EN

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 1.10.2008
SEC(2008) 2532

COMMISSION STAFF WORKING DOCUMENT

Accompanying document to the

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

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

IMPACT ASSESSMENT

{COM(2008) 602 final}
{SEC(2008) 2533}

This document commits only the Commission's services involved in its preparation and does not prejudge the final form of any decision to be taken by the Commission

TABLE OF CONTENTS

1. INTRODUCTION

Financial markets are crucial to the functioning of modern economies. Their integration is critical for the efficient allocation of capital and for long-term economic performance.

Enhancing the single market in financial services is a crucial part of the Lisbon Strategy for Growth and Jobs and essential for the EU's international competitiveness.

The Financial Services Action Plan 1999-2005 (FSAP) aimed at reinforcing the foundations for a strong financial market in the EU by pursuing three strategic objectives:

– ensuring a Single Market for wholesale financial services;

– open and secure retail markets and

– state-of-the-art prudential rules and supervision.

Together with some other 40+ measures of the plan a review of the legislation governing the capital framework for credit institutions (banks) and investment firms was undertaken in order to align it with market developments and work of the G-10 Basle Committee on Banking Supervision (the Basle Committee)[1].

The then existing European legislation, the Consolidated Banking Directive 2000/12/EC and the Capital Adequacy Directive 93/6/EEC, was based on the Basel I Accord[2] of 1988 and the Basel market risk amendment of 1996. To keep up with the developments in the market, the latter were updated with final proposals for the Basel II Framework[3] in June 2004 and the Trading Book Review[4] in July 2005.

The 'new' Basel agreement was reflected in the EU as a new capital requirements framework that was adopted in June 2006 as the Capital Requirements Directive (CRD); this comprises Directives 2006/48/EC[5] and 2006/49/EC[6].

The CRD lays out the so-called **three-pillar** structure[7]:

Pillar 1 covers the capital required for credit risk, operational risk and market risk; the minimum capital requirements became much more risk-sensitive and comprehensive than in the past, facilitating better coverage of the real risks run by the institution;

Pillar 2 covers the review and evaluation of the credit institution's fulfilment of the requirements of the CRD by the supervisor and any resulting action; new rules include requirements for an 'internal capital assessment' by financial institutions, whereby they would

[1] The Basel Committee on Banking Supervision consists of central bank and supervisory authority representatives from the thirteen countries. Nine EU Member States are represented – Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden, and the UK. The other countries represented are Canada, Japan, Switzerland and the US. The European Commission, along with the European Central Bank, participates as an observer in the Committee itself and in its many working groups.

[2] The 'Basel Accord' is an agreement on capital requirements amongst the members of the Basel Committee. Although, strictly speaking applicable only to internationally active banks in the G10, the Accord had been applied to most banks in over 100 countries throughout the world.

[3] http://www.bis.org/publ/bcbs107.htm

[4] http://www.bis.org/publ/bcbs116.htm

[5] Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions

[6] Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions

[7] Certain policy options presented in this impact assessment are designed based on this structure.

need to assess their capital needs considering all the risks they face. These rules also require supervisors to evaluate institutions' overall risk profile to ensure that they hold adequate capital;

Pillar 3 covers the disclosure by institutions and facilitates a better understanding of the soundness and stability of financial institutions.

The new framework also enhanced the role of the 'consolidating supervisor' (the national supervisory authority in the Member State where a group's parent institution is authorised) by assigning it responsibilities and powers in coordinating the supervision of cross-border groups.

It is also important to acknowledge the role played by the Financial Stability Forum (FSF)[8] alongside the Basel Committee since the credit crisis broke out in 2007. The recommendations of both have been observed in developing the Commission's proposals on amendments to the CRD.

2. CHANGES: REASONS, PROCESS AND CONSULTATION

2.1. Reasons for CRD changes

The implementation of this Directive came into full effect on 1 January 2008. It is important to note that the CRD still has specific areas that were 'left open' at the time of its adoption on the understanding that they would be addressed subsequently through additional policy measures.

Recent financial turbulence has prompted an acceleration of certain supplementary legislation that was already being worked upon. These events have also raised certain issues with regard to securitisation, risk management and supervision that also need be addressed by targeted amendments.

In spite of its nascent implementation, revising certain provisions of the CRD has therefore become necessary.

– Amendments in areas **'left open'** at the time of the CRD adoption in 2006 represent:

  – either revisions of rules that were brought forward from previous directives, such as the *large exposures regime* (see Annex 1) and *derogations for bank networks from prudential requirements* (see Annex 4), or

  – establishing principles and rules that had not been formalised at the EU level such as the treatment of *hybrid capital instruments* within original own funds (see Annex 2).

– Inconsistencies that have been identified during the transposition phase of the CRD need to be addressed[9] to ensure that the effectiveness of the underlying goals of the CRD is not compromised. The majority of these are of a rather technical nature and less materiality

[8] After the 1997 crisis in the Far East and the 1998 in Russia and South America the Financial Stability Forum was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance. The Forum brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF seeks to co-ordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk.

