ("junior" to) the items referred to in para. 2 of article 63, i.e., the securities of indeterminate duration which, as already mentioned, are eligible for additional own funds.[84] It is reminded that the provisions governing these securities have to contain an "interest deferral clause" but not a clause proving for the cancellation of interest payments.[85]

According to this "deep subordination" provision, hybrid instruments should entail a higher loss absorption ability than any other category of debt instruments issued by the credit institution, in order to ensure the protection of the most senior claimants, i.e., depositors. Hence, in the event of bankruptcy or liquidation, the holders of hybrid instruments should be satisfied in the last rank among all categories of bondholders, senior only to ordinary shareholders and other holders of subscribed capital.[86]

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[82] CEBS (2008), para. 36.

[83] *Ibid*, para. 37.

[84] **To our opinion, there is a legal issue that has to be resolved in this respect:**

(a) If the provision of para. 5 is intended to impose an obligation on issuers to include a relevant clause in the contract governing the hybrid instrument, i.e., a subordination agreement ("Nachrangingkeitsabrede" in German jargon), then it should be redrafted as follows:

"In the event of the bankruptcy or liquidation of the credit institution, the statutory or contractual provisions governing the instrument shall provide that the instruments shall rank after the items referred to in article 63(2).

(b) Otherwise, it has to be assured that the national legislation of all member states contains a legal instrument to this end.

To our opinion, the first alternative is on the safe side.

[85] See above, under B 1.3.

[86] According to CEBS (2008, para. 32), in this respect the hybrid instruments must:

- neither be secured,
- nor be covered by a guarantee of the issuer or a related entity, nor other arrangements that legally or economically enhance the seniority of the claim on the credit institution.

SUMMARY TABLE 1 Classification of various types of share capital and borrowed funds as "own funds" under Directives 2006/48/EC (after the proposed amendments) and 2006/49/EC			
Category of own funds	**Type of item**	**Absorbency of losses**	**Permanence**
A. Share capital			
Original (upper Tier 1)	Ordinary shares and other "subscribed" capital	Unlimited	Undated
Original (lower Tier 1)[1]	Non-cumulative preferential shares of indeterminate duration (hybrid instruments)	both on a going concern basis and in liquidation	Undated
Additional (upper Tier 2)	Cumulative preferential shares of indeterminate duration	Limited	Undated
Additional (lower Tier 2)	Fixed-term cumulative preferential shares	Limited	Dated
B. Borrowed funds			
Original (lower Tier 1)[1]	"Innovative" and "non-innovative" hybrid instruments	both on a going concern basis and in liquidation	Dated/undated
Additional (upper Tier 2)	Securities of indeterminate duration (not meeting the more stringent requirements for hybrid securities)	both on a going concern basis and in liquidation	Undated
Additional (lower Tier 2)	Subordinated loan capital	only in case of liquidation	Dated (min. 5 years)
Ancillary (Tier 3)	Short-term subordinated loan capital	only in case of liquidation	Dated (min. 2 years)
[1] = new provision after the proposed amendment (in green) [2] = the event of bankruptcy is equalised to the event of liquidation			

SUMMARY TABLE 2 **Sequence of subordination in event of bankruptcy and liquidation under Directives 2006/48/EC (after the proposed amendments) and 2006/49/EC**		
Category of own funds	**Instrument**	**Subordination**
Original (upper Tier 1)	Subscribed capital	*No subordination*
Original (lower Tier 1) (1)	Hybrid instruments	*Deep subordination*: senior only to subscribed capital
Additional (upper Tier 1)	Securities of indeterminate duration (not meeting the more stringent requirements for hybrid securities)	*Junior subordination*: senior to hybrid instruments, junior to subordinated loan capital
Additional (lower Tier 2) Ancillary (Tier 3)	Subordinated loan capital Short-term subordinated loan capital	*Senior subordination*: senior to hybrid instruments, junior to unsubordinated debt
–	Other debt instruments – deposits	*Unsubordinated*
(1) = new provision after the proposed amendment (in green)		

SUMMARY TABLE 3 **Differences between hybrid instruments and other securities of indeterminate duration under Directives 2006/48/EC (after the proposed amendments)**		
Criteria	**Hybrid instruments (1)**	**Other securities of indeterminate duration**
Permanence	Undated – dated	Undated
Deferral – cancellation of interest payments	Cancellation option	Deferral option
Absorbency of losses in going concern	High	Existing
Subordination in bankruptcy and liquidation	*Deep subordination*: senior only to subscribed capital	*Junior subordination*: senior to hybrid instruments, junior to subordinated loan capital
(1) = new provision after the proposed amendment (in green)		

<table>
<tr><th colspan="3">SUMMARY TABLE 4
Various attributes of the categories of own funds[(2)] under
Directives 2006/48/EC (after the proposed amendments) and 2006/49/EC</th></tr>
<tr><th>Category of own funds</th><th>Risks covered</th><th>Quantitative limitations in the use of items</th></tr>
<tr><td>Original (upper Tier 1)</td><td>Credit – market – operational</td><td>unlimited</td></tr>
<tr><td>Original (lower Tier 1) [(1)]</td><td>Credit – market – operational</td><td>various % of “net” original own funds[(1) (3) (4)]</td></tr>
<tr><td>Additional (total sum)</td><td>Credit – market – operational</td><td>100% of “net” original own funds[(1) (3)]</td></tr>
<tr><td>Additional (lower Tier 2)</td><td>Credit – market – operational</td><td>50% of “net” original own funds[(1) (3)]</td></tr>
<tr><td>Ancillary (Tier 3)</td><td>Market</td><td>150% of a fraction of original own funds[(5)]</td></tr>
<tr><td colspan="3">[(1)]: new provision after the proposed amendment (in green)
[(2)]: including all the items laid down in article 57 of Directive 2006/48/EC and article 13 of Directive 2006/49/EC (not only those mentioned in Table 1)</td></tr>
<tr><td rowspan="6">[(3)]: definition of
“net” original own funds</td><td>Items included</td><td>Items excluded</td></tr>
<tr><td>Subscribed capital</td><td>Own shares at book value</td></tr>
<tr><td>Share premium accounts</td><td>Intangible assets</td></tr>
<tr><td>Reserves
(except revaluation ones)</td><td>Material losses of the current financial year</td></tr>
<tr><td>Funds for general banking risks</td><td></td></tr>
<tr><td>Hybrid instruments [(1)]</td><td></td></tr>
<tr><td colspan="3">[(4)]: see in detail Directive 2006/48/EC, article 66, new para. 1a
[(5)]: see in detail Directive 2006/49/EC, article 13, para. 4</td></tr>
</table>

C. General assessment and proposals for amendments

1. General assessment

Concluding this paper, three general statements can be made:

(a) Taking into account all the above considerations, and given also the stringent quantitative limitations proposed for their use, it can be assessed that the proposed provisions of the Directive constitute a solid basis for a common EU approach towards the inclusion of hybrid instruments in credit institutions' original own funds. The rules are in total conformity with the work of the Basel Committee on Banking Supervision on the issue and reflect fully and adequately the considerations which were developed by CEBS in its 2008 report, and substantiated by evidence on data collected since 2006. To our opinion, the heavy reliance on the work of CEBS is welcome taking into account the significant technical expertise of the members of CEBS on the relevant issues.

(b) As to the amendment proposed by the draft Report of the European Parliament, it is our opinion that it should be maintained in the final text of the new Directive for the reasons developed fully in Section B of the present paper (under 1.2.2).

(c) Overall, according to the proposed provisions, a correct balance will be kept among two legitimate demands:

(i) On the one hand, credit institutions will continue to be able to issue hybrid instruments in order to enhance their capital basis, which is in particular necessary under the conditions prevailing currently in international financial and credit markets in the midst of the international financial crisis/turmoil.

(ii) On the other hand, the competent authorities will be satisfied that, especially in stress situations like the current ones, the hybrid instruments will be available to absorb losses both in going concern situations and in the event of bankruptcy or liquidation, which can positively contribute both:

- to the protection of depositors who have totally unsubordinated claims on credit institutions (even though guaranteed to a certain extent or totally, as the case may be, by the national deposit guarantee schemes), if these were to fail, and
- the stability of the financial system.

2. Proposals for amendments

This is a summary of the amendments to the provisions of the proposal for a Directive suggested by the author, in underlined form and blue colour, and already developed in Section B of the present paper.

(1) Recital 3

In consistency with the wording of articles 57, point (a) and 63a, recital 3 should make reference to events of *"bankruptcy or liquidation"*.

(2) Article 63a, para. 2 (third sub-para.) and para. 3 (third sub-para., second sentence)

In these provisions the term *"financial and solvency situation"* should be replaced, for reasons of accuracy and consistency, with the term *"financial and solvency conditions"*, which is used in the second sub-para (second sentence) of para. 2.

(3) Article 63a, para.2, last sub-para.

This provision refers exclusively to "tax events" and "regulatory events" as events that may trigger the right of early redemption of hybrid instruments. "Accounting events" may, however, occur as well. In this respect, to our opinion, this provision should be amended as follows:

"The competent authorities may grant permission at any time for an early redemption of dated and undated instruments ~~in the event that~~ in particular if there is a change (...)."

This is consistent with CEBS (2008, para. 45), which stresses the indicative nature of these events (*"(...) by an event such as a change in regulatory recognition of hybrids or a change in the tax treatment of these instruments (...)"*).

(4) Article 63a, para. 3, third sub-para., second sentence

In this provision, the term "preserve financial resources" is very imprecise.

(a) One alternative to overcome this shortcoming is to expect that CEBS will issue a relevant guideline based on its 2008 paper (*ibid*, para. 52).

(b) A second is to replace the term with the following text in the second sentence of the last sub-para of para. 3:

"(...) provided that any such mechanism allows the credit institution to have full discretion over the payment of coupons or dividends and does not lead to a decrease in the credit institution's capital."

(5) Article 63a, para. 5

There is a legal issue that has to be resolved in this provision:

(a) If the provision of para. 5 is intended to impose an obligation on issuers to include a relevant clause in the contract governing the hybrid instrument, i.e., a subordination agreement ("Nachrangingkeitsabrede" in German jargon), then it should be redrafted as follows:

"In the event of the bankruptcy or liquidation of the credit institution, the statutory or contractual provisions governing the instrument shall provide that the instruments shall rank after the items referred to in article 63(2).

(b) Otherwise, it has to be assured that the national legislation of all member states contains a legal instrument to this end.

To our opinion, the first alternative is on the safe side.

(6) Article 63a, para. 6

The proposed provision of para. 6 is superfluous and could be deleted, since the issuance of guidelines on such issues and the monitoring of their application is an integral and essential part of the tasks that have assigned to CEBS according the legal instruments governing its operation (Commission Decision 2004/5/EC and its own Charter) as a so-called "level 3" committee under the "Lamfalussy procedure".

Hybrid instruments in bank's Tier 1 capital

Briefing Paper for the Financial experts panel of December 2008 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Natalija Stosicki

The current framework does not provide rules for the recognition of hybrid capital instruments in Tier 1 regulatory capital. Therefore national regulators implemented the 1998 Basel Agreement ('Sydney Press Release' - SPR) in an inconsistent manner. The Commission has proposed changes in the CRD aimed at creating level playing field across the EU and sectoral convergence between banking and insurance sector, international competitiveness of EU banking sector, promoting the internal banking market integration, enhancing financial stability and safeguarding of creditor interests.[87] Because of the importance of hybrid instruments as a major funding source for banks, the Commission suggested a common, principle-based approach regulation. The proposed rules duly reflect the three main eligibility criteria for the recognition of hybrids in banks Tier 1 capital: flexibility of payments, permanence and subordination and set clear limits for their inclusion in Tier 1 capital.

I. Definition of hybrid instruments

Hybrids refer to a wide range of capital instruments that combine features of debt and equity: lack of sanction rights to liquidate the firm, subordination after all debt, perpetual maturity and non-cumulative coupons are all equity-like features, whereas priority before common equity, tax-deductable coupons, issuer call-features and no share in profits are the debt-like features.

There is no clear terminology for describing hybrid instruments which are considered to be eligible as Tier 1 capital. In that context, the term "hybrids" has been used consistently to encompass the following categories:

- innovative instruments (i.e. instruments with incentives to redeem such as step-ups);
- non-innovative instruments (i.e. instruments which do not have incentives to redeem); and
- non-cumulative perpetual preference shares.

Hybrid securities come in four main types: [88]

- **Capital notes** - are treated as debt on the issuer's balance sheet, and generally pay a fixed coupon either quarterly or half yearly. They rank just after senior debt in a list of creditors. May rank on the same level as other unsecured creditors of the firm or be subordinate to unsecured creditors. There are very few capital notes on issue as in most cases it is cheaper to access the wholesale funding market directly.
- **Convertible notes** - are subordinated debt where the issuer has the ability to convert into ordinary shares, or redeem for the face value on the conversion date. They can pay either a fixed or floating interest rate and usually have a pre-defined conversion ratio when converting to shares. They are ranked ahead of ordinary and preference shares, but behind senior debt holders and capital notes.

[87] Commission of the European Communities; Commission staff working document: Impact assessment, SEC (2008) 2532, 1st October 2008

[88] ASX: www.asx.com.au/resources/newsletters/investor_update/20080909_hybrids_explained.htm , sept. 2008

- **Perpetual debt securities** - also cover the floating rate note (FRN) market. Some FRNs have more exotic structures that include mortgage-backed securities, credit-linked notes and collateralised loan obligations. Payments on these securities are classed as interest in the hands of holders to take advantage of a tax loophole that has long since been closed. They are treated as equity on the issuer's balance sheet, but rank above all ordinary and preference shares.
- **Preference shares** - come in two main types, reset and mandatory converting. Mandatory converters are quite popular among bank issuers. Reset securities have the ability to offer new terms at a reset date, including margins and time until next maturity. Preference shares pay coupons on a quarterly or semi-annual basis and can have a fixed or floating rate. Many also have franking credits attached.

Hybrids can be issued directly or through Special Purposes Vehicles (SPV).

II. Why issue hybrid instruments?[89]

CRD2 will provide EU banks with a strong incentive to optimise their capital structure by enlarging the elements of eligible capital to innovative tools such as hybrid capital. The issuance of hybrid capital offers several advantages over equity as a funding source. These products benefit from fully tax-deductible interest expenses. Hence the cost of financing is below that of equity, and the retained earnings are higher, producing higher dividends for shareholders. These alternative sources of financing are not only important for banks which need to raise regulatory capital, but banks may also benefit from wide access to an investor class who is willing to take more risk than in fixed income (debt) products and who therefore expect higher returns.

III. Risks of hybrids to investors

Hybrids do not pose any unique risk due to market changes or event risk. Many of the risks contained in Hybrids are also present in other securities[90]:

a) Credit risk (subordination)-risk that the issuer will fail to repay principal and interests in a timely manner:

the likelihood of default is assumed to be the same across all liabilities of an entity while the expected recovery rate varies by subordination level; since hybrid instruments included in Tier 1 capital are junior to the claims of senior and subordinate debt holders and senior to the claims of the equity holders, the degree of possible credit risk is higher compared to other debt instruments and lower compered to ordinary shares.

b) Call and early redemption risk:

Call risk is the risk that the security will be redeemed earlier than expected in a falling interest rate invironment. Early redemption risk is the risk that cash flows may occur earlier than expected and at a time when reinvestment opportunities offer lower yield. Call risk depends primarly on the level of interest rates. Hybrids may contain call provisions where the risk of being called is not closely related to the level of interes rates but rather to non-economic events. If a hybrid issuer is in or heading toward financial distress, the security would likely not be called.

[89] ECB: Potential impact of solvency II in financial stability, july 2007
[90] American Academy of Actuaries: Report on Capital Requirements for Hybrids, September 2007

c) Deferral risk:

preffered stock and other hybrids may suspend dividends/coupons without triggering a default. Deferral can be invoked if an issuer's capital falls below stated minimums, the issuer reports negative earnings for a continued period of time, enters into liquidation, or fails to comply with regulations. This deferral risk is seen mostly in hybrids and is primarly based on the credit quality of the issuer rather than the specific feature of the securitiy. Mandatory deferral feature in Hybrids could create any meaningful risk for investors.

d) Extension risk:

is the risk that cash flows will extend beyond what was expected in a rising interest rate environment; the delay of the return of principal causes the investor to miss the opportunity to invest proceeds at higher yields. Since many hybrids are now issued with very long maturity dates, the extension risk is not significant for hybrid investors.

e) Liquidity risk:

Most hybrids are very liquid and can be traded efficiently and without causing major market price fluctuations, however in distress environment investors may shy away from complex asset structures and/or assets that are subordinate in claim status thereby impacting the liquidity.

f) Price volatility and regulatory/event risk: apply to all assets not just hybrids.

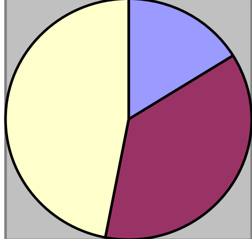
g) Regulatory/event risk: is not significant for hybrids.

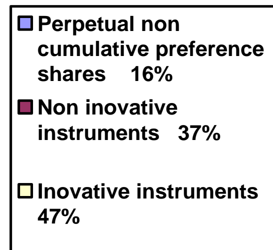
It is important, especially for institutional investors to capture Hybrid risk and features in the projection of their cash flows.

IV. Hybrid environment in Member States

a) Hybrid environment in Member States

The outstanding amount of hybrids reported, on a preliminary basis and as of 31 December 2006, is approximately EUR 213 Bio, which represents around 11.5% of total eligible own funds. Financial institutions from 8 countris (UK, DE, ES, FR, NL, IE, BE and IT) accounted for 89% of all hybrids, consists of the following three main categories of instruments:





Categories of the most common hybrids:[91]

Denominations	**%**
Noncumulative trust preferred securities	**30%**
Undated deeply subordinated noncumulative notes	**22%**
Perpetual non cumulative preference shares	**16%**
Equity contributed through silent partnership interest	**10 %**
Convertible perpetual bonds	**1 %**
Other	**21 %**

Some instruments are significant for a limited number of countries: noncumulative perpetual preference shares are mainly issued in the United Kingdom, which accounts for 90 % of the total amount, silent partnerships are only recognised in Germany (85%), Italy (via consolidation), Belgium and Luxembourg, convertible perpetual bonds are only recognised in Italy (24%), Belgium (73%) and Cyprus. Undated deeply subordinated non cumulative notes are mainly issued in France (33%), UK (20%), Netherland (13%), Sweeden (8%) and non cumulative trust preferred securities are mainly issued in Germany (25%), Netherland (15%), France (14%), Spain (14%), Italiy (13%) and UK (11%).

56% of the hybrids reported are denominated in EUR, 28% in USD, 14% in GBP, 1% in JPY and 1% in other currencies. 50% of hybrids are issued directly and 50% through SpecialPurposes Vehicles (SPV).

Hybrid instruments are recognised as eligible original own fund within following limits:92

Country	**Maximum supervisory limit on hybrids**	**Country**	**Maximum supervisory limit on hybrids**
AT	**30%**	**IT**	**20%**
BE	**33%**	**LI**	**Not eligible**
BG	**Does not exist in legislation**	**LT**	**No limit**
CY	**15%**	**LU**	**15%**
CZ	**Does not exist in legislation**	**LV**	**Not eligible**
DE	**50%**	**MT**	**15%**
DK	**15%**	**NL**	**50%**
EE	**Not eligible**	**NO**	**15%**
EL	**25%**	**PL**	**Does not exist in legislation**
ES	**30%**	**PT**	**20%**
FI	**50%**	**RO**	**Not eligible**
FR	**50%**	**SK**	**Does not exist in legislation**
HU	**No limit**	**SL**	**49%**
IC	**33%**	**SW**	**15%**
IE	**49%**	**UK**	**50%**

[91] CEBS: Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), 13th March 2007

[92] CEBS: Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), 13th March 2007- primary data as of 31 December 2006

V. Hybrid capital in banks' Tier 1 capital

1. Background

In the Sydney Press Release **('SPR')** of 27 October 1998 the Basel Committee on Banking Supervision, has set out the conditions for hybrid instruments to be considered as Tier 1 capital and imposing limits on their inclusion.

In March 2007 Comittee of European Banking Supervisors (CEBS) conducted quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), the objective of which was to assess the importance of the characteristics of hybrid instruments eligible as original own funds.

