



EUROPEAN CENTRAL BANK

EUROSYSTEM

## REVIEW OF THE LAMFALUSSY FRAMEWORK EUROSYSTEM CONTRIBUTION

### I INTRODUCTION

In December 2002, the ECOFIN Council decided to extend the Lamfalussy approach to financial regulation and supervision from the securities sector to the banking and insurance sectors in order to render the EU regulatory and supervisory framework sufficiently efficient, effective and flexible in line with the needs of the rapidly changing and increasingly integrated EU financial market. Given the significance and the innovative character of this institutional change, the effective implementation and smooth functioning of the Lamfalussy approach across financial sectors has been a key priority for EU financial services policy and the progress made has been monitored closely.

The end of 2007 marks a key juncture for a first full review of the Lamfalussy framework across financial sectors, given the EU requirement<sup>1</sup> to assess the framework's functioning by this time. The ECOFIN Council will adopt its formal conclusions on the functioning of the Lamfalussy framework across financial sectors at its meeting on 4 December 2007. In formulating its assessment, the Council will take into account earlier evaluations of the Lamfalussy framework<sup>2</sup> and views expressed by various EU institutions and fora.<sup>3</sup> This note provides the Eurosystem's contribution to the review of the Lamfalussy framework.

The Eurosystem has actively supported the Lamfalussy approach from the outset and has closely followed its development as part of the Eurosystem's task to contribute to the smooth conduct of policies relating to the prudential supervision of credit institutions and the stability of the financial system.<sup>4</sup> The assessment set out in this note, focusing on the banking sector, is fully in line with the Eurosystem's earlier view that the Lamfalussy framework provides

the appropriate regulatory and supervisory setting to support the stability, integration and competitiveness of the EU financial sector.<sup>5</sup> At the same time, as market developments are underscoring the need for further progress in cross-border supervisory convergence and cooperation, a number of measures should be considered to ensure that the full benefits of the Lamfalussy approach are reaped in an effective and timely manner.

The note is structured as follows: Section 2 reviews the key market developments from a regulatory and supervisory perspective and assesses the resulting policy challenges. Against this background, Section 3 evaluates the progress achieved so far in the regulatory and supervisory setting for the banking sector and suggests areas for enhancement. Section 4 concludes. The annex summarises the Eurosystem's view of the key issues for enhancing the functioning of the Lamfalussy framework.

- 1 See Directive 2005/1/EC of 9 March 2005, which extended the Lamfalussy framework to the banking and insurance sectors.
- 2 These refer in particular to the Report on Financial Supervision of the Financial Services Committee (FSC) that was finalised in February 2006 and endorsed by the ECOFIN Council in May 2006; the European Commission's "White Paper on Financial Services Policy 2005-2010", published in December 2005; and the two interim reports of the Inter-Institutional Monitoring Group (IIMG) issued in March 2006 and in January 2007. All of these assessments had pointed to a number of measures to improve the practical functioning of the Lamfalussy process.
- 3 Particularly noteworthy in this context are the "Final Report Monitoring the Lamfalussy Process" of the Inter-Institutional Monitoring Group (IIMG), published on 15 October 2007; the report of the Financial Services Committee's Sub-Group on Long-term Supervisory Issues and the European Parliament's "Report on financial services policy (2005-2010)", which was published in June 2007.
- 4 In particular, the Eurosystem provided contributions for the preparation of the Commission's White Paper and the FSC's Report on Financial Supervision.
- 5 See, for example, the "Eurosystem contribution to the public consultation by the European Commission on the Green Paper for Financial Services Policy (2005-2010)", 1 August 2005.

## 2 REGULATORY AND SUPERVISORY CHALLENGES IN THE PRESENT MARKET ENVIRONMENT

### 2.1 KEY MARKET DEVELOPMENTS

#### PROGRESS IN BANKING INTEGRATION

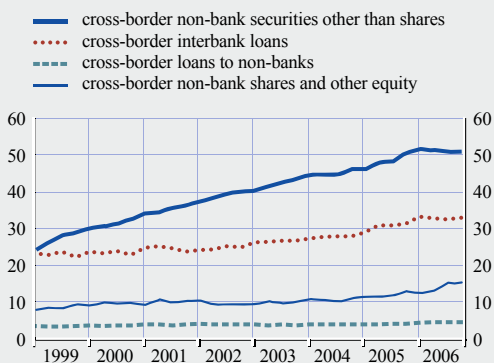
Whereas retail banking markets are still rather fragmented, there are *solid signs of integration in the wholesale and capital market-related segments*. Banks' cross-border loans to non-banks and cross-border non-bank deposits have remained at very low levels over time,<sup>6</sup> while

cross-border holdings of non-bank securities, interbank loans and interbank deposits have reached significant proportions, with an increasing trend since the introduction of the euro in 1999 (see Charts 1 and 2).

<sup>6</sup> The limited integration in the euro area retail banking market can also be observed in price-based indicators of banking integration, namely in the high level of cross-country dispersion of euro-area interest rates, in particular with regard to loans to households for consumption purposes. In 2006 the cross-country standard deviation of euro area interest rates on loans to non-financial corporations ranged from around 20 to 40 basis points, whilst the cross-country standard deviation of euro area interest rates on loans to households for consumer credit ascended to 160 basis points.

**Chart 1 Cross-border provision of financial services in the euro area – assets**

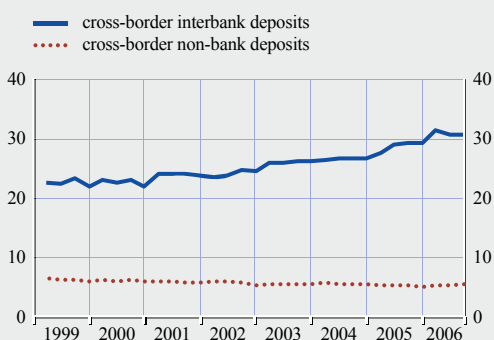
(percentages)



Source: ECB, Report on EU banking structures 2006.  
Note: Cross-border activity is expressed as a percentage of the total euro area provision of financial services.