[9] Mostly through the comitology procedure

and, therefore, are not covered in the impact assessment. However, a couple of more material revisions pertaining to the treatment of *life insurance as eligible collateral* (see Annex 5) and capital requirements for *collective investment undertakings under the IRB approach*[10] (see Annex 6) are covered in the analysis.

– The revision of certain other areas has been prompted by the **financial market turbulence** that started in 2007 and is aimed at ensuring adequate protection of creditor interests and overall financial stability. In this context, rules related to *capital requirements and risk management for securtisation positions* (see Annex 7) and *home-host supervisory issues and crisis arrangements* (see Annex 3) were re-examined.

Proportionate impact assessments were carried out for each of the above subjects individually; these provide a detailed presentation of problems tackled and policy solutions proposed. The main findings of this analysis are summarized in the following sections.

2.2. Consultation of interested parties

Consultative work with key stakeholder groups has been conducted to a large extent through the Lamfalussy committees (see Annex A: The Lamfalussy Process). The European Banking Committee (EBC) and the Committee of European Banking Supervisors (CEBS) have been extensively consulted throughout the project and their views have contributed to the preparation of this impact assessment.

2.2.1. CEBS

CEBS played a key role throughout the project as a source of technical expertise. The committee's work was carried out in response to the Commission's calls for advice.

2.2.1.1. CEBS' advice

In the context of **hybrid capital instruments**, the Commission issued a call for advice to CEBS in June 2005 to:

i. carry out a stock-take of current national rules on own funds;

ii. perform an analysis of the capital instruments recently created by the industry;

iii. develop guiding principles behind own funds and

iv. prepare a quantitative analysis of the types of capital held by credit institutions within the EU.

CEBS' contributions pertaining to parts (i) and (ii) were completed in June 2006 and March 2007, followed with analysis relating to part (iv) in June 2007. In light of the findings of these contributions, the Commission asked CEBS to consider whether convergence in the treatment of hybrids in the EU can be achieved. This led to CEBS' submitting a proposal for a common EU definition of hybrids in April 2008.

[10] The IRB Approach allows institutions to provide their own 'risk inputs' – probability of default, loss estimates, etc – in the calculation of capital requirements. The calculation of these inputs is subject to a strict set of operational requirements to ensure that they are robust and reliable. They are incorporated into a 'capital requirement formula' which produces a capital charge for each loan or other exposure that the institution makes. The IRB approach comes in two modes. The 'Advanced' mode allows institutions to use their own estimates of all relevant risk inputs. The 'Foundation Approach' requires institutions only to provide the 'probability of default' risk input, enabling a large number of less complex banks to reap the benefits of the risk-sensitivity provided by the IRB approach.

On **large exposures** the Commission issued a first call for advice to CEBS for a stock-take of current supervisory and industry practices in December 2005. The advice received in April and August 2006 resulted in a more targeted second call for advice in January 2007 on:

– the purpose and objectives of the large exposures regime;

– the recognition of credit quality and calculation of the metrics;

– a number of technical issues, such as the treatment of credit risk mitigation techniques and

– intra-group and inter-bank exposures.

The CEBS advice on this second call for advice was received in April 2008.

2.2.1.2. CEBS' advice and Better Regulation

CEBS' advice was prepared in a manner consistent with the Better Regulation agenda of the Commission as it follows draft impact assessment guidelines[11] that have been developed by CEBS together with CESR[12] and CEIOPS[13], the other two Lamfalussy Process Level 3 committees. Effective stakeholder consultation is a central part of these guidelines.

In the area of *large exposures*, market participants' views were gathered at various stages of the process. These included a survey of industry costs under the existing framework (2007), two public consultations (June 2007 and December 2007) and two public hearings (July 2007 and January 2008) on both parts of the advice.

On *hybrid capital instruments*, stakeholders' views were gathered via questionnaires on own funds to market participants (November 2005) and on current regimes for own funds to Member States (first half of 2007). A public consultation on CEBS' proposals for a common EU definition of hybrids (December 2007) and two public hearings (June and November 2007) were also carried out.

2.2.2. CRD Working Group

The Commission services also established a CRD working group (CRDWG) with members nominated by the EBC. To discuss possible improvements to the current legislative text, including areas covered by the impact assessment, the CRDWG met four times: in November 2007, January, February and March 2008 and conducted meetings that stretched over nine days.

2.2.3. Other public consultations

In June 2007, the Commission services hosted a **conference on the challenges for EU supervisory arrangements** in an increasingly global financial environment. Key stakeholders, including industry representatives, supervisors, central bankers and regulators, were brought together with a view to discussing efficiency and robustness of supervisory arrangements. All participants underlined the need to further develop a clearer European framework for dealing with cross-border crises, and agreed that efficiency of the current supervisory arrangements had to increase. Industry representatives strongly emphasized that the current nationally-based supervision is lagging behind market developments and business practices.

