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EU Financial services legislation

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Summary

There is a considerable amount of legislation either in the European 'pipeline' or dependent upon decisions taken by other bodies at an international level. Some of the EU initiatives require Treaty changes, others do not. Some of the outstanding pieces of legislation are directly linked to the financial crisis, others pre date it, but have been amended in some cases to reflect new circumstances. This note tries to explain the various strands

Note: this document is of historic interest only. The proposals mentioned here have become legislation already and enacted in their several ways in the UK and in the rest of the EU.

1. The de Larosière Group and Report, February 2009

In response to the financial crisis, the European Commission set up the de Larosière Group (the Group) to recommend changes to the regulatory structure of financial services that would not require changes to the Treaties of the EU. Internal Market and Services Commissioner Charlie McCreevy described this as a "pragmatic approach".[1] The report was published on 25 February 2009.

The report stated its aim to lay out a framework for enhancing EU regulation:

> **Towards** a new regulatory agenda – to reduce risk and improve risk management; to improve systemic shock absorbers; to weaken pro-cyclical amplifiers; to strengthen transparency; and to get the incentives in financial markets right.
>
> **Towards** stronger coordinated supervision – macro-prudential and micro-prudential. Building on existing structures. Ambitiously, step by step but with a simple objective. Much stronger, coordinated supervision for all financial actors in the European Un ion. With equivalent standards for all, thereby preserving fair competition throughout the internal market.
>
> **Towards** effective crisis management procedures – to build confidence among supervisors. And real trust. With agreed methods and criteria. So all Member States can feel that their investors, their depositors, their citizens are properly protected in the European Union.
>
> In essence, we have two alternatives: the first *"chacun pour soi"* beggar-thy-neighbour solutions; or the second – enhanced, pragmatic, sensible European cooperation for the benefit of all to preserve an open world economy. This will bring undoubted economic gains, and this is what we favour. [2]

The following subsections provide details of the central regulatory recommendations contained in the report. The report is divided into two key areas – the **regulation**, and the **supervisory structure**, of the financial services sector. The authors noted the mutual dependence of the two areas:

> Regulation and supervision are interdependent: competent supervision cannot make good failures in financial regulatory policy; but without competent and well-designed supervision good regulatory policies will be ineffective. High standards in both are therefore required.[3]

[1] EU Europa website, SPEECH/09/273, 27 May 2009

[2] High-level Group on Financial Supervision in the EU, De Larosiere Report, 25 February 2009

[3] Ibid., p38

1.1 Proposals to alter the regulation of financial services in the EU

Reforming the present framework

The report analysed the failings of the current regulatory system and made multiple recommendations highlighting ways in which problems could be resolved or mitigated.

Asset bubbles

The report identified asset bubbles, particularly the housing market in the US, as a key concern for macro regulation. The report found that although identifying such bubbles is inevitably difficult, there are a number of policies that may be usefully employed to prevent dramatically inflating such bubbles:

> It is commonly agreed today that monetary authorities cannot avoid the creation of bubbles by targeting asset prices and they should not try to prick bubbles. However, they can and should adequately communicate their concerns on the sustainability of strong increases in asset prices and contribute to a more objective assessment of systemic risks. Equally, they can and should implement a monetary policy that looks not only at consumer prices, but also at overall monetary and credit developments, and they should be ready to gradually tighten monetary policy when money or credit grow in an excessive and unsustainable manner. Other competent authorities can also use certain tools to contain money and credit growth. These are of particular importance in the context of the euro zone, where country-specific monetary policies tailored to countries' positions in the economic cycle, and especially in the asset market cycle, cannot be implemented. The following are examples of regulatory tools which can help meet counter-cyclical objectives:
>
> - introducing dynamic provisioning or counter-cyclical reserves on banks in *"good times"* to limit credit expansion and so alleviate pro-cyclicality effects in the *"bad times"*;
> - making rules on loans to value more restrictive;
> - modifying tax rules that excessively stimulate the demand for assets.[4]

Capital and liquidity requirements

The Group found that a more effective and international capital oversight regime is required. In overview, the authors noted:

> Overall cooperation between monetary and regulatory authorities will have to be strengthened, with a view to defining and implementing the policy-mix that can best maintain a stable and balanced macro-economic framework. In this context, it will be important for the ECB to become more involved in over-seeing

[4] Ibid; p14-15

> the macro-prudential aspects of banking activities (see next chapter on supervision). Banks should be subject to more and more intense scrutiny as the bubble builds up.
>
> Finally, a far more effective and symmetric "*multilateral surveillance*" by the IMF covering exchange rates and underlying economic policies is called for if one wants to avoid the continuation of unsustainable deficits (see chapter on global issues).[5]

The Group also recognised the role of liquidity in the crisis:

> Liquidity issues are important in the context both of individual financial firms and of the regulatory system. The Group believes that both require greater attention than they have hitherto been afforded. Supervisors need to pay greater attention to the specific maturity mismatches of the firms they supervise, and those drawing up capital regulations need to incorporate more fully the impact on capital of liquidity pressures on banks' behaviour.[6]

More specifically, the report identified several areas of cross-national regulation that needed to be enhanced. Although the Basel II framework was not blamed for causing the crisis, the Group argued that it "underestimated some important risks and over-estimated banks' ability to handle them."[7] Accordingly, they recommended,

> Recommendation 1: The Group sees the need for a fundamental review of the Basel 2 rules. The Basel Committee of Banking Supervisors should therefore be invited to urgently amend the rules with a view to:
>
> - gradually increase minimum capital requirements;
> - reduce pro-cyclicality, by e.g. encouraging dynamic provisioning or capital buffers;
> - introduce stricter rules for off-balance sheet items;
> - tighten norms on liquidity management; and
> - strengthen the rules for bank's internal control and risk management, notably by reinforcing the "fit and proper" criteria for management and board members.
>
> Furthermore, it is essential that rules are complemented by more reliance on judgement.
>
> Recommendation 2: In the EU, a common definition of regulatory capital should be adopted, clarifying whether, and if so which, hybrid instruments should be considered as tier 1 capital. This definition should be confirmed by the Basel Committee.

Credit rating agencies

The report argued that credit rating agencies require regulation due to their central importance in the modern complex financial system, but also because of the conflict of interests and anti-competitive opportunities the industry model presents:

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[5] Ibid; p15

[6] Ibid; p16

> Given the pivotal and quasi-regulatory role that they play in today's financial markets, Credit Rating Agencies must be regulated effectively to ensure that their ratings are independent, objective and of the highest possible quality. This is all the more true given the oligopolistic nature of this business. The stability and functioning of financial markets should not depend on the opinions of a small number of agencies – whose opinions often were proven wrong, and who have much too frequently substituted for rigorous due diligence by firms.

Although the report generally supported the European Commission's regulatory proposal (submitted in October 2008), it commented that

> …the system of licensing and oversight contained in this proposal is too cumbersome. The allocation of work between the home and host authorities, in particular, is likely to lack effectiveness and efficiency. The Group is of the view that it would be far more rational to entrust the Committee of European Securities Regulators (CESR) with the task of licensing CRAs in the EU, monitoring their performance, and in the light of this imposing changes (as is proposed in the new supervisory framework proposed in the next chapter).[7]

The Group made a number of recommendations:

> Recommendation 3: Concerning the regulation of Credit Rating Agencies (CRAs), the Group recommends that:
>
> - within the EU, a strengthened CESR should be in charge of registering and supervising CRAs;
> - a fundamental review of CRAs' business model, its financing and of the scope for separating rating and advisory activities should be undertaken;
> - the use of ratings in financial regulations should be significantly reduced over time;
> - the rating for structured products should be transformed by introducing distinct codes for such products.
>
> It is crucial that these regulatory changes are accompanied by increased due diligence and judgement by investors and improved supervision.[8]

Mark-to-market accounting

The mark-to-market accounting principle,[9] which underlies balance sheet calculations in a number of key areas, was criticised in the report. The Group found that although "in general this principle makes sense, there may be specific conditions where this principle should not apply because it can mislead investors and distort managers' policies." In particular, the report argued that:

[7] Ibid.

[8] Ibid., p20

[9] A widely used accounting standard that assigns financial assets their current market value.

- institutions should be able to value assets that it wishes to hold to maturity using a different accounting standard;
- where inactive markets exist it may be inappropriate to enforce mark-to-market in such cases; and
- any accounting system must be avoid pro-cyclicality and remain cycle-neutral.

Specifically, the report recommended:

> Recommendation 4: With respect to accounting rules the Group considers that a wider reflection on the mark-to-market principle is needed and in particular recommends that:
>
> - expeditious solutions should be found to the remaining accounting issues concerning complex products;
> - accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment;
> - the IASB and other accounting standard setters should clarify and agree on a common, transparent methodology for the valuation of assets in illiquid markets where mark-to-market cannot be applied;
> - the IASB further opens its standard-setting process to the regulatory, supervisory and business communities;
> - the oversight and governance structure of the IASB be strengthened.[10]

Despite these recommendations, the Group emphasised the importance of maintaining a transparent global standard:

> To ensure convergence of accounting practices and a level playing-field at the global level, it should be the role of the International Accounting Standard Board (IASB) to foster the emergence of a consensus as to where and how the mark-to-market principle should apply – and where it should not. The IASB must, to this end, open itself up more to the views of the regulatory, supervisory and business communities. This should be coupled with developing a far more responsive, open, accountable and balanced governance structure. If such a consensus does not emerge, it should be the role of the international community to set limits to the application of the mark-to-market principle.[11]

Insurance companies

The Group, noting the systemic importance of insurance giant American International Group (or AIG), supported the Commission's insurance directive, Solvency II, which aims to more effectively supervise large cross-border insurance companies; in addition, the directive seeks to remedy existing levels of fragmentation in regulation and ensure that risk is more effectively assessed.

[10] Ibid., pp21-22

[11] Ibid., p21

The report, endorsing Solvency II, also recommended that disputes regarding the definition of "home" and "host" Member States be resolved:

> Recommendation 5: The Group considers that the Solvency 2 directive must be adopted and include a balanced group support regime, coupled with sufficient safeguards for host Member States, a binding mediation process between supervisors and the setting-up of harmonised insurance guarantee schemes.[12]

Sanctions punishment

The Group identified sanctions against financial institutions as an area where European legislation and the regulation of individual Member States is severely lacking. The report stated:

> A sound prudential and conduct of business framework for the financial sector must rest on strong supervisory and sanctioning regimes. Supervisory authorities must be equipped with sufficient powers to act when financial institutions have inadequate risk management and control mechanisms as well as inadequate solvency of liquidity positions. There should also be equal, strong and deterrent sanctions regimes against all financial crimes - sanctions which should be enforced effectively.
>
> Neither of these exist for the time being in the EU. Member States sanctioning regimes are in general weak and heterogeneous. Sanctions for insider trading range from a few thousands of euros in one Member State to millions of euros or jail in another. This can induce regulatory arbitrage in a single market. Sanctions should therefore be urgently strengthened and harmonised. The huge pecuniary differences between the level of fines that can be levied in the competition area and financial fraud penalties is striking. Furthermore, Member States should review their capacity to adequately detect financial crimes when they occur. Where needed, more resources and more sophisticated detection processes should be deployed.
>
> Recommendation 6: The Group considers that:
>
> Competent authorities in all Member States must have sufficient supervisory powers, including sanctions, to ensure the compliance of financial institutions with the applicable rules;
>
> Competent authorities should also be equipped with strong, equivalent and deterrent sanction regimes to counter all types of financial crime.[13]

New features for the regulatory framework

The Group also made recommendations highlighting ways in which the current financial problems can be resolved by new regulations.