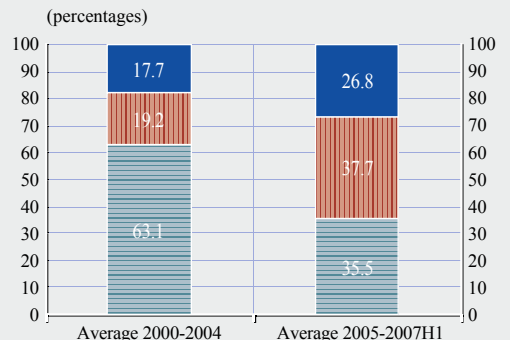
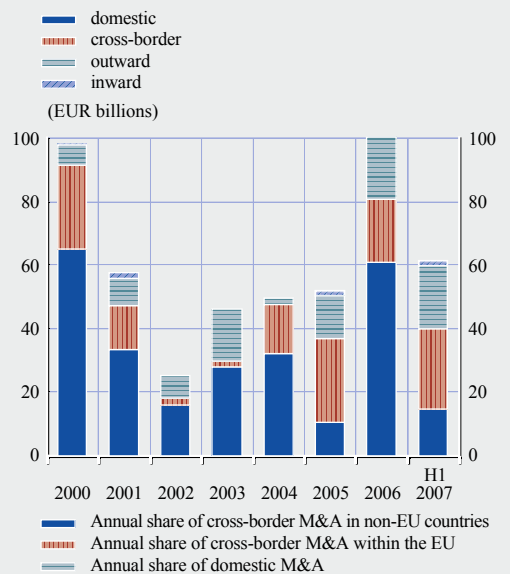
**Chart 2 Cross-border provision of financial services in the euro area – liabilities**

(percentages)



Source: ECB, Report on EU banking structures 2006.  
Note: Cross-border activity is expressed as a percentage of the total euro area provision of financial services.

**Chart 3 Value of M&A deals performed by EU banks - domestic, cross-border and outward deals**



Source: Zephyr, Bureau Van Dijk and ECB calculations.  
Note: Deal values are shown in EUR billions. Cross-border M&A refers to intra-EU-25 transactions involving a non-domestic acquirer. Outward M&A refers to transactions of EU-25 banks targeting a bank outside the EU-25.

Table 1 Major cross-border M&A deals since 2000

Year	Acquirer		Target		Value (EUR thousands)
2007	Danske Bank A/S	DK	Sampo Pankki Oyj	FI	4,050,000
2007	Crédit Agricole SA	FR	Cassa di Risparmio di Parma e Piacenza SpA	IT	3,800,000
2007	Marfin Investment Group SA Holdings	GR	Marfin Popular Bank Public Co., Ltd	CY	2,160,668
2006	BNP Paribas SA	FR	Banca Nazionale del Lavoro SpA	IT	10,046,353
2006	Crédit Agricole SA	FR	Emporiki Bank of Greece SA	GR	3,364,055
2005	UniCredito Italiano SpA	IT	Bayerische Hypo- und Vereinsbank AG	DE	13,269,000
2005	ABN Amro Holding NV	NL	Banca Antoniana Popolare Veneta SpA	IT	6,120,653
2005	UniCredito Italiano SpA	IT	Bank Austria Creditanstalt AG	AT	2,095,000
2005	FöreningsSparbanken AB	SE	Hansapank AS	EE	1,808,086
2005	Danske Bank A/S	DK	National Irish Bank Ltd - Northern Bank Ltd	IE	1,495,682
2004	Banco Santander Central Hispano SA	ES	Abbey National plc	GB	12,151,197
2001	Bayerische Hypo- und Vereinsbank AG	DE	Bank Austria Creditanstalt AG	AT	7,807,000
2001	Gruppo Bipop-Carire SpA	IT	Enrium Direct Bankers AG	DE	2,344,000
2001	Société Générale	FR	Komerčni Banka AS	CZ	1,186,000
2000	HSBC Holdings plc	GB	CCF - Crédit Commercial de France SA	FR	11,223,000
2000	Fortis Bank	BE	Banque Generale Du Luxembourg SA	LU	1,620,000
2000	Skandinaviska Enskilda Banken AB	SE	BFG Bank AG	DE	1,608,205
2000	Erste Bank der Österreichischen Sparkassen AG	AT	Ceska Sporitelna AS	CZ	1,252,406
2000	Banco Santander Central Hispano SA	ES	Banco Totta & Acores SA	PT	1,156,000

Source: Zephyr, Bureau Van Dijk.  
Note: Only deals above EUR 1 billion are shown.

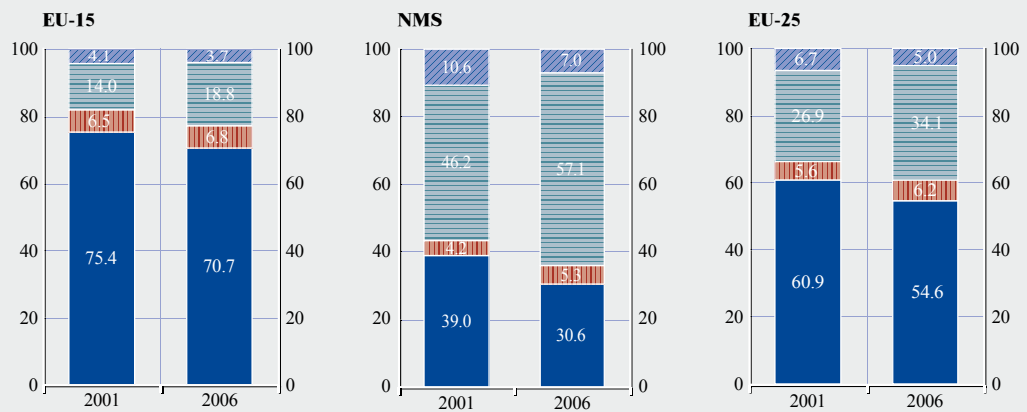
The *growing importance of cross-border M&A transactions* also points to further progress in banking integration. In particular, large volume cross-border deals among EU banks have become more frequent. From 2000, when HSBC acquired Crédit Commercial de France SA, there was no other deal that reached the EUR 10 billion benchmark until 2004; since then, there has been one large volume cross-border M&A deal every year (see Table 1). With a deal value of EUR 70 billion, the acquisition of ABN Amro by the consortium of Royal Bank of Scotland, Banco Santander and Fortis in October 2007 constituted by far the largest cross-border bank M&A transaction ever carried out in the EU. Overall, while the annual breakdown into domestic, cross-border and outward deals in terms of value has varied significantly since 2000, the relative share of cross-border M&A deals in the total value of M&A transactions performed by EU banks has clearly increased since 2005 (see Chart 3).