[11] http://www.c-ebs.org/press/IA_GL.pdf
[12] The Committee of European Securities Regulators, http://www.cesr.eu/
[13] The Committee of European Insurance and Occupational Pensions Supervisors, http://www.ceiops.org/

An **online public consultation on proposed draft changes** to the current legislation, including the areas covered by the impact assessment ran from 16 April until 16 June 2008 on DG MARKT website and the "Your Voice in Europe" web portal. 118 responses were received from various stakeholders, including industry associations and participants in the financial services sector from various Member States. The comments were generally supportive of the objectives of the Commission's draft proposals. In areas where respondents expected the proposals to create practical problems, amendments have been considered to ensure that the attempt to strengthen the prudential framework does not create undue aberrations in financial markets. The responses were also used to finalise the policy option parameters on certain specific issues in the large exposures and home-host arrangements areas. In order to fine-tune proposed policy measures in the securitisation area, the stakeholders were further consulted from 30 June until 18 July 2008 on an adjusted proposal for risk transfer products.

Throughout the project, the Commission services have participated in international fora and have closely followed the work of the Basle Committee.

2.2.4. Inter-service steering group

An Inter-Service Steering Group (ISSG) was set up to follow progress and feed in views from other services of the Commission, including Directorates-General for Enterprise and Industry, Economic and Financial Affairs, Competition, Legal Service and Secretariat General. The steering group met two times, in December 2007 and April 2008.

2.2.5. Impact Assessment Board

The draft impact assessment was discussed with the Impact Assessment Board[14] (IAB) of the Commission on 18 June 2008. This revised impact assessment report takes the comments of the IAB into account as follows:

– Wider benefits, compliance costs and impact on the administrative burden of the package have been clarified in section 5.8;

– The range of options to address supervisory arrangements in going-concern situations has been expanded in section 5.3;

– The report has been updated with the results of the public consultation;

– A glossary of technical terms has been added in Annex B;

– Other comments by the IAB have been reflected throughout the report.

3. PROBLEM DEFINITION

This section contains the overview of main problems and drivers underlying them for the key areas under review.

3.1. Large exposures

The aim of the large exposures regime is to protect against the risk of a regulated institution incurring a traumatic loss that is likely to threaten its solvency, as a result of the failure of an

[14] The IAB is an independent internal body of the Commission set up to ensure more consistent and higher quality of impact assessments prepared by various Commission departments. The IAB works under the direct authority of the Commission President. Its members are appointed in their personal capacity and on the basis of their expert knowledge.

individual client or group of connected clients due to the occurrence of unforeseen events[15]. To address the pertinent market failures of negative externalities, moral hazard and informational asymmetries, the Commission issued a recommendation[16] already in 1987, followed with a directive[17] in 1992. Thus, the regulation of banks' single name concentration risk is more than 15 years old. Even though some limited technical changes[18] were made to it at the time of the CRD adoption, given their limited number and extent, they cannot be said to constitute a review of the large exposures rules themselves. In recognition of this fact, Article 119 of 2006/48/EC and Article 28(3) of 2006/49/EC require a more in-depth review of the existing requirements "together with any appropriate proposals" to be submitted to the European Parliament and to the Council.

The current large exposures regime applies to all credit institutions and investment firms falling within the scope of the CRD. It defines a large exposure as any exposure to a client or group of connected client where its value is equal to or exceeds 10% of financial institution's own funds. The regime imposes regulatory limits in terms of maximum individual and aggregate exposures to a client and group of connected clients, expressed as a percentage of own funds. The CRD offers a number of 'discretions' as to how each Member State may treat a certain type of exposure. For example, Member States can choose to recognise less than 100% of the exposure value by applying a less than 100% risk weighting or exempt it altogether. Even though available evidence[19] [20] seems to indicate that the large exposures regime that has been in place since 1992 played a key role in preventing failures due to single name risk concentration, it nevertheless contains several shortcomings:

1. <u>High compliance costs for the industry</u>. For larger and more complex firms the current rules do not adequately reflect industry practice in measurement, management and reporting of single name concentration risk. The calculation methods used in the context of the large exposures regime significantly vary from methods used for internal risk management purposes. In addition, there is a general sense from financial groups that intra-group exposure limits are unduly constraining, given that risk management is conducted at the group level. Several studies and surveys of compliance costs pertaining to the current large exposures regime have been carried out recently, producing a wide range of estimates, likely driven by sampling and methodological differences.

– With regard to <u>reporting costs</u>**,** a survey of 30 leading financial institutions conducted by International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and British Banking Association (BBA) in 2006, showed that for large

[15] 'Unforeseen events' are events which are outside the parameters of portfolio capital allocation and, therefore, might trigger unexpected default of an institution or cause it to experience difficulties, regardless of the performance of the rest of the portfolio. Such events include a sudden drying up of market liquidity, internal fraud, government action, loss of a major customer or market and are usually not reflected in *ex ante* credit quality assessments.

