

4 DEVELOPMENTS IN INTERNATIONAL BANKING REGULATION AND SUPERVISION
FORA IN 2007

4 Developments in international banking regulation and supervision fora in 2007

In 2007, work to implement the new solvency regulations envisaged in Basel II continued to account for a significant proportion of international committees' activities. In the European Union, 2007 was the year of debate on the revision of the Lamfalussy model and of development of co-operation mechanisms for the supervision of cross-border groups, which meant intense discussion and work for the EU's strategic supervisory committees. Also, from summer the turbulence on financial markets brought a considerable increase in their activity and affected their work plans due to the need to tackle issues directly related to the turbulence and, more specifically, to draw the lessons which the international supervisory community should learn from it.

Once again the Committee of European Banking Supervisors (CEBS) was very active issuing guides and recommendations to facilitate convergence in the implementation of Basel II in the European arena and there was a significant increase in the resources assigned to the tasks of advising the European Commission, in addition to the above-mentioned work for handling the supervision of cross-border groups in a more efficient and co-operative fashion. The Basel Committee also continued to work on the implementation of Basel II, particularly on tasks regarding the definition of capital, liquidity risk and its management and intensifying the dialogue between industry and regulators.

Furthermore, in the latter part of the year, the supervisors began to exchange information about events on financial markets in order to draw lessons from them and decide on the appropriate response of the supervisory community in regard to liquidity risk, the valuation of complex financial products and the treatment of securitisations and of risk transfer under Basel II. In the European arena, the EU Council of Ministers' meeting in October 2007 drew up a road map with the work to be carried out in this respect in 2008, emphasising these very matters, among others.

The Banco de España continued to participate in the work to prepare yearly reports and half-yearly reports on financial stability and developments in EU banking structures within the framework of the European Central Bank's Banking Supervision Committee (BSC).

In the last year the activity relating to cross-sectoral matters has increased. It is handled jointly by the three level 3 ("3L3")¹ sectoral committees of supervisors which exist in Europe, with a considerable increase in the work performed together by the "3L3" and the Interim Working Committee on Financial Conglomerates (IWCFC) for European Institutions. The regulation of substitute products, the valuation of financial instruments, commodities derivatives, cross-border acquisitions and conglomerates was prepared. Also, work was done on developing a training platform with a shared curriculum.

The Joint Forum² completed its work on risk concentration, the update of the 2005-2007 credit risk transfer report and the report on customer suitability. The three reports have been sent to the three "Parent Committees" (Basel, IOSCO and IAIS) for publication in the first half of 2008.

1. The three level 3 committees are: CEBS (banking), CESR (securities) and CEIOPS (insurance). 2. The Joint Forum is a group of experts which conducts its activity under the umbrella of three international committees of supervisors of banking (Basel Committee), securities (IOSCO) and insurance (IAIS). This activity is related to financial conglomerates and the study of topics of interest for the three committees.

ACTIVITY OF SUPERVISORY COMMITTEES IN 2007

TABLE 4.1

Number (a)

	GROUPS	MEETINGS
Committee of European Banking Supervisors (CEBS)	32	101
Groupe de Contact (GdC)	11	30
Expert Group on Capital Requirements (EGCR)	9	25
Expert Group on Financial Information (EGFI)	7	22
OTHER	5	19
Interim Working Group on Financial Conglomerates (IWCFC)	2	7
Banking Supervision Committee (BSC)	9	22
Working Group on Macroprudential Analysis (WGMA)	4	6
Working Group on Banking Developments (WGBD)	1	6
OTHER	4	6
Basel Committee on Banking Supervision (BCBS)	26	59
Policy Development Group (PDG)	12	27
International Liaison Group (ILG)	3	3
Accord Implementation Group (AIG)	3	13
Accounting Task Force (ATF)	8	12
JOINT FORUM	2	8
Working Group on Risk Assessment and Capital (WGRAC)	1	3
Working Group on Financial Conglomerates (WGCP)	1	2
TOTAL	73	197

SOURCE: Banco de España.

a. The numbers for each committee include the individuals in the groups reporting to the committee and the committee members.

Table 4.1 includes information on the groups and sub-groups (numbering more than 70) which report to the various Committees and which held nearly 200 meetings in 2007, the vast majority of them with the direct active participation, as members, of Banco de España representatives. In 2007, the Banco de España chaired four groups.³

Similarly, mention should be made of the increase of the Banco de España's activity undertaken in collaboration with the Association of Supervisors of Banks of the Americas (ASBA).