Because of the lack of EU legislation on the treatment of hybrid instruments, Commission invited CEBS to consider the possiblity of convergence in this area, and in particular to:[93]

- develop general principles that could guide supervisors in each of the three areas identified in the CEBS surveys (permanence, loss absorbency and flexibility of payments), and clarify detailed aspects of each of the principles (see below in the main report);
- seek convergence on the current different quantitative limits to "innovative" and "non-innovative" hybrids;
- explore consideration of the principle of 'substance' prevailing over the form and the importance of assessing any legal risk potentially embedded in hybrids in order to ensure that there is an actual transfer of the issuer's risk to the market;
- to ensure that prudental goal of improving the quality of capital could be achieved in a reasonable period of time.

In march 2008 CEBS proposed a common EU definition of Tier 1 hybrids, the objective of which was to provide guidelines for a common and clear EU-wide interpretation and implementation of eligibility criteria that hybrids must meet.

CEBS has applied the following principles:94

a) Instruments eligible for inclusion in Tier 1 capital have to be measured against the benchmark of 'equity'.

b) "Substance over form" - an instrument eligible for inclusion in Tier 1 capital should comply with the prudential requirements and must result in the effective transfer of the issuer's risk to the market;

c) Have regard to the capital structure and rank of subordination of the capital instruments, whilst recognising that in times of stress hybrid instruments must also be able to absorb losses on a going concern basis.

[93] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008
[94] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008

2. CEBS advice and CRD 2 proposal regarding hybrid Tier 1 capital

The 27 members of CEBS and the 3 EEA countries agreed on the conditions that any hybrid instrument must meet at the same time in order to be considered to be eligible Tier 1 capital in the EU[95]:

a) issued and fully paid-up,
b) proceeds must be immediately available to the issuing institution; if available to the issuing SPV then it should be made available to the institution at a predetermined trigger point,
c) publicly disclosed and easily understood,
d) able to absorb losses in going concern and in liquidation,
e) permanent,
f) able to suspend (waive) payments,
g) limited inclusion in Tier 1.

a) Issued and fully paid-up

The instrument must be issued and fully paid-up: any amount outstanding will not be included as eligible own funds. The proceeds must be immediately available without limitation to the issuing institution, or if proceeds are immediately and fully available only to an issuing SPV, they must be made available to the institution at a predetermined trigger point, well before serious deterioration in the institution's financial position[96].

c) Publicly disclosed and easily understood

The main features of the instrument (including whether it is grandfathered, the proportion of Tier 1 capital it accounts for, mechanisms such as write-down of the principal, conversion into ordinary shares, etc.) must be easily understood and periodically and publicly disclosed by the issuer, and in the case of a principal write-down must be on the issuer's balance sheet (assuming this is possible from an accounting perspective).[97]

d) Ability to absorb losses

Ability to absorb losses in liquidation

The capacity of an instrument to absorb losses in the case of liquidation will depend on its degree of subordination. In order to be able to absorb losses in liquidation hybrid instruments in Tier 1 capital must always rank junior to depositors, general creditors and subordinated debt of the institution, meaning that hybrids are senior only to ordinary share capital.

The instrument must neither be secured nor covered by a guarantee of the issuer or a related entity, nor other arrangements that legally or economically enhance the seniority of the claim vis-à-vis the institution. [98]

In the EEA the vast majority of Tier 1 hybrids are deeply subordinated, being pari passu with ordinary share capital (5%), senior only to ordinary share capital (74%) or senior to other hybrids (21%).[99]

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[95] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008
[96] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008
[97] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008
[98] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008
[99] CEBS: Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), 13th March 2007- primary data as of 31 December 2006

Ability to absorb losses in going concern

CRD 2 propose that the statutory or contractual provisions governing hybrid instrument shall provide for principal to be such as to absorb loses and to not hinder the recapitalisation on an ongoing basis and in particular in stress situations.

The Commission was less definitive than CEBS with respect to the loss absorbency requirement. As it is the most important function of Tier 1 capital, CEBS recommended that the Commission revert to the CEBS loss absorbtion requirements for hybrid instruments on going concern basis:

- they should help to **prevent issuers insolvency** (deep subordination will not help to prevent insolvency and only absorbs losses in a winding up); and
- they should **make the recapitalisation** of the **issuer** more likely.

The instrument helps to **prevent insolvency** and gives institution the opportunity to recover if the following conditions are met :

h) the instrument is permanent;
i) the issuer has the flexibility to cancel coupon/dividend payment;
j) hybrid capital instrument will not be regarded as a liability for insolvency purposes (MS have specific national insolvency laws) and
k) the holder of the instrument cannot be in a position to require the redemption of the instrument or the payment of a coupon/dividend (petition for insolvency).

When issuer has incurred losses which cause a breach of capital requirement, it may need to be recapitalised. The hybrid must include a legally certain mechanism that will make the recapitalisation more likely, by reducing the potential future outflows to the hybrids holders.

Possible **mechanisms for recapitalisation** are:

- a write-down of the principal (permanent or temporary with writte back),
- a conversion into ordinary shares (at a trigger point such as: balance sheet loss or breach of the capital requirement)s
- other mechanisms, capable of achieving the objective of facilitating a recapitalisation. [100]

In EEA, for 39% of hybrid instruments the principle can be written down and for 61% of hybrids the principal cannot be written down (this encompasses 61% of innovative instruments, 45% of noninnovative instruments and 97% of perpetual noncumulative preference shares). A permanent write-down is allowed in a small number of EEA countries and accounts 13% of hybrid instruments. A temporary write down (before profits accrue to ordinary shareholders) is possible for 17% of the hybrid instruments. The large majority of hybrids have no conversion feature: only 1% being convertible into ordinary shares and 18% into noncumulative perpetual preference shares[101].

e) **Permanence**

Permanence is a key feature for a hybrid instruments to be eligible as Tier 1 capital as it provides the bank with the greates flexibility and ensures that capital is available in stress situations. According to CRD2 proposal the hybrid instrument meets the permanence test if it is undated (as such poses no refinancing risk to the issuer) or have a maturity of at least 30 years. Allowance of dated instruments seems contrary to the concept that Tier 1 should be permanent as suggested by CEBS.

[100] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008

[101] CEBS: Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), 13th March 2007- primary data as of 31 December 2006

According to CRD 2 proposal hybrid instruments can be callable, but only:

- at the sole discretion of the issuer, and
- with the prior consent of the supervisory authorities, and
- if financial or solvency conditions of the credit institution are not affected, and
- if they will be replaced with capital instruments of the same or better quality on supervisory authority request,
- after a minimum of 5 years after the issue date, if they contain a pure call option/ after a minimum of 10 years if associated with an incentive to redeem (ex.: Step- ups, principal stock settlement).

Step ups weakens permanency- they are permitted only if they are moderate. The Commission was less definitive than CEBS with respect to what extent are incentives to reedem considered moderate (expected to be covered by level 3 regulations).

CEBS considers step ups to be moderate if:

- max. one rate step-up over the life of the instrument and
- if it results in an increase over the initial rate that is no greater than either (i) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis; or (ii) 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis. The swap spread should be fixed at the pricing date and reflects the differential in pricing on that date between the initial reference security or rate and the stepped-up reference security or rate.

CEBS also proposed that principal stock settlement mechanisms must contain a cap on the conversion ratio in order to limit the potential dilution.

According to CRD 2 proposal, the competent authority shall require the suspension of the redemption for dated instruments, if the credit institution does not comply with the capital requirements.

Early redemption is permitted in conjunction with call option under following conditions:

- if triggered by an event (ex. change in regulatory classification of hybrids or in their tax treatment unforeseen at the issuance date) and
- subject to prior consent of the supervisory authority. [102]

In the EEA the vast majority of current eligible Tier 1 hybrids have strong features of permanence:. at least 95% are explicitly undated, 58% of hybrids do not have any step-up, in most cases the issuer has the option to call the issue after a minimum period which ranges from 5 years (noninnovative instruments) to 10 years (innovative instruments). 90% of hybrids contain redemption features (issuer's call option), early redemptions can be triggered by an event (tax treatment, changes in regulatory recognition of hybrids, etc) and are subject to prior supervisory approval. Principal stock settlement characteristics are present in only 4% of hybrids.[103]

[102] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008

[103] CEBS: Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), 13th March 2007- primary data as of 31 December 2006

f) Ability to suspend (waive) payments

According to CRD2 proposal issuer must waive payments of interest and dividends104:

- on its discretion whenever necessary and for unlimited period, on a non-cumulative basis (subject to prior waiver of distributions on the bank's common stock);
- if issuer is in breach of its minimum capital requirements or
- on the request of the competent authorities based on the financial and solvency situation of the credit institution; such cancellation of payments shall not prejudice the right of the credit institution to substitute the payment of interest or dividend by a payment in the form of Tier 1 eligible instruments – such mechanism must preserve banks financial resources; such substitution may be subject to specific conditions required by the competent authorities.

Compared to CRD2, CEBS is more specific about payment substitute conditions and dividend pushers:

Coupon payments in form of shares, often called Alternative Coupon Satisfaction Mechanisms (ACSM) are permitted in cases:

- where the issuer has full discretion over the payment of the coupons or dividends at all times, and
- if the ACSM achieves the same result as a cancellation of coupon (i.e. there is no decrease in capital),
- the deferred coupons must be contributed without delay to the capital of the issuer in exchange for newly issued shares having an aggregate fair value equal to the amount of the coupon/dividend (the issuer must have already authorised and unissued shares); the shares may be, afterwards, sold in the market but the institution must not be committed to find investors for these shares.

Dividend pushers requires the issuer to pay its coupons on hybrids if it has paid dividends on its ordinary shares. Dividend pushers are acceptable but must be waived in the case of mentioned supervisory events.[105]

Commission proposed that statutory or contractual provisions governing the hybrid instrument shall provide for unpaid interest and dividend to be such as to absorb losses (non-cumulative) and not to hinder the recapitalisation. That gives the issuer full access to waived payments and obligation to pay distributions only out of distributable items.

In EEA, the vast majority of Tier 1 hybrids (93%) are non-cumulative and the issuer has maximum flexibility over the amount and the timing of coupon payments. The most common reason for payments suspension is the breach of regulatory limits (68%) or other limits fixed by supervisors (18%) and solvency difficulties (28%). ACSM account for a small part of the total hybrid instruments, but are, for tax reasons, significant in some jurisdictions.[106]

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[104] 52008PC0602: Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management {SEC(2008) 2532} {SEC(2008) 2533} /* COM/2008/0602 final - COD 2008/0191/

[105] CEBS: Proposal for a common EU definition of Tier 1 hybrids, 26th March, 2008

[106] CEBS: Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA), 13th March 2007- primary data as of 31 December 2006

f) Limits to inclusion hybrid instruments into Tier 1

Common shareholders' funds (common shares and disclosed reserves or retained earnings) should be the predominant elements of capital. Banks should not extensively rely on hybrid capital instruments. To this end, the Commision has proposed a set of limits that differentiate among the types of hybrids according to whether of not the hybrid is likely to promote recapitalisation or to be reedemed:

- Hybrid instruments which will be converted into a core capital during crisis situations may represent max. 50% of original own funds,
- Within 50% limit, all other hybrid instruments shall not exceed a max. 35% of original own funds
- Withing 50% and 35% limit, dated instruments and instruments with incentives to reedem (innovative hybrids) shall not exceed a max. of 15% of original own funds.[107]

The limits apply at all times. However, supervisor should have the ability to temporarly waive the limits relating to additional own funds in emergency situations.

The main criterion for distinction between categories, the convertibility of hybrids in case of need, provides an incentive to develop hybrids that lead to higher quality of capital during crises (i.e. by a higher share of core capital).[108]

However, the Commission proposal does not alter the ratio of hybrids to core Tier I capital or shareholders' equity. Hybrids can still account for up to 50% of total Tier I capital. That implies that core Tier I capital can account for as little as 2% of the bank's risk-weighted assets – a ratio that many Member States feel is too low, particularly as many debt investors also appear to feel that such a low core Tier 1 ratio is too low.[109]

At the moment in EEA, the overall limit on hybrids ranges from 15%-50% of Tier 1.

g) Grandfathering

The eligibility of any instrument authorised or issued under existing national rules which no longer qualifies under the above interpretation as Tier 1 capital has to be gradually reduced over a period of 30 years:

Years after new requirements entered into force	Limit for inclusion of grandfathered instruments
10 years	20% of Tier 1 capital*
20 years	10% of Tier 1 capital*
30 years	0% of Tier 1 capital*

*) after specific Tier 1 deductions, but without taking into account deductions from original and additional own funds.

Any grandfathered instrument which does not comply with the grandfathering rules will be disqualified as Tier 1 and considered as additional own funds (Tier 2). Any call for redemption will be subject to prior supervisory approval.

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[107] European Commission, Internal Market and Services DG: CRD Potential changes/Co-decision Comitology

[108] 52008PC0602: Proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management {SEC(2008) 2532} {SEC(2008) 2533} /* COM/2008/0602 final - COD 2008/0191/

[109] Thomas Huertas, FSA: Hybrid Capital (speach), 26th June 2008

VI. Impact assessment

The estimated impact of proposed changes in the CRD can be summarized as follows[110]:

The CRD 2 proposal would ensure adequate sources of banks' capital funding, allow diversified capital structure and would broadened investor basis; the harmonised EU framework would promote legal certainty and minimise potential competitive distortions, the quality of capital will be improved by distinguishing hybrid instruments depending on their equity-like nature during crisis situations, reinforcing risk management, supervisors will benefit from a harmonised principle-based regulatory approach, possible differences of implementation at national level will be minimized which will reduce compliance costs. Investors will benefit from increased liquidity of hybrid instruments and the efficiency of financial markets will improve.

VII. Rating of Hybrid Capital Securities[111]

With the benefit of a few years of history, the rating agencies issued refinements to their rating methodology in 2005. The modifications recognized that certain features of hybrid securities (i.e. longer maturity, longer deferral period) could boost the equity value of the balance sheet of issuers. Moody's scores each hybrid capital security based on specific features including: (1) maturity or permanence of capital, (2) ongoing payments or coupon deferral option, and (3) loss absorption or subordination. Depending on the score an issue receives, it is placed in a basket on Moody's debt-equity continuum as shown in table:

	A	**B**	**C**	**D**	**E**
Equity Credit	0%	25%	50%	75%	100%

Source: Western Asset

The main reason for the change of equity treatment in this example is due to loss absorption. Rating agencies have witnessed that recovery for hybrids (trust preferred securities) has been more on a scale with equity owners than debt holders. S&P and Fitch use a fairly similar approach to classifying hybrids. In addition to regulatory Tier 1 Capital ratios, an important component of Moody's current methodology for assessing bank capital position is the Thangible Common Equity over Risk Weighted Assets ratio.

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[110] Commission of the European Communities; Commission staff working document: Impact assessment, SEC (2008) 2532, 1st October 2008

[111] Western Asset: Hybrid Capital Securities, March 2007

Topic III: The current crisis has been impacted by the freezing of liquidity and the consequent paralysis in the interbank market, does the revised CRD proposal sufficiently cover these issues and how to deal with them?

The current crisis has been impacted by the freezing of liquidity and the consequent paralysis in the interbank market, does the revised CRD proposal sufficiently cover these issues and how to deal with them?

Briefing Paper for the Financial experts panel of December 2008 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Wolfgang Hartmann

Executive Summary

1. Securitisation

We broadly welcome the initiatives planned to stabilise the "Originate-to-Distribute" (OtD) securitisation model. However, some aspects of the draft regulation still need adjustment (e.g. retention requirement in corporate customer securitisations, high monitoring costs for investors of the originator's retained risk). We require a uniform international approach and the extension of the requirements to other non CRD-regulated market participants (e.g. hedge funds, insurance companies, U.S. banks). Furthermore we require the application of the look-through approach down to the level of the underlying portfolio. This necessitates minimum standards of disclosure rules in all transactions. We recommend the provision of a licensing and regulatory control environment for all structuring and investing institutions participating in ABS transactions. Multilevel models (e.g. CDO, CDO^2) are to be rejected.

2. Market risk models

Historic loss experience and bank's internal capital models have shown that the regulatory capital consumption for market risk underestimates the true economic capital consumption. As a result, a more balanced view between market and credit risk should be achieved with a clear goal of further convergence between regulatory and economic capital requirements. Therefore, in general we welcome the idea of a risk-adequate Incremental Risk Charge ("IRC") model and especially the requirement of an explicit capture of migration and default risk in trading books. Several components of the new framework (e.g. a floor for liquidity of assets, strict abidance to the so called constant level of risk) have, however, to be objectively questioned. Furthermore, it is imperative that both Basel and the EU commission move in lockstep.

3. Integrated Market and Credit Risk

The financial crisis has underscored the need for an integrated market and credit risk management of distinct sub-portfolios of the bank. As a result the risk function should conduct regular, at least yearly, reviews (e.g. in a framework of batch reports) focussing on a holistic analysis of all risks embedded in the considered portfolios. Therefore we welcome all initiatives to set binding standards for the entire sector.

4. Internal rating systems

Modern risk analytics, driven by statistical selection and weighting of potential risk factors, must be augmented (and tempered) by the input of risk management experts, particularly with a view to ensuring more forward-looking assessments of risk. (See also #5.)

5. Forecast financials as the basis for forward-looking risk analysis

Forecasts for key financial figures should play a role alongside published financial statements in the credit rating process, emphasizing risk prognosis over historical risk analysis. Relying only on published figures is not unlike steering using only the rear-view mirror.

6. Homogenous subportfolios

We recommend making it mandatory for risk control / strategy that risk management differentiates between homogenous subportfolios with similar default track record and monitors the macroeconomic risk parameters tightly and in a forward-looking manner. Significant changes within portfolio quality and macroeconomic risk parameters will have to lead to a review of the risk strategy.

7. Limiting bulk risks

The current financial crisis has shown clearly that current Large Exposure rules are not suited to the task. Adequate limitation and mitigation of risk clusters in the market demands a stronger approach. We therefore propose that banks be required to implement internal limit systems based on Unexpected Loss for such risks.

8. Risk strategy

Strategic risk planning and the development of business / investment strategies are deeply and permanently intertwined. A risk strategy, whether global or granular (e.g. expressed as individual strategies for homogeneous subportfolios), must reflect the bank's risk management goals for all material business activities. The risk strategy gives business lines clear guidance (while setting clear boundaries) and must serve to ensure consistently strong market presence in all core portfolios. Active limitation of bulk risk should play an important role in its formulation.

9. Strengthening the risk management function

In the face of increasingly complex financial markets, the Chief Risk Officer can navigate the responsibilities with which he is entrusted only if able to do so independently, free from influence, and with broad reach across the entire banking group. A CRO's relationship with regulators as well as with the Supervisory Board must be built upon a foundation of trust. The role's fundamental independence and freedom from influence should be safeguarded by legislation.

10. Supervisory regime

We welcome a strengthening of general regulatory frameworks and supervisory practices. For system-relevant banks in particular, there is a need for better coordination of supervision and exchange of information between regulators. A single pan-European entity dedicated to the supervision of the 50 or so system-relevant banks should be created to address this need.

11. Disclosure requirements

In our opinion, more extensive disclosure requirements are helpful for a restoring trust in the banking sector and towards individual players. Their effect in overcoming the fundamentals of today's financial market crisis will, however, be small as long as consistent and binding market standards for disclosure are missing.

It is decisive that the external risk communication strengthens the market's trust in the risk management capabilities of the bank. For that aim, transparent portfolio information, reliable assessments of the risk profile and commitment to a clear strategy are indispensable. We recommend that disclosure requirements be based on relevant parameters and the macroeconomic environment relevant for homogeneous subportfolios.

12. Risk-adjusted pricing and valuation

Banks should be brought to commit to risk management based upon risk/return-based pricing measures. Various approaches in common banking use (e.g. hurdle margins or economic value added) would be adequate for the task. Better pricing frameworks would help to ensure that banks can and will continue to show willingness to lend even at the higher end of the credit quality spectrum. In addition, adequate valuation of financial products relies on appropriate selection of mark-to-market, mark-to-index and mark-to-model techniques; transparency regarding the valuation approach applied to each portfolio is critical.