[16] Recommendation 87/62/EEC on monitoring and controlling large exposures of credit institutions

[17] Directive on the monitoring and control of large exposures of credit institutions 92/121/EEC

[18] For example, recognition of the use of certain credit mitigation techniques

[19] Groupe de Contact, Paper for the Banking Advisory Committee *The Causes of Banking Difficulties in the EEA 1988-1998*; unpublished.

[20] CEBS has indicated that it has not found evidence of significant number of bank failures and difficulties caused by a single name concentration risk in the period from 1999 to 2007. CEBS, *Consultation Paper (CP14) on the First Part of its advice to the European Commission on large exposures*, June 2007

and internationally active institutions average annual reporting-related[21] **costs at a firm level were in the region of €2.5 million[22].**

– In terms of opportunity costs which are generally defined as **profits foregone** due to having to comply with the regime, CEBS' survey[23] revealed that firms rejected or partially rejected on average 3.5 transactions per year[24] because to enter into them would have resulted in breaching large exposures regulatory limits. **The ISDA/LIBA/BBA estimated opportunity costs at €6 million per financial group**.

2. The lack of clarity of certain definitions potentially has indirect implications for various stakeholder groups (such as creditors, shareholders and employees). Currently, there is uncertainty related to definitions such as what constitutes 'credit exposure', who can be considered 'counterparty' and when clients should be considered 'connected'[25].

3. Unlevel playing field conditions: As a result of numerous[26] discretions available to Member States and some difficulties arising from different – often inconsistent national - interpretations of definitions, there is a high level of divergence in how the rules are applied across the EU.

4. Higher burden for taxpayers and capital inefficiencies: The current CRD provisions allow a national discretion to exempt claims on other credit institutions and investment firms ('interbank' exposures) with a maturity of one year or less, and has a complex structure of risk weights for claims on other banks, which are different for different maturities above one year. Alternatively, Member States may use a general derogation to simply apply a 20% risk weight to all interbank exposures, regardless of the maturity thereof. Systemic risks can also occur on short term exposures and need to be addressed ex-ante to prevent bank failures; otherwise, the bail out of a bank would imply a high burden on taxpayers and further contribute to moral hazard with regard to the sector, especially in Member States where there is a 'natural' expectation that banks will not be allowed to fail.

5. Unwarranted compliance costs for certain types of investment firms: The public consultation revealed concerns of certain types of investment firms, such as investment managers, that the regime was not 'fit for purpose' in relation to their business. The large exposures of these firms normally take the form of accrued fees from their clients. In effect, the regime punishes success; the better the investment has performed, the larger the fee, and therefore the larger the exposure. In so far as exposures to clients' assets are concerned, these are segregated from the assets of the firm and even if the investment manager were to fail, the clients' assets would be safeguarded.

---

[21] These costs included reporting and policy personnel, IT/systems and system depreciation costs.

[22] No estimate of the Business-as-Usual factor was given.

[23] Survey of 106 banks and 57 investment and investment management firms from 15 EEA countries. For more details see: http://www.c-ebs.org/press/documents/LE_Part%202_07122007.pdf

[24] However this average masked the fact that only 31 out of total 163 respondents gave non-zero answers and 8 gave numbers greater than 10.

[25] For example, in terms of the concept of connected clients, until now, the supervisory authorities have focused only on the asset side of the entities in question in order to identify whether one entity may encounter repayment difficulties because of the financial problems of the other entity. The ongoing financial market turmoil has shown a clear need to clarify the concept, by taking into account not only the risk that derives from the business and assets of two entities but also from their liability or funding side.

[26] For instance, Article 113(3) of Directive 2006/48/EC contains 20 national options.

3.2. Hybrid capital instruments

Hybrid capital instruments (hybrids) are securities that contain features of both equity and debt. The purpose of issuing such instruments is to cover capital needs of banks while appealing to an investor class who is willing to take more risk than in fixed income (debt) products and who therefore also expect higher returns. From the banks' perspective, hybrids offer another source of funds. They are normally designed in a way that for regulatory purposes they qualify as 'original own funds'[27]. Hybrids are also quite tax efficient as the 'coupon' (interest) payable is tax deductible.

For hybrids to be recognised as 'original own funds', they need to fulfil the criteria of *loss absorption*[28], *flexibility of payments*[29] and *permanence*[30]. These criteria were agreed at the G10 level and announced in the Sydney Press Release[31] as far back as 1998; for various reasons they have still not been transposed into EU directives. As a result, several Member States (non-members of G10) do not have a regime for including hybrids within original own funds. Those that do have discretionary regimes that assess the fulfilment of the above criteria.

According to CEBS[32] [33], the outstanding amount of hybrids in the EEA at the end of 2006 was approximately €213 billion.

Financial institutions from eight countries (UK, DE, ES, FR, NL, IE, BE and IT) accounted for 89% of all hybrids. For these Member States, the share of hybrids within banks' original own funds was material at 18%.