Another indicator of banking integration is the degree to which EU banks develop their activities in EU countries other than their home country. While domestic establishments continue to hold the majority of EU banking assets, *the cross-border presence of EU banks has increased in recent years*, predominantly via the establishment of foreign subsidiaries. It should be noted that this development affects EU Member States in different ways. In general, the average market share of foreign establishments is substantially higher in the Member States that joined the EU in 2004 (hereinafter: the new Member States or NMS) than in the EU-15 (see Chart 4), although certain exceptions can be observed (i.e. in a few EU-15 countries foreign establishments have a rather high market share, and in some of the NMS foreign-owned banks account for a relatively small share of domestic banking assets).

**Chart 4 Average share of foreign establishments in total domestic banking assets – 2001 and 2006**

(percentages)

■ domestic credit institutions  
■ branches EU  
■ subsidiaries EU  
■ branches and subsidiaries  
■ rest of the world

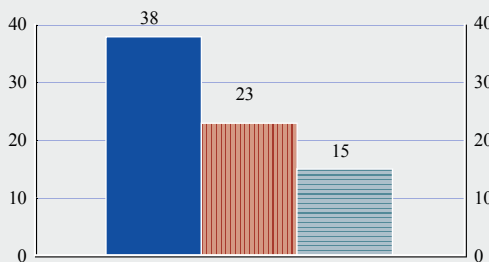


Source: ECB

**Chart 5 EU banking groups covered in the BSC mapping sample – differences among groups in terms of intensity and scope of their foreign activities (2005)**

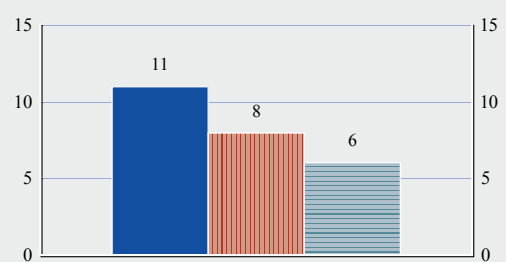
■ key cross-border players in BSC mapping sample (16 groups)  
■ BSC mapping sample (46 groups)  
■ other groups in BSC sample excluding 'key players' (30 groups)

**Intensity of foreign activity**  
(percentages)



Sources: BSC, ECB calculations.  
Note: The chart shows the share of EU group assets which is held outside the home country for the year 2005.

**Average presence in EU countries**  
(number of countries)



Sources: BSC, ECB calculations.  
Note: The chart shows the number of EU countries in which the groups maintain a foreign presence for the year 2005.

### INCREASING PROMINENCE OF EU BANKING GROUPS WITH SIGNIFICANT CROSS-BORDER ACTIVITIES

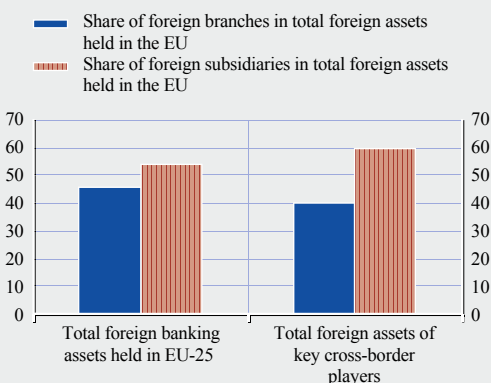
The internationalisation of EU banking groups has increased in recent years. This is a clear finding from the ESCB Banking Supervision Committee's (BSC) biannual survey of

banking groups with significant cross-border activity, which was conducted for the years 2001, 2003 and 2005.<sup>7</sup> While the number of

<sup>7</sup> The next BSC survey, which will produce figures for 2007, will only be conducted in the coming months. Therefore, the most recent data available refer to 2005.

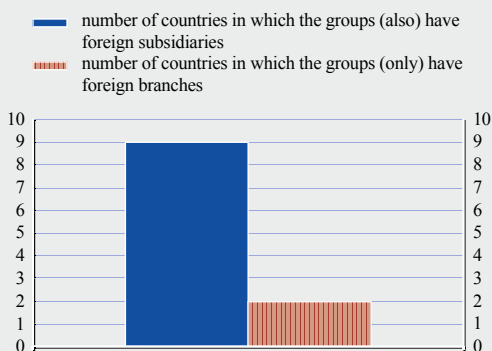
**Chart 6 Relative shares of subsidiaries and branches in foreign banking assets (2005)**

(percentages)



Sources: BSC, ECB calculations.

**Chart 7 Average number of countries in which the key cross-border players have a foreign presence (2005)**



Sources: BSC, ECB calculations.

banking groups included in the analysis increased only slightly (from 41 to 46) over time, the consolidated assets of the sample as a whole grew by 54% from 2001 to 2005, and its share in consolidated EU banking assets increased from around 54% to 68%. This indicates that *EU banks with significant cross-border activity hold a sizable – and rising – share of total EU banking assets.*

A closer analysis of the data reveals that the *intensity and geographical scope of foreign activity varies considerably among the banks* included in the sample. A simple measure of this, referring to the banking activity performed within the EU and based on 2005 data, shows that only 16 of the 46 banking groups included in the survey held at least 25% of their EU assets outside their home country and were present in at least 25% (i.e. six) of the other 24 EU countries. These 16 groups could be labelled the “key cross-border players” in the EU. The average intensity and geographical reach of the foreign activity of the remaining 30 groups was significantly lower (see Chart 5).

In 2005 the 16 key cross-border players accounted for around one-third of EU banking assets. They held substantial market shares in their home countries as well as in several of the host countries in which they had foreign

establishments. In 15 EU countries at least one of the key cross-border players alone accounted for more than 15% of domestic banking assets, and the average market share of the banking groups with the greatest activity in these countries was 26% (the range being from 16% to 59%). Another interesting fact is that the key cross-border players carried out their activities in other EU countries primarily via foreign subsidiaries rather than branches. Similarly, the share of foreign assets held in subsidiaries, already predominant in the EU banking sector in general, was even larger in the case of the key cross-border players (see Charts 6 and 7).