Last, but not least, it should be underlined that within the Banco de España's activity there has been a substantial increase in the tasks of supporting international technical co-operation on supervision as regards attending to and receiving delegations of foreign supervisors and tasks which require the participation of members of the Banco de España as speakers in national or international seminars for supervisors from other countries.

4.1 The work of the Committee of European Banking Supervisors⁴

2007 saw a considerable increase in the CEBS's activity in line with the plan envisaged in its programme for 2007, focusing on three main areas: the implementation of Basel II, including

³ The Basel Accord Implementation Group (AIG); the Group on Large Exposures, and the Delegation Task Force within the CEBS; and the Conglomerates Group within the Joint Forum. All the groups will continue their work in 2008. ⁴ Annex 6 of the version of this Report published on the Banco de España's website lists the documents on advisory matters and the standards and guidelines published by the CEBS in 2007.

technical advice for the European Commission, the review of the functioning of the Lamfalussy framework and the development of mechanisms for co-operation and convergence in supervisory practices for cross-border groups.

Tasks involving advice to the EC have absorbed a substantial amount of the CEBS's resources. Five specific issues were raised:

Own funds. The preparation of a report on the quantitative analysis of the types of own funds of credit institutions in the EU was completed. The report placed particular emphasis on the analysis of the impact of the differences in national implementation of EU rules on hybrids which are based on the rule known as the "Sydney Press Release". The purpose of this study is to support a possible review of the definition of own funds which is also being revised by the Basel Committee.

Large exposures. The group of experts, chaired by the BE, completed the first part of the work commissioned by the Commission to prepare a proposal on how regulation of the limits on large exposures should be adapted to new solvency regulations. It was concluded that maintaining the limits on large exposures makes sense in order to strengthen financial stability, although, certain technical aspects should be modified to take into account the new regulatory framework. In particular, greater convergence of supervision was achieved with a sharp reduction in the large number of areas open to national discretion under current regulations.

Liquidity. The CEBS continued to work on the analysis of liquidity risk as a result of the turbulence in summer.

The other two matters which completed the tasks involving advice were: the completion of the document on *supervisory practices for the commodities business and firms specialised in the commodities business* and, in collaboration with the IWCFC, the *equivalence of EU, Swiss and US supervision*.

As for the work related to the review process of the Lamfalussy framework, the CEBS completed the implementation of the ECOFIN's recommendations based on the report of the Financial Services Committee (FSC) known as the Francq Report (design of a mediation mechanism, development of instruments to foster a common supervisory culture, etc.) and actively participated by contributing its experience and opinion about the process of reflection on the functioning of the Lamfalussy approach, in general, and on its own role (that of the CEBS) and resources, in particular.

Lastly, in the area of co-operation and convergence of supervisory practices, the CEBS endeavoured to achieve real convergence of practices and to strengthen relations between national supervisors. Noteworthy is its active role in the organisation and work of colleges of supervisors to achieve more effective supervision of large banking groups. In this same vein, for example, are the drafting of a template for an agreement or memorandum between supervisors involved in the supervision of the various institutions in a group, focusing on the functioning of the colleges, and the exploration of possible delegation of tasks between supervisors. Likewise, the CEBS continues to work very actively to achieve harmonised prudential statements for financial reporting (FINREP) and capital requirements (COREP). Finally, peer reviews will be an important mechanism for convergence: the CEBS has already completed the protocol and methodology for such reviews and has created a group, the Review Panel, which will undertake the first one in 2008.

In December 2002, ECOFIN decided to extend the Lamfalussy approach to financial regulation and supervision to the banking and insurance sectors in order to bring the EU regulatory and supervisory framework into line with a rapidly changing and increasingly integrated EU financial market.¹

Directive 2005/1/EC of 9 March 2005 stipulated that the first full review of the functioning of the Lamfalussy approach in the financial sectors had to be conducted at the end of 2007. To this end, the *Inter-Institutional Monitoring Group* (IIMG, originally created for the securities sector) was set up in 2005 with the remit that by the end of 2007 it was to issue a report assessing the progress made in implementation of the Lamfalussy approach and identifying possible bottlenecks.

The ECOFIN Council adopted its final conclusions on the review of the Lamfalussy approach at its meeting on 4 December 2007. It concluded that, after these initial years, the outcome is positive, with a significant increase in the efficiency and effectiveness of the EU regulatory and supervisory framework and in the quality of the legislative process.