The lack of legislation at the EU level has created the following problems:

1. Unlevel playing field conditions, Treatment across the EU differs in terms of characteristics that a hybrid instrument must meet in order to be eligible for inclusion within original own funds. For instance, several economic characteristics could be considered to evaluate whether the flexibility of payments criterion is met, including a 'payment-in-kind' feature that allows the issuer to suspend coupon payments by delivering newly issued shares. With regard to this feature, CEBS' analysis[34] showed that 10% of outstanding hybrids had it (mostly in UK, BE and NL) while 90% did not. Moreover, when Member States recognize hybrids as eligible, they apply diverging limits to their inclusion in original own funds. In BG, CZ, EE, LV, SK, PL and RO hybrids are not recognized as eligible original own funds. In the instance of Member States where there is a regime for hybrids, the maximum supervisory limit varies from 15% of original own funds in LU to 50% in DE, FI, FR, NL and UK. Diverging eligibility criteria and limits have created an unlevel playing field for banks operating within

---

[27] Original own funds is the most reliable and liquid element of a bank's capital. It comprises share capital, retained earnings and hybrid capital instruments which meet the criteria agreed at G10 level. Subject to technical differences, 'original own funds' correspond to the Basel Accord terminology of Tier 1 capital.

[28] Loss absorption: the instrument must be available to absorb losses, both on a going concern basis and in liquidation, and to provide support for depositors' funds if necessary.

[29] Flexibility of payments: the instrument must contain features permitting the noncumulative deferral or cancellation of payment of coupons or dividends in times of stress.

[30] Permanence: the instrument must be permanently available so that there is no doubt that it can support depositors and other creditors in times of stress.

[31] http://www.bis.org/press/p981027.htm

[32] CEBS, *Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA)*, March 2007

[33] CEBS, *Quantitative analysis of eligible own funds in the EEA*, June 2007

[34] CEBS, *Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA)*, March 2007

the single market area as the differences in treatment between Member States impact the relative issuance costs associated with hybrid capital instruments.

2. Regulatory arbitrage opportunities: the recent proposal for insurance regulation (Solvency II) includes a European legal framework for the recognition of hybrids within own funds. Inconsistent banking and insurance frameworks would provide opportunities for regulatory arbitrage, especially for financial conglomerate groups operating in both sectors, as they could opt to apply a more lenient set of sectoral rules. This would not only aggravate the unlevel playing field issues discussed above but also pose risks to the effectiveness of supervision.

3.3. Home-host issues and crisis management arrangements

The EU supervisory framework is based on the principles of:

– supervision on a consolidated basis and

– the country of origin.

The supervision of credit institutions is carried out by both home and host Member State supervisory authorities. Cross-border branches, as they do not have independent legal status, fall under the supervision of home Member State of their parent institutions, with limited and residual responsibilities (e.g., liquidity) entrusted to host Member State supervisors. Cross-border subsidiaries, as separate legal entities, are supervised on a solo basis by the authorities of the host Member State where they are incorporated. Home Member State authorities (consolidating supervisor) are, however, responsible for the consolidated overview of the financial health of a financial group, including its parent, branches and subsidiaries.

According to the ECB[35], in 2006, total assets of credit institutions in the EU27 were €36,894 billion (almost thrice the GDP of the entire EU). The European banking landscape is dominated by large cross-border groups: in 2005, 46 groups held about 68%[36] of EU banking assets. In the new Member States, the share of the total assets controlled by these groups ranged from 20% in CY and SI to around 90% in EE[37].

Over recent years, financial institutions have reconfigured their internal organisation. In pan-European institutions, risk, liquidity and capital management are increasingly executed centrally for all organisational units, and groups are increasingly organized according to business lines. Consequently, it is becoming increasingly difficult to organize supervision on a predominantly national basis. In this context, the following problems were identified:

1. Extra compliance costs and unlevel playing field for cross-border financial groups in going-concern situations. According to the IMF[38], current nationally-based supervision risks delivering a collection of customized and 'goldplated' national rather than a single set of best EU prudential policies and practices. This generates additional compliance costs for large cross-border financial institutions that have increasingly reorganised their internal organisational set-up, especially by centralising important business functions such as risk and

[35] ECB, *EU Banking Structures*, October 2007

[36] J-C Trichet, *Towards the review of Lamfalussy approach: market developments, supervisory challenges and institutional arrangements*, May 2007

[37] ECB, *EU Banking Structures*, October 2006

[38] IMF Country Report No. 07/260, paragraph 26 (http://www.imf.org/External/Pubs/FT/SCR/2007/cr07260.pdf)

liquidity management. Banks claim[39] that a multitude of differing supervisory requirements stemming from the divergent implementation of EU rules require more costly IT solutions and take more time to comply with the requirements. In addition, as not all market players are affected in the same way, this situation could lead to an uneven playing field.

