

4 DEVELOPMENTS IN INTERNATIONAL BANKING REGULATION AND SUPERVISION
FORA IN 2006

4 Developments in international banking regulation and supervision fora in 2006

4.1 *The participation of the Banco de España in international committees*

International banking regulation and supervision committees and fora were once again very active last year. Convergence in regulation and supervision, and close co-operation among supervisors are considered essential to achieve the objective of a more globalised financial market in which financial stability is ensured. The work to implement the new prudential framework for bank solvency has simply highlighted these needs and the international fora have organised their work in consequence.

The Banco de España participates in all the banking regulation and supervision fora that are important from the viewpoint of our interests. Notable among them on account of their importance as issuers of principles and recommendations and of their level of activity are the Committee of European Banking Supervisors (CEBS) and the Basel Committee on Banking Supervision (BCBS), the former having a European scope and the latter being more international. The Bank also participates in intersectoral committees, both at the European level (Interim Working Committee on Financial Conglomerates (IWCF)) and at the international level (Joint Forum (JF)). In addition, the Banco de España participates in the BSC of the Eurosystem.

Box 4.1 contains a description of the committees mentioned.

The Banco de España's commitment to the work of these international committees has been reflected in the draft Law on Solvency released for comment in December. It states that *"the Banco de España may adopt as its own and transmit to institutions and groups, guidelines, (...) approved by international bodies and committees active in banking regulation and supervision"*. Also, as Table 1 shows, the Banco de España participates actively both in Supervisory Committees and in their diverse working groups, which enables it to influence preparation of their recommendations from the outset.

This significant presence in international groups not only involves regular participation in all meetings (in 2006 there were more than 150) but, above all, intensive work at the Banco de España, which enables greater and better co-ordination between national regulation and supervision policies and European initiatives in both spheres. In this respect, as mentioned in Chapter 2, the internal reorganisation that has taken place in the area of supervision is also conducive to closer co-operation between the operational departments responsible for the supervision of credit institutions, groups horizontal with the Directorate General Banking Supervision and the Division responsible for international co-ordination in supervision matters.

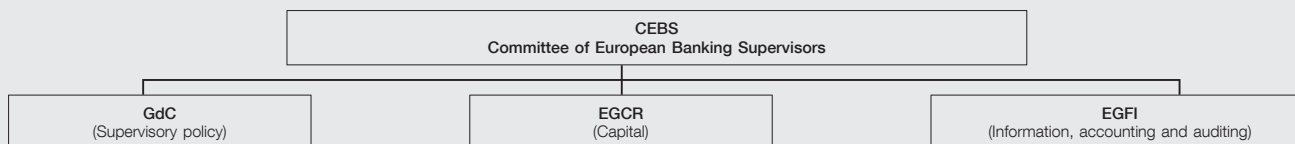
It should also be noted that since October 2006 the Banco de España has been an associate member of ASBA.

In 2006, the CEBS and the BCBS remained highly focused on the implementation of Pillars 1 and 2 of the Basel II Accord, while starting to consider new projects on their agendas.

Thus, having completed and published the basic tasks commenced in prior years (validation, the supervisory review process and co-operation between supervisors), the CEBS's efforts in Europe focused on developing guidelines for certain specific pillar 2 risks, creating and developing communication networks between supervisors and providing advice to the European Commission. It also commenced an in-depth reflection on the recommendations of the Francq

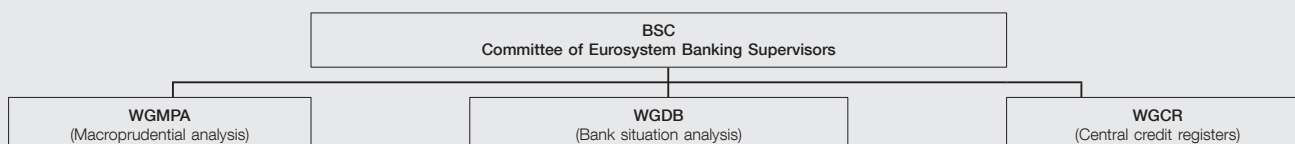
The following is a very simple representation of the organisation in 2006 of the international banking supervision committees.