#### GROWING CENTRALISATION OF BUSINESS FUNCTIONS

The centralisation of business functions has been a major development in some cross-border banking groups in recent years. While only limited information is available on the precise scope of this development, there is evidence that the functions frequently centralised include strategic planning, treasury, market risk management, parts of credit risk management, wholesale banking, and trading activities. Areas such as communications and information systems are also increasingly centralised or covered by strategic guidelines set at the group level. Furthermore, as some back-office functions are progressively harmonised,

centralised back-office platforms are becoming more prominent (e.g. securities handling, payments and retail loans). The degree of centralisation may vary significantly within banking groups. Furthermore, centralised functions are not necessarily carried out at the head office, but are frequently performed by functionally specialised “centres of excellence” within the group.

## 2.2 POLICY CHALLENGES

The above market developments underscore the importance of progress in cross-border supervisory convergence and cooperation.

*First, the EU framework for prudential supervision should support the efficient functioning of cross-border banks.* Cross-border banks are important drivers of banking integration, helping to address the relatively high degree of fragmentation of European retail banking markets. In this context, the supervisory framework should support the efficient functioning of cross-border banking as a channel for further financial integration, in view of its benefits for economic growth and competitiveness.

With a view to this objective, *differences in supervisory requirements and approaches and overlapping policy measures should be greatly reduced and eventually eliminated* so as to decrease the compliance costs associated with cross-border activities and to streamline the interaction between cross-border groups and their supervisors.<sup>8</sup> The practical relevance of achieving a more coherent supervisory framework becomes readily apparent if one considers that, in 2005 the 46 groups with significant cross-border activities were on average active in eight different EU host countries, and the 16 key cross-border players had foreign establishments in an average of 11 EU host countries. The fact that EU banks, and the key cross-border players in particular, expand into other EU countries primarily via foreign subsidiaries further amplifies the costs of supervisory differences, both for the

competent authorities and the market participants concerned.

*Second, in order to safeguard financial stability, it is crucial to ensure the effectiveness of cross-border supervision.* Given the growing internationalisation of EU banking groups and the rising importance of intra-group linkages, the complexity of safeguarding financial stability is also increasing, as financial risks may spread across separate group entities and national boundaries, not only within the banking groups concerned but also throughout the wider financial system. The substantial market shares held by the key cross-border players – in total EU banking assets as well as in the domestic banking assets of several EU countries – may be seen as an indication of the importance of effective cross-border supervision.

Against this background, *strengthened information sharing and cooperation among supervisors* have become a prerequisite for adequate monitoring and addressing of potential financial vulnerabilities in cross-border banking groups. Moreover, the recent financial market turbulence has underscored the need for *effective information sharing between supervisors and central banks*, given the important responsibilities of central banks in ensuring the orderly functioning of money markets, promoting the smooth operation of payment systems, and more generally in helping to safeguard financial stability.

Finally, recent financial market events have also highlighted the fact that *supervisory convergence is a key objective not only from a financial integration point of view, but also from a financial stability perspective.* In particular, consistent prudential reporting requirements for financial institutions would enhance the rapid availability of a consistent set of relevant supervisory information.

<sup>8</sup> Close regulatory and supervisory convergence is also fundamental to ensuring a level playing field for all EU banks, regardless of the intensity and scope of their foreign activity.

### 3 PROGRESS ACHIEVED AND AREAS FOR ENHANCEMENT

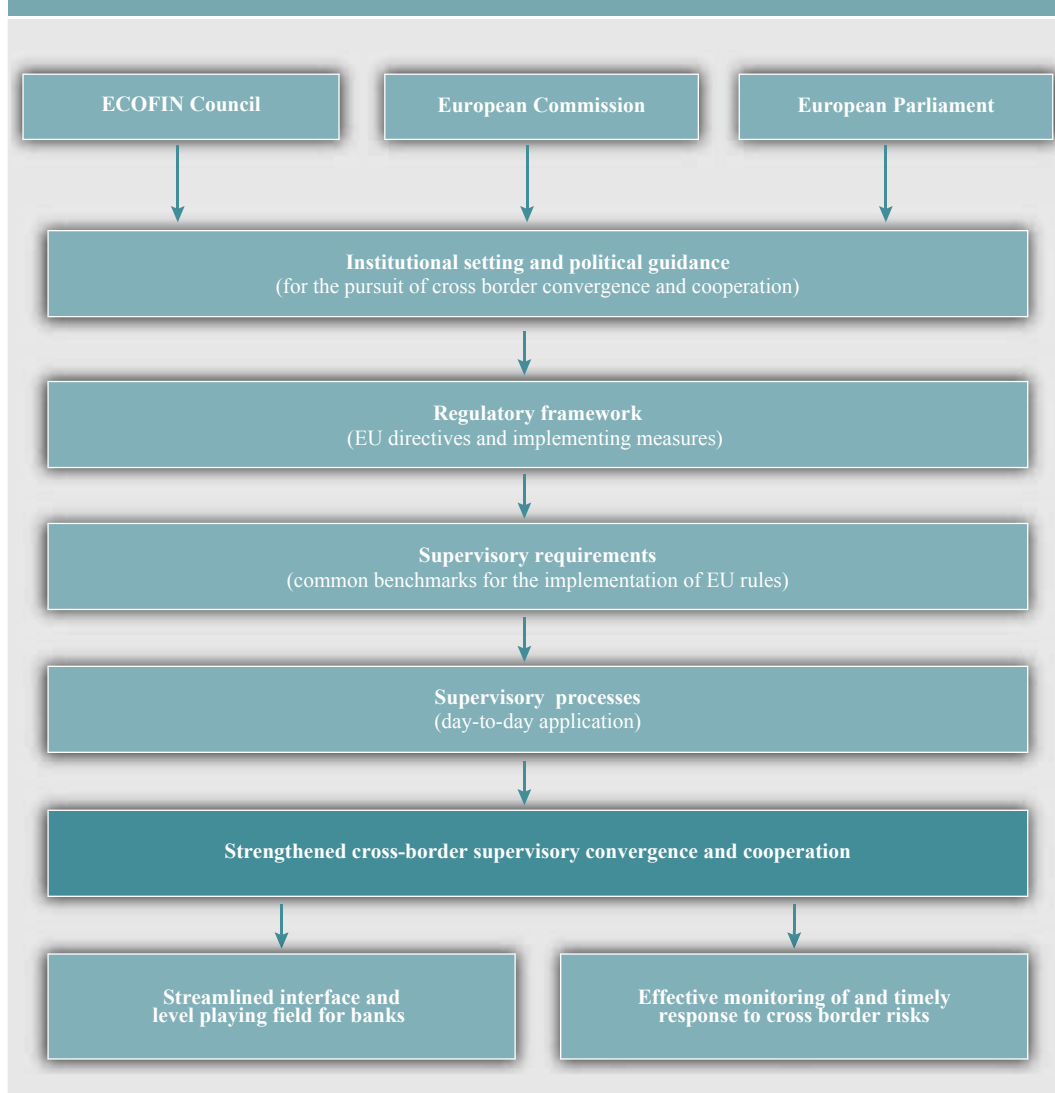
#### 3.1 OVERVIEW OF THE POLICY PROCESS TO ENHANCE CROSS-BORDER CONVERGENCE AND COOPERATION