Lack of clarity in the coordination role of the consolidating supervisor contributes to the sub-optimal cooperation level of the current supervisory arrangements, and, in turn, to the aforementioned issues. While the consolidating supervisor is expected to coordinate all supervisory activities, this CRD requirement is not explicit in how and which activities shall be covered. Without specific requirements in place, supervisors are less likely to cooperate and come to a common and coordinated approach.

In order to facilitate and establish effective and efficient group supervision, CEBS has developed a template Memorandum of Understanding[40] (MoU), which is currently tested by colleges of supervisors of 8 out of the 46 European cross-border banking groups. However, these guidelines are not legally binding, and supervisors would implement them on a best effort basis only. As a result, the initiative might lack effectiveness in preventing the duplication of supervisory requirements for cross-border banking groups.

2. <u>Increased financial stability risks for host Member States of systemically relevant branches</u>. With regard to cross-border branches, the home supervisor is not required to provide the host supervisor of a branch with specific prudential information. Therefore, supervisors of branches that are relevant for the stability of the banking system of a host Member State may receive little information about these establishments[41]. Furthermore, with the possibilities offered by the EU company statute, some companies are considering changing their subsidiaries into branches. This is already the case in the Nordic Member States (e.g., Danske Bank and Nordea Group) and potentially applies to other financial services providers throughout the EU. Whilst there may not be any real change in the way that such groups function, this would lead to an automatic shift in supervisory responsibility from the host to the home Member State. In the instance of a crisis this would imply that host authorities would normally be expected to limit any negative spill-over effects of a systemically relevant branch[42] in their domestic market, without having access to the necessary information.

3. <u>Sub-optimal effectiveness of supervisory arrangements in the prevention of crisis situations.</u> As financial supervision under the current framework is organized on a predominantly national basis (despite the fact that the 46 largest cross-border groups held about 68% of EU banking assets) with each Member State responsible for ensuring financial stability in its jurisdiction, Member States' incentives to develop EU principles and procedures for cross-border crisis prevention may be limited.

4. <u>Costs to creditors, employees and shareholders of cross-border groups as well as tax payers in case of a bank failure</u>. According to the IMF[43], a scramble for assets in a crisis, involving a

---

[39] The European Financial Services Roundtable (EFR), *Monitoring Progress in EU Prudential Supervision*, September 2007. EFR members are CEOs or chairmen of leading European financial institutions.

[40] MoU consists of a set of principles and procedures for sharing information, views and assessments, in order to facilitate the pursuance by participating authorities of their respective policy functions.

[41] According to the ECB, in EU25, asset share controlled by branches of credit institutions from other Member States increased from 7.7% in 2002 to 8.5% in 2006.

[42] For instance, according to Sweden-based Nordea's 2007 annual report, its market share in Finland for mortgage lending was 31%, personal costumer lending - 30% and corporate customer lending – 37%; while its market share in these segments in Denmark was 16%, 14% and 18%, respectively.

[43] IMF Country Report No. 07/260, paragraph 26

large and complex financial institution, is likely as the dominant strategy for supervisors would likely be to look out for the national interests, using informational advantages to that end. The current legal framework does not ensure that national authorities take into account the effect of their decisions on the financial stability of another Member State. The lack of incentives to cooperate might be detrimental not only to creditors, but also to shareholders and employees of cross-border banks (and eventually to tax payers in the instance of failures).

The IMF put special emphasis on the consequences facing EU states if large cross-border financial institutions were to fail. According to the ECB[44], 16 'key' banking groups that held around one third of total EU banking assets in 2005, held on average 38% of their EU assets in other Member States. At the same time, in 60% of Member States at least one such 'key' group accounted alone for more than 15% of domestic banking assets.

5. Potentially higher direct and indirect costs for EU economy in case of broader crisis. In terms of cooperation in crisis situations, the CRD only addresses the context of individual banking groups. It did not introduce any specific requirements where a broader crisis, e.g. turbulence in financial markets, would require supervisors of all affected entities to act collectively, and, if necessary, in cooperation with central banks. Recent financial market turmoil triggered by problems in the US 'sub-prime' mortgage market sector has demonstrated this to be a further shortcoming of the current supervisory structures.

In addition, while the CRD requires the consolidating supervisor to alert central banks and finance ministries in emergency situations, this is subject to confidentiality safeguards. The Member States' answers to a questionnaire of EBC on this subject confirmed the existence of legal impediments to information sharing between competent authorities, and central banks and finance ministries in other jurisdictions. The CRD does not provide for clear 'gateways', and its implementation in this area varies from one Member State to another. In the context of market turbulence, where the central banks are required to take actions through money market operations, the possibility of unfettered multilateral sharing of information between central banks and supervisors is of key importance.

3.4. Derogations for bank networks from certain prudential requirements

Article 3 of Directive 2006/48/EC allows Member States to establish derogations from certain requirements laid down by the directive for domestic credit institutions permanently affiliated to a central body, provided that:

(1) the central body fully guarantees the commitments of its affiliates or is jointly and severally liable along with them for their commitments,

(2) the central body's and affiliates' solvency and liquidity are supervised on a consolidated basis,

(3) the central body has the power to issue instructions to the management of its affiliates.