13. Regulatory capital and procyclicality

We welcome the current thinking regarding defence against procyclicality, by which banks could build up additional capital buffers in profitable phases of the cycle in order to be able to draw upon them in other phases. Decisive for allocation of such capital buffers should be both the delta between Expected Loss and actual risk provisioning as well as the fluctuation of Expected Loss through the cycle due to changing business mix.

14. Liquidity Risk Management

We welcome the initiative to implement mandatory standards for liquidity risk management of financial institutions which shall also include hedge funds and conduits. We believe that a coordinated effort on the part of the regulatory authorities would be effective in containing the practice of maturity transformation as has been the case to date, in the favour of a sustainable level playing field for adequate management of this risk class.

We advocate that in the future, all system-relevant banks be obliged to implement internal liquidity models that incorporate systemic stress tests. These models should also be drawn upon to monitor the refinancing function. In this respect, a process of certification should be implemented by the end of 2010.

1. Securitisation

a. Revitalisation of the "Originate-to-Distribute" Model

The OtD model contributed significantly to the rapid growth of the securitisation market until the onset of the financial crisis. It applied in particular to the US mortgage securitisation market (e.g. OtD represented 75% of Subprime RMBS in 2006; see Appendix). The securitisation issuance shows the dominance of the U.S. market (2007 U.S. issuance of EUR 2,055 billion versus EU issuance of EUR 454 billion). European banks became further involved by making significant investments in these US securitisations[112].

[112] "ESF Securitisation Data Report, Q3 2008", page 3.

The inherent weaknesses of the OtD model and inadequate risk analysis by the investors are considered crucial triggers of the financial crisis. Despite the failure of the OtD model, it is essential that institutions will still be able to share risk in future. The CRD draft includes stabilisation measures to align incentives, to enhance risk management practices and to increase market transparency for originators, sponsors and investors alike:

- In particular, a **risk retention** of 5% (Article 122a, EU Commission proposal, 12.11.08) or 10% (status: EU Parliament Reporter, 27.11.08) is planned for **originators or sponsors**. We welcome that the risk retention will not apply to securitisation transactions beyond the OtD model. However further clarification of the excluded transactions is required (e.g. corporate customer funding transactions as well as securitisation of bank assets for risk management purposes). We reject a further increase of the risk retention level. Moreover a precise definition of the reference value (EAD or RWA or volume) is required as it significantly influences the economic viability of the transactions.

- We appreciate the EU Parliament's proposal to abandon the (disproportionate) full capital deduction imposed where the investor does not meet fully the risk **management requirements**. The alternative proposal of an **additional capital charge** (1.5 times the original risk weight) provides from our point of view sufficient incentives for compliance and is economically justifiable.

- The **requirement to monitor the risk retention continuously** is difficult to implement. The investor is confronted with the problem of getting continually updated information, which is even more difficult where the originator or sponsor is not regulated by the CRD. It is essential that the investor is able to monitor any change in the risk retention without prohibitive effort. When the risk retention is also relevant for corporate customer funding transactions, this requirement can only be met by the corporate customer himself (as originator) or by a third party. This would make the monitoring by the investor even more complicated.

- To keep the benefits of securitisation as a flexible instrument of liquidity management and risk transfer, its risks must be properly measured and excesses preventable. **Transparency of securitisation structures** is therefore a crucial prerequisite for the correct assessment of securitisation risk (see also #1d).

b. Standardisation and licensing of market participants

Parallel to the regulatory initiatives, the industry is also working on due diligence guidelines and transparency requirements.

- Industry and supervisory initiatives will establish significantly **higher market standards** for the securitisation business. The growing qualitative requirements, as audited/verified by the regulators, in addition to the anticipated sharply rising capital costs for (re-)securitisations in the trading book, will trigger a withdrawal of market participants. Thus the market participants remaining on the structuring and investing side will have proven expertise **("licensing")**.

- To prevent a shift of securitisation activities to less-regulated or unregulated areas, a uniform **international approach to regulation** is necessary. Without supervision of non-banks, the proposed rules might give rise to regulatory arbitrage. Therefore the EU rules must result in internationally accepted regulatory requirements to ensure a level playing field for EU banks.

c. Reduction of product complexity

The explicit risk management requirements and the future increase in the cost of capital will also contribute to a sustained market adjustment of the product range of structured finance.

Ultimately, we expect a more consistent focus on customer or investor needs. This is particularly true for complex, multilevel products (e.g. CDO, CDO^2), for which an adequate and permanent risk analysis by the investor is — even with improved public information — only feasible with greater resources. The simplification of the product structure assists not only sound risk management by the market participants, but also the reduction of systemic risk.

d. Enhanced market transparency

Various initiatives by the regulators and the industry (especially FSF, CEBS, ESF, IASB) are currently underway to remedy the lack of transparency in the securitisation market.

- Transparency improvements must also be achieved through **internationally harmonised standards and definitions**. Currently the national implementations of the ABS Basel II Pillar III requirements are diverse and exacerbate the difficulties of international comparability.

- Moreover, the disclosure of details is to be extended, in particular regarding information on the quality of the securitised portfolios. Most meaningful would be a more granular **specification of risk profiles** through default rates, credit statements (ratings/expected loss), duration data (Weighted Average Lifetime (WAL)), asset categorisation (trade receivables, consumer loans, etc.), asset-specific ratios (LTVs, subprime ratio, etc.) and geographic and sector distribution. Furthermore information on the transaction structure, tranches, size of the first loss piece, and any risk retention as well as additional collaterals (e.g. monolines) should be disclosed.

- The **frequency and the extent of information** should be determined in accordance with the needs of the addressee (e.g. ABS investors, bank analysts, rating agencies, regulators, shareholders, etc.). A harmonised monthly publication of the above mentioned details would be adequate for those issues with, for example, short-term debt in the collateral pool.

e. Use of external ratings

The close linkage of regulatory capital requirements for external ABS ratings is dependent on the critical adoption of strong market discipline. The latter failed, due to insufficient differentiation between corporate ratings and structured ratings, the misaligned incentives in the OtD model and unsatisfactory risk analysis and transparency.

- The planned **more detailed disclosure of rating methodologies** and the underlying transaction data will allow investors to conduct a more accurate analysis and their own stress tests. These are necessary for the assessment of the adequacy of risk cushion. Increasing transparency is also useful in improving the banks' internal ABS rating systems, which are, due to regulatory requirements, linked to the rating agencies' own models (Basel II Internal Assessment Approach).

- The planned **licensing and monitoring of credit rating agencies** will reduce the conflicts of interest and improve the rating quality. In the future a mandate to rate transactions should not be granted to those who offer auxiliary advisory services to the customer at the same time (structuring of transactions, valuation of structured products). In addition the supervision of the virtually legally binding IOSCO standards as well as the regulatory appraisal of the rating models will lead to a noticeably better and more stable rating quality.

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Current situation

Liquidity risk compared to other risk types has been quite a neglected topic from regulatory aspect, but because of the current market turmoil it has become a hot topic. One of the key elements of the present situation has been - through the loss of confidence - liquidity crisis. No one knew which bank would be the next victim of the crisis that is why banks have not dared to credit each other thus the interbank market dried up . i.e. the confidence crisis led to liquidity crisis.

For the new challenges . like liquidity risk . a reply is requested from the participants of the market. In this context among others, the banking regulations and rules have to be reviewed, as well. Now we have to think out how? Of course there is not only one right answer, but in order to give a well-considered answer we have to scrutinise the issue from several aspects.

There are plenty of questions in connection with liquidity management of banks . such as how should a bank.s liquidity structure look like, to what extent maturity mismatch is acceptable, how should banks measure liquidity risk . but there is no consensus on these questions, moreover there is no mutual understanding how it should be regulated.

Liquidity risk

Let us first analyze liquidity risk itself. Liquidity is a complex category. It can be classified in many ways and the treatment also varies from case to case.

We will separate the following main types of liquidity (see for similar classification in Goodhart (2008) and Sharma (2004)):

1. Funding liquidity: ability to come by money in case of lack of liquidity (thus to fulfil the short term obligations) and to lend out liquidity surplus.

2. Asset liquidity: ability to sell an asset at about the expected price (i.e. without suffering considerable losses).

Obviously there is interrelation between them, but we will separate them as they require clearly different treatment.

Funding liquidity

The fluctuation in the level of a bank's liquidity (irrespectively of how it is measured) accompanies the usual operation of the banks. In case of normal circumstances the liquidity transfer between banks takes place on the interbank market.

Problems occur when the system gets damaged for some reasons (like confidence problems) which is quite a realistic scenario as in the banking sector there is a high risk of contagion, i.e. financial difficulties encountered by one or few bank(s) may infect other banks as well or even shock the whole market. In such cases when the interbank market breaks down banks with liquidity surplus lose the incomes from lending out the surplus while which is usually more serious banks in lack of liquidity cannot or only dearly can access cash. In such a situation the role of the Central Bank (so called lender of last resort function) is essential as in case of liquidity crisis Central Banks are the ones who can give liquidity assistance for the banks.

One can argue that this kind of problem occurs quite rarely, and even so when it comes about, the intervention of the Central Bank efficiently gets the banks through the difficulties. This raises the question whether regulators have to deal with this issue or are ad hoc treatments enough?

Obviously we can go through a crisis easier if we are well prepared, if we have acting plans, policies to deal with the situation. So of course liquidity risk has to be managed by banks. But it can occur that some banks are not sufficiently aware of this need or just have not got enough incentive for that. Thus it is obvious that regulators have to control this issue as well, the question is how and to what extent i.e. in the course of the implementation how much freedom has to be given to the banks? And our main question is: how should CRD cover risk arising from funding liquidity?

Basel II type regulations (like CRD) are based on 3 pillars: Pillar 1 deals with the quantitative aspects of risk management, focuses on capital requirement and through that on potential loss. Pillar 2 deals rather with the qualitative aspects of risk management, focuses on processes, proceedings and principles of risk management. Capital requirement can also be covered in Pillar 2 but in a less standardized way. Pillar 3 deals with the disclosure requirements thus it is designed to promote transparency.

The revised CRD covers more detailed rules on liquidity risk then the current version, but still leaves it in Pillar 2 and 3. Should not Pillar 1 also cover liquidity risk? In order to answer this question, first we have to consider if additional capital requirement is needed for covering funding liquidity risk. Let us just summarize the pro and contra arguments usually mentioned in connection with this question.

On the one hand it is clear that liquidity problems cause losses which like other losses have to be covered by own funds instead of other parties' money. Moreover high capital adequacy ratio helps to maintain confidence and thus the funding willingness of the partners that is to say capital allocation is also a kind of .PR tool..

But on the other hand capital is basically not an efficient solution for managing liquidity risk. Although as we mentioned before additional capital requirement mitigates risk of insolvency arising from funding liquidity, but capital itself is not adequate to resolve liquidity problems or even to avoid liquidity shocks i.e. liquidity stresses cannot be redressed by capital. Moreover capital is a pretty expensive regulatory tool. Furthermore losses caused by liquidity problems are cyclical that is to say that during normal circumstances loss arising from liquidity risk is immaterial but when it is significant which is quite rare it is usually huge. Thus the level of capital which is enough to cover such big losses is disproportionately high compared to the average loss. And what is more, banks differ so much from each other in this respect that there is no one solution which fits all banks i.e. regulation should not be standardized, a kind of flexibility is desired.

All in all . in our opinion - additional capital requirement for liquidity risk management purposes causes more damage than good, thus setting standardised capital requirement rules is undesirable. What is needed is such a regulation which does not put disproportionately large burden on banks. For this purpose Pillar 2 is ideal as like that the main principles and required acts can be defined while the details of the execution are left to the banks. Of course the set standards have to be controllable and enforceable, thus Pillar 3 also has to cover this topic.

Asset liquidity

An asset is liquid if the owner sold it within a reasonable short time without suffering considerable losses. The related risk is that an asset assumed to be liquid becomes unmarketable or can be sold only at a depressed price.

This problem is especially crucial in case of the elements of the trading book as they are handled as liquid assets (a clear evidence for this is the holding period used for VaR calculations in case of internal method). This assumption is followed evidently from the definition of the trading book.

The problem is that in many cases not sufficiently liquid assets can also be found in the trading book. For example an asset, which was originally fitted into the trading book (i.e. asset backed securities), suffers problems which cast doubts on its liquidity, still has not been moved from the trading book into the banking book. The regulation of classifying the assets into the trading book ought to be stricter. So what is surely needed is revising these rules in CRD. For example the liquidity profile of the positions in the trading book should be reconsidered daily, and like that not sufficiently liquid assets have to be put into the banking book.

Additional solution can be penalizing the less liquid assets by setting additional capital requirements based on the liquidity profile of trading book assets. Thus the liquidity of the assets has to be measured, an adequate indicator can be the bid-ask spread. In this case setting additional capital requirement is appropriate as if mid price is used for valuation then the bank indeed loses the difference between the mid and the bid/ask (depending on whether the position is short or long) price.

Note, that valuing assets on bid (or ask) prices only aggravates the problem. In both the standardized and internal methods the capital requirement is a percentage of the value of the asset. So if the asset is valued conservatively - on the bid price, the capital requirement is smaller, not larger, than the case would be for a liquid asset. The solution would be to use a liquidity add-on in these cases based on a linear function of the bid-ask spread or an internally modelled value based on the historical distribution of the spread.

For an example of such an application see Appendix.

Summary

Current turmoil highlighted the liquidity risk and the importance of its management. CRD was also revised from this aspect which resulted in expanding the rules concerning liquidity risk in Pillar 2 and Pillar 3. We have been interested in whether the revised CRD proposal covers sufficiently these issues. We have found that additional capital requirement is not an adequate liquidity management tool, i.e. funding liquidity risk should only be monitored but capital should not be tied to it.

On the other hand, we propose stricter eligibility rules for trading book instruments from asset liquidity point of view and a liquidity add-on based on the bid-ask spread.

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Columns of the report:

- Original NAV: net asset value of the instrument calculated with the closing price

- NAV with Bid-Ask price: net asset value of the instrument calculated with the bid (or

ask) price

- Daily illiquidity haircut: the daily illiquidity difference divided by the original NAV (i.e.the difference expressed in percentage)

- Daily illiquidity difference: difference between original NAV and NAV calculated with Bid-Ask price

- 100 day average illiquidity haircut: the 100 day average illiquidity capital requirement divided by the original NAV

- 100 day average illiquidity capital requirement: average of 100 day historical daily illiquidity difference (i.e. the difference expressed in percentage)

- 100 day st. normal distribution 95% illiquidity haircut: the 100 day st. normal distribution 95% illiquidity capital requirement divided by the original NAV

- 100 day st. normal distribution 95% illiquidity capital requirement: the 95% confidence interval of the estimated standard normal distribution based on 100 day historical daily illiquidity difference (i.e. VaR or maximum loss)

Illiquidity capital requirement			*Daily*		*100 day average*		*100 day st. normal distribution 95%*	
Product name	*Original NAV*	*NAV with Bid-Ask prices*	*Illiquidity haircut*	*Difference*	*Illiquidity haircut*	*Illiquidity capital requirement*	*Illiquidity haircut*	*Illiquidity capital requirement*
A090424E06	10 243 864.00	10 239 494.00	0.0427%	4 370.00	0.1044 %	10 693.74	0.1895 %	19 408.21
A110422C08	9 745 610.00	9 716 695.00	0.2967%	28 915.00	0.2264 %	22 061.53	0.3908 %	38 089.19
A171124A01	8 853 548.00	8 783 763.00	0.7882%	69 785.00	1.1356 %	100 539.19	1.9818 %	175 464.17
MOL	10 300 000.00	10 140 000.00	1.5534%	160 000.00	1.0494 %	108 088.91	4.2089 %	433 520.20
OTP	3 000 000.00	2 985 000.00	0.5000%	15 000.00	0.9106 %	27 316.96	4.5373 %	136 118.61
PANNERGY	9 030 145.00	8 424 095.00	6.7114%	606 050.00	4.8378 %	436 861.21	27.3564 %	2 470 326.81
RICHTER	3 772 800.00	3 641 800.00	3.4722%	131 000.00	1.6556 %	62 461.27	5.6566 %	213 414.00
Total	*54 945 967.00*	*53 930 846.99*		***1 015 120.01***	*1.3978 %*	***768 022.82***	*6.3450 %*	***3 486 341.20***
Daily Difference of NAV because of illiquidity			***1 015 120.01***					
Avg. Difference of NAV because of illiquidity			***768 022.82***	Days: 100				
Max. Difference of NAV because of illiquidity			***3 486 341.20***	Standard normal distribution 95% Days: 100				

On the report we can observe that fixed income treasury with longer maturity has bigger spread, that is to say less liquid (for example while the daily illiquidity haircut of A090424E06 is 0.1044% the same figure for A171124A01 is 1.1356 % - i.e. almost 11 times bigger). The same can be observed in connection with shares: as we supposed Pannergy is significantly less liquid than the other shares.

At the bottom of the report the results (the aggregated values of the daily differences, the 100 day averages and VaR values) are summarized. The average difference is the expected value for the loss arising from liquidity risk while VaR gives the maximum potential loss at 95% confidence level, thus both number can be used as capital requirement.

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Marco Lamandini

Executive summary

The Committee has requested an opinion on CRD and liquidity. This briefing paper is intended to offer a view on this issue, the relevance of which for the sound management and prudential supervision of banks has been clearly highlighted by the current financial crisis. Paragraph 1 provides for a brief overview of the CRD proposed amendments concerning liquidity risk management and supervision. Paragraph 2 briefly discusses these proposed amendments and CEBS's recommendations on liquidity risk management. Paragraph 3 considers liquidity risk management in a banking group perspective, calling for some additional regulatory efforts to address the problem of "liquidity trap" and to strengthen cross border liquidity crisis management.

1.- The CRD proposal, drawing lessons from the recent liquidity crisis, acknowledges that liquidity is a key determinant of the soundness of the banking sector. It is widely accepted, indeed, that if the current crisis tells us anything, it is that a number of market developments, such as the increasing reliance of large banks on market funding (in addition to retail deposits), the increasing use of complex financial instruments (based on a "originate-rate-transfer" model) and the globalisation of financial markets have created significant new challenges in the liquidity risk management within banks.

The current crisis showed that large banks' liquidity was affected, in times of sudden and unexpected fall of confidence: i) by the shortening of maturity in the inter-bank market (with borrowing limited for a time to overnight or a few days); ii) by the drying up of ABS markets (regardless of the assumed quality of the paper as reflected in external ratings) which, on one hand, left banks unable to access liquidity by securitising portfolios and, on the other hand, left banks exposed to liquidity drains from SPVs conduits on the ground of their often implicit off balance sheet commitments to them; iii) by an unprecedented difficulty in issuing securities in the primary markets and illiquidity of secondary markets. In this context, banks heavily depending on wholesale funding instead of retail deposits (the former much more volatile than the latter) faced a severe liquidity shortage which triggered the need for emergency liquidity assistance by central banks and other public intervention.

The size of the problem showed that widespread liquidity risk mismanagement leads to systemic instability, putting even at risk the wise and sound central banking principle of strict separation between liquidity provision policy and monetary policy.

Indeed, the setting of the level of interest rates should be directed solely at the goal of maintaining price stability; charging monetary policy with additional objectives, such as providing exceptional and emergency liquidity support to ensure financial stability, could result in a policy at war with itself. This is particularly true when we face, as it seems to happen these days, inflationary pressures combined with weaker economic activity and financial turbulence.

The current EU framework on prudential regulation in liquidity is quite light. The host supervisor is in principle in charge of monitoring liquidity risks for branches as an exception to the home country control principle (see also Article 41 of CRD). CRD requires banks to address this type of risk but does not get into details. As a matter of fact, point 14 of Annex V to Directive 2006/48/EC sets out – with quite a broad wording – that "policies and processes for the measurement and management of their net funding positions and requirements on an on going and forward looking basis shall exist. Alternative scenarios shall be considered and the assumptions underpinning decisions concerning the net funding position shall be reviewed regularly". Point 15 sets out that "Contingency plans to deal with liquidity crisis shall be in place". In turn, Annex XI provides that "the review and evaluation performed by competent authorities shall pursuant to Article 124 include the following: (…) e) the exposure to and management of liquidity risk by the credit institutions. As a consequence of these vague principles, there are wide differences in national prudential treatments for liquidity risk (most if not all authorities within the EEA recognize, though, the Basel sound practices for liquidity risk management as a general reference) ([113]).