Establishing a streamlined supervisory interface and a level playing field for market participants and ensuring the adequate monitoring of and timely response to potential cross-border risks requires effective action at consecutive steps of the EU regulatory and supervisory process. In

particular, cross-border supervisory convergence and cooperation will be sufficiently strengthened only if effective progress is made at each of the following four steps (see Figure 1):

- First, the relevant EU bodies (the ECOFIN Council, the European Commission and the European Parliament) should provide an *effective institutional setting as well as political impetus and guidance* for the pursuit of cross-border convergence and cooperation within the Lamfalussy framework.

Figure 1 Policy process to enhance cross-border supervisory convergence and cooperation



- Second, *EU directives and implementing measures fostering closer convergence of national rules and enhancing the regulatory framework for cross-border cooperation* should be adopted and effectively enforced by Member States. This work relates to Levels 1, 2 and 4 of the Lamfalussy process.<sup>9</sup>
- Third, *enhanced EU rules should be implemented in the form of closely convergent supervisory requirements*. With a view to this objective, EU supervisors should agree on common guidelines for the implementation of EU directives and implementing measures at national level and monitor the respective compliance. For the banking sector, this work is performed at Level 3 of the Lamfalussy process with the support of the Committee of European Banking Supervisors (CEBS).<sup>10</sup>
- Finally, *common supervisory requirements should be translated into consistent supervisory processes on a day-to-day basis*. This more operational work, performed by the competent national authorities, is also supported by the Level 3 process and the corresponding activities of the CEBS.

The following sections will, for each of the four steps towards improved cross-border convergence and cooperation, highlight the progress achieved so far and suggest areas for enhancement.

### 3.2 INSTITUTIONAL SETTING AND POLITICAL GUIDANCE

#### INSTITUTIONAL SETTING

The Eurosystem considers that there is scope for reinforcing the role of the CEBS in fostering supervisory convergence and cooperation. First, given that the CEBS is not an EU body in its own right, but an independent network of national authorities, *its connection to the EU institutional setting* should be enhanced. While the need for operational independence of the CEBS needs to be stressed, the references to its role in promoting supervisory convergence and cooperation should be further explicitly

specified in the Commission's decision establishing the CEBS and in the respective EU banking legislation. Furthermore, possible options for enhancing the EU legal basis of the CEBS – such as a legal text adopted by the EU Council and the European Parliament – warrant consideration. This would underscore the importance of the work of the CEBS, facilitate the introduction of respective references in relevant EU Level 1 rules, and enhance the accountability of the CEBS vis-à-vis the EU. Second, the responsibility of the members of CEBS to foster EU convergence and cooperation should also be underscored. To this end, an EU reference could be introduced in the national mission statements of supervisors.

#### POLITICAL GUIDANCE

In view of the recent overhaul of the regulatory framework in the banking sector with the adoption of the Capital Requirements Directive (CRD), political guidance and impetus have focused on fostering supervisory convergence and cooperation in the implementation process. EU bodies have closely monitored the progress, identified potential bottlenecks and suggested areas for further action. A milestone in this regard was the FSC's Report on Financial Supervision. The present assessment of the Lamfalussy framework provides an opportunity to review and further specify the political guidance required in light of the practical experience gained in the meantime and recent

- <sup>9</sup> At Level 1 of the Lamfalussy process, the basic principles of the legislation are laid down via the normal legislative process: a co-decision procedure involving the European Parliament and the EU Council, acting on a proposal of the European Commission. At *Level 2*, measures for the implementation of Level 1 legislation are adopted and amended via fast-track procedures. In the banking sector, this process is steered by the Commission with the assistance of the European Banking Committee, composed of representatives of the Member States nominated by the relevant finance ministers, and relies on advice provided by the "Level 3" committees of supervisors (see Footnote 10). *Level 4* relates to Commission measures to strengthen the enforcement of EU law, underpinned by enhanced cooperation between Member States, their regulatory bodies and the private sector.
- <sup>10</sup> Level 3 encompasses strengthened cooperation between national supervisors to ensure a consistent and timely implementation of Level 1 and Level 2 measures at the national level; this process is assisted by the CEBS, in which the ECB and central banks, with and without supervisory responsibilities, participate.



market developments. An issue which deserves consideration in this context is the *enhanced specification of policy objectives*.

Experience has shown that stakeholders refer at times to different objectives to be achieved in the convergence of supervisory requirements and processes, ranging from broadly consistent to fully congruent outcomes. The different notions of convergence should be clarified at the political level. The enhanced specification of policy objectives would benefit from more information on the effective compliance costs for market participants that are associated with existing supervisory differences. While it will be primarily the responsibility of market participants to provide an assessment of the costs of compliance associated with supervisory differences, the Commission could play a useful coordinating role in this respect. The Eurosystem therefore very much welcomes the Commission's recently launched study on compliance costs associated with a number of EU directives. EU bodies should specify the level of convergence to be achieved in each area of regulation to be covered by measures at Levels 1 and 2 and monitor the respective progress. In addition, EU bodies should endorse periodic work programmes submitted by the CEBS for comments and high level political guidance, with due respect to the operational independence of the CEBS. The work programmes should specify convergence deliverables and timelines and should be subject to regular monitoring mechanisms. The enhanced political guidance would foster transparency, facilitate the effective steering and monitoring of the process, and strengthen the accountability and involvement of all stakeholders.