When these conditions are met, affiliated credit institutions do not have to meet certain prudential requirements[45] even though they are legally separate entities, based on the rationale that the economic behaviour of such a network closely resembles that of a single entity.

[44] J-C Trichet, *Towards the review of Lamfalussy approach: market developments, supervisory challenges and institutional arrangements*, May 2007

[45] Requirements to present a business plan and have two directors in order to get authorized to conduct their activities; initial and ongoing capital requirements as well as provisions governing risk management, large exposures and qualified holdings may be applied to the central body and its affiliates as a group rather than individually.

Therefore, from a prudential point of view, it is sensible to treat such legally separate credit institutions as branches by exempting them from certain CRD provisions.

The current Article 3 was introduced by the First Banking Co-ordination Directive 77/780/EEC and has been reproduced unchanged in the following recasts[46]. The provision sets the time limits for its application: in order to be eligible for the derogations, credit institutions had to be affiliated to a central body by 15 December 1977 and the regimes implementing it in national law had to be in place by 15 December 1979. At the time of its introduction, the proposed regime was applied to cooperative banks[47] only, therefore, it seems that the restriction of its scope to the then existing institutions was motivated by the concern of some Member States that it might lead to an unrestrained increase in the number of credit institutions benefiting from it. As the necessary adaptations of these 'eligibility dates' have not been provided for in the accession treaties of Member States[48] since 1979, the following problems emerged:

1. <u>Higher compliance costs for cooperative bank networks in the post-1979 accession Member States.</u> Currently, cooperative banks located in the Member States that acceded to the EU after 1979 cannot benefit from the derogations as the respective accession treaties did not include the necessary adaptations of the 'eligibility dates'. As a result, cooperative bank groups/networks with assets over €477 billion[49] and representing nearly 10 million members[50] in twelve Member States are potentially affected, assuming they are organized in structures meeting the aforementioned conditions (1), (2), and (3) as they could be exposed to higher compliance costs than is warranted from the prudential supervision standpoint. Effectively, such compliance costs might get passed onto cooperative members (as both clients and owners) and non-member clients.

2. <u>Cost increases for cooperative banks using the derogations if the directive provisions are enforced.</u> Another problem which is closely inter-linked with the issue described above is that certain Member States which acceded to the EU after 1979 have nevertheless implemented the derogations in their national law based on the understanding that the 'eligibility dates' could be interpreted as the date of their accession or some other date different from those set out in the article. Even though in line with the spirit of Article 3, from a legal point of view, this is in breach of the directive. According to the information available to the Commission services, out of the ten Member States[51] that applied Article 3 in 2007, only five (BE, FR, LU, NE and DK) had joined the EU before 1980. In the case of PT, its accession treaty provides for the adaptation of the 'eligibility dates' of Article 3. The remaining four Member States (ES[52], FI, CY and RO) were applying it in contradiction with the directive since their EU accession treaties had not adjusted the time limits laid down in the article. If no alternative solution is found, the Commission will have to enforce the directive provisions in the non-compliant Member States. As a result, banks based in these Member States would become subjected to higher than warranted compliance costs.

---

[46] Directive 2000/12/EC and Directive 2006/48/EC

[47] The introduction of this regime was requested by the Netherlands which applied it at the time (and still is) to a co-operative bank organisation.

[48] Except for Portugal where the amendment was carried out.

[49] Source: European Association of Cooperative Banks (2006 data)

[50] Cooperative banks are normally established based on their member capital contributions. However, some cooperative networks also access public capital markets for additional funding.

[51] The derogations were used by 11 cooperative bank groups: eight of them in the compliant and three in the non-compliant MS.

[52] Spain has transposed the regime, but had no Article 3 users.

3.5. Life insurance as eligible collateral

The CRD allows for life insurance policies pledged to the lending credit institution to be recognised as collateral, thus reducing the net exposure and hence the capital required for credit risk. Recognition is, however, limited to situations where the life insurer is externally rated in a way that would qualify him for a risk weight of 50% or less under the Standardized Approach[53] OR the equivalent under the Internal Ratings Based (IRB) Approach. Where they are recognised, life insurance policies are treated as if they were a guarantee provided by the life insurance company.

Currently, the ratings and the risk weights derived from them depend on the general ability of the life insurance company to fulfil its financial obligations. This disregards the fact that the realisation of the claim resulting from a life insurance policy does not depend on the general ability of the life insurance company to fulfil its financial obligations, but on the value of assets specifically dedicated to cover the company's liabilities from the outstanding life insurance contracts. This is because the life insurance company is required to protect the surrender values of the life insurance policies by the values of assets of a certain minimum quality and ensure their appropriate diversification[54]. Furthermore, the policyholders' claims on these assets take precedence over any other claims in case of default of the life insurance company[55]. Consequently, even where an insurance provider is not eligible based on its general financial strength, the special protection of life insurance policyholders' claims will in many cases still justify the prudential recognition of these claims as collateral.