The "parallel banking system"

The "parallel banking system", as the report described it, encompassed hedge funds, investment banks, mortgage brokers (in some cases) and

[12] Ibid., p23
[13] Ibid.

off-balance sheet vehicles. The report strongly endorsed regulation of these enterprises given their systemic importance and their vulnerability to crises (arising from their relatively limited capital bases):

> The Group considers that appropriate regulation must be extended, in a proportionate manner, to all firms or entities conducting financial activities which may have a systemic impact (i.e. in the form of counterparty, maturity, interest rate risks…) even if they have no direct links with the public at large. This is all the more important since such institutions, having no deposit base, can be very vulnerable when liquidity evaporates – resulting in major impacts in the real economy.[14]

The report focused particularly on enhancing information disclosure in the case of hedge funds, and suggested that EU nations as well as the US should follow the UK's approach of registering hedge funds and monitoring the activities of the largest 30. Equating the proprietary trading activities of investment banks and some commercial banks to hedge funds, the report suggested that capital restrictions and other regulations should be tightened:

> The conventional wisdom has been that light regulatory principles could apply to these because they were trading "at their own risk". Evidence has shown that the investment banks were subject to very thin capital requirements, became highly leveraged and then created severe systemic problems. ...
>
> While these institutions should not be controlled like ordinary banks, adequate capital requirements should be set for proprietary trading and reporting obligations should be applied in order to assess their degree of leverage. Furthermore, the wrong incentives that induced excessive risk taking (in particular because of the way in which bonuses are structured) must be rectified.[15]

The Group summarised their recommendations:

> Recommendation 7: Concerning the "parallel banking system" the Group recommends to:
>
> extend appropriate regulation, in a proportionate manner, to all firms or entities conducting financial activities of a potentially systemic nature, even if they have no direct dealings with the public at large;
>
> improve transparency in all financial markets - and notably for systemically important hedge funds - by imposing, in all EU Member States and internationally, registration and information requirements on hedge fund managers, concerning their strategies, methods and leverage, including their worldwide activities;
>
> introduce appropriate capital requirements on banks owning or operating a hedge fund or being otherwise engaged in significant proprietary trading and to closely monitor them.[16]

[14] Ibid., p23
[15] Ibid., p24
[16] Ibid p15

Securitisation and derivatives

The Group observed that trust in the credit default swap market had rapidly deteriorated, and attributed much of this to fears of counterparty risk arising from a system lacking a centralised clearing party. The high levels of risk detected in securities markets could be mitigated by ensuring that the issuer retains a significant stake in the asset. The report recommended:

> Recommendation 8: Concerning securitised products and derivatives markets, the Group recommends to:
>
> - simplify and standardise over-the-counter derivatives;
> - introduce and require the use of at least one well-capitalised central clearing house for credit default swaps in the EU;
> - guarantee that issuers of securitised products retain on their books for the life of the instrument a meaningful amount of the underlying risk (non-hedged).

Investment funds

Noting the difficulties encountered by money market firms and the Bernard Madoff fraud case in the US, the Group recommended that:

> Recommendation 9: With respect to investment funds, the Group proposes to further develop common rules for investment funds in the EU, notably concerning definitions, codification of assets and rules for delegation. This should be accompanied by a tighter supervisory control over the independent role of depositories and custodians.[17]

Corporate governance

The de Larosière Group identified corporate governance as “one of the most important failures of the present crisis.” The report provided an overview of the problems created by financial incentives:

> Most of the incentives – many of them being the result of official action – encouraged financial institutions to act in a short-term perspective and to make as much profit as possible to the detriment of credit quality and prudence; interest rates were low and funding plentiful; the new accounting rules were systematically biased towards short-term performance (indeed these rules led to immediate mark-to-market recognition of profit without allowing a discount for future potential losses). As a result of all this, the long-term, "through the cycle" perspective has been neglected.

Although the Group believed that some of these problematic incentives can be resolved by counter-cyclical capital buffers, changes to accounting procedures and the closure of regulatory gaps, the report also explained that reforms to remuneration and risk management

[17] Ibid., p26

practices would be necessary to maintain a more sustainable financial system.

Remuneration

Distinguishing between the *level* and *structure* of remuneration, the Group explained that,

> There are two dimensions to this problem: one is the often excessive level of remuneration in the financial sector; the other one is the structure of this remuneration, notably the fact that they induce too high risk-taking and encourage short-termism to the detriment of long-term performance. Social-political dissatisfaction has tended recently to focus, for understandable reasons, on the former. However, it is primarily the latter issue which has had an adverse impact on risk management and has thereby contributed to the crisis. It is therefore on the structure of remuneration that policymakers should concentrate reforms going forward.
>
> It is extremely important to re-align compensation incentives with shareholder interests and long-term, firm-wide profitability. Compensation schemes must become fully transparent. Industry has already come up with various sets of useful principles to try and achieve this. The principles agreed in 2008 by the Institute of International Finance, for example, are a first step. [18]

The Group proceeded to outline a number of core principles for determining a prudent remuneration structure:

> Recommendation 11: In view of the corporate governance failures revealed by the current financial crisis, the Group considers that compensation incentives must be better aligned with shareholder interests and long-term firm-wide profitability by basing the structure of financial sector compensation schemes on the following principles:
>
> - the assessment of bonuses should be set in a multi-year framework, spreading bonus payments over the cycle;
> - the same principles should apply to proprietary traders and asset managers;
> - bonuses should reflect actual performance and not be guaranteed in advance.
>
> Supervisors should oversee the suitability of financial institutions' compensation policies, require changes where compensation policies encourage excessive risk-taking and, where necessary, impose additional capital requirements under pillar 2 of Basel 2 in case no adequate remedial action is being taken.[19]

Risk management

Turning to internal risk procedures, the Group argued that "In many cases, risk monitoring and management practices within financial institutions have dramatically failed in the crisis."[20]

[18] Ibid., pp30-31
[19] Ibid., p31
[20] Ibid p32

Accordingly, the report provided a general set of principles that would apply to risk-taking firms:

> Recommendation 12: With respect to internal risk management, the Group recommends that:
>
> the risk management function within financial institutions must be made independent and responsible for effective, independent stress testing;
>
> senior risk officers should hold a very high rank in the company hierarchy, and - internal risk assessment and proper due diligence must not be neglected by overreliance on external ratings.
>
> Supervisors are called upon to frequently inspect financial institutions' internal risk management systems.

Crisis management

Although the Group noted that financial crises were inevitable, it stressed that a more effective supervisory structure could mitigate some of the greatest damage:

> Of course, crisis prevention should be the first preoccupation of national and EU authorities (see chapter on supervision). Supervisors should act as early as possible in order to address the vulnerabilities identified in a given institution, and use all means available to them to this effect (e.g. calling on contributions from shareholders, fostering the acquisition of the institution concerned by a stronger one). In this respect, the role of central banks which are by essence well placed to observe the first signs of vulnerability of a bank is of crucial importance. Therefore in countries where supervision is not in the hands of the central bank, a close collaboration must be ensured between supervisors and central banks. But crises will always occur and recent experiences in managing crises have shown that many improvements to the present system are called for.[21]

Moral hazard

To address the moral hazard issues regarding support for failing institutions,[22] the Group proposed adopting an approach of "constructive ambiguity":

> "Constructive ambiguity" regarding decisions whether or not public sector support will be made available can be useful to contain moral hazard. However, the cure for moral hazard is not to be ambiguous on the issue of public sector involvement as such in crisis management. Two aspects need to be distinguished and require different treatment. On the one hand, a clear and consistent framework for crisis management is required with full transparency and certainty that the authorities have developed

[21] Ibid., pp32-33

[22] The problem of moral hazard (a term derived from the principle-agent problem familiar to economists) in the case of finance has been that some banks have become too large to be allowed to fail – upon recognition of this fact, any such institution then faces different incentives. The new incentives are such that there is only a limited downside to taking risk because of the knowledge that the government will provide support if the risk goes wrong.

> concrete crisis management plans to be used in cases where absence of such public sector support is likely to create uncertainty and threaten financial stability. On the other hand, constructive ambiguity and uncertainty is appropriate in the application of these arrangements in future individual cases of distressed banks.[23]

Crisis management framework

The report also noted that a "lack of consistent crisis management and resolution tools across the Single Market places Europe at a disadvantage vis-à-vis the US and these issues should be addressed by the adoption at EU level of adequate measures." To address these concerns, the report recommended a more systematic and structured approach to dealing with financial crises:

> Recommendation 13: The Group calls for a coherent and workable regulatory framework for crisis management in the EU:
>
> - without pre-judging the intervention in future individual cases of distressed financial institutions, a transparent and clear framework for managing crises should be developed;
> - all relevant authorities in the EU should be equipped with appropriate and equivalent crisis prevention and crisis intervention tools;
> - legal obstacles which stand in the way of using these tools in a cross-border context should be removed, with adequate measures to be adopted at EU level.[24]

Deposit guarantee schemes

Although the Group welcomed the increases in deposit guarantees offered by the EU, it strongly argued that a uniform deposit protection policy should be applied across the EU – not simply a minimum level, as specified by current EU regulations:

> A critical element of this proposal is the requirement that all Member States apply the same amount of DGS protection for each depositor. The EU cannot indeed continue to rely on the principle of a minimum coverage level, which can be topped-up at national level. This principle presents two major flaws: first, in a situation where a national banking sector is perceived as becoming fragile, there is the risk that deposits would be moved to the countries with the most protective regime (thus weakening banks in the first country even further); second, it would mean that in the same Member State the customers of a local bank and those using the services of a third country branch could enjoy different coverage levels. As the crisis has shown, this cannot be reconciled with the notion of a well-functioning Single Market.[25]

The report further argued in favour of pre-funded deposit guarantee schemes funded by the financial sector itself. The authors argued that such "schemes are better to foster confidence and help avoiding pro-

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[23] High-level Group on Financial Supervision in the EU, De Larosiere Report, 25 February 2009, p33

[24] Ibid., p36

[25] Ibid., p34

cyclical effects resulting from banks having to pay into the schemes at a time where they are already in difficulty."[26] The report added that where large cross-border institutions fail, it should be made clear that the state would be willing provide any additional guarantee funds where necessary. However, the Group decided against recommending a pan-European guarantee fund.