### 3.3 REGULATORY FRAMEWORK

#### REGULATORY CONVERGENCE

The Eurosystem considers the *clear distinction between Level 1 and Level 2 legislation a key feature of the Lamfalussy process in terms of fostering regulatory convergence*. In particular, given the lengthy and complex procedure even

for minor modifications of Level 1 rules, their scope should be limited as much as possible to legislative framework principles, while the technical aspects should be specified in Level 2 measures, which benefit from more flexible legislative procedures. So far, the distinction between Level 1 and Level 2 has been implemented only to a very limited degree in the banking sector. In particular, the CRD acknowledges this differentiation only implicitly through a number of provisions which can be adjusted via comitology procedures. As a result, the CEBS has been involved only to a limited degree in the drafting of technical details, especially when compared with the stronger role of the Committee of European Securities Regulators (CESR) in the securities sector. The experience gained in the securities sector has highlighted the fact that close supervisory involvement in the drafting of implementing measures facilitates the subsequent work at Level 3 considerably. Overall, the Eurosystem considers that in drafting the CRD an opportunity was missed to revise the EU capital requirements in line with the Lamfalussy framework<sup>11</sup>. Moreover, the CRD raises additional concerns regarding the large number of national options and discretions which may be exercised by supervisory authorities. Finally, the CRD provides further scope for regulatory divergence and "gold-plating" owing to the significant scope for interpretation as regards several important regulatory concepts.

Effective regulatory convergence is a prerequisite for supervisory convergence. Against this background, efforts should be made to enhance regulatory convergence in the banking sector. First, as regards the existing legislative framework, the Commission should

<sup>11</sup> See in this respect the Opinion of the European Central Bank of 17 February 2005 at the request of the Council of the European Union on a proposal for directives of the European Parliament and of the Council recasting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (CON/2005/4), available at [http://www.ecb.europa.eu/ecb/legal/pdf/c\\_05220050302en00370046.pdf](http://www.ecb.europa.eu/ecb/legal/pdf/c_05220050302en00370046.pdf)

make further efforts to *strengthen Level 4 of the Lamfalussy process* in order to ensure the convergent transposition of EU requirements into Member States' national laws. Second, the strong support of all stakeholders to ensure the effective and timely conclusion of the *Commission's review of the options and discretions set forth in the CRD* will be crucial. Efforts to reduce options and discretions in EU banking legislation should also be continued in the future, e.g. by including a review clause on such provisions in existing rules (and introducing further options or discretions only coupled with a standard sunset clause), as proposed by the CEBS. Third, the Eurosystem welcomes the CEBS's suggestion to provide *own initiative advice* to the Commission on priority areas where regulatory convergence should be enhanced in order to broaden the scope for supervisory convergence and identifies liquidity risk as one of these areas. While liquidity risk has been a focal area of analysis for the Eurosystem in the past few years, the current developments in the global financial markets further underscore its significance and bring to the forefront aspects that warrant further investigation and measures, such as liquidity stress testing and contingency funding plans as well as the interaction between liquidity risk and other types of risk (such as concentration and reputational risk). Furthermore, the Eurosystem sees merit in the IIMG's proposal to *specify more clearly in EU legislation the level of harmonisation* to be achieved and to include a *requirement for Member States to disclose regulatory additions* adopted at national level. In the meantime, *an enhanced use of the existing legal possibilities for mutual recognition* would provide a tool to reduce the effects of regulatory divergence. In the medium term, the need to *restructure the CRD and other banking acts* in line with the spirit of the Lamfalussy framework should be assessed on the basis of an effective cost-benefit analysis.

#### HOME-HOST COOPERATION

The CRD has considerably strengthened the existing framework for home-host cooperation, building on the basic principles of home

country control and mutual recognition in cross-border supervision. In particular, the CRD enhances the legal provisions concerning the exchange of information and coordination between the consolidating supervisor and the host supervisors and provides the consolidating supervisor with a coordinating role for the collection and dissemination of information concerning the banking group and for planning and coordinating supervisory activities, both in normal times and in crisis situations. The strengthened home-host framework is expected to foster the effectiveness and efficiency of cross-border supervision significantly. First, the cross-border availability of information regarding the risk exposures and management of cross-border groups will be enhanced, facilitating the close monitoring of and timely response to financial vulnerabilities. Second, the coordination of supervisory measures will be promoted, thus reducing the risk of potentially diverging requirements, streamlining the interaction between the competent authorities and the supervised entities, and contributing to an level EU playing field. The Eurosystem considers that the main priority in this field in the coming period will be to ensure the *effective implementation of the enhanced framework in the day-to-day cooperation among supervisors*. Measures in this area are already under way, as discussed in the following sections.

At the same time, some *clarifications of the existing framework* should be considered, as noted by the October 2007 ECOFIN Council. The ECOFIN Council invited the Commission, for example, to assess possible enhancements with a view to (i) specifying the nature and extent of the legal obligations for supervisory authorities, central banks and finance ministries to exchange information and to cooperate, and to increase the information rights and involvement of host countries in this context and (ii) clarifying the role of consolidating supervisors and facilitating the timely involvement of relevant parties in a crisis situation. The Eurosystem supports these proposals. The home-host arrangements for foreign branches deserve particular attention

in this context, notably with the purpose of ensuring adequate host country involvement with respect to large foreign branches.

### 3.4 SUPERVISORY REQUIREMENTS

The work of the CEBS to translate the EU regulatory framework into consistent supervisory requirements has focused so far on establishing guidance for the implementation of the CRD. By the end of 2006 the CEBS had delivered a large number of guidelines in this respect, e.g. relating to the supervisory procedures for the validation and assessment of banks' internal models for capital adequacy purposes, the application of the supervisory review process, supervisory cooperation for cross-border groups, and the introduction of a minimum harmonised reporting framework.<sup>12</sup> While the high quality and quantity of the CEBS's work, delivered within a short timeframe, is widely acknowledged, *the progress achieved in the convergence of supervisory requirements has been uneven across the guidelines issued by CEBS*. For example, greater progress would have been desirable in the CEBS's guidance on supervisory reporting.