Even so, it considered that there are a number of improvements to be made, dividing them by level.²

For *levels 1 and 2* (framework principles and technical measures, respectively), the improvements recommended are as follows:

- The transposition and implementation deadlines should be more realistic.
- It welcomes the Commission's recent practice of explaining divergences in its decisions from Level 3 technical advice, should such explanations be requested.
- Greater importance is accorded to communication with the users of financial services.
- It underlines the importance of economic impact assessments.
- It notes the need to make an effort in reducing to a minimum the national options and discretions in directives, and invites Parliament to join in this effort.
- It invites the member countries to review the options and discretions implemented in their national legislation, limit their use and report to the Commission on these findings. Also, it proposes the inclusion of a "review clause" when the legislation introduces any options and discretions.
- It invites the Commission to conduct cross-sectoral consistency checks.

For *level 3* (uniformity in transposition, advice and co-operation and convergence between supervisors), the recommendations are as follows:

- It invites the Commission, in cooperation with the level 3 committees, to study the differences in supervisory powers between countries. In addition, cross-sectoral studies are requested on the consistency, equivalence and use of powers by the various Member States and on the variance of sanctioning regimes and powers.
- It invites the Commission by April 2008 to clarify the role of the level 3 committees and strengthen the working of these committees, without unbalancing the current institutional structure.
- It invites the level 3 committees to send their draft work programmes to the Commission, the Council and the European Parliament and to report annually on the achievement of their objectives.
- It underlines the importance of including in the mandates of national supervisors the obligation to co-operate within the EU and to work towards European supervisory convergence and to take into account the financial stability concerns in all Member States.
- It invites the level 3 committees to explore the possibilities of strengthening the national application of their guidelines by the Member States, without changing their legally non-binding nature.
- It requests the level 3 committees to introduce the possibility of using qualified majority voting (instead of consensus) for certain cases, as well as the obligation that the countries not complying with the decisions taken have to explain why they have not done so.
- Given the heavy workload of these committees due to Community legislation, it invites the Commission to consider financial support under the EU budget for specific EU-wide projects that are requested from the level 3 committees. It also asks for an itemised cost-benefit analysis to be conducted before these committees are asked to undertake work that would require significant investment.
- It welcomes the level 3 committees' efforts to develop tools aimed at achieving a common supervisory culture (joint training programmes, etc.), and invites the Commission to study the possibilities for EU funding under the EU budget of such programmes.

Within the recommendations to level 3 committees, ECOFIN has included a specific section aimed at efficient and effective supervision of cross-border groups, in which it:

- Invites the Commission to review financial services Directives to include provisions to enable the use of the voluntary delega-

1. See the 2003 and 2004 Reports on Banking Supervision in Spain. 2. See Box A1.1 of the 2003 Report on Banking Supervision in Spain.

tion of tasks. In addition, the Commission, as well as the level 3 committees, are invited to analyse the options for the voluntary delegation of supervisory competences.

- It considers that the functioning of the colleges of supervisors could be enhanced by the introduction of a set of common operational guidelines referring to the rights and responsibilities of the different members. Also, it invites the committees to be the ones to set these guidelines (focusing on working procedures and on decision-making processes) and subsequently supervise their functioning.
- It invites the Commission, with the assistance of the level 3 committees, to review the financial services Directives in the area of supervisory co-operation and exchange of information between competent authorities.
- Finally, it proposes to the committees that the statements to be sent by institutions should have a common format at EU level.

Also, it invites the Commission and the committees to suggest by mid-2008 a common timetable for the remittance of these statements.

For *level 4* (compliance with EU rules) the recommendations are as follows:

- It reminds the Member States that they have to meet the deadlines set for implementing FSAP (Financial Services Action Plan) and other measures.
- It invites the Member States, with assistance from level 3 committees where needed, to adopt common formats to inform of the transposition and implementation of EU legislation.
- It stresses the importance that the required resources are allocated by the Commission to monitor accurate transposition and possible infringements.

4.2 Work of the Basel Committee on Banking Supervision⁵

The Committee's work in 2007 revolved around the implementation of Basel II and, from summer, the financial market turbulence. Notable in this connection is the work done by two of its main groups: the Accord Implementation Group (AIG) and the Policy Development Group (PDG).⁶ To this work was added other initially unplanned work which, in the case of the CEBS, derived from the financial market turbulence.

At the end of 2007 the Accord implementation Group, chaired by the Banco de España, had three sub-groups specialised in the validation of credit risk models, in the treatment of operational risk and in the trading portfolio.⁷ These groups continue to work on the exchange of experience in implementation of the Accord and on fostering convergence between the various jurisdictions. In the second half of 2007, the group focused its attention on reviewing the principles of banking supervision (Pillar 2) and began to work on Pillar 3 (market discipline).