1.2 Proposals to improve the supervision of financial services

The Group highlighted the importance of, and distinction between, macro- and microprudential supervision:

> The experience of the past few years has brought to the fore the important distinction between micro-prudential and macro-prudential supervision. Both are clearly intertwined, in substance as well as in operational terms. Both are necessary and will be covered in this chapter.
>
> Micro-prudential supervision has traditionally been the centre of the attention of supervisors around the world. The main objective of micro-prudential supervision is to supervise and limit the distress of individual financial institutions, thus protecting the customers of the institution in question. The fact that the financial system as a whole may be exposed to common risks is not always fully taken into account. However, by preventing the failure of individual financial institutions, micro-prudential supervision attempts to prevent (or at least mitigate) the risk of contagion and the subsequent negative externalities in terms of confidence in the overall financial system.
>
> The objective of macro-prudential supervision is to limit the distress of the financial system as a whole in order to protect the overall economy from significant losses in real output. While risks to the financial system can in principle arise from the failure of one financial institution alone if it is large enough in relation to the country concerned and/or with multiple branches/subsidiaries in other countries, the much more important global systemic risk arises from a common exposure of many financial institutions to the same risk factors. Macro-prudential analysis therefore must pay particular attention to common or correlated shocks and to shocks to those parts of the financial system that trigger contagious knock-on or feedback effects.
>
> Macro-prudential supervision cannot be meaningful unless it can somehow impact on supervision at the micro-level; whilst micro-prudential supervision cannot effectively safeguard financial stability without adequately taking account of macro-level developments.[27]

[26] Ibid.
[27] Ibid., p38

The Group identified a number of problems with the supervisory system operating in the EU, although were careful to explain that it was not the fault of this system that the crisis occurred:

- lack of macro-prudential supervision;
- ineffective early warning systems;
- specific failures by some regulators to effectively address crises (e.g. Northern Rock);
- inadequate processes and practices for challenging the views of an institution's home regulator when they spread across borders (e.g. Icelandic banks);
- lack of frankness and cooperation between supervisors across borders;
- lack of resources, combined with a heavy workload, inhibited the level 3 pan-EU supervisory bodies (i.e. Committee of European Securities Regulators, Committee of European banking Supervisors and Committee of European Insurance and Occupational Pensions Supervisors);
- level 3 bodies also lacked the legal basis for making decisive judgements.

In response to these problems, the report proposed that the quality of national *and* Europewide supervisory structures be strengthened. The report laid out a number of specific recommendations, including the colleges of supervisors proposed as part of the Capital Requirements Directive and Solvency II proposals that seek to achieve this goal:

> Recommendation 16: A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up under the auspices and with the logistical support of the ECB.
>
> The ESRC should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR as well as one representative of the European Commission. Whenever the subject discussed justifies the presence of insurance and securities supervisors, the Governor could choose to be represented by the Head of the appropriate national supervisory authority;
>
> The ESRC should pool and analyse all information, relevant for financial stability, pertaining to macro-economic conditions and to macro-prudential developments in all the financial sectors.
>
> A proper flow of information between the ESRC and the micro-prudential supervisors must be ensured.
>
> Recommendation 17: an effective risk warning system shall be put in place under the auspices of the ESRC and of the Economic and Financial Committee (EFC).
>
> The ESRC should prioritise and issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU.

> If the risks are of a serious nature, potentially having a negative impact on the financial sector or the economy as a whole, the ESRC shall inform the chairman of the EFC. The EFC, working with the Commission, will then implement a strategy ensuring that the risks are effectively addressed.
>
> If the risks identified relate to a global dysfunction of the monetary and financial system, the ESRC will warn the IMF, the FSF and the BIS in order to define appropriate action at both EU and global levels.
>
> If the ESRC judges that the response of a national supervisor to a priority risk warning is inadequate, it shall, after discussion with that supervisor, inform the chairman of the EFC, with a view to further action being taken against that supervisor.[28]
>
> Recommendation 18: A European System of Financial Supervisors (ESFS) should be setup. This ESFS should be a decentralised network:
>
> existing national supervisors would continue to carry-out day-to-day supervision;
>
> three new European Authorities would be set up, replacing CEBS, CEIOPS and CESR, with the role coordinate the application of supervisory standards and guarantee strong cooperation between the national supervisors;
>
> colleges of supervisors would be set up for all major cross-border institutions.
>
> The ESFS will need to be independent of the political authorities, but be accountable to them.
>
> It should rely on a common set of core harmonised rules and have access to high quality information.[29]

With regard to the European Central Bank (ECB), the report suggested that "the Group supports an extended role for the ECB in macro-prudential oversight," although "it does not support any role for the ECB for micro-prudential supervision."

Creating an EU supervisory structure

The creation of such a supervisory structure is envisaged in two stages. In the first stage,

- national supervisory authorities would be strengthened "with a view to upgrading the quality of supervision in the EU";
- the "EU should also develop a more harmonised set of financial regulations, supervisory powers and sanctioning regimes";[30]

[28] Ibid., p46
[29] Ibid., p48
[30] Ibid., p51

- level 3 committees will receive additional resources, "upgrade the quality and impact of their peer review processes" and "prepare the ground, including through the adoption of adequate supervisory norms, for the setting-up of supervisory colleges for all major cross-border financial firms in the EU by the end of 2009."

The second stage would establish the European System of Financial Supervision:

> Recommendation 22: In the second stage (2011-2012), the EU should establish an integrated European System of Financial Supervision (ESFS).
>
> The level 3 Committees should be transformed into three European Authorities: a European Banking Authority, a European Insurance Authority and a European
>
> Securities Authority.
>
> The Authorities should be managed by a board comprised of the chairs of the national supervisory authorities. The chairpersons and director generals of the Authorities should be full-time independent professionals. The appointment of the chairpersons should be confirmed by the Commission, the European Parliament and the Council and should be valid for a period of 8 years.
>
> The Authorities should have their own autonomous budget, commensurate with their responsibilities.
>
> In addition to the competences currently exercised by the level 3 committees, the Authorities should have, inter alia, the following key-competences:
>
> i) legally binding mediation between national supervisors;
>
> ii) adoption of binding supervisory standards;
>
> iii) adoption of binding technical decisions applicable to individual financial institutions;
>
> iv) oversight and coordination of colleges of supervisors;
>
> v) designation, where needed, of group supervisors;
>
> vi) licensing and supervision of specific EU-wide institutions (e.g. Credit Rating Agencies, and post-trading infrastructures);
>
> vii) binding cooperation with the ESRC to ensure adequate macro-prudential supervision.
>
> National supervisory authorities should continue to be fully responsible for the day-today supervision of firms.[31]

It was also recommended that the new system be reviewed no later than three years after its establishment. Such a review, it was suggested, should consider shifting the structure to rely upon only two authorities, granting the authorities with wider regulatory powers of horizontal application and examining the case for wider supervisory duties in the EU.[32]

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[31] Ibid., pp55-56
[32] Ibid., p58

Further detail on the proposed supervisory structures and the stages of its implementation is available in chapter III of the report.

Global implications

However, the Group acknowledged that successfully implementing such a supervisory framework would be difficult, and would likely encounter political problems:

> The goal set out above is an ambitious one. It will require important institutional, legislative and operational changes. It will also require the emergence of the broadest possible political consensus on the necessity to move in this direction and the steps that must be taken to do so. The Group hopes that all Member States will aspire to these changes. If not, a variable geometry approach based on the mechanisms of Enhanced Cooperation or an inter-governmental agreement provided for in the Treaty may be required.[33]

The final chapter of the Report concerned regulation at the global level. The report noted:

> It is clearly in the EU's interest to try to shape the reform of the international financial architecture. The EU should take the lead by improving its own regulatory and supervisory system, which, necessary in its own right, is also required for international convergence.[34]

The examination of global regulation focused on: enhancing the consistency of regulation across borders; ensuring cooperation among supervisors; developing a financial stability early warning system; increasing the resources available to the IMF in its macroeconomic surveillance function; and increasing capital requirements for institutions operating in zones of inferior regulatory standards. Further detail on suggested reforms to the global supervisory structure is available in chapter IV of the report.

1.3 Immediate EU response to the report

Although the report met with a mixed reception, the President of the European Commission, Jose Manuel Barroso, announced on 4 March 2009 that the Commission had "decided to endorse in general the conclusions" of the report.[35] In particular, the Commission supported the creation of a separate body under ECB auspices to tackle and identify systemic risks and the need for a core EU-wide policy.[36] In

[33] Ibid., p48
[34] Ibid., p59
[35] EU Europa website, Opening remarks of President Barroso at the press conference presenting the Commission's contribution to the Spring European Council, 4 March 2009
[36] European Commission, Communication for the Spring European Council, 4 March 2009

addition to the prospect of discussion at the G-20 meeting in London, the Commission also outlined a more definitive timeline for action:

> In April the Commission will bring forward initiatives already in the pipeline on hedge funds, private equity and remuneration structures. Following an impact assessment, the Commission will put forward to the June European Council a detailed timetable for further measures based on the de Larosière report. It will bring forward proposals in the autumn on the new supervisory framework and on issues including: liquidity risk and excessive leverage; further reinforcing protection for depositors and policy holders; and effective sanctions against wrongdoing.[37]

Many of the regulatory reforms proposed in the report had already been initiated by the European Commission. The proposals to alter the supervisory structure also met with approval from the Commission:

> The Commission agrees with the Group's finding that the structure of the existing Committees – whose role has reached the limits of what is legally possible - is not sufficient to ensure financial stability in the EU and its Member States, and that the inefficiencies in the present structure need to be resolved as swiftly as possible. The Commission also considers that there are merits in a system which combines certain centralised responsibilities at European level with maintaining a clear role for national supervisors who are closest to the day-to-day operation of companies.
>
> The Commission considers that action is urgently needed and will propose to accelerate the implementation of the Group's findings. By combining the two phases proposed by the Group, it should be possible to move more quickly to both improve the quality and coherence of supervision in Europe, and to transform the three existing Committees into authorities within a European financial supervision system. The feasibility of whether to combine one or more of these authorities should be examined with a view to ensuring maximum supervisory coherence and enhancing consistency and interaction between banking, insurance and markets supervisory experts.
>
> The authorities could be charged with oversight and ultimate decision-making powers regarding colleges of supervisors for cross-border groups; ensuring consistency and good practice through setting common high standards and providing common interpretations of requirements for supervisory activities; and a key role in early warning mechanisms and crisis management, working with the body set up to look at the overall picture.
>
> Building on the recommendations of the de Larosière Group, the Commission will now move forward in developing proposals to establish a new European financial supervision system. Drawing on views expressed by Member States, the existing Committees, the European Parliament, the ECB and other stakeholders, the

[37] European Commission, Commission calls on EU leaders to stay united against the crisis, move fast on financial market reform and show global leadership at G20, 4 March 2009

Commission will prepare its proposals on the basis of an impact assessment, in line with its better regulation principles.[38]

[38] European Commission, Driving European Recovery, COM(2009) 114, 4 March 2009, 6

2. Changes proposed to EU financial regulation

2.1 Bank capital: Capital Requirements Directive: the June 2008 proposals (CRDII)

Regulatory changes to capital requirements are to be effected through changes to the existing Capital Requirements Directive.[39] Consultation on changes was announced in June 2008, and the European Commission's proposal was submitted on 1 October 2008. On 6 May 2009, the European Parliament approved the changes to the Directive and it was adopted in July 2009.