The proposed changes to Annex V of CRD are intended to set in much greater detail the guiding principles for banks' liquidity risk management. It is proposed therefore to amend the existing points 14 and 15, so as to make clear, on one hand, that "adequate levels of liquidity buffers" and "robust strategies, policies, processes and systems" are expected in order to "identify, measure and manage liquidity risk over an appropriate set of time horizons, including intra-day". Note that according to the new point 14a each bank shall adopt the strategies and processes proportionate to its complexity and exposure to risk, considering also the bank's systemic relevance in each Member State in which it carries on its business. Under the new Article 15 banks are requested to develop a system of limits and appropriate methodologies for "the identification, measurement, management and monitoring of funding positions". The proposal adds to the existing Annex V points 16 to 22 to require banks: i) to distinguish between pledged and unencumbered assets in their liquidity management; ii) to consider different liquidity risk mitigation tools, including liquidity buffers and an adequately diversified funding structure and access to funding sources; iii) to consider alternative scenarios in their liquidity risk management; iv) to consider the potential impact of institution-specific, market-wide of combined alternative scenarios in different time horizons and under varying degrees of stress; v) to have in place and to regularly test contingency plans to address possible liquidity shortfalls.

In turn, and consistently, Annex XI is also amended to subject these new management requirements to the supervision of competent authorities and to spell out in detail, under new point 1a, that supervisors "shall regularly carry out a comprehensive assessment of the overall liquidity risk management and promote the development of sound internal methodologies".

[113] Compare CEBS, *Survey of the current regulatory frameworks adopted by the EEA regulators*, August 2007, passim.

In so doing, they "shall have regard to the role played by the bank in the financial markets and to the potential impact of their decisions on the stability of the financial system in all other Member States".

2.- The proposed amendments are certainly welcome. They should help boards of directors and senior management to better understand their role and their duty of care vis-à-vis liquidity risk and at the same time they should increase the strictness of the legal requirements on liquidity risk management. They also enhance the cooperation between banks and supervisors to better detect liquidity risks and better understand liquidity profiles; in this respect banks can rely also, to some extent, on internal methodologies for supervisory purposes.

They do represent, though, still quite vague general principles, still open to a potentially highly differentiated application by banks and enforcement by supervisors.

To be true, these general principles are now better detailed, for the EEA, in a wider set of recommendations issued by CEBS on 18 September 2008 (CEBS 2008 147). They can also heavily rely on the new 2008 Principles for Sound Liquidity Risk Management and Supervision of the Basel Committee. These principles and recommendations are however "only" best practices for banks and "simple" supervisors' expectations on better liquidity risk management. Nonetheless, they will certainly serve as an important tool of supervisory orientation and are likely to be adopted at national level as supervisory principles; in this way they could and should contribute to bring about more convergence over time in the approaches followed by banks and supervisors within Europe, also through the colleges of supervisors.

However, to my mind, there may be a case here for more regulatory harmonization. Although the liquidity management dimension is increasingly international (and even more so after the EU enlargement: core domestic banks in the new Member State, becoming for the vast majority subsidiaries of larger groups, function as a source of liquidity within the group), national rules and supervisory frameworks differ substantially. Thus a common position on quantitative requirements (such as liquidity ratios; mismatch limits, assets eligible as liquid assets) as well as on qualitative requirements (such as internal policies and controls, contingency planning, stress testing) would certainly prove very helpful in aligning industry and supervisors' behaviors. Indeed, in my view, it is now time, in the wake of the current crisis, to pursue the more ambitious objective of establishing a common European compulsory and detailed framework for liquidity risk management and supervision. This, on one hand, in order to prevent the evil of regulatory and supervisory arbitrage and the inherent competition in laxity which has been one of the causes of the current crisis; on the other hand, to avoid conflicting national responses to the current liquidity crisis and the likely regulatory overload which could follow.

This regulatory overload could prove very costly and ineffective for cross border groups. It should be recalled, in this respect, that CEBS recommendation 29 does not grant (and, due to its very nature, cannot grant without a CRD provision) to the consolidating supervisor any decision making power in the colleges to set common requirements on liquidity management for cross border groups where national requirements or supervisory practices differ.

Such common requirements would be fully justified, in my view, under the subsidiarity principle: recent European events have clearly showed the macro-prudential effects of cross border liquidity mismanagement. They would also comply with the principle of proportionality because they would and should leave appropriate room to each bank for individual adjustments depending on its specific features.

As Governor Mario Draghi recently noted at his Bundesbank lecture 2008 “history has repeatedly shown that needed reforms are ignored until a crisis forces action and that the will to reform quickly dissipates after the crisis has passed. This crisis is no different, and this is an opportunity to strengthen the structure of the financial services industry”.

3.- The CRD proposal does not tackle the very topical issue of asset transferability within a cross border group. In emergency situations of illiquidity within a cross border banking group, asset transferability (within 24-48 hours) makes the difference.

To be sure new point 16 of Annex V sets out that, when considering available assets at all times, in particular for emergency situations, banks “shall take into account the legal entity in which the asses reside as well as their eligibility and timely mobilization”. In turn, point 17 sets out that banks “shall also have regard to existing legal, regulatory and operational limitations to potential transfers of liquidity and unencumbered assets amongst legal entities, both within and outside the EEA”.

However, these provisions do not go any further than requiring that the board properly identifies and considers the existing and defective situation of liquidity risk management within cross border groups. Subsidiaries and branches are treated very differently in this respect. The latter can take advantage of a centralised management of liquidity. The former, on the contrary, when facing a liquidity crisis are not legally entitled to claim the support of the parent company, unless the parent company granted an explicit guarantee and this guarantee complies with home and host company laws. This is why cross border groups suffer from the so called “liquidity trap”: each subsidiary must comply with national supervisory requirements on liquidity computed on a stand alone basis: this makes the liquidity management of a cross border group much more expensive than that of a trans-national bank with foreign branches. This is even more so when collaterals accepted by home and host country supervisors differ.

The Commission is working on this topic within the frame of the revision of the winding up directive (2001/24/EC). In its summary of the public consultation on the reorganisation and winding up of credit institutions, the Commission circumstantiates the importance of assets transferability, the legal obstacles still existing due to company law and insolvency law national fragmentation and possible solutions.

In my opinion, time has come to level the prudential supervision of fully integrated subsidiaries and branches, including their liquidity supervision. Colleges should play a similar role for both.

Also cross border groups, in my view, should be allowed to have a centralised liquidity management reflecting their often integrated economic unity; ring fencing should be avoided. However, the parent company’s right to reap the (liquidity) fruits of a subsidiary, both under ordinary and emergency circumstances, should go along with a duty to assist the subsidiary in times of need and to compensate its minority shareholders and creditors, if and when the asset transfer may cause harm to them. This would apply at the European level – at least in the banking field – principles already embeeded in some national laws (as for instance Articles 2497 and following of the Italian Civil Code) Appropriate “group contracts”, approved by the competent home and host supervisors (also within the colleges) should be put in place.

The tricky exercise consists here not only in solving long lasting company law and insolvency law national discrepancies in respect to the concept of group interest and the treatment of cross border groups in insolvency but also in finding a balanced approach for an equitable "burden sharing" among home and host countries. It is clear, indeed, that internal arrangements whereby the parent company is legally entitled and at the same time obliged to transfer assets to the subsidiaries facing an emergency situation (and viceversa within the group) are viable insofar as the bail out costs of the whole group are equitably split among all Member States where the group operates.

But does CRD matter in this respect? In my view, it does. If cross border asset transferability is allowed, Article 69 should be extended so as to cover also cross border groups. The CRD proposal should therefore tackle also the very issue of consolidated versus solo liquidity risk management and supervision. A number of cross border groups already manage liquidity risks on a centralised basis and would deserve more attention also in the CRD framework.

The CRD Amendments and Liquidity Risk Management

Briefing Paper for the Financial experts panel of December 2008 by the Committee on Economic and Monetary Affairs of the European Parliament with the President of the European Central Bank

Jane Welch

Executive Summary

1. The global financial turmoil and the freezing of liquidity in the inter-bank market have shown the inadequacy of the existing liquidity risk management requirements for credit institutions, both in the EU and elsewhere.
2. The Commission has now proposed amendments to the CRD to strengthen liquidity risk management and supervision in the EU, following advice from CEBS and the 2008 revision of the Basel Principles for Sound Liquidity Risk Management and Supervision.
3. The amendments are to be welcomed. If implemented sensibly by each Member State in the light of its own market structure and the diversity of the liquidity risk profiles of its institutions , they should do much to address the weaknesses which led to the present paralysis in the inter- bank market.
4. The CRD amendments emphasise the obligation on each institution to take responsibility for the sound management of liquidity risk. The senior management of the institution must determine its risk profile and risk tolerance and ensure that robust strategies, policies, processes and systems exist for the identification, measurement and management of liquidity risk.
5. This requires the assessment of liquidity risk in all relevant jurisdictions, legal entities and currencies across appropriate time horizons.
6. Credit institutions must have regard to a range of different liquidity risk mitigation tools, including liquidity cushions.
7. Liquidity risk management should no longer be seen as a profit centre. Henceforth institutions will be required to incorporate adequate liquidity cost allocation mechanisms in their risk management systems.
8. Institutions must pay greater attention to diversification of funding sources
9. Particular attention must be paid to collateral management.
10. Stress testing and contingency planning will be crucial to the success of the new regime.
11. Supervisors are required to play their part in monitoring and supervising compliance with the new provisions.

Background

Definition of Liquidity: CEBS defines liquidity, in the broadest sense of the term, as the "capacity to obtain funding when it is needed". 114 By the nature of their business- taking deposits short term and lending long-term- banks are inherently vulnerable to liquidity risk.

Funding Liquidity and Market Liquidity There are two types of liquidity risk- funding liquidity risk and market liquidity risk. Whereas these have traditionally been treated separately, the recent financial turmoil has shown the interaction between market liquidity and funding liquidity. The operations of the inter-bank market have been frozen, because of uncertainty about the size and location of losses created by the transfer of credit risk as a result of complex securitisations. This in turn has led to increased concern about counterparty credit risk and consequent paralysis of the inter-bank lending market. The fact that global banks have been increasingly reliant on wholesale market funding and have moved away from retail deposits has made access to funding liquidity more dependent on market conditions. This has meant that central banks have been forced to support market liquidity as a way of addressing funding liquidity shortages.

EU Capital Directives Liquidity risk receives minimal attention in the existing EU capital framework. Directive 2006/48/EC115: Annex V, point 10 established a basic requirement for credit institutions to have policies and processes for the measurement and management of their net funding position and contingency plans to deal with liquidity crises. The directive did not elaborate further on what would be needed to satisfy this requirement. Banking supervisors were required to review and evaluate the response to and management of liquidity risk by credit institutions. Competence for monitoring liquidity of a credit institution is shared between the host state branch supervisor and the home state. There is no EEA harmonised regime for liquidity risk management and the arrangements for cooperation between all the prudential supervisors responsible for each cross-border banking group must be improved.

Basel Liquidity Principles Previously most EEA supervisors used the 2000 Basel Sound Practices for Liquidity Risk Management 116 as an authoritative guide, and there is a degree of consensus among supervisors in terms of qualitative expectations. As a result of its 2007 survey, CEBS found that for quantitative requirements, roughly one third of all EEA states relied entirely on institutions' internal methodologies while two thirds applied supervisory limits based on predetermined methodologies, supplemented in most cases by qualitative requirements.

Challenges The expansion of the EU from 15 to 27 Member States has resulted in new challenges to liquidity risk management and supervision. The increased number of domestic institutions owned by foreign parents has raised issues between the proper balance between the need for local liquidity to be held against local retail deposits and the management of liquidity at group level, which involves consideration of the transferability of liquid assets. There has been a shift away from locally managed liquidity risk to centralisation of liquidity policies, procedures, limits and contingency plans. This poses additional challenges for national regulators.

[114] CEBS Technical Advice to the European Commission on Liquidity Risk Management, CEBS 2008 147, 18 sept 2008.

[115] OJ 2006 L 177/1,30.6.2006.

[116] Revised principles were published in September 2008;Basel Committee on Banking Supervision: Principles for Sound Liquidity Risk Management and Supervision.

Structural market changes in recent years have also presented challenges. There has been a movement away from traditional retail deposit funding to more volatile short-term market funding, even by smaller domestic banks, coupled with increased reliance by some institutions on complex financial instruments and growing use of cross-border collateral. The freezing of liquidity for a prolonged period, caused by the failure of the US sub-prime market, illustrates the inadequacy of the present liquidity requirements and the failure of banks and supervisors to manage and supervise liquidity risk adequately.

Basel Principles 2008 As a result of the deliberations of a working group set up in early 2007 , the Basel Committee on Banking Supervision ("Basel") substantially revised its original guidance published in 2000 and published its updated Principles for Sound Liquidity Risk Management and Supervision in September 2008.

CEBS advice to the Commission The Committee of European Banking Supervisors ("CEBS") also established a working group in early 2007 to provide advice to the Commission under the Lamfalussy framework on matters not adequately addressed by existing EU requirements. CEBS published its final advice in September 2008.

The Commission published its draft Directive117 amending the CRD in October 2008. The proposed CRD changes are intended to implement the recommendations of both Basel and CEBS in respect of liquidity risk management and supervision.

CRD Amendments

The amendments dealing with liquidity risk take the form of amendments to Annexes V,XI and XII of the CRD. They are designed to implement and reinforce the fundamental principle for the management and supervision of liquidity risk, articulated in the 2008 Basel Principles, that:

> "A bank is responsible for the sound management of liquidity risk. A bank should establish a robust liquidity risk management framework that ensures it maintains sufficient liquidity, including a cushion of unencumbered, high quality liquid assets, to withstand a range of stress events, including those involving the loss or impairment of both unsecured and secured funding sources. Supervisors should assess the adequacy of both a bank's liquidity risk management framework and its liquidity position and should take prompt action if a bank is deficient in either area in order to protect depositors and to limit potential damage to the financial system"

The amendments focus on the following issues:

1) The responsibility of the senior management of the institution for determining the risk profile and risk tolerance of the institution

2) Time horizons, business lines, currencies and legal entities

3) Internal methodologies

4) The adequacy of liquidity buffers

5) The adequacy of liquidity cost allocation mechanisms

6) The importance of diversified funding sources

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[117] COM(2008) 602.

7) The management of collateral

8) Stress testing

9) Contingency planning

10) Supervision of liquidity risk management

Governance of Liquidity Risk Management

The CRD amendments require that the management body of the credit institution determine the liquidity risk tolerance of the institution in the light of the complexity and range of its business and its systemic importance in each Member State in which it carries on business. "Robust strategies, policies, processes and systems shall exist for the identification, measurement and management of liquidity risk" but point 14a emphasises that these should be proportionate, in line with the Pillar 2 provisions of Directive 2006/48/EC and endorsed by CEBS in its guidelines.

It was evident during the financial turmoil that many credit institutions' boards had not set out a clearly defined liquidity risk strategy, or had failed to monitor the implementation of the strategy and policies of the institution adequately so that in many cases its business strategy was out of line with the desired liquidity risk tolerance. The objective now is to move to a position where senior management of the institution should define the institution's liquidity strategy and risk tolerance on an informed basis, in the light of the institution's funding profile and the robustness of its liquidity risk management. Senior management should have a clear view of all liquidity risks, including the impact of concentrated funding sources and the institution's maturity transformation.

Time Horizons, Business Lines, Currencies and Legal Entities

A bank should assess the liquidity risk to which it is exposed for all legal entities and branches in the jurisdictions in which it is active. This process should include a framework for projecting cash flows arising from assets, liabilities and off-balance sheet items over an appropriate set of time horizons, including intra-day. A bank should assess its foreign currency liquidity needs and establish a liquidity strategy for each currency in which it is active, determining the size of acceptable currency mismatches. This should take into account the bank's ability to raise funds in foreign currency markets and the ability transfer a liquidity surplus from one currency to another and from one legal entity or jurisdiction to another.

Internal Methodologies

The CRD amendments require credit institutions to develop internal methodologies as part of their liquidity risk management, which should be tested regularly as should the assumptions and expert opinions underlying the internal models. Experience of the credit crisis has shown, however, that, whereas internal models may serve as a control framework , they have limitations in times of severe liquidity stress, when assumptions have to be drastically revised. They are a necessary liquidity tool, but should be supplemented by others.

Liquidity Buffers

The CRD amendments require credit institutions to consider a range of different liquidity risk mitigation tools including liquidity buffers in order to withstand a range of different stress events. CEBS saw liquidity buffers as extremely important in times of stress when an institution needs to raise liquidity urgently and normal funding sources are unavailable. There is a danger, however, that institutions may rely on a buffer of liquid assets to protect against liquidity stress when the risk crystallises, rather than being aware of their gross liquidity risk at all times and taking steps to ensure that it does not exceed acceptable levels.118

Liquidity Cost

It is clear that many banks have developed new products or lines of business without proper assessment of the liquidity cost of new business activities. The amendments to the CRD require credit institutions to incorporate "adequate liquidity cost allocation mechanisms" in their liquidity risk management systems. The aim is to ensure that the institution's liquidity management process includes measurement of the liquidity costs, benefits and risks of all major business activities, including the creation of contingent exposures. These issues should be addressed explicitly in the approval process for any new product and should take into account all relevant factors such as expected sources of funding and how this might be affected in times of stress.

Diversified Funding Sources

The growing reliance by many institutions on short-term wholesale funding has caused major problems for some with the freezing of liquidity in the wholesale markets. The Commission is therefore putting forward amendments to the CRD to require institutions to "consider…an adequately diversified funding structure and access to funding sources." Since wholesale market funding tends in any case to be more volatile than retail funding, it would be sensible for institutions to move away from short-term wholesale funding, including funding from foreign counterparties and back towards greater reliance on retail time deposits. CEBS urged credit institutions to keep their funding sources under active review to identify potential concentrations, in terms of providers of liquidity, secured v. unsecured funding, market places and products, as well as geographic, currency or maturity concentrations.

Management of Collateral

A credit institution should be able to calculate its collateral positions, distinguishing between pledged and unencumbered assets. The level of available collateral should be monitored by legal entity, by jurisdiction and by currency exposure. But a credit institution should also be aware of the operational and timing requirements associated with accessing the collateral depending on its physical location – the custodian bank or securities settlement system where the collateral is held. Assets should be assessed in terms of their eligibility for pledging as collateral with central banks (for intraday credit, overnight and term lending operations and borrowing under standing facilities) and in terms of their acceptability to major counterparties and funds providers in secured funding markets.

[118] See the Consultation Paper 08/22, published by the UK Financial Services Authority on 4 Dec 2008 , "Strengthening Liquidity Standards" .

Stress Testing

The fall-out from the market turmoil has shown that institutions tend to underestimate the extent of the liquidity stresses which have in fact materialised. They did not anticipate the simultaneous failure of different sources of funding nor the extreme liquidity stress, nor the combination of institution- specific and market –wide stress which occurred. Although it is not unexpected that the stress tests conducted by banks should assume normal or at least plausible market conditions, banks will now be required to consider a range of short-term and protracted institution-specific and market –wide stress scenarios (both separately and in combination) to identify areas of potential liquidity strain. The link between reductions in market liquidity and constraints on funding liquidity should be taken into consideration- particularly for banks relying heavily on specific funding markets. The CRD amendments will also require banks to take into account the liquidity absorbed by off-balance sheet vehicles and activities, including conduit financing. Supervisors will undoubtedly have to devote more attention to the adequacy of banks' stress testing systems in the future, particularly when the current crisis has abated and the lessons learned have been forgotten.

Contingency Planning

The results of the stress tests above should feed into the institution's contingency funding plan, so that senior management can consider whether to adjust the liquidity position. The CRD amendments take on board Basel Principle 11, i.e., that:

> "A bank should have a formal contingency funding plan (CFP) that clearly sets out the strategies for addressing liquidity shortfalls in emergency situations. A CFP should outline policies to manage a range of stress environments, establish clear lines of responsibility, include clear invocation and escalation procedures and be regularly tested and updated to ensure that it is operationally robust."