In this context, it may be useful to recall that supervisory convergence can be achieved only if commensurate progress is made in the convergence of the underlying regulatory requirements and that further action to enhance regulatory convergence is warranted, as set out in the preceding section.

More rapid progress in the convergence of supervisory requirements also calls for a *reinforced role and operating mechanisms for the CEBS*. In particular, enhanced decision-making mechanisms for the CEBS, such as greater recourse to majority voting, could effectively complement the previously mentioned measures to strengthen the CEBS's institutional standing at EU and national level. While majority voting is already possible with respect to the CEBS's advice on Level 2 rules, it should also be considered for the adoption

of Level 3 products for those cases in which effective progress is not possible on the basis of work by consensus. The introduction of majority voting on Level 3 products, which would require a change in CEBS's charter, would not impact on their legally non-binding nature. To ensure the effective implementation of majority decisions in the CEBS's voluntary setting, a commitment of the members of the CEBS to observe majority decisions on a comply-or-explain basis would be useful.

Closer convergence of supervisory requirements also requires the *effective implementation of the CEBS's products at national level*. Adequate tools to monitor and enforce compliance are important in this respect. The CEBS has initiated two major measures in this field, which are expected to spur significant progress in the coming period. First, its on-line *supervisory disclosure framework* became available in December 2006 and is being completed by national authorities in parallel to the national transposition of the CRD, which will be required in full as of 1 January 2008. The framework will enhance market participants' access to information regarding the applicable national supervisory requirements, thereby facilitating peer and market pressure towards consistent implementation. It should therefore become fully operational as soon as possible. At the same time, as noted by the IIMG, the framework should be gradually extended to cover the transposition of other supervisory requirements which are not part of the CRD. Second, the CEBS has recently established a *peer review mechanism* among its members, which is envisaged not only to support the effective monitoring of the implementation of the CEBS's products but also to provide a structured process for identifying bottlenecks to compliance and possible measures to address them. The effective implementation of the new mechanism should be a short-term priority for the CEBS.

<sup>12</sup> The CEBS also developed guidelines in two other important areas, namely the use of prudential filters for regulatory capital and outsourcing.

### 3.5 SUPERVISORY PROCESSES

The impact of the CEBS's guidelines on progress in convergence and cooperation in day-to-day supervisory processes has remained rather limited so far. The Eurosystem considers that this is to a certain extent an issue of timing. First, the main regulatory reference point so far, the CRD, will only fully enter into force in January 2008. Second, several important measures to translate the CEBS's flexible, principles-based guidelines into convergent supervisory outcomes have only recently been implemented or are still under development. More specifically, as regards the convergence of supervisory practices, the CEBS has recently begun to establish "convergence networks" of supervisors, which are aimed at gathering, developing and effectively deploying technical supervisory expertise to ensure the consistent implementation of the CEBS's products at the operational level and to strengthen the respective dialogue with market participants. The Eurosystem sees considerable potential for this approach to promote practical progress and supports its further development in the future.

As regards supervisory cooperation, the CEBS will conclude by the end of this year its pilot project on "*operational networking*", which is aimed at fostering consistent approaches within and across the colleges of supervisors responsible for cross-border groups. This project should be further developed and extended beyond the current sample of ten major EU groups. The Eurosystem considers this strand of work a priority with a view to establishing, on the basis of the enhanced regulatory setting provided by the CRD, a sufficiently integrated, practical framework for day-to-day supervisory cooperation and to identifying possible legal or regulatory obstacles in this respect. In this context, the Eurosystem also concurs with the IIMG's assessment that the arrangements for cooperation between supervisors and central banks with respect to major cross-border banking groups in the EU should be further strengthened, notably with a view to enhancing preparedness for crisis situations. In particular,

*an enhanced dialogue should be established between the supervisory colleges responsible for the EU major banking groups and competent central banks without supervisory responsibilities.* Furthermore, the CEBS has recently adopted a *mediation mechanism* among supervisors designed to strengthen mutual understanding when potential disagreements in the interpretation of its guidance for cross-border cooperation, as set forth in particular in the guidelines on validation and home-host cooperation, are addressed. With a view to rendering this tool effective, all supervisors should stand ready to actively participate in possible mediation procedures. Finally, the CEBS is currently finalising guidelines on the *delegation of tasks* among supervisors to support the enhanced use of the existing legal delegation opportunities, which is expected to promote efficiency and effectiveness in the cross-border allocation of labour among supervisors and to streamline the interaction with the supervised entities. The CEBS's work on "operational networking" could provide a useful setting for fostering the effective and consistent implementation of the guidelines in the coming period.

More in general, the efforts of the CEBS to further the emergence of a *common supervisory culture*, building on tools such as joint training and staff exchanges, are expected to spur significant overall progress in the commonality of supervisory approaches and to reduce structural differences in national supervisory frameworks in the medium term. This work, already well under way at present, should therefore continue and be pursued vigorously.

In view of the ambitious targets and wide scope of the CEBS's tasks to promote convergence and cooperation, the Eurosystem concurs with the IIMG's assessment that the present funding arrangements for the CEBS may warrant further enhancement. In this context, it may be useful to consider the possibility of complementing the regular funding of the CEBS, provided by its members, with *additional financing from the EU budget for specific deliverables which are*

*requested in EU legislation or mandated by EU bodies.* A decision on the possible provision of such financial assistance could be taken when the periodic work programmes of the CEBS are endorsed.

Overall, the Eurosystem considers that the combined practical effect of the above measures to foster effective progress in convergence and cooperation could be very significant. Against this background, it will be important to keep the momentum to ensure the effective and timely implementation of these measures.

#### 4 CONCLUSION

Market developments underscore the urgency of enhancing cross-border convergence and cooperation in the supervision of EU banks in order to ensure an effective monitoring of and response to cross-border financial risks and to provide a streamlined supervisory interface and a level playing field for market participants. Adequate progress in supervisory convergence and cooperation requires improvements at each step of the regulatory and supervisory process, pertaining to (i) the overall institutional setting and political guidance, (ii) the regulatory framework, (iii) supervisory requirements, and (iv) supervisory processes. While substantial work has already been carried out or is currently under way in each of these fields, further efforts will be required.