EUROPEAN UNION



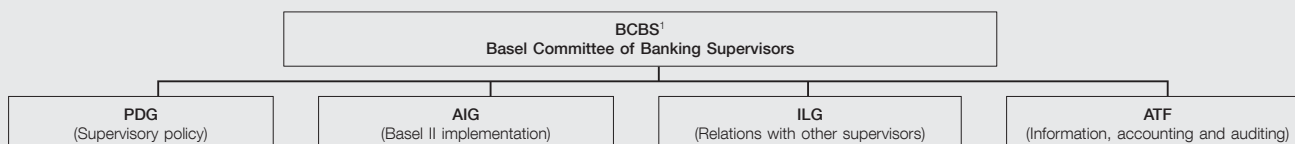
Mandate	<ul style="list-style-type: none"> - To advise the Commission on banking matters - To promote co-operation and convergence of supervisory practices across the EU - To promote and review the common implementation and consistent application of Community legislation
Chairman	Danièle Nouy (Commission Bancaire, France)
Members	EU supervisors and central banks, including the European Central Bank
Banco de España	José María Roldán (Director General Banking Regulation) and Fernando Vargas (Associate Director General Banking Supervision)

EUROPEAN CENTRAL BANK



Mandate	<ul style="list-style-type: none"> - Analyses matters relating to both banking and other sectors that affect the euro area/EU with an emphasis on financial stability - Analyses the impact of regulatory and supervisory developments on financial stability and on the economy's financing structure and conditions - Promotes co-operation and information exchange among central banks and supervisors on matters of common interest.
Members	Supervisors and central banks of the euro area and the EU and the European Central Bank.
Chairman	Edgar Meister (Bundesbank)
Banco de España	Jesús Saurina (Director of the Financial Stability Department) and Luis Javier Rodríguez (Head of the Supervision Technical Secretariat and Institutional Relations)

INTERNATIONAL



Mandate	Promotes convergence in banking supervisory policies and practices through periodic meetings, the issuance of standards and information exchange among its members.
Members	Supervisors and central banks of Germany, Belgium, Canada, Spain, the United States, France, the Netherlands, Italy, Japan, Luxembourg, the United Kingdom, Sweden and Switzerland.
Chairman	Nout Wellink (De Nederlandsche Bank, the Netherlands). Appointed in mid-2006 to replace Jaime Caruana
Banco de España	José María Roldán and Fernando Vargas

As for co-ordination with other sectoral committees, both the CEBS and the BCBS are very active. The CEBS has signed a protocol on co-operation with the CEIOPS and the CESR² which provides for regular meetings and joint work plans. Also a new committee (IWCF)

has been created this year, to seek convergence in the treatment of financial conglomerates). For its part, the BCBS co-ordinates with IOSCO and IAIS³ through the Co-ordination Group and the Joint Forum.

1. Set up in 1974. It reports to the Financial Stability Forum. It is made up of four permanent working groups (Policy Development Group, Accord Implementation Group, International Liaison Group and the Accounting Task Force) and ad-hoc groups that are dissolved when their task is completed. 2. Other Level 3 committees in the financial area: CESR (securities) and CEIOPS (insurance).

3. Sectoral insurance (IAIS) and securities (IOSCO) committees at the international level.

	2006	
	COMMITTEES AND GROUPS	BANCO DE ESPAÑA PARTICIPATION
BCBS	22	20
JOINT FORUM	4	4
CEBS	23	21
BSC	9	8
IWCFC	3	2
TOTAL	61	55

report¹. These matters, along with liquidity risk and application of the third money laundering directive, will also account for a large part of the Committee's work in 2007.

In the international arena, the BCBS, like the CEBS, continued to work for smooth implementation of the Capital Accord. At the same time, the Core Principles for Effective Banking Supervision were revised in order to adapt them to current supervision practices and to strengthen certain aspects, such as sound management of both institutions and supervisors. Looking to the near future, the management of liquidity risk and the definition of capital will be priorities for the Committee, as they are for the CEBS.

Meanwhile, relations between the sectoral supervision committees, both in Europe and in the intercontinental arena, were intensified in response to the increasingly blurred line separating insurance, securities and banking transactions and to the identification of more financial conglomerates. This trend can be expected to strengthen in the future.

Also in the European context, but in the area of financial stability, the Bank participated in the Banking Supervision Committee (BSC) of the ESCB, which continued to work on the preparation of the semi-annual Financial Stability Review, and on publication of annual reports on the stability of the EU banking sector and on banking structures in the EU.

It also worked jointly with the Committee of European Banking Supervisors (CEBS) on identifying appropriate practices for the management of cross-border financial crises and participated in various financial crisis simulation exercises to acquire practical knowledge of the mechanisms in place in the EU. In this respect, it participated in the exercise organised at the EU level in April 2006 under the auspices of the Economic and Financial Committee and also in those carried out by the euro area central banks.

In 2006 the BSC also published a report on assessment of the new accounting standards from the standpoint of financial stability.