The changes passed by the European Parliament overwhelmingly accorded with the European Commission's initial proposal, and contained the following specific provisions:[40]

> **Improving supervision of cross-border banking groups.** Creation of colleges of supervisors, which would be coordinated by the Committee of European Banking Supervisors, to facilitate cooperation between national regulators dealing with cross border institutions. MEPs inserted a clause demanding that full EU level supervisory integration be fully implemented by the end of 2011, with a further legislative proposal designed to achieve further integration put forward by the end of 2009; this fits with the belief that the college structure is likely to be only a transitional measure.[41]
>
> **Improving liquidity risk management.** For banking groups that operate in multiple EU countries, their liquidity risk management – i.e. how they fund their operations on a day-to-day basis – will also be discussed and coordinated within colleges of supervisors. These provisions reflect the on-going work at the Basel Committee on Banking Supervision and the Committee of European Banking Supervisors.
>
> **Improving the management of large exposures.** Prohibit banks from lending more than 25% of their funds to a client or group of clients; this may only be exceeded where credit institutions lend to each other, and in this case lending must not exceed €150m. MEPs inserted a clause specifying that a review of large exposure regulation take place at the end of 2011.
>
> **Improving the quality of banks' capital.** There will be clear EU-wide criteria for assessing whether 'hybrid' capital, i.e. including both equity and debt, is eligible to be counted as part of a bank's

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[39] *Official Journal of the European Union*, 2006/48/EC, L177/1, 30 June 2006 and *Official Journal of the European Union*, 2006/49/EC, L177/201, 30 June 2009

[40] European Commission, Commission proposes revision of bank capital requirements rules to reinforce financial stability, IP/08/1433, 1 October 2008; European Parliament, New rules to avoid future financial crisis – Capital Requirements Directive, 6 May 2009; EU COM(2008) 602; Euractiv, Parliament backs tighter capital rules for banks, 7 May 2009

[41] *Europolitics*, Parliament discusses capital requirements revisions, 12 February 2009

> overall capital – the amount of which determines how much the bank can lend.
>
> **Improving risk management for securitised products.** Firms (known as 'originators') that re-package loans into tradable securities will be required to retain at least 5% of the total value of such securities. The European Parliament passed a review clause requiring the Commission to consider raising the 5% requirement by the end of 2009. Firms that invest in the securities will be allowed to make their decisions only after conducting comprehensive due diligence. If they fail to do so, they will be subject to heavy capital penalties. Ultimately, MEPs decided against drawing a distinction between 'good' and 'bad' securitisation processes.
>
> **Improving the regulation of over-the-counter products.** MEPs called upon the Commission to submit legislative proposals to increase the transparency of over-the counter products – most notably credit default swaps – and setup an EU central clearing house for such products.

Charlie McCreevy, Internal Market and Services Commissioner, supported most of the changes passed by the Parliament, although suggested that more should be done in the area of securitisation:

> Moving on to the review of the CRD, I am pleased to express the Commission's general support for the Parliament's amendments... General support, but not full support since the Commission still harbours some concerns on securitisation.
>
> …
>
> On the now famous '5% retention' for securitisation, I'm pleased to see that the Parliament has resisted the call from industry to do away with what they had only last year characterised as complete non sense. I am delighted to say that the retention rule has emerged as something that is not non sense but plain 'common sense'. It is now recognised by G20 as a key measure to strengthen the financial system.
>
> …
>
> I am also pleased to see that the Parliament has resisted the calls from industry for less stringent rules on inter-bank risks. Let's just remind ourselves that banks are not risk-free. This is a crucial lesson of the financial crisis. Adequate diversification and collateral are critical to ensuring financial stability.
>
> On own funds, I understand the reluctance of some members of the Parliament to consider the 'downgrading' of certain national instruments that do not meet the eligibility criteria for core Tier 1. Let me be more precise. I understand this reluctance but only for the current economic context. Once recovery is on track, the Commission is strongly committed to further enhancing the quality of own funds as agreed at the G20 summit.
>
> As regards securitisation, , the Commission still considers that in some aspects there would have been merit in further clarifying and specifying the way the 5% retention will be calculated. I understand that the EP has worked under time pressure, and I am

> pleased that the Commission has been given a second chance to tighten up the text in a report due by the end of 2009.[42]

2.2 The July 2009 proposals: CRD III

Having made these first round changes, the Commission then embarked on a series of consultations about further changes to be made to the new Directive. These were included in a Commission proposal published in July 2009 which was summarised in a Commission press release:[43] they included:

- a further revision of EU rules on capital requirements for banks that is designed to tighten up the way in which banks assess the risks connected with their trading book;
- higher capital requirements for re-securitisations. ; Under the new rules, banks will be restricted in their investments in highly complex re-securitisations if they cannot demonstrate that they have fully understood the risks involved
- increase market confidence through stronger disclosure requirements for securitisation exposures; and require banks to have sound remuneration practices that do not encourage or reward excessive risk-taking

The consultation period for these proposals ends in April 2010. The Commission noted in the proposal document:

> However, as indicated above, these possible changes would follow other changes to the CRD contained in Commission proposal adopted on 13th July. That draft directive proposes changes to the capital requirements for the trading book and for resecuritisations which are likely to increase significantly the levels of capital that banks are required to hold under those provisions. The possible provisions discussed in this document concerning non-risk based supplementary measures, capital requirements for residential and commercial real estate (including specific provisions for mortgages denominated in a foreign currency) and through-the-cycle expected loss provisioning would also represent a quantitative increase in regulatory capital, or would require institutions to commit resources to expected loss provisioning.[44]

The proposed new measures include what might be called for short the 'Spanish provision'. Spain has a system of bank capital requirements that has elements of contra-cyclicality within it, thus, unlike in other countries, when asset prices rise Spanish banks had to retain more capital. In other countries, higher asset values reduced the need for retained (real) capital. The Commission's proposals on this and remaining issues are summarised below.

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[42] Charlie McCreevy, Programme to support specific activities in the field of financial services, financial reporting and auditing and Capital Requirements Directive, EP Plenary Session – Joint Debate on Finances, Strasbourg, speech 09/215, 6 May 2009

[43] EC 13 July 2009

[44] European Commission, *Possible further changes to capital requirements directive*, July 2009

A counter cyclical measure for capturing expected losses

In order to stabilize bank capital and earnings over time, credit institutions should, in line with the ECOFIN conclusions on pro-cyclicality, build up through-the-cycle expected loss provisions for credit risks during good times (when relatively more loans are granted) and use these provisions during a downturn to cover (some) of the incurred losses. Through the-cycle expected loss provisioning is essentially a countercyclical measure for timely capturing *expected* losses due to inherent credit risks that have not yet materialised as incurred' losses. The through the cycle provisioning should be applied to items on the balance sheet (such as loans) and possibly to off-balance sheet items (such as guarantees). It is different from countercyclical regulatory capital approaches that basically provide a capital buffer for *unexpected* losses.

The Commission services believe that a robust and effective sound through-the-cycle expected loss provisioning methodology should meet the following standards:

- it should be formula driven and largely non-discretionary;
- it should be based on agreed rules and automatic triggers for the building up and use of the through-the-cycle expected loss provision;
- it should allow through-the-cycle expected loss provisions to have a material size in relation to the exposure classes (i.e. no specific cap);
- it should not allow the through-the-cycle expected loss provision to count as regulatory capital / own funds; it should have countercyclical factors based on a common EU methodology.

Since through-the-cycle expected loss provisioning refers to *expected* credit losses the Commission services conclude that these should not count towards regulatory capital which conceptually is a buffer for *unexpected* losses. Moreover the working assumption is that such a prudential measure would in parallel become acceptable under international accounting standards, and would be built up "above the line" and would therefore have an impact on accounting profit. The Commission services stress their intention not to prejudge any decisions of the international accounting standard setter.[45]

Residential mortgages denominated in a foreign currency

The Commission propose that where a domestic mortgage is denominated in a foreign currency and its loan to value ratio exceeds

[45] Ibid

50% "should lead to a full one to one backing by capital requirements as the loan to value ratio reaches 100% and beyond."[46]

Removal of national options and discretions

The Commission explain:

> Unless otherwise provided, the CRD is a 'minimum harmonisation' Directive. This is explicitly acknowledged in recital 15 of Directive 2006/48/EC. 'Regulatory additions' or 'super-equivalent provisions' adopted at national level fall into three categories:
>
> Additions in areas which are not explicitly covered by EU legislation (e.g. the Spanish dynamic provisioning), or not fully harmonised (e.g. supervision of liquidity in accordance with Article 41 of Directive 2006/48/EC);
>
> Discretionary treatment that is expressly permitted by the CRD in areas which are not fully harmonised (e.g. under Article 61 of Directive 2006/48/EC on the composition of own funds);
>
> Additions in areas which are fully harmonised.

The Commission's intention is to eliminate only this third category of regulatory 'additions', which are commonly labelled 'gold plating'. In that respect, the scope of the 'maximum harmonisation' that is to be achieved by this exercise needs to be clearly circumscribed. The Commission services suggest limiting it to Pillar 1 (minimum capital requirements, large exposures rules) and Pillar 3 (disclosure). Other areas of the Directive do not lend themselves to maximum harmonisation, either i) because they are not yet fully harmonised (e.g. own funds) or ii) because the decisions are based on specific risk assessments (e.g. Pillar 2).

2.3 The February 2010 proposals: CRD IV

In February 2010, the Commission launched a further consultation on key detailed revisions to the CRD. These included some of the issues discussed in previous consultations. It is the key document for detailed analysis of major decisions being taken by the Commission.

The seven areas of potential action are as follows:

Liquidity standards: Introducing liquidity standards that include a liquidity coverage ratio requirement underpinned by a longer-term structural liquidity ratio.

Definition of capital: Raising the quality, consistency and transparency of the capital base.

Leverage ratio: Introducing a leverage ratio as a supplementary measure to the Basel II risk-based framework based on appropriate review and calibration.

[46] Ibid section 2.2

Counterparty credit risk: Strengthening the capital requirements for counterparty credit risk exposures arising from derivatives, repos and securities financing activities.

Countercyclical measures: A countercyclical capital framework will contribute to a more stable banking system, which will help dampen, instead of amplify, economic and financial shocks.

Systemically important financial institutions: The Commission is consulting on appropriate measures to deal with the risk posed by such institutions.

Single rule book in banking: The Commission is consulting on areas where more stringent requirements might be necessary. In addition, the Commission is consulting on the appropriate prudential treatment of real estate lending. This is part of the Commission's commitment to create a single rule book in Europe.

The Commission describe these changes in the opening to the consultation as being:

> The possible changes set out in this document are closely aligned with the expected amendments to the Basel II framework and the introduction of a global liquidity standard that are currently being drawn up and their impact assessed by the Basel Committee on Banking Supervision (BCBS). They also reflect commitments made by G-20 leaders in London on April 2, 2009 and in Pittsburgh on September 24-25, 2009 as regards building high quality capital, strengthening risk coverage, mitigating procyclicality, discouraging leverage as well as strengthening liquidity risk requirements and forward-looking provisioning for credit losses.[47]

The proposals are described below.

Liquidity standards

It is commonly accepted that liquidity requirements, as opposed to capital requirements, had been under-represented in the control system of banks prior to the crisis. The assumption had been that the sophistication of capital markets would always make credit available to fundamentally good banks whenever they needed it. This assumption was shown to be unjustified when inter-bank lending stopped at the height of the credit crunch.

The Commission propose two things, a short term, liquidity coverage requirement and a longer term, net stable funding requirement.

Liquidity coverage requirement (LCR)

The LCR is a requirement that an institution could match its liquidity needs against a similar value of high quality assets if it came under undue stress. The document defines what it means by stress:

[47] EU Commission consultation doc: *Possible further changes to the CRD*,

> The specified 30 day stress scenario entails both institution-specific and systemic shocks built upon actual circumstances experienced in the global financial crisis which began in mid-2007:
>
> a) a three-notch downgrade in the institution's public credit rating;
>
> b) run-off of a proportion of retail deposits;
>
> c) a loss of unsecured wholesale funding capacity and reductions of potential sources of secured funding on a term basis;
>
> d) loss of secured, short-term financing transactions for all but high quality liquid assets;
>
> e) increases in market volatilities that have an impact on the quality of collateral or potential future exposure of derivatives positions and thus require larger collateral haircuts or additional collateral;
>
> f) unscheduled draws on all of the institution's committed but unused credit and
>
> g) liquidity facilities; and
>
> h) the need for the institution to fund balance sheet growth arising from non-contractual obligations honoured in the interest of mitigating reputational risk.[48]

Annex 1 of the document sets out the possible specification of the LCR. In particular, it sets out suggested weightings to be given to assets in determining their sufficiency. So if the LCR is £10 billion, it can be composed of £10 billion cash (which has a 100% weighting) or £12.5 billion of AA rated bonds (which have an 80% weighting).[49]

One notable feature of the proposals has been the disqualification of intra group support. Under the suggested rules, promises of support from one part of the entity to another would, not count towards the LCR. A justification for this is that in periods of stress there might be reluctance on the part of one branch of a group to support another. Similar restrictions are proposed for the funding requirement rule.