The CFP's design and procedures should be closely integrated with the institution's monitoring of liquidity risk and with the results of the scenarios and assumptions used in stress tests. It should therefore take into account a range of different time horizons including intra-day. The CFP should contain clear policies and procedures to enable the bank's management to make timely and well-informed decisions, to execute contingency measures as and when required, and to specify the roles and responsibilities of any crisis management team.

Supervision of Liquidity Risk Management

The CRD amendments inevitably mean increased responsibilities for banking supervisors. The Commission proposal imposes an obligation on the competent authorities to carry out a comprehensive assessment of the overall liquidity risk management by credit institutions. Significantly the competent authorities in one member state "must have regard to the potential impact of their decisions on the stability of the financial system in all other Member States concerned."119

[119] See new point 1a in Annex XI of the Commission proposal.

Study on Impact Assessment

Prudential Supervisory Arrangements and Financial Crises — A Critique of the European Commission's Impact Assessment on the Revision of the CRD

Europe Economics

Executive Summary

This document was commissioned by the European Parliament's Committee on Economic and Monetary Affairs (ECON). It is a quick critique, conducted over a four week period, of those sections of the European Commission's Impact Assessment (hereafter "the IA") on the revisions to the Capital Requirements Directives that relate to home-host issues and crisis management.[120]

Reform of the CRD

1 The Capital Requirements Directives (implementing the Basel II framework) — hereafter collectively referred to as the CRD — had previously left open a number of issues relating to home-host supervision and crisis management. Current proposals are under consideration for modifying the CRD in these areas.

2 The Commission's Impact Assessment of these proposed revisions in these areas defines the problems with the current approach that they seek to address as being:

3 Extra compliance costs and unlevel playing field for cross-border financial groups in going-concern situations

4 Sub-optimal effectiveness of supervisory arrangements in prevention of crisis situations

5 Costs to creditors, employees and shareholders of cross-border groups as well as taxpayers in case of bank failure

6 Increased financial stability risks for host Member States of systemically relevant branches

7 Potentially higher direct and indirect costs for the industry and EU economy in case of broader crisis

8 The four general objectives of the proposals are to ensure that the effectiveness of the Capital Requirements Directives is not compromised in terms of:

- Enhanced financial stability
- Enhanced safeguarding of creditor interests
- Ensuring international competitiveness of EU banking sector
- Further promoting the internal banking market integration

[120] See pp99ff of http://ec.europa.eu/internal_market/bank/docs/regcapital/impact_assessment_en.pdf

9 There are six specific objectives: to

- Enhance legal certainty
- Enhance supervisory cooperation
- Enhance level playing field
- Reduce compliance burden
- Promote cross-sectoral convergence
- Reinforce risk management

10 For Home-Host Issues & Crisis Management, the following Operational Objectives were identified

- Clarify and define rules and appropriate structures for cooperation and information sharing between home and host supervisors in going concern situations
- Clarify and define appropriate rules for cooperation and information sharing between home and host supervisors in crisis situations.
- Remove impediments to information sharing between supervisors, central banks and finance ministries.
- Allow host supervisors to be better informed.

Going Concern situations

11 Regarding cooperation in "going concern" situations, the IA rejects the options of retain the current approach of relying on the country of origin principle, developing a lead supervisor model, or having a single EU financial supervision authority. The preferred option is to have formal colleges of supervisors with involvement of CEBS and reinforced powers of a consolidating supervisor. The key putative advantage of this option is that increased cooperation would identify potential crises at an earlier stage.

12 We note a number of weaknesses in the IA in this area, including

- It is unclear, in this arrangement, how decisions of colleges are to be enforced at Member State level.
- The IA focuses on the drawbacks of regulatory diversity, but neglect the benefits (especially in terms of the discovery of regulatory best practice) and understate the drawbacks of excessive harmonisation of imperfect rules in terms of increasing systemic risk.
- The proposal also appears not to take account of widely-discussed proposals for reforming the international financial architecture, including a wider role for the IMF as an international "early warning" system, or of the possibility that capital requirements might in future become an instrument of counter-cyclical monetary policy.

Supervisory management in crisis situations

13 The IA's preferred option here is "specification of tasks, mandates and interaction with other forums", and it rejects the current approach of cooperating under a memorandum of understanding, and likewise rejects the option of assigning responsibility to a consolidating supervisor. The key putative advantage of the preferred option is that it is believed to enhance stability, legal certainty, supervisory cooperation, and the safeguarding of creditor interests.

14 We consider that it might have been better to define various sorts of crises and the institutional interactions that would be appropriate to each form of crisis (e.g. which forms of institution would be expected to be in the lead). We consider rather odd the IA's apparent view that there is a sudden change between a no-crisis and crisis situation, yet in a crisis situation the supervisory framework is likely to be swept away in practice.

15 Furthermore, our view is that the IA does not appear to reflect the reality of the close involvement of finance ministries in the current crisis, its consideration of the role of central banks is sketchy, and the roles of competition authorities and international agencies such as the IMF and the Basel Committee (all of which have been importantly involved in present events) are overly vague.

Access to information for host supervisors of systemically relevant branches

16 The IA's preferred option was to increase information for colleges in crisis situations, in preference to retaining the current approach of specific information exchange requirements. This is believed to be more effective in terms of legal certainty, supervisory cooperation and financial stability.

17 We note that information-sharing could be complicated if there are many participants involved. We also wonder whether the IA recognises sufficiently that there may be good reasons, as opposed to frivolous ones, why supervisors are currently reluctant to share information, and that forced sharing might undermine the quality of information provided.

Determination of which branches are systemically relevant

18 The IA's preferred option was to have an open list of criteria and determination by host supervisor.

Exchange of information between central banks, finance ministries and supervisors

19 The preferred option is to require supervisors to exchange information with central banks and finance ministries. This is preferred to the current approach in which home supervisors must alert central banks and finance ministries in emergency situations (subject to confidentiality safeguards), because this is considered better at achieving financial stability.

20 We note that the IA may not take full account of the potential intrinsic costs of information sharing (to firms and to Member States) in cases where sharing is currently limited. The IA's assumption appears to be that current refusals to share information are largely frivolous.

Combined impacts

21 The IA regards its measures as having unambiguously positive combined impacts for the banking industry, supervisors, and financial stability.

22 Without, here, entering into a separate overall assessment, we note that some of the considerations in previous sections may imply that impacts are less unambiguously positive, and that potential drawbacks of various sorts of the proposals might usefully have been acknowledged, even if the conclusion would still be that, on balance, the same options were preferred.

23 The single most important weakness appears to us to be the lack of an adequate treatment of how supervisory arrangements should differ in different types of crises. We believe that the proposals might potentially usefully be amended to spell this out in more detail — for example by emphasizing the lead role of central banks in liquidity crises, finance ministries in solvency crises associated with past losses, and competition and industrial policy authorities when solvency crises reflect future profitability concerns and hence a need for material industrial restructuring.

24 Overall, the IA appears to us to reflect relatively few of the insights garnered during the evolution of the crisis since summer 2007. Perhaps this is because a judgement was made that it is too early to learn all the lessons from this crisis. That judgement may be correct. But in that case, might one consider whether this is the time to be revising the CRD at all? Given the fluidity of events and the acknowledged difficulty in drawing lessons, how confident can one be that reforms at this time will make matters better rather than worse?

25 The limited timescale and scope of the present study mean that we have not been able to conduct our own independent quantitative analysis of the options the Commissions or of others we might have recommended be considered. But, based on the considerations above and in the main body of this document, our tentative recommendations would be either to delay reforms in this area until it is clearer, drawing on the lessons of the present crisis, what reforms are most appropriate; or, if reform at this stage really is considered urgent and imperative, at least to include among these reforms a much clearer specification of arrangements for dealing with crises, recognising the different lead players in different kinds of crisis: central banks in liquidity crises; finance ministries in solvency crises associated with past losses; and competition and industrial policy authorities in future profitability crises necessitating significant restructuring of the sector.

1 Introduction

1.1. This document was commissioned by the European Parliament's Committee on Economics Affairs (ECON). It is a quick critique, conducted over a four week period, of those sections of the European Commission's Impact Assessment (hereafter "the IA") on the revisions to the Capital Requirements Directives that relate to home-host issues and crisis management.[121]

1.2. From Section 2 we critique the IA. In each section we mark in **bold blue** the Commission's line from the IA, and in *italic red* our own remarks upon what the Commission says.

1.3. Section 2 itself considers the IA's overall assessment of the problem motivating the proposed CRD amendments in this area, and sets out the Commission's objectives for these amendments. From Section 3 onwards, we move to considering the Commission's options and its assessment of the impacts of those options, for each of the detailed proposals. Specifically:

a) Section 3 considers "going concern" situations

b) Section 4 considers how supervisory arrangements might respond in/to a crisis

c) Section 5 looks at access to information for host supervisors

d) Section 6 considers how to assess whether branches are systemically relevant

e) Section 7 considers interaction with finance ministries and central banks.

f) Section 8 considers the IA's view of the combined impacts of its preferred options.

g) In two Appendices, we set out, at a general theoretical level, how one might understanding the goals of prudential supervision and the nature of financial crises, and sketch a brief history of the relevant legislation.

1.4. As will be seen, our view is that the IA is set out elegantly and is formally adequate so far as it goes (in the sense of addressing the formal steps of an impact assessment), with the possible exception of its treatment of geographic impacts (see paragraph 0 below), but that the proposals and analysis appear to reflect surprisingly few of the lessons and debates that have emerged during the financial crisis that has been in progress since summer 2007 — perhaps the single most important of these being its sketchy treatment of crises and consequently its failure to provide an adequate framework for determining how cooperation between authorities should differ in different types of crisis. This lack of absorption of the implications of recent events leads us to wonder whether the reforms proposed might perhaps be premature, and whether, instead, it might have been better to wait until clearer and more widely accepted lessons could be drawn.

121 See pp99ff of http://ec.europa.eu/internal_market/bank/docs/regcapital/impact_assessment_en.pdf

2 Home-Host Issues & Crisis Management — the Commission's Impact Assessment

This section lays out the Commission's definition of the problem motivating this set of amendments to the CRD and its objectives in addressing those problems.

Definitions

2.2. **Cross-border branches** do not have independent legal status. They are supervised by the home Member State of their parent institutions. Member State supervisors have limited and residual responsibilities (e.g. liquidity).

2.3. **Cross-border subsidiaries** are separate legal entities. They are supervised on a solo basis by the authorities of their host Member State of establishment (i.e. where they are incorporated).

2.4. **The 'consolidating supervisor'** (the national supervisory authority in the Member State where a group's parent institution is authorised) is responsible for the consolidated overview of the financial health of a financial group, including its parent, branches and subsidiaries.

Problem Definition

The IA identifies[122] the problems with the current approach as:

- **Extra compliance costs and unlevel playing field for cross-border financial groups in going-concern situations**
- **Sub-optimal effectiveness of supervisory arrangements in prevention of crisis situations**
- **Costs to creditors, employees and shareholders of cross-border groups as well as taxpayers in case of bank failure**
- **Increased financial stability risks for host Member States of systemically relevant branches**
- **Potentially higher direct and indirect costs for the industry and EU economy in case of broader crisis**

Remarks

2.6. *The present system for preventing cross-border spread of bank failures and banking crises and for handling them is based on nation states and in principle downplays or ignores cross-border problems. It is this crucial area that that the proposed changes must address.*

[122] Page12, IA.

2.7. *One can always quibble with problem definitions in IAs, and indeed problem definition (or "rationale") is often the weakest part of IAs — the "error at the outset" that undermines the quality of the IA as a whole. Further, in the case of this particular IA it is questionable how robust the problem definition is to what might be quite large structural changes in the EU financial services sector, over the next few years, as a consequence of recent events. There must be a danger of chasing the problem or of solving yesterday's problem instead of tomorrow's.*

2.8. *Nonetheless, the problem definition here is at least arguably defensible.*

Objectives

2.9. The objectives of the policy review are broken down into the following categories[123]. The first four general policy objectives are to ensure that the effectiveness of the Capital Requirements Directives is not compromised:

- Enhance financial stability (G-1);
- Enhance safeguarding of creditor interests (G-2);
- Ensure international competitiveness of EU banking sector (G-3);
- Further promote the internal banking market integration (G-4).

2.10 The specific objectives are to:

- Enhance legal certainty (S-1);
- Enhance supervisory cooperation (S-2);
- Enhance level playing field (S-3);
- Reduce compliance burden (S-4)
- Promote cross-sectoral convergence (S-5);
- Reinforce risk management (S-6);

2.11. Operational Objectives were identified in order to address specific problem drivers. The achievement of these Operational Objectives is supposed to lead to the achievement of the general objectives and certain specific objectives. For Home-Host Issues & Crisis Management, the following Operational Objectives were identified

- Clarify and define rules and appropriate structures for cooperation and information sharing between home and host supervisors in going concern situations. (S-1,2,3,4) and (G1,2,3,4)
- Clarify and define appropriate rules for cooperation and information sharing between home and host supervisors in crisis situations. (S-1,2) and (G-1,2,3,4).
- Remove impediments to information sharing between supervisors, central banks and finance ministries (S-1,2) and (G-1,2,3,4).
- Allow host supervisors to be better informed (S-1,2) and (G-1,2,3,4).

123 Page 20, IA

3 Improving cooperation arrangements in "Going Concern" Situations

Current Approach

3.1. The EU supervisory framework is based on the supervision on a consolidated basis and the country of origin principle. The supervision of credit institutions is carried out by both home and host Member State (MS) supervisory authorities.

3.2. Supervisors are required to have specific written arrangements in place in order to facilitate and establish effective supervision.

3.3. CEBS has developed a template Memorandum of Understanding (MoU) for colleges. This is focused on developing a common risk assessment, and is not specific in other areas. This is for guidance only, and is not legally binding.

3.4. *"Going concern" is the language the IA employs to refer to a non-crisis situation. It is worth noting, that a "going concern" in usual parlance refers to a single company operating in its present form. This may be thought indicative of, in the language of Appendix paragraph A1.1, a type (b) approach to regulation in which the focus is on an individual firm and the systemic risks involved are not central — potentially a weakness.*

Policy Option Comparison

Policy Options	Policy Option Comparison			
	Effectiveness	**Acceptability**	**Consistency**	**Efficiency**
1.1 Retain current approach	5	2	4	
1.2 Formal colleges of supervisors	4	2	2	
1.3 Formal colleges of supervisors with involvement of CEBS	2	1	1	
1.4 Develop a lead supervisor model	3	2	4	
1.5 Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor	1	2	3	
1.6 EU financial supervision authority				

**The policy highlighted is the preferred policy option. 5 is the maximum score. The scores are as determined by the IA (i.e. these scores are determined by the Commission).*

Option 1.1: Retain current approach

3.5. Option 1.1 contains a MoU to encourage cooperation between supervisors. However, the IA argues that the MoU is not specific in areas such as development of a common reporting framework, implementation of Pillar 2 measures and disclosure requirements on subsidiaries. It believes differences in supervisory approaches between home and host supervisors in these areas may be costly for cross-border groups, and concerns of cross-border banking groups about overlapping supervisory requirements would not be fully addressed. Hence it does not enable an enhanced level playing field (S-3).

3.6. The MoU is not legally binding, so it is believed it would not enhance legal certainty (S-1).

3.7. The IA highlights concerns that the MoU does not provide supervisors with the necessary incentives to develop a group-wide approach to prudential requirements (Enhanced supervisory cooperation, S-2), and may lead to the development diverging national approaches.

3.8. The IA holds that it would not reduce the compliance burden (S-4) or enhance financial stability (G-1).

Regulatory competition

3.9. *Although there is no space to argue the point in detail here*[124]*, it is important to note that, as well as the perils of regulatory competition often rehearsed and reflected in the discussion in the IA, there are also potential merits to having some limited degree of regulatory competition. Regulatory competition and harmonisation are not obvious contradictories in a dynamic setting in which policy makers either do not know the perfect form of regulation or in which the best form of regulation evolves through time. Through regulatory competition it is possible to identify best practise measures and then later implement them in a harmonised manner.*

3.10 *Furthermore, there are drawbacks to excessive harmonisation, particularly the associated elimination of diversity. If all Member States in Europe have the same regulations, then this may lead to all Member States making the same regulatory mistake together. This poses a clear systemic risk. An all too clear example of which is the current financial crisis, with many commentators pointing to common regulatory failings as one of the causes.*

3.11. *Regulatory competition is also desirable to prevent regulatory excess. The Sarbanes-Oxley Act is now frequently used to show the dangers of burdensome regulation, which diverted much business away from the USA and towards the London markets.*

[124] See Section 4, pp56ff, of *The Impact of the New Financial Services Framework — A Report by Europe Economics for the Internal Policies Directorate of the European Parliament*, March 2007.

Option 1.2: Formal colleges of supervisors

3.12 The IA argues that this approach would enhance financial stability (G-1) in terms of being more effective in the prevention of cross-border financial crises, by allowing for a broader picture of a group's risks.

3.13. The IA holds that more structured multilateral cooperation between supervisors would better involve host supervisors and while improving efficiency by avoiding duplication of tasks (Reduce compliance burden, S-4).

3.14. The IA states that the need to produce 'collegial' decisions will provide strong incentives for supervisors to consider the allocation of economic and regulatory capital within the group and reduce overlapping prudential and information requirements.

3.15. The IA acknowledges that there may be a possible increase of administrative burden to supervisors.

Remarks

3.16. *An objection which could be made to supervisory colleges is that there is no mechanism to ensure national enforcement of international decisions.*

3.17. *It could be argued*[125] *that this scheme would only be only be helpful for banks of modest size, since, at least typically, large banks in the EU do extensive business outside the EU. In which case, this system could be effective for major cross-border institutions only, whilst the remaining banking activity, such as small national banks and banks active in a few countries, could use the supervisory colleges structure.*

Conflicts of authority

3.18. *One question that remains unclear is how decisions of colleges are to be implemented in practice if parts of those colleges (e.g. a host country's supervisor) does not enforce the decision to the satisfaction of other parts of the college.*

3.19. *The IA states "that all cross-border banking groups might not necessarily need a strongly formalized college in place." It continues by saying that in this instance, written arrangements would be made (not legislative) among home and host authorities. It might have been useful if guidelines were offered as to when a cross-border banking group would not need a strongly formalized college. The fact that different arrangements may need to be made for each cross-border banking group may significantly complicate the job of the supervisors and this should be addressed in the more detail in the IA. Considerable debate may ensue on which supervisors to include in which college. There is also a risk that, in order to achieve "collegial" decisions, guidelines end up being based on the lowest common denominator.*

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[125] e.g. page 5, "Comment on *Achieving Financial Stability with Cross-Border Banking in an EU Perspective by Mattias Persson*", Geoffrey Wood.

3.20. *A more extreme version of such problems might be the danger that the parent bank's home countries authorities could, in principle, be unable or unwilling to use powers given to them, whilst, in turn, host countries might lose powers that they would have been willing and able to employ.*[126]

3.21. *A further issue the IA might want to consider in more depth, is that argued by Schuler (2002). He argues that there may be incentive conflicts between home and hosts as home country regulators might want to disguise or delay information about a poorly performing branch. Supervisory conflicts may also be deepened when the systemic relevance of banks differs between countries.*

Option 1.3: Formal colleges of supervisors with involvement of CEBS

3.22. The IA expresses concerns that the level playing field between firms may be impeded by diverging regulatory and supervisory practices adopted under a narrow college of supervisors model. Hence, this option would not achieve an enhanced level playing field (S-3). It goes on to say that this may be detrimental to further convergence of practices among Member States.

3.23. In the approach laid out by Option 1.3, the IA argues that these conerns would be mitigated by involvement with CEBS, which could closely monitor the convergence of supervisory practices.

3.24. The IA argues that, unlike Option 1.2, Option 1.3 will allow for minority views to be expressed, since matters could be referred to CEBS, who would act in a 'mediation' role where supervisors do not agree within colleges on key group supervisory aspects (e.g. Pillar 2 measures on subsidiaries, reporting requirements). This, the IA expects, would provide supervisors with stronger incentives to reach agreements within colleges (Enhance supervisory cooperation, S-2).