During the year substantial progress was made in implementing co-ordination measures between home and host supervisors. Although many of the matters relating to home-host supervision are not new and it is the growing globalisation of banks that is responsible for this issue again being on the table, the fact is that Basel II has acted as a catalyst driving greater co-operation and communication, not only among supervisors, but also between supervisors and industry. Noteworthy in this respect has been the positive role that this exchange of information has played in the work of the "colleges of supervisors", where the contributions received from both individual entities and associations have been of enormous help.

The most noteworthy work carried out by the PDG is: that on liquidity risk, performed in parallel with CEBS work, that on definition of regulatory capital (analysing the characteristics of items

5. Annex 6 of the Internet version of this Report lists the documents published by the BCBS in 2007. 6. Sub-committee which began to operate in 2007, replacing the now-defunct "Capital Task Force". 7. The group specialised in the trading portfolio now reports to the PDG because its work has become increasingly focused on the preparation of rules for the treatment, in solvency conditions, of trading portfolio instruments and, in particular, on so-called incremental credit risk.

considered to be tier 1 and the differences across countries), the review of economic capital models used internally by institutions and the work on asset valuation. Work was also carried out to quantify the effect of the entry into force of Basel II on institutions' capital requirements and on incremental default risk in the trading book. Also, the PDG was the forum which initiated discussion on the lessons learned from the financial market turbulence and on the possible answers.

In 2007 the Accounting Task Force (ATF) continued working to ensure that international accounting and audit rules foster appropriate risk management at financial institutions, support market discipline through transparency and strengthen the solvency of the credit system. To this end it held high-level meetings with representatives of accounting and audit regulators, of the industry and of other international organisations and sent written comments on the most significant rules proposed for financial institutions.

Lastly, important work was carried out by the International Liaison Group (ILG) to extend the committee's debates to non-G10 supervisors.

In cross-sectoral matters, the Joint Forum, apart from completing the three reports mentioned above⁸, is examining the degree of implementation of the 1999 principles on financial conglomerate supervision. This work is being carried out by the Financial Conglomerates Group co-chaired by the Banco de España.

4.3 Work on financial stability in the ECB⁹

As in previous years, the Banco de España, as a member of the Banking Supervision Committee (BSC) of the European System of Central Banks, continued to co-operate in the work of the BSC groups and sub-groups. The main areas of work continue to be the monitoring of developments in EU banking structures, analysis of the impact of regulation on financial stability, the promotion of co-operation between central banks and supervisory authorities and the provision of support to EU activities in international fora.

As regards the first two, the Banco de España helped to prepare the reports regularly released by the respective groups: the yearly report on developments in banking structures, the yearly report on banking sector stability in the EU and the two half-yearly reports on financial stability published in 2007.

The yearly report on banking structures includes two (brief) special studies: one on liquidity risk management and another on retail banking product distribution channels. That on financial stability includes a special chapter on bank exposures in the mortgage market.

4.4 Association of Supervisors of Banks of the Americas (ASBA)

In 2007 the Banco de España stepped up its co-operation with the ASBA, which groups together banking supervisors in the Americas. The Banco de España, as an associate member since 2006¹⁰, participates in the governing bodies of the Association, in its management bodies, in its empowerment plans and in its working groups.

In the area of empowerment, two seminars were held (in May in Mexico DF and in October in Lima) on the most significant and controversial issues of the standardised and advanced approaches to credit risk under Pillar 1 of Basel II. Also, with the co-participation of CEMLA, a seminar was held in March on practical applications of the XBRL standard at central banks and banking supervisors, also in Mexico DF.

⁸. Risk concentration, update of the report on credit risk transfer 2005-2007 and the report on customer suitability. ⁹. Annex 6 lists the documents on financial stability published by the ECB in 2007. ¹⁰. On 2 October 2006 the Assembly approved the Banco de España's change in status from collaborating member to associate member.

Within the framework of co-operation with ASBA on training, for the first time Latin American countries were offered five places on each course given under the continuous training programme of the Banco de España's Directorate General Banking Supervision. Under this programme, supervisors of several Latin American countries attended.

In 2007 the Banco de España participated in the ASBA working group on consolidated supervision. Its aim is to prepare a document setting out the obstacles to effective consolidated supervision in Latin America and to identify the best practices and the challenges in this connection in the various countries. Its work will foreseeably be completed next July with the publication of the ASBA report.