Net stable funding requirement

The document explains what the NFR is:

> The Net Stable Funding Requirement (NSFR) aims at ensuring a sound funding structure of an institution over one year in an extended firm-specific stress scenario where an institution encounters, and investors and customers become aware of: • A significant decline in profitability or solvency arising from heighted credit risk, market risk or operational risk or other risk exposures;

[48] Ibid p4

[49] Ibid p70

- A potential downgrade in a debt, counterparty credit or deposit rating by any nationally recognised credit rating organisation; or;
- A material event which calls into question the reputation or credit quality of the institution.[50]

Annex 2 of the document sets out the possible specification of the NFR with a similar weighting system. From 'Own funds eligible instruments and other liabilities > 1year residual term' a 100% weighting to 'Wholesale funding provided by non-financial corporate customers (non-maturity or residual maturity < 1year)' a 50% weighting.

Definition of capital

The document starts by summarising changes made already and the need for further change:

In 1998, the Basel Committee reached agreement on the treatment of hybrid capital instruments. The agreement became known as the "Sydney Press Release." The lack of rules at the EU-level in respect of hybrid capital resulted in wide variation in the prudential treatment of hybrid capital instruments at national level. The amendments under CRD II harmonise the requirements for hybrid capital in the EU and transposed the Sydney Press Release into EU legislation. The requirements of CRD II will apply from 31 December 2010. They will:

> raise the quality of Core Tier 1 capital;
>
> provide a common interpretation of the main eligibility criteria for hybrid capital: permanence, loss absorption and flexibility of payments;
>
> establish harmonised quantitative limits for the extent to which hybrid capital instruments may be recognised as eligible regulatory capital; and
>
> introduce grandfathering provisions to minimise disruption in the financial markets resulting from the revised definition of capital.
>
> 36. Article 63a of the amended CRD requires the Committee of European Banking Supervisors (CEBS) to provide guidelines on the convergence of supervisory practices in respect of the CRD II requirements for Core Tier 1 and Hybrid Tier 1 capital instruments, and to monitor the application of these requirements. In response to Article 63a of the CRD, CEBS has published:
>
> guidance on supervisory practices in respect of hybrid capital instruments on 10 December 2009; and
>
> a consultation paper on implementation guidelines for Core Tier 1 capital instruments under Article 57a.
>
> CEBS' implementation guidance in these areas will also apply from 31 December 2010. In making further revisions to the CRD's own funds requirements, the Commission services will consider the

[50] Ibid p6

> guidelines issued by the CEBS and the potential need for further additional guidance in this area from the CEBS.
>
> There will also be significant changes to the solvency requirements of insurance and reinsurance undertakings under Solvency II (Directive 2009/138/EC), which was published in the Official Journal on 17 December 2009 and which enters into force on 31 December 2012. In the area of own funds, the Solvency II Framework Directive sets out the high-level principles of the characteristics that own fund items for insurers must display, including going concern loss absorbency and loss absorbency in a winding-up.
>
> The Commission services are in the process of developing level 2 implementing measures that will elaborate on these principles. In order to ensure the appropriate level of consistency, we will ensure co-ordination of the changes made to the definitions of capital for institutions under CRD IV and under Solvency II to ensure the appropriate degree of cross-sector consistency.[51]

The Commission propose that the future capital structure should comprise:

> Tier 1 – going concern capital comprising Core Tier 1 – common equity; and Non-Core
>
> Tier 1 – hybrid capital; and
>
> Tier 2 – gone concern capital.
>
> This would eliminate the current distinction for the purposes of capital limits between: upper Tier 2 (certain undated subordinated debt instruments); and lower Tier 2 – e.g. dated subordinated debt instruments. It would also eliminate existing Tier 3 capital from the capital structure.
>
> As with the liquidity calculations, certain weightings and filters would be applied to the capital held by institutions. These can be found in Annex V of the document.[52]

Significant deductions from nominal capital include:

- Minority interests are excluded
- Goodwill is excluded
- Shares held as treasury stock (shares the company owns in itself – often for pension or bonus awards) are excluded
- Shares held as part of reciprocal shareholding agreements with other financial organisations shall be deducted

Annex VI includes the new proposed definition of tier 1 capital.

In addition to new rules about the individual components of capital, the Commission proposes changes to the rules about the predominance (or ratio) of Core tier 1 and tier 1 capital to assets. It also discussed the implementation of all the capital rules:

[51] Ibid p15
[52] Ibid p78

> Minimum capital requirements and predominance
>
> In revising the definition of capital, the Commission intends to introduce explicit, higher minimum requirements for the minimum levels of the ratios of Core Tier 1, Tier 1 and total capital (net of deductions) to risk weighted assets. This approach is required in order to align minimum capital requirements more closely with an institution's ability to absorb losses. It also reflects the focus of the market on going concern capital in assessing an institution's financial and solvency position. The Commission services will reflect on whether the proportion of Tier 1 capital that must comprise Core Tier 1 capital – i.e. the required level of predominance of Core Tier 1 - should be raised above the current level of 50%. The Commission services will also consider the potential for the minimum ratios for Core Tier 1 and Tier 1 to be used to deliver the requisite level of predominance.
>
> 74. CEBS' quantitative impact assessment will be used to determine the appropriate calibration of these regulatory minima, and the nature and extent of any changes required to the level of predominance.
>
> Implementation timing, grandfathering and transitional provisions
>
> 75. The G20 leaders have stated that the new capital rules will be phased in as financial conditions improve and economic recovery is assured, with the aim of implementation by end-2012. The Commission services agree strongly with such an approach to phasing in and with the aim that the further changes to the definition of capital be implemented by end-2012.[53]

Leverage ratio

Along with the controls on liquidity, the leverage ratio is the other main new control to be suggested for banks. The Commission explain:

> The ratio that is being considered is a non-risk based, gross leverage ratio that is based on going concern regulatory capital, incorporates an institution's on and off balance sheet assets and applies at the same level as minimum capital requirements, i.e. at the solo, consolidated and sub-consolidated levels. Annex VIII summarises the elements of the ratio the Commission services propose.
>
> **Implementation**
>
> 81. The G20 leaders intend that a leverage ratio be introduced by end-2012. The Commission services are mindful of the need to ensure that the ratio is phased-in in such a way as not to impede financial and economic recovery. The appropriate approach to phasing in of the ratio will depend on its final design and calibration, and the extent of financial and economic recovery.[54]

This ratio requires two calculations; that of capital and of assets. How these terms are defined will have a crucial bearing upon how the ratio 'bites' on banks' ability to expand and do business. The Commission

[53] Ibid p23

[54] Ibid p25

propose that capital will mean tier 1 capital and assets will be valued at their accounting value – which should include all necessary provisioning for bad debts and the like. The Commission appears undecided at this point on the treatment of securitised (i.e. off balance sheet) lending, whether to include them or not. They are similarly undecided over how to value derivative contracts. Credit derivatives would be included however. Derivatives are also dealt with in the next section on counterparty risks.

Counterparty credit risk (CCR)

The Commission, whilst acknowledging the benefits of the derivatives market and seeking to promote them, intend to introduce further controls:

> The Commission services are considering a legislative proposal amending the treatment of counterparty credit risk (CCR) in the Capital Requirements Directive. The purpose of such proposal would be to strengthen the capital requirements for counterparty credit exposures arising from institutions' derivatives, repo and securities financing activities. The objective of these amendments – that would seek consistency with the changes to the Basel II framework in this area as proposed in the Basel Committee's consultative document of 17 December 2009 - would be to raise the capital buffers backing these exposures, reduce procyclicality and provide additional incentives to move OTC derivative contracts to central counterparties, thus helping reduce systemic risk across the financial system. They would also provide incentives to strengthen the risk management of counterparty credit exposures.[55]

The Commission found that the existing CCR risk framework failed to pick up many of the losses which institutions made in their CCR trading. For example, CCR contracts – derivatives are designed to insure against markets moving against the issuer, thus when the market becomes more volatile, the issuer is insulated from its movements and become relatively more creditworthy. The Commission noted however, that the reverse happened during the crisis – the 'wrong way' risk – and this was not reflected in the derivatives controls. Nor did the former rules capture the 'mark to market' credit valuation losses on these products which accounted for two thirds of all the CCR losses. The crisis also revealed 'serious shortcomings' in institutions' risk management of counterparty credit exposures, including in particular the areas of back-testing, stress testing, addressing wrong way risk and collateral management. Amongst the Commission's proposals are, incorporating stress testing models in the valuation of CCR risks and imposing simple capital surcharges for holding such contracts.

The Commission also comments on one suggestion for reducing credit risks which was that contracts should be traded through exchanges

[55] Ibid p30

rather than over-the-counter (OTC). The advantage of this would be that the exchange would bear some of the risk and the trades could be better managed and observed whereas the OTC trade is less transparent to regulators and hence hard to quantify in risk terms. The Commission makes several proposals therefore for improved controls of clearing houses and exchanges dealing in these trades.[56]

Countercyclical measures

Countercyclical capital retention – putting away money for the rainy day whilst the sun shines, is seen now as a 'good thing'. As mentioned above the Commission had already looked at what can be called the 'Spanish system' of capital provisioning in earlier policy statements. They are revisited in this document. The Commission outlined its general proposals and commented on consultation responses:

> Commission contribution to improving loan loss provisioning
>
> The Commission services consulted stakeholders in July on a proposal for through-the-cycle provisioning – largely inspired by the Spanish model which has proven effective. In the absence of any such measure in accounting standards at the time, and in line with the ECOFIN conclusions, the envisaged proposal suggested that regulatory dynamic "provisioning" should be above the line, thus dampening the volatility of bank profits.
>
> The majority of responses to the consultation called for a cautious approach in introducing EU measures on dynamic provisioning affecting financial reporting, suggesting that it would be better to wait for the outcome of the pending changes to IAS 39 on loan loss provisioning. Several respondents pointed at the difficulty of combining investor-oriented financial reporting with supervisory concerns for financial stability in accounting standards. They argued that supervisory prudence would undermine the "true and fair view" of the financial position and economic performance and therefore prefer a separate regulatory approach mainly via capital requirements. There was broad support for allowing the use of internal models for dynamic provisioning on the grounds that internal models would better capture the specific risk profile, make sense for banks with IRB portfolios, and could alleviate problems with the availability of historic credit loss data. See Annex X for a more detailed summary of comments to the consultation.[57]

The Commission acknowledges that the interaction between banking and accounting rules has made it difficult to achieve acceptable guidelines, and that further work by both the EU and by the Basel Committee is needed. Firmer proposals are expected in April 2010.