4.2 The work of the Committee of European Banking Supervisors

The work of the CEBS was structured around its three objectives:

In its task of advising the European Commission, the CEBS issued technical opinions in response to requests for advice from the European Commission on key subjects such as the

¹. The Francq report was issued in February 2006 by the Financial Services Committee (its members represent ministers of finance and the current chairman is the Secretary of State for the Economy David Vegara). It gives a strategic view of how financial regulation and supervision should develop in the coming years and expresses objectives and specific measures to be adopted.

practices of the industry and of supervisors in relation to large exposures and on the current regulations and market trends in relation to capital. In 2007 the CEBS has continued to work on both subjects since further requests for advice have been made by the Commission on specific aspects of large exposures and on a quantitative analysis of the elements that make up capital.

The CEBS prepared two reports on review of the large exposure rules in the light of the new capital adequacy framework. The first one analyses the regulatory differences across Member States and the synergies or conflicts between them. The second one describes the large exposure management practices followed by the industry, as well as its opinion of the current regulatory framework. The CEBS is currently preparing concrete proposals to enhance these rules, in response to a further call for advice from the European Commission, which must be delivered by February 2008.

The CEBS also published two reports on own funds. The first one reviewed the current state of the rules on own funds and the supervisory practices in place in the Member States, concluding that although there is a high degree of similarity in the definition of the purpose of own funds, differences arise not only from the flexibility granted by the Directive, but also from the local market specificities and from differences in tax systems and supervisory practices. The second report analyses the capital instruments recently created by the industry, noting that there are differences across Member States in the application of the Sydney press release, that is to say in the recognition of certain hybrid instruments as Tier 1 capital. The group has continued to work in 2007 on a quantitative analysis of own funds and on revision of the legal framework for the eligibility of hybrid instruments.

For its part, the IWCFC published in January 2007 a comparison of the rules for the eligibility of capital instruments in application of the respective banking, securities and insurance directives.

Another call for advice on commodities derivatives was also received, which the CEBS has already answered, at the beginning of 2007, with the results of its survey of prudential practices.

In addition, the CEBS, together with CESR and CEIOPS, sent a letter to the Commission regarding the proposal to amend the procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of shareholdings in the financial sector². The aim of the amendment is to improve the legal certainty, clarity and transparency in the approval process for these operations in the financial sector and to avoid the ambiguous situation in which supervisors found themselves when applying Article 19 of the current Directive (16 of the previous one).

In relation to the consistent application of Community law and convergence in supervision policies, the CEBS completed its guidelines³ for the implementation of the Capital Adequacy Directive ("CEBS guidelines on supervisory cooperation for cross-border banking and invest-

2. Proposal to amend Directives 92/49/EEC, 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of shareholdings in the financial sector. The final text is due to be adopted on 11 July 2007. 3. The guidelines issued by the CEBS will be a key element in consistent application across the Member States of the new Capital Adequacy Directive. Both institutions and supervisors needed guidelines that, without being prescriptive, would serve as guidance from the standpoint of the proportionality principle. This facilitates the dialogue between supervisors and supervised institutions when supervisors' expectations in this area are set. The Banco de España has actively participated in the preparation of such guidelines, influencing their final design, and they will certainly be one of the main sources of inspiration when it prepares its own recommendations.

ment firm groups” and “Validation”). Both sets of guidelines involve a significant advance in the rationalisation of the approval procedures for the advanced models of cross-border groups in which more than one European supervisor is involved.

It also completed its guidelines on “The Supervisory Review Process under Pillar 2”, developing the areas of interest rate risk in the banking book, concentration risk and stress tests through technical guidance.

In the case of interest rate risk, apart from requiring institutions to manage this risk appropriately, the Directive requires that measures shall be taken by supervisors where an institution’s economic value declines by 20% as a result of a “standard shock”. In these guidelines the CEBS proposes a common definition of “standard shock” to be used by supervisors, which will certainly help to level the playing field in the application of this requirement. In addition these guidelines give guidance to institutions on how to identify, measure and manage this risk and to supervisors on how they should review this item.

In the case of concentration risk arising from excessive exposure to certain counterparties and to certain risk factors, the guidelines make a number of recommendations to institutions such as the use of internal limits on these concentrations or equivalent systems and the need to have written policies on the management of this risk and systems for assessing the capital necessary to cover it.

As for stress tests, these are required in various parts of the Directive. Their scope differs but their aim is always to obtain a view of risks that is more independent of the assumptions that underlie capital calculations. The guidelines address aspects like the frequency with which these tests should be performed, the type of scenario that should be envisaged, the quality of the data, etc.