First, as regards the *institutional setting and political guidance*, the connection of the CEBS to the EU institutional setting should be enhanced and the responsibilities of the CEBS's members in fostering EU convergence and cooperation should be underscored. Furthermore, EU policy objectives should be specified more clearly. In this respect, EU bodies should better specify the level of convergence to be achieved by Level 1 and 2 measures, monitor the respective progress, as well as endorse periodic work programmes submitted by the CEBS for comments and high level political guidance.

Second, with respect to the *regulatory framework*, there is a need for enhanced action at Level 4 of the Lamfalussy framework in order to ensure a convergent transposition of EU requirements. In addition, the degree of regulatory convergence in existing EU banking directives should be further improved. The reduction or phasing out of the national options and discretions in the CRD is a key priority in this respect. In addition, input from the CEBS will be essential to identifying specific areas within and beyond the CRD in which enhanced convergence of EU rules should be achieved in order to support more consistent policy outcomes. While the main priority in the area of home-host cooperation will be the effective day-to-day implementation of the enhanced regulatory framework provided by the CRD, some clarifications of this framework should also be considered, notably as regards the arrangements for foreign branches. Furthermore, an enhanced application of the Lamfalussy framework to the banking sector should be pursued in the medium term. In contrast to the securities sector, where a number of major EU directives were developed under the Lamfalussy approach, most of EU banking legislation – except the CRD – had been adopted before the innovative institutional setting became available. In addition, the regulatory structure provided by the Lamfalussy framework, notably the important distinction between “Level 1” framework principles and “Level 2” technical details of legislation, was only applied to a very limited degree in the CRD.

Third, with a view to fostering further progress in the convergence of *supervisory requirements*, the introduction of majority voting for the CEBS's legally non-binding products should be considered, coupled with implementation on a “comply-or-explain” basis. Another priority during the coming period should be to foster the successful implementation of CEBS products via the timely completion and gradual extension of the CEBS's supervisory disclosure framework and the effective use of its recently established peer review mechanism.

Fourth, it will be important to keep the momentum on several recently launched measures to foster convergence of *supervisory processes*. This mainly relates to the further development of “convergence networks” to provide technical support for the consistent implementation of the CEBS’s products, the extension of the CEBS’s project on “operational networking”, the finalisation and effective implementation of the CEBS’s guidelines on the delegation of tasks among supervisors and the active participation of CEBS members in possible mediation procedures. In addition, efforts to further the emergence of a common supervisory culture should be continued at full speed. Finally, the possible provision of complementary financing for the CEBS’s activities from the EU budget for specific deliverables requested in EU legislation or mandated by EU bodies should be assessed.

# ANNEX

## KEY ISSUES FOR ENHANCING THE FUNCTIONING OF THE LAMFALUSSY FRAMEWORK

### 1 INSTITUTIONAL SETTING AND POLITICAL GUIDANCE

– *Strengthening the CEBS's connection to the EU institutional setting, with due respect to its operational independence:*

– Further specification of references to the role of the CEBS in promoting supervisory convergence and cooperation in the Commission's decision establishing the CEBS.

– Assessment of options for strengthening the legal basis of the CEBS.

– *Underscoring the responsibility of CEBS members to foster EU convergence and cooperation:*

– Possible introduction of an EU reference in the national mission statements of supervisors, subject to a prior assessment of the respective practical and legal consequences.

– *Clarifying policy objectives*

– Enhanced specification of the level of convergence to be achieved by Level 1 and Level 2 rules, taking into account effective compliance costs stemming from supervisory differences.

– Submission of periodic work programmes, specifying convergence deliverables and timelines, by the CEBS to the EU bodies for comments, high level political guidance and endorsement, coupled with a regular monitoring mechanism.

### 2 REGULATORY FRAMEWORK

– *Promoting regulatory convergence within the existing legislative framework*

– Enhanced action at Level 4 of the Lamfalussy framework to ensure

a convergent transposition of EU requirements.

– Effective and timely conclusion of the Commission's review of options and discretions in the CRD.

– General review clause for options and discretions in existing EU banking legislation (and introduction of further options and discretions only coupled with a standard sunset clause).

– Specification of the desired level of harmonisation in the existing EU rules and disclosure of regulatory additions by national authorities.

– Own initiative advice of the CEBS to signal priority areas for enhanced regulatory convergence within and beyond the CRD.

– *Reducing the effects of regulatory divergence*

– Enhanced use of the existing legal possibilities for mutual recognition.

– *Enhanced application of the Lamfalussy approach to banking in the medium term*

– Restructuring of EU banking legislation in line with the spirit of the Lamfalussy approach, on the basis of an effective cost-benefit analysis.

– *Possible clarification of the existing framework for home-host interaction*

– Assessing scope for enhancement in line with the October 2007 ECOFIN Council request, with particular attention to home-host arrangements for foreign branches.

### 3 SUPERVISORY REQUIREMENTS

- *Reinforcing the CEBS’s decision-making mechanisms*
  - Possible introduction of majority voting on the legally non-binding Level 3 products, coupled with implementation on a “comply-or-explain” basis.
- *Ensuring the effective implementation of CEBS products*
  - Full implementation and gradual extension of the CEBS’s supervisory disclosure framework.
  - Effective use of the CEBS’s peer review mechanism.

### 4 SUPERVISORY PROCESSES

- *Promoting day-to-day convergence of supervisory practices*
  - Further development of “convergence networks” for the implementation of CEBS products.
- *Strengthening home-host cooperation on a day-to-day basis*
  - Extension of the scope and depth of the CEBS’s project on “operational networking”.
  - Establishment of an enhanced dialogue between the supervisory colleges for major EU banking groups and competent central banks without supervisor responsibilities.
  - Active participation of all supervisors concerned in possible mediation procedures.
  - Finalisation and effective implementation of CEBS guidelines for delegation,

supported by the CEBS’s project on operational networking.

- *Furthering the emergence of a common supervisory culture*
  - Continued efforts to make full use of all possible tools in this respect.
- *Enhancing the funding arrangements for the CEBS*
  - Possible provision of supplementary financing from the EU budget, for specific deliverables requested in EU legislation or mandated by EU bodies.

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