3.25. The IA acknowledges that the mediation mechanism in case of disagreement on key supervisory issues might make the decision-making process difficult and lengthy, which would be a negative aspect to this approach from the banks' perspective. Although the IA says, as in the case of the Solvency II proposal, the mediation mechanism is coupled with the consolidating supervisor having a last say in taking final decisions, which is subject to a specific timeframe.

[126] See, for example, p9 of "Achieving Financial Stability with Cross-Border Banking in an EU Perspective" by Mattias Persson.

Option 1.4 Develop a lead supervisor model

3.26. The lead supervisor model was developed by the European Financial Roundtable.[127] In it, the lead supervisor would be the single point of contact for the credit institution and would be the sole authority for all matters of prudential supervision at the level of the group and its constituents, including, but not limited to, model validations and authorisations, Pillar 2 and Pillar 3 issues and capital allocation. The lead supervisor would make use of the expertise and knowledge of local supervisors / other members of the college and entrust tasks to them by means of the delegation of tasks and, where appropriate, responsibilities. A mediation mechanism at CEBS would be available if disagreements were to arise between the 'lead supervisor' and other members of the college.

3.27. The IA states doing away with solo supervision for subsidiaries is not viable in the banking sector. IA argues that since national supervisors would remain responsible for the financial stability in their own jurisdiction, this option would result in a misalignment between the host supervisors' financial accountability and their competencies in terms of prudential requirements and, therefore, is not commensurate with the EU financial architecture. The IA believes this would particularly impact on new Member States.

Remarks

3.28. *This model could affect the level playing field for cross-border banking groups (in opposition to objective S-2, to enhance the level playing field).*

3.29. *It could be argued that this model could work for banks with limited cross-border activities that are insignificant to the host country. On the other hand, it should be noted that the importance of cross-border banking has grown in recent years, so (if this trend were to continue) this may not be a viable long-term solution.*

3.30. *A possible counter to the concerns expressed in the IA, would be to consider the possibility of extending the lead supervisor model by giving the home country a pan-EU mandate, in which the home country regulators would be required to take the other countries concerned into account in its assessments and decisions (e.g. because they were agencies of the EU as a whole rather than of individual Member State governments).*

[127] Also known as the European Financial Services Roundtable — see http://www.efr.be/ for a list of members. For the development of this model, see *Monitoring Progress in EU Prudential Supervision*, The European Financial Services Roundtable, September 2007.

Option 1.5: Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor

3.31. Supervisors will be required to draw up "formal colleges of supervisors". CEBS defines colleges of supervisors as "permanent, although flexible, structures for cooperation and coordination among the authorities responsible for and involved in the supervision of the different components of cross-border banking groups."

3.32. Colleges would involve central banks, "where appropriate" *(we are unclear what "where appropriate" means, and regard the concept as vague and rather odd, since central banks must surely be centrally involved in the provision of lender-of-last-resort funds in the event of a crisis and hence must be intimately involved in the supervisory process in advance).* The legislation would specify i) authorities to be involved in the college and ii) supervisory activities to be dealt with by supervisors in a collegial manner. CEBS would act as a moderator in case of disagreement on key supervisory issues and to allow for minority views to be taken into account.

3.33. The IA argues that this option provides a clearer decision making process to increase both the effectiveness and the efficiency of supervision while ensuring consistency across colleges (Reduce compliance burden (S-4).

3.34. The IA believes this approach will enhance supervisory cooperation (S-2) (as in Option 1.3), due to host supervisors being fully involved and better informed within colleges on group-related supervisory aspects.

3.35. The IA believes this approach to be compatible with the current supervisory accountability structure in the EU in crisis situations.

Balance between regulatory objectives

22 In Appendix 1 we explain that prudential regulation and supervision can be conceived of as operating at three levels:

a) as the counterpart of the lender of last resort function;

b) as the representative of small stakeholders;

c) as the protectors of financial stability.

23 The prudential regulation of banks typically blends these three aspects in some way. It is worth noting however, that:

- *These three notions of supervision involve subtle differences of stakeholder and thus potentially different (and even potentially conflicting) supervisory interests.*
- *Assuming, for our purposes here, that all three roles will always be present to some degree, it is by no means clear that the balance between them will be invariant to circumstance.*

3.36. *The form of the proposals for colleges of supervisors does not appear to us to reflect the potential diversity of needs and circumstance arising from these multiple overlapping regulatory objectives. This weakness in the IA will become more significant in the next section when we move on the consider crises, but is of specific relevance to the issue of the separation of central bank from supervisory functions.*

The separation of central bank from supervisory functions

3.37. *Central banks in the EU have responsibility for monetary policy and price stability mandates, whilst banking supervision is carried out by independent agencies. The study on "Financial Supervision and Crisis Management in the EU" comments that although there are formal and informal communication lines between the two, there may lie a problem "that this separation no longer breeds officials with the appreciation of systemic risks that naturally arises out of an experience that combines banking supervision with open-market and foreign exchange operations."*[128]

3.38. *It argues that a potential development on an EU scale would be for the Working Committee on Financial Conglomerates to support Member State supervisors in monitoring and coordinating supervisory activities over the twenty or so systemically relevant, largest banking and financial groups in Europe. The Study argues that The Financial Conglomerates Committee*

- *could take on a broader strategic view of the European market as a whole and examine the risks and related challenges posed by financial conglomerates to the European financial system.*
- *should conduct research into systemic issues, working closely with the ECB in a mutually informative and supporting role.*
- *could, in due course, become a focus for the discussion of systemic issues that arise not only across EU borders, but also within Member States, and throughout international financial markets.*

[128] Page 50, "Study of Financial Supervision and Crisis Management in the EU", (IP/A/ECON/IC/2007-069), by the European Parliament's Committee on Economic and Monetary Affairs, December 2007.

Option 1.6: EU financial supervision authority

3.39. The IA states that Option 1.6 would entail different models of supervision (European regulatory agencies, European system of supervisors, single European supervisor), and hence "upgrading" CEBS.

3.40. The IA believes that upgrading CEBS to an agency could enhance the confidence of host supervisors that the consolidating supervision will duly take into account financial stability concerns in all Member States and would not result in further fragmentation.

3.41. The IA states that efficiency of centralised supervision is questionable if compared to that of colleges of supervisors, which benefit from the expertise of local supervisors.

3.42. The IA believes that the system is likely to create an uneven level playing field between institutions supervised at the European level and those supervised at the national level. Thus, it would not create an enhanced level playing field (S-3).

3.43. The IA considers that a more centralised and direct supervision of banks by a European agency does not seem commensurate with the current financial accountability structure and would likely entail a change to the Treaty. In conclusion, the IA rejects this option, and does not deem it appropriate to do a thorough assessment.

Remarks

3.44. *Some benefits to an EU financial supervision authority which have not been detailed in the IA might be that the setting up of such a body would lead to the establishment of principles for equitable treatment of the partner countries and burden-sharing, should there be a cost. In turn, this could increase the effectiveness of supervision and reduce the regulatory burdens for firms in substantial cross-border activities. Interestingly, where reducing the compliance burden and improving efficiency are objectives of the Commission, Schüler and Heinemann (2005) have estimated substantial cost efficiency gains with a European supervisor.*

3.45. *It may well be unlikely that at the present time there would be the necessary political will to give up national control of national budgets, and give an international body unlimited access to these budgets. Such grievances could perhaps be worked around eventually, however, and this is a possible route to which more thought could be given in future.*

Summary

3.46. Option 1.1 is rejected as it is believed it would not enhance legal certainty (S-1), supervisory cooperation (S-2) orthe level playing field (S-3). The IA holds that it would not reduce the compliance burden (S-4) or enhance financial stability (G-1).

3.47. Options 1.3 and 1.5 alone are deemed to effectively contribute to all of the relevant objectives.

3.48. Option 1.5 is considered more effective with regard to reducing the compliance burden (S-4), and so is the preferred option.

Further comments

Increased costs to regulators

3.49. *The IA does acknowledge that there may be a possible increase of administrative burden to supervisors, as they would be required to regularly meet to come to common supervisory decisions. However, the IA concludes that it is "expected to be rather immaterial". Unfortunately, no quantitative evidence is offered in the IA to support this conclusion.*

3.50. *It is perhaps worth noting that, since the IA does not spell out in detail by how much regulatory/administrative costs would be greater under Option 1.3 than Option 1.5, this appears a somewhat weak basis for preferring Option 1.5.*

International aspects

3.51. *The IA takes little or no account of the developing ideas on the international financial architecture, for example how the colleges of supervisors would interact with a newly reconstituted IMF acting as a "global early warning system" or as a global coordinator in coping with global crises. For this to function there would have to be quite strict formal arrangements, but this possibility is not reflected in the IA. Similarly, there has been much coordination of international central banks (e.g. coordinated interest rate cuts) and of finance ministries (e.g. proposals for coordinated fiscal stimulus packages). It might have been useful for the IA to address the issue of how the IA's colleges of supervisors would interact with supervisory authorities in countries outside the EU.*

3.52. *The crisis has led to (perhaps temporary) changes in the Basel arrangements (e.g. in respect of the mark-to-market provisions). It would have been useful to understand more precisely how colleges of supervisors would contribute to interaction in such decision-making.*

4 Improving Supervisory Cooperation in Crisis Situations

Current Approach

The CRD currently requires cooperation between supervisors, and, "where appropriate"[129], with central banks in crisis situations. This is complemented by a Memorandum of Understanding developed by the EFC.

Policy Option Comparison

Policy Options	Policy Option Comparison			
	Effectiveness	**Acceptability**	**Consistency**	**Efficiency**
2.1 Retain current approach	4	3	2	
2.2 Assign responsibility and leading role to the consolidating supervisor	3	3	2	
2.3 Specification of tasks and mandates of home and host supervisors	2	1	1	
2.4 Specification of tasks, mandates and colleges for crisis situations	2	2	1	
2.5 Specification of tasks, mandates and interaction with other forums *[sic.]*	1	1	1	

**The policy highlighted is the preferred policy option. 5 is the maximum score. The scores are as determined by the IA (i.e. these scores are determined by the Commission).*

Option 2.1: Retain current approach

4.2. Existing CRD requirements to cooperate and coordinate activities between supervisors and central banks in crisis situations would be expanded upon and complemented with a MoU developed by the EFC.

4.3. *The IA notes that l*egislative changes may be premature as further developments are underway and are yet to be tested. In particular, it expects the guidelines to move from purely national concerns to include a cross-border component. However, the IA also notes that MoU's are not legally binding (so would not enhance legal certainty (S-1), and hence may not be sufficiently efficient or effective (i.e. it would not enhance financial stability, G-1).

4.4. *The IA may well be right in its caution concerning the effectiveness of Memorandums of Understanding at promoting supervisory cooperation. However, it should be noted that a MoU may well be a necessary first step in the process by which central banks and finance ministries are involved in crisis prevention.*

[129] IA page 113

Option 2.2: Assign responsibility and leading role to the consolidating supervisor

4.5. The consolidating supervisors tasks would be to coordinate supervisory activities and take a lead in the decision making process.

4.6. The IA sees the advantage to this approach is that it would enhance legal certainty (S-1).

4.7. The IA highlights the disadvantages to this option being that it does not incentivise the consolidating supervisor to take into account the effects of its decision on the financial stability of the host Member States. Plus, it considers this approach to not be commensurate with the current financial stability architecture, where national supervisors are accountable to their national Parliament and Treasury.

Option 2.3: Specification of tasks and mandates of home and host supervisors

4.8. Legislation could impose on supervisors the obligation to have regard to potential impact of their decisions on the stability of the financial system in all Member States concerned. Thus, there would be a clear legal obligation to cooperate. Tasks performed by the consolidating supervisor in relation to host supervisors of subsidiaries and systemically relevant branches would be specified.

4.9. By facilitating bank crisis resolution solutions, the IA believes that this option would contribute to minimizing the collective costs facing EU states from potential cross-border bank failures.

4.10. The IA holds that this option is compatible with the current European financial stability framework.

4.11. The IA see this option as a way to reconcile the goals of stable financial system and integrated financial market with the national financial supervision, through joint responsibility and accountability.

4.12. It sees the advantages to this option being that it addresses disincentives to cooperate, but does not modify the responsibility of home and host authorities to ensure the financial stability in domestic jurisdictions.

Policy option 2.4: Specification of tasks, mandates and colleges for crisis situations

4.13. The IA believes that "crisis prevention and crisis management must be seen as a continuum."[130] Hence, it holds that colleges in crisis situations would logically complement option 1.3 where colleges are established for going-concern situations.

4.14. The IA states the advantages to this option are that colleges are best situated to prepare contingency plans, and, as a crisis evolves, to perform and specify the assessment of the crisis.

4.15. However, the IA argues that since colleges are only a vehicle for supervisory cooperation, they and are likely to become less relevant in crisis situations as most decisions would take place elsewhere.

4.16. The IA argues that formal colleges do not seem suited to all crisis scenarios, since specifying the form and the structure of cooperation between supervisors and central banks in crisis situation is likely to introduce unintended bureaucracy and reduce the flexibility that may be needed in a crisis situation.

4.17. *Interestingly, in the light of our discussion in Appendix 1, this appears to accept, albeit implicitly, that crises can differ in nature and that such differences may impact upon the ideal supervisory arrangements.*

Defining a Crisis

4.18. *The IA states that "a 'crisis situation' does not lend itself to a precise definition. In terms of supervision, crisis prevention and crisis management must be seen as a continuum." If this is the case, and one cannot strictly delineate a crisis prevention from a crisis management situation, it may nonetheless be useful to define different types of crises. For example, as discussed in previous sections, it is not clear that all crises would require the same actions. Hence, in this way, appropriate specific supervisory arrangements could be outlined for each crisis type. Consider Figure 1. The IA wants to argue that there is no strict separation between "No Crisis" and "Crisis", which we illustrate, in a stylized way, by drawing a continuous line between "No Crisis" and "Crisis" in the upper case in the figure. But this is not the only way in which there might be a continuum. In the lower case there are three different types of crisis – in each case with a continuous (solid) line between "No Crisis" and some type of crisis. But in this case the crises are distinct from one another.*

[130] Page 114, IA

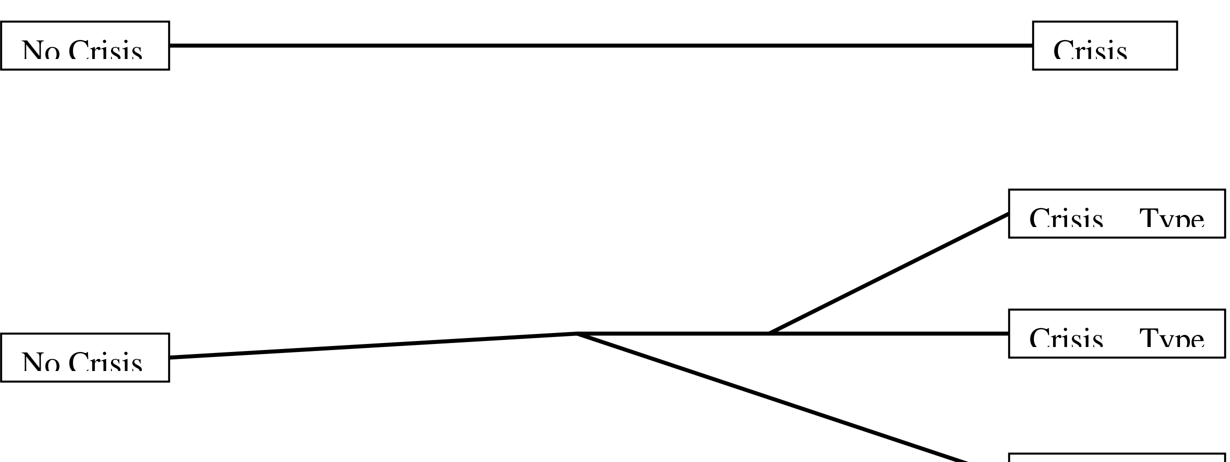

Figure 1: 'No Crisis' to 'Crisis' as a continuum

4.19. *Figure 1 perhaps concedes too much, because of course it could be argued that, in terms of supervision, the transition from crisis prevention to crisis management should not be seen as a continuum. Examples to support this idea include September 2007 where the Libor rates soared above the Bank of England base rate and a week later Northern Rock is granted emergency financial support from the Bank of England, and Monday 15th September 2008, when Lehman Brothers filed for bankruptcy early in the morning, followed by shares around the world plummeting. It seems fairly clear that the nature (or at least degree) of the crisis was (non-incrementally) different on September 16th from September 12th 2008.*

4.20. *The IA does not appear to us to reflect the reality of the close involvement of finance ministries in the current crisis, and its consideration of the role of central banks is sketchy (at best). Further, there is no recognition of the potential need to include competition authorities in decision-making and the role of international agencies is not very explicit. The IA's attitude appears to be that in a crisis the supervisory framework is liable to swept away by force majeure, stating that "Colleges are only a vehicle for supervisory cooperation and are likely to become less relevant in crisis situations as most decisions would take place elsewhere"[131], leaving one rather to wonder what the point is of setting out a crisis management framework at all. This view also seems at odds with the idea, expressed earlier in the same paragraph of the IA (and disputed here above), that "crisis prevention and crisis management must be seen as a continuum." If colleges are irrelevant in a crisis situation, but there is no distinction between a crisis situation and one of no crisis, when are colleges ever really relevant at all? The IA's position here seems frankly incoherent.*

[131] IA, p115

Policy option 2.5: Specification of tasks, mandates and interaction with other forums

4.21. This option is designed to address the shortcomings of Option 2.4. Whilst colleges "will have a part to play in a crisis"[132], legislation would make it clear that other forum (i.e. cross-border standing groups involving in particular Ministries of Finance) will take the lead in reaching certain decisions.

4.22. Competent authorities participating in colleges will be expected to have full regard to the work of other forums that will be established under the EFC MoU between supervisors, Ministries and Finance and central banks.

Financial Crises

4.23. *As explained in more detail in Appendix 1 we believe it is important to distinguish between three forms of crises:*

Liquidity crises

Solvency crises arising from past losses

Future profitability crises

4.24. *The authorities likely to be involved will differ depending on the nature of the crisis:*

- *if the crisis is purely or mainly a liquidity crisis, then central banks would be in the lead;*
- *if the crisis is purely or mainly a solvency crisis arising from past losses in which taxpayer capital injection is a potential policy response, then finance ministries would be in the lead;*
- *if the crisis is purely or mainly a future profitability crisis necessitating significant industrial restructuring, then competition and industrial policy authorities would be in the lead.*

4.25. *As well as differing in form, crises might differ in scope (one member state; a small number; the whole EU or even the whole world) and sector (just banks, banks and insurers, the whole financial sector, etc.).*

4.26. *Different kinds and scopes of crises may involve different forms of interaction between regulatory and supervisory authorities.*

4.27. *The above considerations suggest that, setting aside the option of establishing both a single currency operating throughout the EU and a single pan-EU financial regulator (either through the ECB or as a separate institution), the reality is that there must be cooperation between Member State-based supervisory institutions. Let us use the term "colleges" to denote groups of small numbers of Member State-based supervisory institutions. The membership of such colleges will obviously include financial regulators, and in times of crises, inevitably, also include central banks, ministries of finance, and competition authorities.*

[132] Page 115, IA

4.28. *In crises of broad scope, there will also need to be cooperation between these colleges and EU-level institutions (e.g. DGCOMP) and also international institutions such as the IMF and the Basel Committee.*

Summary

4.29. Option 2.1 is rejected as it is believed it would not achieve the objectives to enhance legal certainty (S-1), enhance supervisory cooperation (S-2), enhance the level playing field (S-3), enhance financial stability (G-1) and enhance safeguarding of creditor interests (G-2).

4.30. Option 2.2 is deemed only effective with regard to enhanced legal certainty (S-1), and to be not acceptable to all stakeholders.

4.31. Option 2.5 is considered effective with respect to all the relevant objectives, and to be "marginally more effective" with regard to attaining enhanced financial stability (G-1) and enhanced safeguarding of creditor interests (G-2), and so is the preferred option.