The CEBS’ work on the FINREP (relating to financial information) and COREP (relating to solvency) reporting frameworks continued to pursue the further rationalisation of reporting requirements in the EU. In 2006 updated versions of each were published.

The CEBS declared its intention to update periodically the guidelines for preparing financial statements (FINREP) and prudential returns (COREP) so as to take account of new developments in international accounting standards (IAS/IFRS) and in the reporting requirements derived from Directives 2006/48/EC and 2006/49/EC.

The CEBS published last December the version of FINREP for 2007. This new version includes changes of minor importance to resolve problems noted when the FINREP taxonomy and the national adaptations to it were being developed. Similarly, in October 2006, the CEBS published an updated version of the common framework for prudential returns. In preparing it, the CEBS secretariat was supported by the operational network entrusted with updating and maintaining it.

Since its creation in September 2006, the COREP operational network has been co-ordinated by the Banco de España. In addition, the Banco de España has co-ordinated the XBRL operational network.

In other areas, the CEBS completed its guidelines on “The recognition of external credit assessment institutions” which, in addition to providing guidance for assessing rating agencies, establishes a joint procedure for assessment by European supervisors which has already been

put into practice for the recognition (informal until such time as the legislation comes into effect) of those agencies that have requested it.

After several years of discussion, guidelines on “Outsourcing” were also published. These consist of a set of principles based on the current practices of the industry and of supervisors, without overlooking international regulatory developments. The CEBS and CESR co-operated closely to make the guidelines consistent with the Markets in Financial Instruments Directive (MiFID).

It is also important to note the work on supervisory transparency commenced last year, whereby both the CEBS and all national supervisors are publishing on their respective websites information on how the Capital Adequacy Directive is being implemented.

To implement the recommendations included in the Franq report, the CEBS set up a Convergence Task Force entrusted with this task. The work of the task force has focused on analysing the mechanisms for fostering joint inspections, common training programmes, staff exchanges, mediation and peer review⁴ among supervisors. In all these projects it has worked in conjunction with the CESR and CEIOPS and, in particular, for the mediation and peer review projects the mechanisms already implemented by the CESR are being analysed to adapt them to the specifications of banking supervision.

Regarding the aim of promoting co-operation and information exchange between supervisors, now that it has completed the package of guidelines, the CEBS has undertaken a clear change in its focus, moving from the design of the conceptual framework of supervision (represented by the issuance of guidelines) to concentrate on greater convergence in day-to-day supervisory practice. The most obvious sign of this change has been the creation of a group formed by the “operational” supervisors (both home and host) of a set of banking groups with a presence in various EU countries which, in turn, are supported by “operational” groups of specialists in credit and operational risk. The aim of this group, which works in close co-operation with the related banking groups, is to identify any issues that arise in the practical application of the Directive and the CEBS guidelines. The Banco de España is present in this group in its capacity as home-country supervisor of one of these banking groups.

Also, the CEBS has started to hold implementation seminars (four in 2006) to which it invites industry representatives. These seminars provide a forum in which to share experiences and discuss practical problems affecting both supervisors and supervised institutions.

Following is a list of the documents published by the CEBS in 2006:

Advice to the European Commission

May	Current supervisory practices on large exposures
June	Current rules on own funds and market trends in new capital instruments
August	Industry practices on large exposures
October	Joint letter with the CESR and CEIOPS regarding the proposal to amend the procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of shareholdings in the financial sector.

4. Peer reviews of national supervisory practices by supervisors from other EU countries are intended to strengthen compliance with members' commitments to supervisory transparency at level 3.

Standards and guidelines

January	Guidelines	Common reporting framework (COREP) to be used in reporting the solvency ratio to supervisory authorities
January	Guidelines	Recognition of External Credit Assessment Institutions
January	Guidelines	Supervisory review process under Pillar 2
January	Guidelines	Supervisory co-operation for cross-border banking and investment firm groups
April	Guidelines	Validation
October	Technical guideline	Interest rate risk in the banking book.
October	Recast version of guidelines	Common Reporting (COREP) of the new solvency ratio
December	Guidelines	Outsourcing
December	Technical guideline	Concentration risk.
December	Technical guideline	Stress testing
December	Recast version of guidelines	Financial reporting (FINREP)

QIS 5

June	Results for Europe
------	--------------------

4.3 Work of the Basel Committee on Banking Supervision

The Committee's work revolved around two broad matters: the implementation of Basel II and the review of the core principles for banking supervision.