Systemically important institutions

The Commission is also looking at the 'too big to fail' question. Apart from rejecting any blanket 'size' restriction on institutions, as being

[56] Ibid p40
[57] Ibid p45

against EU competition policy, it has not put forward any proposals as yet.

Single Rule Book

Again, the Commission reported back on the basis of previous consultations on this. It claims support for a move towards greater harmonisation of rule books and an end to national; options and exceptions. It does acknowledge however, that markets vary in different countries and therefore some national characteristics could be retained. For example, the housing market is more highly developed in some member states than others and different rules might apply there. With respect to housing, it says that it is looking at arithmetic controls such as maximum ratios for lending against both the income of the borrower and the value of the property.

3. Regulatory issues outside of the CRD

3.1 Credit rating agencies

New regulations proposed by the European Commission were agreed by the Parliament (569-47) on 23 April 2009[58] and by the Council of Ministers on 5 May 2009, although the first proposals for new regulation surfaced as early as 2004. The new rules, which will come into force for all rating agencies operating in the EU in 2010, include:

- Credit rating agencies may not provide advisory services.
- They will not be allowed to rate financial instruments if they do not have sufficient quality information to base their ratings on.
- They must disclose the models, methodologies and key assumptions on which they base their ratings.
- They must differentiate the ratings of more complex products by adding a specific symbol.
- They will be obliged to publish an annual transparency report.
- They will have to create an internal function to review the quality of their ratings.
- They should have at least two independent directors on their boards whose remuneration cannot depend on the business performance of the rating agency. They will be appointed for a single term of office which can be no longer than five years. They can only be dismissed in case of professional misconduct. At least one of them should be an expert in securitisation and structured finance.[59]

The new rules will also require that all credit rating agencies become registered, with EU financial institutions only permitted to trade in instruments rated by registered agencies. The final document containing the new rules for credit rating agencies is available online.[60] Commenting, Charlie McCreevy said:

The Commission has long insisted that profound changes were necessary to the framework in which the credit rating industry operates. With this Regulation, the EU is setting an example to be followed and matched. Today we are satisfied that as a result of intense cooperation between the European Parliament, the Council and the Commission this state-of-the-art regulatory regime has been adopted swiftly. We expect the conduct of the credit rating

[58] European Parliament, *Texts adopted: Credit Rating Agencies*, 23 April 2009

[59] EU Europa website, *Approval of new Regulation will raise standards for the issuance of credit ratings used in the Community*, IP/09/629, 23 April 2009

[60] European Commission, EU COM(2008) 704, 12 November 2008

agencies to be significantly improved as a result of this Regulation, with clear benefits to the integrity and stability of the financial markets.[61]

However, a *Financial Times* article highlighted some residual concerns regarding the effectiveness of the regulations:

> But S&P also stressed that there needed to be "consistent application" of the rules by the different regulators in the EU, and said it looked forward to discussing their practical application with the securities watchdogs.
>
> Some investors continued to question whether it was sensible to have a separate European oversight regime – although Commission officials claim that, by taking the lead, they are setting an example others can follow.
>
> Peter Montagnon, director of investment affairs at the Association of British Insurers, said: "We still think this is better dealt with at a global level, rather than a regional one."
>
> Jeremy Jennings-Mares, capital market partner at law firm Morrison & Foerster, said:
>
> "There's a danger that if regulation isn't globally co-ordinated, regulatory arbitrage opportunities will be created."[62]
>
> The reforms are not sufficiently far reaching for some commentators. Joseph Stiglitz, for example, has suggested that a publicly-sponsored rating agency is the only way to resolve the conflicts of interests that emerge from both the existing 'issuer pays' and the alternative 'investor pays' models.[63]

3.2 Alternative investment funds

On 29 April 2009 the European Commission proposed a new directive on Alternative Investment Fund Management (AIFM), which mainly targets the regulation of hedge funds and private equity funds. The regulations will also regulate real estate funds. The General approach of the directive is outlined below:[64]

Establish a secure and harmonised EU framework for monitoring and supervising the risks that AIFM pose to their investors, counterparties, other financial market participants and to financial stability; and

Permit, subject to compliance with strict requirements, AIFM to provide services and market their funds across the internal market.

Managers of all non-UCITS[65] funds require authorisation under the Directive

While the focus is currently on hedge funds and private equity, the European Commission believes that it would be ineffective and short-

[61] EU Europa website, *Approval of new Regulation will raise standards for the issuance of credit ratings used in the Community*, IP/09/629, 23 April 2009

[62] *Financial Times*, EU votes for rating agency rules, 23 April 2009

[63] Joseph Stiglitz, Hearing on The Future of Financial Services Regulation, House Committee on Financial Services, 21 October 2008

[64] Alternative Investment Fund Managers directive; Com 2009/207

[65] UCITS: fund regulation for things such as unit trusts widely sold to retail investors

sighted to limit any legislative initiative to these two categories of AIFM: ineffective because any arbitrary definition of these funds might not adequately capture all the relevant actors and could be easily circumvented; and short-sighted because many of the underlying risks are also present in other types of AIFM activity. The regulatory solution which is likely to prove the most enduring and productive is therefore to capture all AIFM whose activities give rise to those risks. Accordingly, the management and administration of any non-UCITS in the European Union must be authorised and supervised in accordance with the requirements of the Directive.

This broad coverage does not imply a 'one size fits all' approach

A common set of basic provisions will govern the conditions for the initial authorisation and organisation of all AIFM. These core provisions will be tailored to the different asset classes so that irrelevant or inappropriate requirements are not imposed on investment policies for which they make no sense. In addition to these common provisions, the proposal foresees a number of specific, tailored provisions which will only apply to AIFM that employ certain techniques or strategies when managing their AIF (for instance, systematic use of a high degree of leverage, acquisition of control of companies) and will ensure an appropriate degree of transparency with respect to these techniques.

The focus is on the decision making and risk-taking entities in the value chain

The risks to market stability, efficiency and investors stem primarily from the conduct and organisation of the AIFM and certain other key actors in the fund governance and value-chain (depositary bank where relevant and valuation entity). The most effective way to tackle the risks is therefore to focus on these entities which are decisive in terms of the risks associated with the management of AIF.

AIFM will be entitled to market AIF to professional investors

Authorisation as an AIFM will entitle the manager to market the AIF to professional investors only (as defined by MiFID). Many AIF entail a relatively high level of risk (of loss of much or all of the capital invested) and/or have other features which render them unsuitable for retail investors. In particular, they may lock investors in to their investment for longer than is acceptable for retail funds. Investment strategies are typically complex and often involve investment in illiquid and harder-to-value investments. The marketing of these AIF will therefore be limited to those investors that are equipped to understand and to bear the risks associated with this type of investment.

The limitation to professional investors is consistent with the current situation in many Member States. However, some of the categories of AIF covered by the proposed Directive – such as funds of hedge funds

and open-ended real estate funds - are accessible to retail investors in some Member States, subject to strict regulatory controls. Member States may allow for marketing to retail investors within their territory and may apply additional regulatory safeguards for this purpose.

… including the right to market funds cross-border:

Compliance with the requirements of the proposed Directive would be sufficient to permit AIFM to market AIF to professional investors on markets in other Member States. Cross-border marketing would be subject only to the filing of appropriate information with the host competent authority.

AIFM will be permitted to manage and market AIF domiciled in third countries

Currently, many EU domiciled managers manage funds which are domiciled in third countries and market them in Europe. The Directive introduces new conditions to address any additional risks to European markets and investors that could arise from such operations. It also ensures that national tax authorities may obtain all information from the tax authorities of the third country which are necessary to tax domestic professional investors investing in offshore funds. The activities of management and administration of AIF are reserved to EU domiciled and authorised AIFM, with the possibility for AIFM to delegate administration (but not management) functions to offshore entities subject to appropriate conditions. In particular, depositaries appointed to take custody of money and assets must be EU established credit institutions which can only sub-delegate functions subject to strict conditions. Valuators appointed in third country jurisdictions must be subject to equivalent regulatory standards.

Subject to these strict conditions, the proposals envisage that EU AIFM could market AIF domiciled in third countries to professional investors throughout Europe after an additional period of three years. In the meantime Member States may allow or continue to allow AIFM to market AIF domiciled in third countries to professional investors on their territory subject to national law.

This directive has been very controversial and is attacked strongly by most of the industry. Responses from the British Bankers Association are shown below:[66]

> **Is the directive likely to capture all the activities of hfs?**
> What is a hf? No universal definition of one. Collectively, they share some characteristics but vary widely across the spectrum.
>
> **Given the international dimension of hf activity, will a purely European response be effective?** An isolated European solution would not lead to an optimal outcome. The commission should work with other regulatory authorities and IOSCO to create a consistent regulatory framework.

[66] British Bankers Association

Did hfs pose a systemic threat in the crisis? Yes, but because of high trading volumes in specific sectors contributing to 'herd effects', rather than weak capital adequacy.

Is the 'indirect regulation' of hf leverage through prudential requirements on prime brokers (banks) sufficient? We do not support the tightening of indirect regulation of hfs. Banks cannot assume responsibility for investors choosing to deal with hfs.

Do authorities have enough information about hedge fund exposures? This is the 'responsibility' of MiFID directive.

Has recent decline in hf activity affected the market? The recent reduction of hf trading adversely affected the financial markets; removing liquidity from the market leads to poorer price formation. But, hfs short selling has in some cases accelerated share price falls.

Are short selling controls on hfs justified? Regulation should not be aimed at decreasing short selling activities, but rather at limiting the potential for market abuse. Legal requirements should be imposed on certain investor groups, whilst not on others. This type of discrimination seems questionable, from both a legal and economic perspective. This reiterates the need for the term 'hedge fund' to be clearly defined.

How should the internal processes of hedge funds be improved, particularly with respect to risk management? Hfs should be restricted to wholesale investors who should have adequate controls and expertise themselves.

The Investment Management Association is pleased with the cross border marketing aspects of the directive but had issues with the political nature of the directive; the speed with which it was put together and a lack of genuine consultation. Parts are claimed to be inconsistent with other directives, e.g. UCITS and MiFID. The controls on sales to wholesale investors are stricter than those for retail sales.[67]

The most vocal critic has been the Alternative Investment Management Association which calculated that the directive could cost the industry £22.3 billion a year in increased charges and lost performance.[68]

The European Central Bank produced its report, in which it warned of the dangers of not having a "globally coherent regulatory and supervisory framework…and the consequent risks of regulatory arbitrage".[69]

Responses by hfs themselves have varied. FT reported (12/11/09) that *BlueCrest Capital* hf is relocating 50 (out of 300) staff to Geneva, but (23/11/09) that "more than half of European hedge fund companies plan to launch regulated onshore versions" mainly of UCIT type funds. The combination of a passport to market EU funds anywhere in the EU

[67] The Investment Association
[68] Reported *Financial Times* 2 November 2009
[69] ECB opinion

and the three year ban on similar funds from outside the EU could affect US funds. The Washington counterpart of the IMA said "we're hoping substantive changes will be made".[70] The main concern in the US is to abolish the third party country provision. The FT also reported on recent EP amendments to the directives:

- Hedge fund and private equity fund managers yesterday gave a lukewarm and very conditional welcome to all-important proposed changes to legislation regulating their activities on a Europe-wide basis for the first time. Jean-Paul Gauzes, the French MEP who is steering the proposed rules through the European parliament, set out more than 130 suggested amendments in his first in-depth report on the legislation.
- These will be debated by European lawmakers and melded with changes being negotiated separately among European Union member states next year. Richard Wilson, the new chairman of the European Private Equity and Venture Capital Association, said the report only "takes us some way along the road to improving [the legislation]." This echoes the initial reactions from the hedge fund industry.
- Managers reacted positively to Mr Gauzes's suggestion that they should, in effect, set their own limits on leverage, but have to spell out the rationale and report this to national authorities. Some hedge fund sources suggested that this could be complicated. But there was concern about a further amendment in which Mr Gauzes suggested that the European Commission could have the power to impose limits on how much leverage a fund manager could use in "exceptional circumstances".
- The manager of one large fund in London said: "It is not clear why it is necessary for the European Commission to be able to impose leverage caps. A lot of regulatory powers are still being unnecessarily devolved away from national regulators to Brussels.[71]

Most commentators believe that the directive is very much unfinished business and the final form will be much changed from the original.