Other remarks

4.32. *The proposition that a going-concern situation developing into a crisis situation should be viewed as a continuum in terms of supervision, perhaps indicates an alignment to the prudential regulation of type (b) (Appendix paragraph A1.1), i.e. the form of prudential regulation that exists to protect the providers of bank capital. This may suggest that inadequate consideration is given to the systemic risk that the failure of a single institution may pose (more relevant to type (a) or type (c) concepts).*

4.33. *This is in line with other commentators' views concerning the central weaknesses of the Basel II framework. For example, from the "Study of Financial Supervision and Crisis Management in the EU"* [133]*:*

> *"The major weaknesses in the CRD stems from the flawed regulatory model of Basel II – a model that attempts to approximate a bank's regulatory capital to its economic capital without directly focusing on the externality of systemic risk – and hence fails to protect society from the social cost of bank risk-taking and banking behaviour."*

4. 34. *In response to this crisis, there has been some policy debate about the use of bank capital requirements as a counter-cyclical instrument of monetary policy (including at the Basel Committee).*[134] *If implemented, such a system would require highly formalised interactions between central banks and other financial regulators acting as prudential supervisors. Drawbacks and advantages of the Options considered in the IA if such monetary policy were to become widespread are not considered.*

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[133] Page 40, "Study of Financial Supervision and Crisis Management in the EU", (IP/A/ECON/IC/2007-069), by the European Parliament's Committee on Economic and Monetary Affairs, December 2007.

[134] See, for example, the speech by UK Shadow Chancellor George Osborne to the Harvard Business School on 8 April 2008: http://www.conservatives.com/News/Speeches/2008/04/George_Osborne_Lessons_from_the_credit_crunch.aspx

Access to information for host supervisors of systemically relevant branches

Current Approach

5.1. Specific information exchange requirements only apply to legal entities within a group, but arrangements for sharing information with supervisors for branches are far less comprehensive. The CRD requires host and home supervisors to collaborate, but does not specify which information shall be passed on. Networks of MoUs complement this, though are not legally binding.

Policy Option Comparison

Policy Options	Policy Option Comparison			
	Effectiveness	**Acceptability**	**Consistency**	**Efficiency**
3.1 Retain current approach	**3**	**2**		**2**
3.2 Further access to information in crisis situations	**2**	**1**		**1**
3.3 Further access to information in crisis situations by involvement in colleges	**1**	**1**		**2**

**The policy highlighted is the preferred policy option. 5 is the maximum score. The scores are as determined by the IA (i.e. these scores are determined by the Commission).*

Option 3.1 Retain current approach

5.2. The IA notes that the CRD requires specific information exchange, but that this only applies to legal entities (i.e. subsidiaries) within a group, and that information sharing arrangements are far less comprehensive for branches (i.e. the CRD does not specify which information shall be passed on).

5.3. The IA points out that under this approach, supervisors of branches that are significant for the stability of the banking system of a host Member State may receive little information about these establishments. Hence, this approach does not enhance financial stability (G-1).

5.4. The IA argues that the MoUs are not legally binding (and so do not enhance legal certainty (S-1)), and they do not provide strong enough incentives to cooperate (enhance supervisory cooperation, S-2).

Option 3.2 Further access to information in crisis situations

5.5. The home authority will be required to pass on information pertaining to adverse developments in the credit institution (enhancing financial stability (G-1)).

5.6. The IA argues that specific information requirements would reduce asymmetries of information between host and home supervisors, particularly in crisis situations.

Option 3.3: Further access to information in crisis situations by involvement in colleges

5.7. Supervisors of systemic relevant branches might be invited to participate in meetings of colleges, where the home supervisor considers how its decision may impact the financial stability in the host Member State. This is hoped to ensure that host supervisors receive information that is relevant for the stability of their financial system (in line with achieving enhanced financial stability (G-1)).

5.8. It is envisaged that host supervisors could be invited according to the relevance of the issue to be discussed and the impact of the possible decisions on the financial stability in the host Member State.

5.9. The IA argues that a flexible composition of colleges would be required, depending on the type of issues to be discussed, to avoid any substantial additional administrative burden to supervisors (in line with the objective to reduce compliance burden (S-4)).

5.10. The IA argues that colleges will further enhance information exchange and cooperation between home and host authorities (achieving enhanced supervisory cooperation (S-2)), where systemically relevant branches are not part of a cross-border banking group with subsidiaries in other Member States.

Summary

5.11. Option 3.1 is rejected as it is believed it would achieve objectives Enhance legal certainty (S-1), Enhance supervisory cooperation (S-2), and Enhance financial stability (G-1).

5.12. Option 3.3 has higher implementation costs for supervisors than Option 3.2, but is considered more effective with regard to achieving objectives Enhance supervisory cooperation (S-2) and Enhance financial stability (G-1), and so is the preferred option.

Further examples and comments

5.13. *The example of the Nordic and Baltic countries highlights certain potential information sharing problems.*[135] *There are six Nordic banking groups with significant cross-border activities. The regulatory contacts of these groups include seven supervisors and eight central banks. It seems natural to be concerned that that information sharing could be complicated and slow in such a setting.*

5.15. *One perhaps important overall comment here is the following. The IA appears to take the view that supervisors are currently reluctant to share information without good reason. Consequently, forcing them to share such information comes at no intrinsic cost — for example:*

[135] "Achieving Financial Stability with Cross-Border Banking in an EU Perspective" by Mattias Persson

a) perhaps forcing information sharing would reduce the quality of such information provided by firms, leading to policy decisions being made on the bass of flawed information, reducing rather than enhancing stability;

b) perhaps forcing information sharing might lead to actions by authorities in other Member States that would be to the detriment of systemically relevant branches. For example, authorities in a host Member State, on discovering problems in a branch in another Member State, might act so as to protect the interests of the host financial sector. The Market might then consider why these actions had been taken, and correctly conclude that there were problems with the host state branch, reacting by withdrawing credit from that host state branch — when, given more time and less transparency, the host branch's problems might have been resolved without incident. One lesson drawn from the crisis since summer 2007 is that there can be excessive transparency. Thus, for example, the Bank of England's Special Liquidity Scheme includes provisions protecting users of the scheme from disclosure, so as to avoid stigma effects.

This tale illustrates that there can be problems even when regulatory authorities and the Market act optimally (from their own point of view) to information. Of course, the problems might be even worse if regulatory agencies or the Market over-react.

5.15 But it must, at least in principle, be possible that supervisors do have good reasons for their reluctance. This might imply that there are costs of the Commission's proposals here that are not accounted for in the IA.

Determination of which branches are systemically relevant

Current Approach

6.1. The objective of reforming the CRD in this area is to produce a method for determining which branches of an institution are systemically relevant, and to set out which authorities should have the final say concerning the systemic relevance of cross-border branches. This proposed change is a consequence of retaining the policy option 3.3. There is no current approach to this issue.

6.2. The IA states that "from the crisis management standpoint, the notion of a 'systemic branch' relates to the potential impact of a crisis on the financial stability in a host Member State, and not to the significance of such branch to its parent credit institution".

Policy Option Comparison

Policy Options	Policy Option Comparison			
	Effectiveness	**Acceptability**	**Consistency**	**Efficiency**
4.1 Limited list of criteria	**2**	**1**		**2**
4.2 Open list of criteria and determination by host supervisor	**1**	**2**		**2**
4.3 Open list of criteria and determination by home supervisor	**2**	**2**		**1**

**The policy highlighted is the preferred policy option. 5 is the maximum score. The scores are as determined by the IA (i.e. these scores are determined by the Commission).*

Option 4.1: Limited list of criteria

6.3. Under this option, home and host authorities would be required to liaise together to define which branch is significant based on specific criteria.

6.4. The IA argues that there would be advantages in specifying which criteria (quantitative or qualitative) should be taken into account, due to the legal obligations that a systemically relevant branch entails. It notes that a disadvantage to this approach would be that a limited list of criteria could result in arbitrary decisions and might not necessarily address all crisis scenarios.

6.5 *We consider it unclear what value there could be, even potentially, in having a home supervisor involved in the final determination of whether a branch is systemically relevant in another Member State (though obviously there might be potential value in liason over information, for example).*

Option 4.2: Open list of criteria and determination by host supervisor

6.6. Systemically relevant branches would be determined jointly by home and host supervisors, with the host supervisor having the final say in the case of disagreement.

6.7. The IA acknowledges that a disadvantage to this approach is the risk that the effectiveness of the decision making process in colleges might be undermined if too many authorities were involved in their activities. However, it notes that this could be mitigated by allowing the consolidating supervisor to have the right to choose which authority participates in college meetings depending on the relevance of the issues to be discussed.

6.8. We consider it unclear in what sense there is a real problem to mitigate here.

Option 4.3 Open list if criteria and determination by home supervisor

6.9. The home authority would have the final say in the decision making process, consistent with the EU supervisory framework based on supervision on a consolidated basis and the country of origin principle.

6.10. The IA highlights an inconsistency with this approach: the determination of systemically relevant branches relates to the financial stability in a host country and does not pertain to the significance of a branch within a group.

Summary

6.11. Option 4.1 is considered most effective at achieving enhanced legal certainty (S-1), but least effective in achieving enhanced financial stability (G-1).

6.12. Option 4.2 is considered less efficient than Option 4.3, though more effective with regard to enhanced financial stability (G-1), and so is the preferred option.

7 Exchange of information between central banks, finance ministries and supervisors

Current Approach

7.1. The CRD require the home supervisors to alert central banks and finance ministries in "emergency situations"[136], although this is subject to confidentiality safeguards. There is evidence[137] for the existence of legal impediments to information sharing between competent authorities, and central banks and finance ministries in other jurisdictions. The implementation of the CRD in this area varies from one country to another.

Policy Option Comparison

Policy Options	Policy Option Comparison			
	Effectiveness	**Acceptability**	**Consistency**	**Efficiency**
5.1 Retain current approach	**2**			
5.2 Require supervisors to exchange information with central banks and finance ministries	**1**			

**The policy highlighted is the preferred policy option. 5 is the maximum score. The scores are as determined by the IA (i.e. these scores are determined by the Commission).*

Option 5.1: Retain current approach

7.2. The IA contends that keeping the current legal framework would be "sub-optimal" for crisis management, since this task may involve not only competent authorities but also central banks or finance ministries of Member States where an entity or a systemically significant branch of a banking group is located. *(It is unclear to us what "sub-optimal" means in this context, and the use the term seems to pre-judge the impact assessment on this issue.)*

7.3. With the current legal framework, the IA states concerns that supervisors may object to sharing information because it may be communicated to third parties (e.g. central banks and finance ministries).

7.4. The IA states concerns that the EFC's efforts to enhance European financial stability framework by developing cross-border standing groups involving central banks, finance ministries and supervisors to deal with crisis situations would be undermined.

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[136] We are unaware of a precise definition of an "emergency situation".

[137] European Banking Committee (Lamfalussy process Level 2 committee) questionnaire to Member States.

Option 5.2: Require supervisors to exchange information with central banks and finance ministries.

7.5. This option is consistent with the existing obligation under Article 130 of the CRD to alert central banks and finance ministries.

7.6. Competent authorities would be required to pass on "all relevant information" in crisis situations. This option would put the creation of cross-border standing groups between supervisors, central banks and finance ministries being led by the EFC on a legal footing.

7.7. The IA asserts that this would not entail additional administrative burden to supervisors.

7.8. *A problem here, of course, is that the question of which information is or is not "relevant" might be disputable — who makes the judgement?*

Summary

7.9. Option 5.2 is considered more effective than Option 5.1 at achieving enhanced financial stability (G-1), and so is the preferred option.

Other issues

7.10. *In crisis situations, positions may quickly change and complicate information gathering. This resolution of this issue is not fully fleshed out in the IA. For example, in very fast-moving crisis situations, could there be a conflict of priorities between supervisors dealing with domestic matters and interacting with or sending information to authorities in other Member States?*

8 Combined Impacts of Preferred Options

The Banking Industry

8.1. The proposed changes are argued, in combination, to increase the overall efficiency of supervision in going-concern situations by reducing conflict, overlap of requirements, establishing a clear decision making process and allowing the consolidating supervisor to have the last final say in disagreements. It is believed that there would be a more level playing field for cross-border banks. Greater supervisory cooperation is hoped to benefit the banking industry in crisis situations.

8.2. *Since the IA does not specify at all how colleges of supervisors are to interact with competition authorities, industrial policy authorities, or international agencies, and since its coverage of interaction with central banks and finance ministries is limited, it is unclear how much progress is really made.*

8.3. *Another area in which more overall consideration might have been useful is the strategic response of banks. Financial institutions tend to be very adaptable in the face of regulatory changes, developing regulatory get-arounds. Events over the past few years suggest that financial institutions have sought to avoid regulatory restrictions through the use of special purpose companies, some of the complex financial products and various other forms of off-balance-sheet accounting, as well as through changing regulatory jurisdiction (e.g. in response to Sarbanes-Oxley). There appears limited explicit consideration in the IA as to how (a) firms might be adapting their cross-border structure anyway, given recent events; and (b) what the risks are that these changes drive regulatory get-arounds (e.g. perhaps firms establishing branches in certain Member States purely in order to increase the chances of being determined as systemic in those Member States and hence eligible for certain kinds of support).*

Supervisors

8.4. With respect to the supervisory authorities, it is argued that the proposed changes will increase their cooperation in going-concern and crisis situations via better access to information and involvement in colleges of host supervisors. The changes will mean that the consolidating supervisors will have the final decision on which authorities participate in individual meetings, and so will be able to control the operational efficiency of colleges. The mediation mechanism in case of disagreements between competent authorities is hoped to reassure host authorities.

8.5. *We consider this plausible, but there remain areas of potential dispute, as discussed in previous sections, such as:*

a) Who determines which information is relevant in different situations?

b) What will happen if a college makes a determination, but then participants in the college disagree as to the adequacy of national enforcement?

c) In very fast-moving crisis situations, could there be a conflict of priorities between supervisors dealing with domestic matters and interacting with or sending information to authorities in other Member States?

Financial Stability

8.6. The proposed changes are argued to enhance financial stability by allowing for signs of stress to be detected earlier in college-type environments, along with joint contingency plans being produced.

8.7. The IA acknowledges that whilst colleges of supervisors will have a role in crisis situations, work of other forums (e.g. cross-border stability groups established under the EFC's Memorandum of Understanding and involving finance ministries and networks of central banks) would be at the centre of reaching certain decisions.

8.8. It is believed financial stability will be enhanced by improved information exchange between supervisors, central banks and finance ministries in crisis situations, and better access to information from host supervisors for host Member States of systemically relevant branches.

8.9. The IA asserts that "more concerted responses to crisis situations will effectively help to minimise the ensuing economic and social costs for bank creditors, employees and shareholders, and eventually, taxpayers."

8.10 *We would, however, repeat again the issue raised earlier that there is a danger of creating over-harmonisation, losing the learning benefits of regulatory competition and increasing systemic risk by increasing the chance that all regulators make the same mistake at around the same time.*

8.11. Similarly, we have argued that increased information flow and hence increased transparency is not an unambiguous contributor to financial stability — instability can also be the result of transparency and the doctrine of maximal transparency appears now to have past.

8.12. Furthermore, the IA appears to assume that more concerted responses, and responses that reflect wider social concerns, will be better responses and responses that reduce financial instability. But it by no means obvious that political responses in crisis situations always enhance economic welfare or financial stability. For example, many commentators have suggested that the creation of Fannie Mae in 1938 in response to the events of the 1930s was an important contributor to the instability of the 2000s. We do not seek here to assert either

that political responses to recent events have been suboptimal or that responses to future events will ever be suboptimal, but we do think that the (perhaps theoretical) possibility that government intervention might make things worse rather than better cannot be completely ignored.

Geographical aspects

8.13. *We suspect the IA might have benefited from a more thorough setting out of how impacts might differ between different, and between different sorts of, Member State. The approach seems more to assume the current existence of a Single Market in banking, rather than regarding itself as a step along the path to achieving it.*

Overall

8.14. *The single most important weakness of the IA appears to us to be the lack of an adequate treatment of how supervisory arrangements should differ in different types of crises. We believe that the proposals might potentially usefully be amended to spell this out in more detail — for example by emphasizing the lead role of central banks in liquidity crises, finance ministries in solvency crises associated with past losses, and competition and industrial policy authorities when solvency crises reflect future profitability concerns and hence a need for material industrial restructuring.*

8.15. *Overall, though the IA sets out its view of the issues elegantly and is formally adequate so far as it goes, the proposals and analysis appear to reflect surprisingly few of the lessons and debates that have emerged during the financial crisis that has been in progress since summer 2007. Perhaps this is because a judgement was made that it is too early to learn all the lessons from this crisis. That judgement may be correct. But in that case, might one consider whether this is the time to be revising the CRD at all? Given the fluidity of events and the acknowledged difficulty in drawing lessons, how confident can one be that reforms at this time will make matters better rather than worse?*

APPENDIX 1: UNDERSTANDING THE GOALS OF PRUDENTIAL SUPERVISION AND THE NATURE OF CRISES

Concepts of Prudential Regulation

A1.1 Prudential regulation and supervision can be conceived of as operating at three levels:

a) as **the counterpart of the lender of last resort function**: Imagine a central bank that operated as a "lender of last resort", in the sense of providing the currency managed/issued by the central bank in notionally limitless quantities under certain conditions — e.g. if the borrowing bank were solvent; would remain solvent even after paying penalty interest on loans from the central bank; and faced a liquidity crisis as a consequence of a systemic liquidity crisis rather than as a consequence of poor cashflow management. In order to carry out this lender of last resort function, the central bank would need to establish whether these conditions applied — it would need some form of oversight of the solvency and liquidity of those banks for which it promised to act as a lender of last resort. A natural partner of determining whether lender of last resort funds would be available would be informing the bank of when it was at risk of ceasing to be eligible for such borrowing. This form of oversight/lender-of-last-resort arrangement might even exist with a private central bank (e.g. like the Bank of England until 1946) — this is not intrinsically a state regulatory function. Note that this form of regulation exists to protect ***the interests of the currency manager***.[138]

[138] Concerning the lender of last resort function as conducted by the European Central Bank (ECB), Article 105 (5) of the Treaty states that "the ESCB [European System of Central Banks] shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system".

Article 25.1 of the ESCB Statute authorises the ECB to "offer advice to and be consulted by the Council, the Commission and the competent authorities of the Member States on [all relevant legislation]".

The ECB's advisory role in supervising credit institutions could be extended into a more direct prudential function if it satisfies the requirements of Article 105 (6) of the Treaty that state, in relevant part, "the Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning the policies relating to the prudential supervision of credit institutions".

This has not been implemented thus far, presumably because the strong political support required within the Commission and the Parliament has been lacking.

Perhaps partly as a consequence of this, concerns have been raised over the ambiguous division of authority between the Member State central banks and the European Central Bank (ECB) with regards to the provisions governing emergency liquidity, and have been subject to a variety of interpretations regarding the exact role of the ECB and national central banks (Goodhart, 2000; Kremers et al., 2000; Padoa-Schioppa, 2004; Lastra,2006). This has lead to academic uncertainty regarding the ECB's role in a liquidity crisis, and a lack of academic confidence in the European System of Central Banks' (ESCB) lender of last resort function. Tomasso Padoa-Schioppa, a former ECB official, dismissed these concerns as unfounded because relating to an outdated concept of the lender of last resort function. In the European Parliament study "Financial Supervision and Crisis Management in the EU" , it states that: "Padoa-Schioppa's views appear to have been vindicated in the recent crisis in light of the ECB's successful management of market operations to inject liquidity into the eurozone banking system during the liquidity crunch." However, at the time of the writing of that report there was particular acclaim of the ECB's liquidity operations during 2007 — in contrast, 2008 has seen greater criticism of the ECB's handling of events.

b) as **the representative of small stakeholders**: The managers of depositing institutions face limited liability (even if managers are also shareholders, bankruptcy is a limited form of punishment). Therefore they have incentives to engage in risky activities that might return high rewards but also might lead to large losses — or alternatively to engage in many different very risky activities, each of which has only a relatively small chance of success. This means that such managers need monitoring by those whose money they invest. However, many depositors are small (in fact a major function of banks is to collect relatively small deposits to use for relatively larger loans) so each depositor faces incentives to free-ride on the monitoring of other depositors, and the same would apply to a bank with many small shareholders. Hence (in the absence of market-led aggregate monitoring solutions) there may be under-monitoring of banks to the detriment of some depositors and shareholders. Hence it is argued that there is a need for private or public "representatives" of small stakeholders.[139] Note that this form of regulation exists to protect ***the interests of the providers of bank capital***.

c) as **the protector of financial stability**: Failure by one financial institution might harm not only its depositors, but also other firms by affecting the confidence of investors more widely. For example, because banks operate on the basis of fractional reserves, bank runs can sometimes cause the failure of even the soundest banks.[140] Note that this form of regulation exists to protect ***the interests of other financial institutions (and perhaps also the wider economy)***.