Regarding Basel II, the BCBS focused its efforts on smoothing the process of implementation of this complex agreement. In view of the findings of the fifth Quantitative Impact Study (QIS 5), the BCBS decided not to change the quantitative parameters, thereby concluding the Basel II new framework⁵. In general, the QIS 5 yielded results in line with the incentives included in the framework to encourage credit institutions to adopt more advanced methods to calculate their capital requirements.

The BCBS also worked, through its implementation group (AIG) currently chaired by the Banco de España, to promote consistency in implementation through the exchange of information and experience between supervisors. This work includes most notably: 1) validation, operational risk and trading book studies, and 2) principles for effective home-host information sharing.

Noteworthy in the area of information exchange between supervisors is the work by the AIG in conjunction with the Core Principles Liaison Group⁶ (CPLG) (currently the International Liaison Group (ILG)) which enabled the publication in June 2006 of a document setting out general principles for information exchange between home and host supervisors for effective implementation of Basel II. The document includes practical examples of the information to be provided by institutions and by home and host supervisors to facilitate the implementation process. Further to this work, in February 2007 the BCBS released for public comment a se-

5. The CEBS, which had played a primary role in conducting the QIS 5 at EU level, published in June 2006 the results of the study for Europe. 6. Working group in which supervisors from 16 countries not belonging to the Committee participate.

ries of principles for home-host supervisory co-operation and allocation mechanisms in the context of Advanced Measurement Approaches (AMA).

From a more academic standpoint, the BCBS also worked on certain matters on which the industry had requested clarification, such as the inclusion of vendor models in advanced internal models and the requirements for use tests. Also, important work was done on concentration risk.

Review of core principles for effective banking supervision (BCP). Following the publication of Basel II, this review accounted for a good part of the work of the BCBS in close consultation with the ILG (formerly the CPLG — Core Principles Liaison Group) and its final text was approved in an international meeting of banking supervisors (Mexico, October 2006). The “new principles” pay significantly more attention to appropriate risk management and to corporate governance practices. A new catch-all principle covering all matters common to the different risks was added, and improvements were made to the criteria for assessing interest rate, liquidity and operational risk and to those for money laundering, terrorist financing and preventing fraud. In addition, international and inter-sectoral trends and developments are reflected more fully, as is the need for closer co-operation and information exchange between the supervisory authorities of different countries and sectors. The review also highlights the importance of independence, accountability and transparency of the supervisory authorities.

In other areas, mention should be made of the Basel Committee’s work on accounting matters, such as the use of fair value, the valuation of assets and corporate governance.

The Joint Forum carried out important work on business continuity (see table) giving useful insight into the wide range of practices used by institutions, on the regulatory and market differences across sectors and on liquidity risk management.

The documents published by the BCBS/Joint Forum in 2006 were:

October	BCBS	Document	Practices in the application of AMA
October	BCBS	Principles	Effective banking supervision
August	Joint Forum	Principles	Business continuity
June	BCBS	Guidelines	Sound credit risk assessment and valuation for loans
June	BCBS	Guidelines	Use of the fair value options for financial instruments by banks
June	BCBS	Principles	Home-host information sharing for effective Basel II implementation
May	BCBS	Press release	Calibration of Basel II framework
May	Joint Forum	Document	The management of liquidity risk in financial groups
May	Joint Forum	Document	Regulatory and market differences: issues and observations
February	BCBS	Guidelines	Corporate governance in banking organisations

4.4 Work on financial stability in the ECB

The Banco de España, via its participation in the Eurosystem's Banking Supervision Committee (BSC), continued working in 2006 on the preparation of the reports published by the ECB, such as the half-yearly Financial Stability Review, the yearly report on banking sector stability in the EU and the analysis of developments in European banking structures. Specific issues also addressed in 2006 included the impact of the new accounting standards on financial stability and the activity of hedge funds. Work also proceeded on the risk management practices of European banks.

Mention should also be made of the study in the area of cross-border financial crisis management that the BSC and CEBS carried out jointly on practices in information exchange and co-operation that should be followed by central banks and supervisors. The aim of this work was to enhance the operational effectiveness of the existing mechanisms and to determine the areas that can be improved.

4.5 ASBA

On 2 October 2006 the Assembly of the Association of Banking Supervisors of the Americas (ASBA by its Spanish acronym) approved the Banco de España's change in status within the Association from collaborating member to associate member, which will entail a greater involvement of the Banco de España in the activities of ASBA.

In 2006 the Banco de España again organised the seminar on validation of advanced credit risk models and the Basel II implementation process for Latin American supervisors. The supervisors of other countries in which Spanish banks have a presence were also invited to attend the seminar. The aim was to communicate the experience of the Spanish supervisory authority in this area and to promote an exchange of view on the best way of confronting the transition to Basel II.