3.3 Deposit insurance

On 15 October 2009, the European Commission published its proposal to increase the minimum level of deposit insurance across Europe from €20,000 to €100,000 by the end of 2010. The main changes to the existing Deposit Guarantee Schemes Directive [72] were:

- **Level of coverage for deposits:** Member States are required to increase the coverage level to at least €50,000 and within a further year to at least €100,000. The current Deposit Guarantee Schemes Directive covers savings up to at least €20,000, although individual Member States can

[70] *Financial Times* 2 November 2009
[71] *Financial Times* 26 November 2009
[72] Deposit Guarantee Schemes Directive, 1994/19/EC

choose to increase this level. According to estimates, about 65% of eligible deposits are covered under the current regime. The new levels would cover an estimated 80% (with coverage of €50,000) and 90% (with coverage of €100,000) of deposits.

- **Co-insurance (i.e. where the depositor bears part of the losses) is abandoned:** Member States must ensure that the deposit is reimbursed up to the coverage level. Under the current Directive, Member States have the option to decide that deposit guarantee only covers 90% of savings.
- **Reduction of the payout period:** The time allowed for the deposit guarantee scheme to pay depositors in the event that a bank fails will be reduced to three days. Currently the period is three months, and can even be extended to nine months.[73]

The changes were approved by the European Parliament on 18 December 2008, and by the Council of Ministers on 26 February 2009. The final text became Directive 2009/14/EC, and is available online.[74]

The amended Directive – which was written, although not passed, before the de Larosiére report was published – does not set a maximum level of deposit insurance or harmonise deposit protection schemes across the EU.

The new Directive also specifies that the European Commission submit a report to the Parliament and Council by the end of 2009 that examines further changes to the deposit guarantee system, but also whether the new level of €100,000 is in fact appropriate and financially viable. More specifically, the Directive requests that the report consider: harmonising funding mechanisms for the guarantee scheme; offering full coverage under some circumstances; risk-based contributions; a Community-wide basis; the impact of diverging legislation; harmonising the scope of products and eligible institutions; and links with alternative means of reimbursing depositors. Accordingly a consultation is underway, and is due to be concluded on 27 July 2009.

3.4 Credit default swaps

Although not achieved by legislative process, the European Commission has successfully persuaded the financial industry to move credit default swaps (on European entities and European indices) to a central clearing platform established, regulated and supervised by the EU by 31 July 2009. A letter to Charlie McCreevy explained:

[73] EU Europa website, Commission sets out proposal to increase minimum protection for bank deposits to €100,000, IP/08/1508, 15 October 2009

[74] *Official Journal of the European Union*, Directive 2009/14/EC, L68/3, 13 March 2009

> Following your request on 22 October 2008 to AIMA, CEA, EBF, ISDA, LIBA, SIFMA, WMBA and representatives from Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Morgan Stanley, Nordea and UBS, and in relation to the meeting on 10 December 2008 of the Working Group on Derivatives, the signatories to this letter wish to confirm their engagement to use one or more central counterparties (CCPs) in the European Union once they are established to (i) clear CCP-eligible Credit Default Swaps (CDS) on European reference entities and indices based on these entities, and (ii) back-load outstanding eligible contracts.[75]

As of May 2009, the list of signatories includes: Barclays capital, Citigroup Financial Markets, Credit Suisse, Deutsche Bank, Goldman Sachs, HSBC, JP Morgan Chase, Morgan Stanley, UBS, and Nomura International.[76]

3.5 Executive remuneration

On 29 April 2009, the European Commission announced its adoption of new guidelines for director remuneration. The new guidelines highlight several key principles:

- variable pay should be subject to predetermined limits, and the non-variable component should be sufficiently large for the company to withdraw variable pay where performance criteria are not met;
- performance criteria "should promote the long-term sustainability of the company and include non-financial criteria that are relevant to the company's long term value creation, such as compliance with applicable rules and procedures";
- variable compensation should, in large part, be deferred;
- clawback provisions should exist in the case where "variable components of remuneration that were awarded on the basis of data which subsequently proved to be manifestly misstated";
- termination payments should be restricted and not paid in the case of poor performance;
- share options and awards may not be vested until at least three years after the award; and
- after vesting share awards, directors should retain a certain level of shareholder interest in the company;
- severance pay should be limited to a maximum of two years' fixed remuneration, and may be rescinded in the case of failure.[77]

[75] International Swaps and Derivatives Association, *Letter to Charlie McCreevy*, 17 February 2009

[76] European Commission, List of signatories (updated May 2009), retrieved 4 June 2009

[77] European Commission, Commission Recommendation on remuneration policies; C(2009) 3159, 30 April 2009

The Commission also proposed a number of changes to the way in which remuneration is to be determined:

- extend disclosure requirements in order to improve shareholder oversight of remuneration practices;
- ensure that shareholders, and particularly institutional investors, attend general meetings and make considered votes on remuneration proposals;
- ensure that non-executive directors do not receive share options in order to avoid conflicts of interests;
- strengthen the role and operation of remuneration committees by issuing new principles on (i) the composition of remuneration committees, (ii) the obligation for the members of the remuneration committee to be present at the general meeting where remuneration policy is discussed, (iii) avoiding conflicts of remuneration consultants.[78]

The guidelines are not intended to be binding on Member States. The European Commission has also set out guidelines for risk-taking staff.[79]

3.6 Accounting

The accounting rules governing the EU are determined by the International Accounting Standards Board (IASB). However, for changes in the rules to apply, they must follow the usual process of becoming EU law.

In light of the financial crisis that was unfolding, and following a unanimous recommendation made by the Economic and Financial Affairs Council, the EU adopted a number of switches to the IASB accounting standards on 13 October 2008. These changes principally allow banks to reclassify assets that would be held over a long term by removing them from their trading books, and instead permit them to be booked at amortised cost (thus circumventing fair value accounting standards).[80] The rule changes were passed to apply from the third quarter of 2008.

The new rules were quickly formalised into EU regulatory law[81] on 3 November 2008 with unanimous support from Member States.[82] The changes brought European accounting standards in line with those of

[78] EU Europa website, *Directors' pay: Commission sets out further guidance on structure and determination of directors' remuneration*, IP/09/673, 29 April 2009

[79] European Commission, C(2009) 3159, 30 April 2009

[80] IASB Press Release, IASB amendments permit reclassification of financial instruments, 13 October 2008

[81] *Official Journal of the European Union*, Commission Regulation (EC) No. 1128/2008, L 320/1, 29 November 2008

[82] EU Europa website, *Accounting standards: Commission adopts changes to mitigate consequences of financial turmoil*, IP/08/1513, 15 October 2008

the Financial Accounting Standards Board governing US accounting practice.

The European Commission wrote to the IASB in October 2008 requesting that a number of further alterations be made:

…we consider that three specific issues should be addressed in time for the publication of year-end results, i.e. a saluting ensuring that (a) financial assets presently classified under the Fair Value Option can be reclassified into other categories and not measured at fair value, for the same reasons and under the same conditions as the assets reclassified out of the held-for-trading category; (b) clarification is provided whether synthetic CDOs include embedded derivatives; and (c) adjustments to impairment rules applicable to available-for-sale financial assets are made.[83]

The IASB is currently undertaking round table discussions, consultations and internal research with a view to addressing criticisms of their accounting standards. Particular focus is being given to:

Off-balance sheet vehicles:

- In order to ensure that some entities are not ignored by accounting practices, the IASB is looking to tighten up its definition of control, review how the notion of financial control applies and improve disclosure requirements for entities that rightly remain off-balance sheet – round table discussions on IASB proposals are expected in June 2009;

The IASB is also reviewing and seeking to clarify when entities should stop accounting for assets transferred to other entities - round table discussions on IASB proposals are expected in June 2009;

Fair value:

- To unify diverse and sometimes inconsistent methods of measuring fair value – a draft and subsequent round table discussions are due in the second quarter of 2009;
- Addressing the recognition and measurement of financial instruments, which can be complex and may not always produce the most useful information – a project is currently underway.[84]

The IASB has investigated whether further disclosures are required in the calculation of the fair value of financial instrument – especially in the case where there is only limited market data available. The IASB also investigated in the possibility of providing further information on liquidity risk. In March 2009, the IASB published amendments to its accounting standards in these areas:

Responding to the calls of policymakers, many investor groups and other interested parties, the IASB is bringing the disclosure requirements of International Financial Reporting Standards (IFRSs) more closely into line with US standards. The amendments to IFRS 7 Financial

[83] European Commission, Letter to the IASB, 27 October 2008
[84] IASB, IASB response to the financial crisis, retrieved 9 June 2009

Instruments: Disclosures introduce a three-level hierarchy for fair value measurement disclosures and require entities to provide additional disclosures about the relative reliability of fair value measurements. These disclosures will help to improve comparability between entities about the effects of fair value measurements.

In addition, the amendments clarify and enhance the existing requirements for the disclosure of liquidity risk. This is aimed at ensuring that the information disclosed enables users of an entity's financial statements to evaluate the nature and extent of liquidity risk arising from financial instruments and how the entity manages that risk.

The amendments to IFRS 7 apply for annual periods beginning on or after 1 January 2009. However, an entity will not be required to provide comparative disclosures in the first year of application.[85]

3.7 Oversight and supervision of financial systems

A consultation process on the establishment of a new 'college of supervisors' for financial services lasted from May 2008 to December 2008. Responses to the consultation were published in December 2008.[86] The idea of a new supervisory framework was also discussed at the G-20 meeting in London.

On 27 May 2009, the European Commission announced a consultation on its plan to alter the system of financial supervision in Europe. Building on the de Larosiére report's recommendations, the Communication suggested that two new bodies – the European Systemic Risk Council and the European System of Financial Supervisors – be established to monitor macro and micro-level risks respectively. It is envisaged that rather than rival the IMF and the recently established global Financial Stability Board, the EU bodies would "closely liaise" with them.[87] More specifically, the Commission proposed:

- a **European Systemic Risk Council (ESRC)** which should monitor and assess risks to the stability of the financial system as a whole ("macroprudential supervision"). The ESRC will provide early warning of systemic risks that may be building up and, where necessary, recommendations for action to deal with these risks. The creation of the ESRC would address one of the fundamental weaknesses highlighted by this crisis, which is the exposure of the financial system to interconnected, complex, sectoral and cross-sectoral systemic risks.