A1.2 The prudential regulation of banks typically blends these three aspects in some way. It is worth noting however, that:

a) These three notions of supervision involve subtle differences of stakeholder and thus potentially different (and even potentially conflicting) supervisory interests. These interests are not even clear subsets of one another. For example, the providers of bank capital have an interest in maximising return as well as controlling risk. It is by no means obvious that the risk-return trade-off that would be optimal for stakeholders in an individual institution is the same as that optimal from the point of view of maximising stability for the system as a whole.[141] Again, the manager of the currency may be content with more risk for certain institutions than would be considered optimal from the point of view of the wider economy under some circumstances, but less risk under others (e.g. the famous "paradox of thrift" points to a situation in which banks maximize their individual stability but the wider economy is said to suffer as a consequence).

[1.6] Many commentators argue that the that EU and ESCB procedures and mechanisms for resolving a financial crisis should be publicised in advance and that they should be clear regarding which EU institutions and Member State bodies should have responsibility for providing emergency liquidity.

[139] This is the famous Dewatripont and Tirole "representation hypothesis". See Dewatripont, M. and Tirole, J. *The prudential regulation of banks*.

[140] For example, during the US bank runs 1930-32, the Bank of the United States failed, but paid over 92 cents in the dollar to its creditors (albeit some time later).

In passing, we note that the issue of confidence loss contagion leading to bank runs on sound institutions is rather less straightforward than many accounts suggest. It is most unclear why, under conditions of widespread bank runs, sufficiently sound institutions could not simply offer very high interest rates to attract depositors — the example of IceSave illustrates that depositors are indeed attracted by high interest rates even under conditions of crisis (and IceSave was not eliminated by a bank run) — or borrow from sophisticated highly-monitoring lenders (e.g. other banks or a private central bank).

[141] This point has been raised, for example, in the UK in the context of the "dual mandate" of the FSA in respect of the stability of individual institutions and the stability of the financial system as a whole.

b) Assuming, for our purposes here, that all three roles will always be present to some degree, it is by no means clear that the balance between them will be invariant to circumstance. For example, the role of "protector of financial stability" may be of value as a means of reducing the likelihood of crisis, but once a crisis is underway, it may be that the "counterpart of the lender of last resort function" gains in prominence. In "normal" trading conditions it may be adequate for lenders of last resort to rely upon information provided by other institutions (e.g. financial regulators) but in fast-moving crises lenders or providers of capital may demand an ability to form their own view as to the solvency and viability of firms seeking assistance. However, this is not a universally accepted view. For example, in the "Study of Financial Supervision and Crisis Management in the EU" which states:

> "There is no meaningful distinction between the necessary supervisory arrangements for crisis prevention and crisis management given the crucial role of supervisors, acting in concert through colleges, to detect and forestall crises, along with their duties to coordinate crisis management operations with central banks and finance ministries."[142]

A1.3 Institutional arrangements for prudential supervision must, if they are to be practical, represent the need to blend these three aspects of supervision and to adapt that blend if appropriate in times of crisis. [143]

A Taxonomy of Crises

Forms of crisis

A1.4 This brings us to the issue of how to understand a "crisis". Let us distinguish between three forms of crisis that firms — in any industry — can face:

a) Liquidity crises

b) Solvency crises arising from past losses

c) Future profitability crises

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[142] Page 39 of the "Study of Financial Supervision and Crisis Management in the EU", (IP/A/ECON/IC/2007-069), by the European Parliament's Committee on Economic and Monetary Affairs, December 2007. Of course, since the study was done in 2007, it is unclear whether the authors would still hold this view after the events of September 2008.

[143] In 2007, a new Memorandum of Understanding set out "practical guidelines for crisis management" that provide a common understanding of the steps and procedures that need to be taken in a cross-border crisis.(see Council of Ministers (ECOFIN) statement on 'Clearing and Settlement' 13571/07 (Presse 217) (9 Oct 2007) p. 23). 1.1 Key points to note on these principles are:

- the common principles recognise that the objective of crisis management is to protect the stability of the financial system in the EU as a whole while reducing the social costs of harmful financial activity.
- private sector solutions will be given primacy in resolving a crisis,
- the principles emphasise that managers should be held accountable and that shareholders should not be bailed out,
- public money should not be used unless there is a serious disturbance to the economy and the overall social benefits of the bailout exceed the public costs of recapitalising a failed institution.
- Supervisory arrangements for crisis prevention must be consistent with supervisory arrangements for crisis management and resolution.

A1.5 A liquidity crisis is a lack of available cash to pay bills that are now (or will shortly become) due for payment. If there is no solvency problem, either from past or future losses — in other words, if a firm has assets securely greater than its liabilities and likely to remain greater than liabilities if the firm continues trading — then a liquidity crisis can be resolved straightforwardly by borrowing money.[144]

A1.6 A solvency crisis arising from past losses is less easy to resolve by just borrowing money — though that may be a solution. When a firm has assets less than its liabilities, there is a risk to its continuing trading, because perfectly normal business practices — like paying bills at the end of the month — will impose risks on the firm's suppliers (if it were to cease trading there would not be sufficient money to pay all those to whom the firm owes money). If a firm's future profitability is secure, it might trade its way out of problems — future profits will restore solvency eventually. In some industries, however, the risks imposed by insolvent firms continuing to trade will be high (for example, an insolvent firm may be tempted to take great risks, because limited liability for shareholders makes those risks a one-way bet for an insolvent firm). Indeed, in some industries it is considered sufficiently risky for insolvent firms to continue trading that it is not normally permitted — banking would be an example. An alternative way through would be an injection of new capital — "recapitalisation". This restores solvency, and if future profitability is secure, then this may be sufficient.

A1.7 Lastly, we have a future profitability crisis. By this we mean a situation in which either there will be future losses rather than profits, or, at best, future profits will be insufficient to pay off future interest on current debts. In other words, the company is no longer viable over the medium term in its current form. In such a situation, unless the company is liquidated quickly or action is taken to raise future profitability expectations, equity capital will disappear and the company will become insolvent. In this kind of situation neither lending nor recapitalisation will be adequate, unless accompanied by a credible plan to restore profitability. An attempt to address such a situation by recapitalising will simply throw good money after bad, because future losses will, over time, eliminate the new capital injection — all recapitalisation will achieve is to (i) lose more money; and (ii) put off, a little, the day at which the company becomes terminally insolvent.

A1.8 The kinds of institutions likely to be involved will differ depending on the nature of the crisis. A pure liquidity crisis may be resolvable by the central bank alone. A solvency crisis arising from past losses may require wider input — for example, institutions providing new capital injections may be competitors of the banks they are recapitalising and give rise to competition considerations, necessitating the involvement of merger and other competition authorities; if the taxpayer is involved in the recapitalisation then Member State ministries of finance will need to be involved, as may European Commission authorities considering whether issues such as State Aid arise. Similarly, if there is to be major restructuring of the industry that may, again, give rise to competition issues, and also may potentially have very broad economic and political implications (e.g. concerning the security of ordinary deposits) necessitating the involvement of multiple government departments and institutions.

[144] A liquidity crisis is perhaps the most natural pair of the “lender-of-last-resort” concept of prudential regulation. The other forms of crisis are not such “clean” matches to prudential regulation concepts.

A1.9 Thus, perhaps the most obvious relationship between supervisory arrangements and the nature of crises might be that:

if the crisis is purely or mainly a liquidity crisis, then central banks would be in the lead;

if the crisis is purely or mainly a solvency crisis arising from past losses in which taxpayer capital injection is a potential policy response, then finance ministries would be in the lead;

if the crisis is purely or mainly a future profitability crisis necessitating significant industrial restructuring, then competition and industrial policy authorities would be in the lead.

A1.10 Thus, the appropriate institutional arrangements for prudential supervision might well depend on the form of the crisis. In practice, of course, most crises will involve a blend of these three aspects, but the balance between them (and hence the appropriate balance in supervision arrangements) may differ materially between crises.

Scopes of crisis

A1.11 As well as differing in form, crises can differ in scope. For example, a crisis might

affect just one firm or a small and contained number of firms (e.g. the collapse of Barings Bank did not create a systemic crisis);

affect sufficient firms to represent a systemic crisis within one country or a small number of countries (e.g. the Scandinavian banking crisis of the 1990s did not generate financial crisis in France or Spain);

be sufficiently widespread to constitute a systemic event even at the international level (e.g. the financial crisis beginning in the summer of 2007).

A1.12 Clearly the institutions involved will depend on the scope of the crisis. If a crisis is systemic at the international level, then there will almost certainly be involvement for bodies, such as the IMF and the Basel Committee, that would be much less likely to have an interest in crises affecting only individual institutions.

A1.13 Another issue of scope concerns the sectors affected. The classical account of financial contagion involved bank runs. This is, however, outdated in the modern financial system. Insurance firms possess significant systemic threats of their own. A clear example of this from the recent financial turbulence is the case of American International Group (more commonly known as AIG), whose role of insuring investment vehicles meant that its collapse was considered too great a risk to financial stability.[145] Its failure would certainly have had significant affects on European institutions. Insurers are currently required to follow the Solvency II rules laid out by the European Commission. These requirements are often coined the "Basel for insurers", and stipulate the minimum amounts of financial resources that insurers and reinsurers must have in order to cover the risks to which they are exposed, and provide principles to guide the insurers' overall risk management.

[145] On the 16th September 2008, AIG's credit rating was downgraded and it suffered a liquidity crisis. That evening the US Federal Reserve announced that a 24-month credit-liquidity facility was to be created from which AIG may draw up to $85 billion.

A1.14 It is useful to distinguish between contagion arising via an exposure channel and an information channel. In the case of the exposure channel, this refers to a bank's insolvency problem leading to a chain reaction of bank failures in other locations (the collapse of Lehman Brothers is a case in point). Contagion via the information channel refers to the way in which information about one insolvent bank can quickly develop into a general belief that other banks are also having problems. This form of contagion was seen in many ways in the last year, including 90 per cent plus drops in the share prices of major UK banks, and a rush to the "safe haven" of the fully government backed deposits in Irish banks by UK depositors.

APPENDIX 2: HISTORY OF THE LEGISLATION AND TWO THORNY ISSUES ARISING

The Basel Accords

A2.1 The Basel Accords refer to the accords Basel I and Basel II issued by the Basel Committee on Banking Supervision. The original Basel Accord was agreed in 1988 and is now referred to as Basel I. It had two main purposes:

- "To promote world financial stability by coordinating supervisory definitions of capital, risk assessments, and standards for capital adequacy across countries";
- "To link a bank's capital requirements systematically to the riskiness of its activities, including various off balance-sheet forms of risk exposure."

A2.2 Basel I required lenders to calculate a minimum level of capital required based on a single risk weight for each of a limited number of asset classes. The regulatory measure of bank risk could differ greatly from the actual risk. It failed to adequately highlight contingent credit risk as there was little incentive for banks to monitor the risk associated with the loans they shifted into structured products.

A2.3 Basel II revises the existing framework, to make it more risk sensitive and representative of modern banks' risk management practices. The objectives underlying Basel II are to enhance the level of consumer protection by limiting the possibility of consumer loss or market disruption that may arise as a consequence of prudential failure. Four main components:

- It is more sensitive to the risks that firms face: the new framework includes an explicit measure for operational risk and includes more risk sensitive risk weightings against credit risk.
- It reflects improvements in firms' risk management practices, for example by the introduction of the internal ratings based approach (IRB) to allows firms to use their own estimates of credit risk.
- It provides incentives for firms to improve their risk management practices, with more risk sensitive risk weights as firms adopt more sophisticated approaches to risk management.
- The new framework aims to leave overall capital held by banks collectively broadly unchanged.

The Financial Services Action Plan

A2.4 The 42 measures of the Financial Services Action Plan (FSAP), commencing from December 1998, were intended to create a legal and regulatory environment supporting the integration of EU financial markets. Some FSAP measures take the form of EC Regulations, which apply directly in all Member States. Most take the form of EC Directives, which have to be transposed into the law of each Member State. Of these, some replace earlier Directives (e.g. on investment services), which were out-of-date. Others recast earlier proposals (e.g. on takeover bids). Some of the FSAP measures (e.g. on mutual funds) were already under negotiation when the FSAP was launched; others added subsequently.

The Capital Requirements Directives

A2.5 The FSAP measures included the Capital Requirements Directives (Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions)

A2.6 These Directives update European legislation (technically, by recasting two existing Directives; Consolidated Banking Directive 2000/12/EC and the Capital Adequacy Directive 93/6/EEC) and introduce a new supervisory framework in line with the international Basel II rules on capital measurement and capital standards. The Directives apply to all credit institutions and certain investment institutions.

A2.7 The Directives aim to implement the Basel II agreement, in particular by striving to ensure that the financial resources held by a firm are commensurate to the risks they face (i.e. those risks associated with the external and internal profile of the business environment).

A2.8 The new framework consists of three 'pillars':

- **Pillar 1** sets out a firm's minimum capital requirements firms, given credit, market and operational risk.
- **Pillar 2** instructs that firms and supervisors have to take a view on whether a firm should hold additional capital against risks not covered in Pillar 1 and must take action accordingly.
- **Pillar 3** requires institutions to publish some details of their risks, capital and risk management.

A2.9 In respect of cross-border supervision, the Basel II objectives were incorporated into the CRD via the adoption of principles of home-host country control to facilitate the approval of Basel II credit risk methodologies on a cross-border basis. The principles in the Directives for the allocation between home and host country authorities for approving and validating a bank's risk methodologies internationally, are vague, though they urge home and host authorities to cooperate. The Home supervisor has the authority to approve the home bank's validation of its internal credit risk models. In areas that are not detailed to be under the home supervisor's authority, such as operational risk, the home and host authorities have to come to agreement over the approval of the bank's validation of its internal models.

A2.10 On 1 October 2008, the Commission published proposals to amend the Capital Requirements Directives. These amendments are, according to the Commission, designed to "reinforce the stability of the financial system, reduce risk exposure and improve supervision of banks that operate in more than one EU country. Under the new rules, banks will be restricted in lending beyond a certain limit to any one party, while national supervisory authorities will have a better overview of the activities of cross-border banking groups."

Implementation timeframe of Capital Requirements Directives

A2.11 This Directive came into force on 14 June 2006 and the deadline for national implementation was the 31 December 2006. Until this date, credit institutions and investment firms (as defined by MiFID) were able to choose between the 'Basel I' approach and the simple or medium sophisticated approaches under the new framework. According to the Commission's update on the state of play (as of September 2008) on the transposition of Directive 2006/48/EC, all but one Member State had provided the Commission with notification which had been checked by the Commission.

The remaining Member State had only partially notified the Commission. For Directive 2006/49/EC, the picture was broadly similar but there were two remaining Member States which had only partially notified the Commission.

Review of the CRD

A2.12 The European Commission has proposed various revisions to the Capital Requirements Directives (amending Directives 2006/48/EC and 2006/49/EC). The CRD had specific areas to be addressed subsequent to its initial implementation; however the proposals also in part reflect the current financial crisis.

A2.13 The areas of change are:

- Large Exposures,
- Hybrid Capital Instruments,
- Home-Host and Crisis Management Arrangements,
- Derogations for bank networks from certain prudential requirements,
- Life insurance as eligible collateral,
- Capital requirements for Collective Investment Undertakings under the Internal Ratings Based Approach,
- Capital requirements and risk management for securitisation positions.

A2.14 This critique will focus on the proposed changes to Home-Host and Crisis Management Arrangements.

Two Thorny Issues of Cross-Border Institutions

1) The large home, small host problem

A2.15 Banking groups are increasing centralising a number of key functions at the group level in order to gain economies of scale and synergies in specialist operations. Such functions include risk management, liquidity management, funding operations and credit control, are typically exercised at the group level or in specialised affiliates.

A2.16 This also has led to the distinction between branches and subsidiaries becoming blurred. For instance, it is no longer the case that a large subsidiary bank operating in one jurisdiction will be allowed to stay in business if its parent company bank defaults or fails in another jurisdiction (at least not for the short-run).[146]

A2.17 One complex situation, of particular interest in the EU context, is the following. Consider a financial institution that is headquartered in a large Member State and has a branch/subsidiary operating in a small Member State.

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[146] In addition to this, the EU company statute offers companies the possibility of changing their subsidiaries into branches. This is already underway in the case of certain Nordic ember States (e.g. Danske Bank). This would lead to a shift in supervisory responsibility from the host to the home Member State, and raises supervisory challenges, i.e. the operational difference between a group and a company is likely to be very small while the legal and taxation effects may be substantial.

It is possible that the failure of such an institution might not represent a systemic crisis within its home Member State (for it is large) but *would* represent a systemic crisis within the small Member State in which its subsidiary operates. In such a scenario, who should be responsible for supervision of the institution and who should be responsible for decisions such as whether the institution should be lent money, recapitalised, or restructured in the event of a crisis?

A2.18 The standard passporting principle within EU financial regulation might suggest that it would be the financial regulator in the home Member State that would be responsible. But such a regulator could not be held responsible for rescuing the institution in order to avoid systemic crisis in the host. In some ways the most "efficient" arrangement might be for the home regulator to have oversight of all aspects of the institution, including in the host Member State, and then interact with the host's central bank, finance ministry, competition authorities, and so on to assist in determining the nature and scope of any support in the event of financial crisis. But even this is not straightforward, in that the home Member State might have an interest in free-riding on taxpayer funds, central bank lending, and so on provided by the host, and hence there might be a conflict of interest in taking at face value the indications of the home regulator concerning the allocation of the financial institution's assets and liabilities between home and host. This is complex enough in the case of just one host Member State, but in practice large cross-border financial institutions are likely to be involved in multiple other Member States, with the complexity magnified greatly — a situation that could be particularly unhelpful during a fast-moving crisis.

A2.19 Although the large home, small host problem makes the issue of supervisory scope most naked, the conflict would arise, also, in solvency crises in which the financial institution were systemic in the home country as well as the host (for there would remain conflict of interest between the taxpayers in different Member States, and the incentive to free-ride).

A2.20 An interesting case study on these questions is New Zealand, which requires that every bank is an own legal entity. This was true in Canada for every systemically important bank until 1999, whereas today foreign branches are allowed but this is accompanied by substantial restrictions. In the EU context, however, it seems certain that the benefits from increased integration are too important for this form of restriction.

2) The differing currencies problem

A2.21 If all Member States were members of the euro, then, at least in pure liquidity crises, home-host problems might be potentially amenable to a solution involving emphasizing the role of prudential supervision as the counterpart of the lender of last resort function. This would still leave many issues untouched in the case of solvency crises, but might represent some progress. However, given the reality that different Member States have (and for the foreseeable future are expected to continue to have) different currencies, this solution has only limited applicability.

A2.22 Currency issues can arise in two main ways. First, there is the version of the home-host problem in which home and host operate different currencies, and hence there are different central banks. The second form of the problem is that in which the institution has considerable liabilities denominated in a currency other than the home's domestic currency. The means that lender-of-last resort actions by the home central bank cannot be unlimited (debts cannot, even in principle, simply be inflated away by the printing of money).

This may limit the home Member State's ability to rescue failed financial institutions (e.g. this was a problem for Iceland, which had considerable liabilities denominated in other currencies) and thus increase the interest of other Member State authorities in participating in rescues.

Implications

A2.23 The above considerations suggest that, setting aside the option of establishing both a single currency operating throughout the EU and a single pan-EU financial regulator (either through the ECB or as a separate institution), the reality is that there must be cooperation between Member State-based supervisory institutions. Let us use the term "colleges" to denote groups of small numbers of Member State-based supervisory institutions. The membership of such colleges will obviously include financial regulators, and in times of crises, *inevitably*, also include central banks, ministries of finance, and competition authorities.

A2.24 In crises of broad scope, there will also need to be cooperation between these colleges and EU-level institutions (e.g. DGCOMP) and also international institutions such as the IMF and the Basel Committee.