[85] IASB, IASB enhances financial instruments disclosures, 5 March 2009

[86] European Commission, *Public Consultation on Amendments to Commission Decisions establishing CESR, CEBS and CEIOPS*, December 2008

[87] European Commission, *Financial Supervision – Frequently Asked Questions*, MEMO/09/251, 27 May 2009

- a **European System of Financial Supervisors (ESFS)** for the supervision of individual financial institutions ("micro-prudential supervision"), consisting of a robust network of national financial supervisors working in tandem with new European Supervisory Authorities, created by the transformation of existing Committees for the banking securities and insurance and occupational pensions sectors. The ESFS is to be built on shared and mutually-reinforcing responsibilities, combining nationally-based supervision of firms with specific tasks at the European level. It aims to foster harmonised rules and coherent supervisory practice and enforcement. This network should be based on the principles of partnership, flexibility and subsidiarity and should aim to enhance trust between national supervisors by ensuring, inter alia, that host supervisors have an appropriate say in setting financial stability and investor protection policies so that cross-border risks can be addressed more effectively.[88]

An accompanying memorandum[89], as well as the full Communication document, provide further details of the specific roles proposed for these bodies. The move from stage one to stage two of the reforms was taken forward on 26 October 2009 by the publication draft directive "*Amending Directives 1998/26/EC, 2002/87/EC, 2003/6/EC, 2003/41/EC, 2003/71/EC,2004/39/EC, 2004/109/EC, 2005/60/EC, 2006/48/EC, 2006/49/EC, and 2009/65/EC in respect of the powers of the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority*".[90]

The opening introductory paragraph confirms the continuation of the de Larosiere 'thread'.

Establishing a *European System of Financial Supervisors (ESFS)*, consisting of a network of national financial supervisors working in tandem with new European Supervisory Authorities (ESAs), created by transforming the existing European supervisory committees into a European Banking Authority (EBA), a European Insurance and Occupational Pensions Authority (EIOPA), and a European Securities and Markets Authority (ESMA), thereby combining the advantages of an overarching European framework for financial supervision with the expertise of local microprudential supervisory bodies that are closest to the institutions operating in their jurisdictions; and

– Establishing a European Systemic Risk Board (ESRB), to monitor and assess potential threats to financial stability that arise from macro-economic developments and from developments within the financial

[88] EU Europa website, *Financial services: Commission proposes stronger financial supervision in Europe*, IP/09/836, 27 May 2009
[89] European Commission, *Financial Supervision – Frequently Asked Questions*, MEMO/09/251, 27 May 2009 [103] European Commission, COM(2009) 252, 27 May 2009
[90] EU Draft Directive 2009/0161

system as a whole. To this end, the ESRB would provide an early warning of system-wide risks that may be building up and, where necessary, issue recommendations for action to deal with these risks.

3.8 Solvency II directive

The Solvency II directive[91105] and contentious issues arising from the proposals were succinctly summarised in a speech by John Tiner in April 2006.[92] Extracts, focussing on the areas where there has been the most controversy, are shown below:

> The design of Solvency 2 is based on a three-pillar structure that is similar to the Basel 2 three-pillar structure already being put in place for banks and financial firms under the EU Capital Requirements Directive. Pillar One refers to the setting of minimum capital requirements. It requires regulated firms to calculate its capital requirement using either a standard formula or an internal model. Pillar Two requires regulated firms to assess and manage the risks to which they are exposed and to assess their own capital needs and maintain that capital. The firm's assessment of its capital needs and of its risks is subject to supervisory review. Pillar Three requires regulated firms to disclose publicly, key information that is relevant to market participants. Its purpose is to enhance market discipline on the regulated firm.
>
> Pillar One
>
> Under Pillar One a regulated firm is required to hold a prudent excess of assets over liabilities. This is called the solvency capital requirement (SCR). Pillar One sets out how the amount of liabilities, including technical provisions, is to be measured; how the SCR is to be calculated; which assets are eligible to be held to match liabilities and cover the SCR; and, how those assets are to be valued. For measuring assets and liabilities the choice is between setting detailed rules or setting out the principle that a market-consistent value is to be used. It will not, I hope, surprise you to hear me say that I strongly argue for the latter. Our aim in Pillar One is to require sufficiently prudent levels of capital to be held by insurance firms so as to leave less than a 1 in 200 chance that capital will prove inadequate over the next 12 months. However, one only knows if one is being prudent by first measuring assets, liabilities and risks as they really are. Economic reality is the measuring stick against which one tests whether one has achieved the desired prudent outcome.
>
> If assets are not marked to market there is a risk that undisclosed, perhaps even unascertained, falls in asset values will be dismissed as temporary, and so ignored, putting policyholder security at risk; or that undisclosed rises in asset value will be ignored, leading to under-distribution of profits or overcharging to policyholders. Similarly, if liabilities are set using arbitrary margins, there is a risk

[91] Also known as the Amended Proposal for a Directive of the European Parliament and of the Council on the taking-up and pursuit of the business of insurance and reinsurance (Solvency II) (recast)/* COM/2008/0119 final/2 - COD 2007/0143 */

[92] ABI website

> that they will be inadequate or excessive for their purpose, either putting policyholder security at risk or imposing excessive cost on policyholders.
>
> The main component of liabilities is technical provisions. The purpose of technical provisions and the purpose of the SCR are related - but are distinct. The SCR absorbs unexpected shocks, stresses and losses. As I said a moment ago, the Pillar One prudence objective for the SCR is to leave less than a 1 in 200 chance that capital will prove inadequate over the next 12 months. The purpose of technical provisions is to protect policyholders even if all of the capital is used up, i.e. even if the 1 in 200 loss has occurred. The technical provision best does this, by including sufficient margin in excess of the best estimate of policyholder liabilities to make it attractive for investors either to recapitalise the firm back to the level of the SCR or, where this is possible, to transfer the liabilities to another insurance company capitalised at least to the amount of the SCR. The margin is therefore the price to be paid for reacquiring capital equal to the amount of the SCR and therefore needs to be set equal to the cost of that capital.
>
> [...]
>
> I shall now move on from discussing technical provisions and their relationship with the SCR to discussing the SCR in its own right. Pillar One allows a regulated firm to calculate its SCR using either the standard formula or an internal model. I believe that both the internal model approach and, even at least to some extent the standard formula, should follow a principles-based design. Solvency 2 already states the objective that an internal model should achieve. It does this in terms of a probability of survival of a defined percentage (1 in 200) over a defined period (one year) where survival is defined as assets at least equal to liabilities with both measured on the basis I have just mentioned. Solvency 2 should not set rules as to the detailed design of an internal model. An internal model should be an *internal* model with the key design decisions being made by the management of the regulated firm and in a way that is consistent with the way in which they risk manage the firm.

The Commission's summary of the directive's aims and content can be found on their website (see below).[93] It should be noted that Solvency II incorporates no less than 13 existing directives so much of the new directive is simply a restatement.[94] It is the solvency capital and the valuation of illiquid assets that have provoked nearly all of the comment and criticism at industry level. The remaining 'pillars' concern, supervision, supervisory reporting and public disclosure.

Having been approved, the directive is now at stage two implementation stage, where the detailed points are debated. Stage 3 will be national implementation which is by October 2012.

[93] Europa website

[94] Europa web site at: http://eurlex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008PC0119R(01):EN:HTML

Whilst the directive itself appears to have been regarded with equanimity by all sides, its implementation in stage 2 appears to have caused all sorts of problems. The Association of British Insurers (ABI) has set up a dedicated web area on its site dealing with the directive.[95] It publishes various bulletins. The latest sets out the worries of the annuity providers who are the sector most worried by it:[96]

To ensure an appropriate and effective application of Solvency II there needs to be a proper recognition of the benefits insurers capture by investing in relatively illiquid assets to provide annuity contracts. These benefits are shared with customers through significant enhancements to their returns, reflecting the special nature of the asset-liability relationship underpinning irredeemable annuity contracts. A one-size-fits-all approach to liability valuation would prevent these benefits being shared with customers. Therefore a more sophisticated approach to liability valuation, recognising the effects of illiquidity will be crucial to the success of the Solvency II project and it is something the ABI is investing considerable time in.

As the European insurance market integrates and develops, firms will increasingly want to offer a range of products to provide guaranteed incomes in retirement or in long term illness. These products rely on the capacity of insurers to hold assets, such as corporate bonds, to deliver a good income to policyholders – based on the coupon and holding to maturity. They do not need to hedge the spread. This is underpinned by a sound economic approach which Solvency II should recognise, whilst of course obliging insurers to hold capital on a robust basis against bond defaults. The details will take some working out. The benefits for European consumers are considerable; without recognising these returns, consumers would be substantially disadvantaged. The ABI is committed to ensuring this is built into the delivery of Solvency II.

Put simply, the point at issue appears to be that the liabilities associated with annuities are overvalued in the framework; so consequently, the insurers will need to provide more capital to cover them. This point appears to be fairly common ground between the industry, the government and the FSA. Lord Myners is quoted in the FT (13 November 2009), as saying that the government had a 'social duty' to support negotiations in Europe given the potential impact on pensions. According to the same article the ABI forecast that insurers would need to raise an extra £50 billion to comply with the directive as it currently stands.

On the calculation of assets and liabilities the Explanatory memorandum to the directive notes:[97]

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[95] ABI website: http://www.abi.org.uk/Solvency_II/More_detail_on_Solvency_II.aspx
[96] ABI Solvency II Bulletin: http://www.abi.org.uk/Solvency_II/44852.pdf
[97] Solvency II directive (recast) com/2008/0119 final/2

Valuation of assets and liabilities – Article 74

Article 74 introduces valuation standards for all assets and liabilities, based upon the current IFRS definition of fair value. Implementing measures will be developed setting out how the fair value of specific balance-sheet items should be calculated, in order to ensure that these items are valued consistently across all Member States. With respect to liabilities, valuation standards do not take account of own credit standing, whilst with respect to assets, these standards take account of current credit and liquidity characteristics.

Technical provisions – Articles 75 to 85

Technical provisions need to be established in order for the undertaking to fulfil its (re)insurance obligations towards policyholders and beneficiaries. Their calculation will be based on the general provisions set out in Article 75:

In particular, the calculation of technical provisions will be based on their current exit value. The current exit value reflects the amount an insurance or reinsurance undertaking would expect to have to pay today if it transferred its contractual rights and obligations immediately to another undertaking. The use of current exit value should not be intended to imply that an (re)insurance undertaking could, would or should actually transfer those obligations.

The calculation of technical provisions must be market-consistent and undertaking-specific information will only be used in the calculation of technical provisions in so far as that information enables (re)insurance undertakings to better capture the characteristics of the underlying insurance portfolio.

Articles 76 to 79 and 81 to 85 describe the calculation of technical provisions. They will be calculated as the sum of a best estimate and a risk margin, except in the case of hedge-able risks arising from (re)insurance obligations (see below):

The best estimate corresponds to the expected present value of future cash flows, taking into account all the cash in and out flows (adjusted for inflation), required to settle the (re)insurance obligations over their lifetime, including all expenses, future discretionary bonuses, embedded financial guarantees and contractual options. The calculation of the best estimate is to be based on sound actuarial techniques and good quality data and regularly checked against actual experience.

The risk margin ensures that the overall value of the technical provisions is equivalent to the amount (re)insurance undertakings would expect to have to pay today if it transferred its contractual rights and obligations immediately to another undertaking; or alternatively, the additional cost, above the best estimate, of providing capital to support the (re)insurance obligations over the lifetime of the portfolio.

As in the case of the AIFM directive, most commentators believe that the regulations are unfinished business and the final form will be much changed from the original.

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