Given the existing eligibility requirements, many life insurance companies[56], regardless of their actual credit quality, have a competitive disadvantage as they are not rated as required and hence their policies cannot be used as collateral under the CRD. Smaller insurance companies are particularly affected as an external credit rating may be prohibitively costly. In turn, the clients of unrated insurers incur costs as their ability to obtain a loan in general or on better terms by securing it with their existing policies, is impaired.

3.6. Capital requirements for Collective Investment Undertakings under the Internal Ratings Based Approach

Generally, a credit institution that uses the IRB approach has to do so for all exposures. This rule is meant to avoid cherry picking by institutions: otherwise they could apply the more risk sensitive IRB approach for their less risky exposures and the less risk sensitive Standardised Approach for the riskier exposures, thus, playing with the capital requirements. For exposures in the form of a Collective Investment Undertakings (CIUs), such as investment funds, in principle, banks should 'look through' to the investments that the CIU has made and apply the IRB approach to them[57]. However, normally banks do not know all individual items[58] in the

---

[53] Standardized Approach does not require institutions to provide their own estimates of risks in the calculation of capital requirements. It nonetheless incorporates enhanced risk-sensitivity by permitting the use of, for example, external ratings of rating agencies and export credit agencies. It also permits the recognition of a considerably expanded range of collateral, guarantees and other 'risk mitigants'.

[54] Articles 20 to 26 of the Directive 2002/83/EC

[55] Article 10 of the Directive 2001/17/EC

[56] According to the CEA, the European insurance and reinsurance federation, in 2005 there were some 1,250 companies writing life insurance in EU25. Standard & Poor's, for instance, currently rates only 103 EU life and multi-line (writing both non-life and life business) insurers and only 81 of them in a way that allows for a risk weight of 50% or less.

[57] Article 87(11) and (12) of Directive 2006/48/EC

[58] This could be impossible on an ongoing basis, because the CIU manager will treat its investment decisions as confidential in particular vis-a-vis banks who could imitate the strategies of the CIU.

CIU and, even when they do they are not able to provide internal rating[59] for these items. Consequently, banks resort to alternative solutions.

The CRD provides for the possibility to have the asset manager of the CIU calculate the capital requirement for the CIU on the basis of the Standardised Approach, although subject to the modification that for every exposure, the risk weight applied is that of the next riskier category ('Standardised Plus' Approach, SPA). For instance, an exposure subject to 20% risk weight under the Standardised approach would then be subject to a 50% risk weight if held in a CIU that would be normally subject to the IRB (representing a percentage increase in risk weights of 150%). The purpose for this penalisation is to give incentives to banks to provide internal ratings and discourage partial use of the Standardised Approach. However, the current incentive-geared formula is too punitive for banks, resulting in:

1. Higher compliance costs for the IRB approach banks due to capital requirements disproportionate to risk. As in practice banks will be often unable to apply the IRB to individual exposures in the CIU, they will be forced to resort to the SPA. This approach delivers, however, extreme increase in capital requirements, for the lowest risks from 0% to 20% and for the next best still by 150%, 100%, 50% and 30% respectively. Furthermore, these increases create the perverse effect of being higher for externally well rated, less risky exposures where there is less of a concern of them being "hidden" in the CIU. For externally unrated exposures, the percentage increase is by 50% for corporates, to take an example, and is much lower than the percentage increase for a corporate rated single A, which would be 150%. However, it is in particular externally unrated exposures where there should be more emphasis on incentives to provide an internal rating so that they can be covered in a risk-sensitive fashion.

2. Negative implications for the CIU managers. CIU managers are also negatively affected if there is no adequate treatment for CIUs held by credit institutions that apply the IRB approach. As a consequence, some credit institutions might choose to avoid investments in CIUs and manage their investments on their own balance sheets.

3.7. Capital requirements and risk management for securtisation positions

Current estimates of the IMF[60] indicate that there may be losses of approximately €600 billion for the world wide financial system due to the current financial market turmoil, with securtised instruments accounting for the bulk of them. Estimates of the OECD[61] peg the subprime crisis' losses at approximately €270 billion[62]. Even though the turmoil was triggered by losses on US mortgage loans, the impact on EU banks was huge as they are exposed via securitisation[63] to the risks that originate from the US. As of April 2008, Bloomberg reports losses totalling over €45 billion for European banks and over €155 billion for banks worldwide. These losses essentially raise the question whether EU banks' risk management and related regulations were good enough and associated capital requirements commensurate with the risks.

---

[59] Often the CIU exposures will not be the same as those that the bank has rated internally, thus it would have to perform a rating process for every new exposure in the CIU. However, the necessary access to information to assign the rating may be lacking, as the bank would have no direct client relationship with the issuer of an instrument that the CIU invested in.

[60] IMF, *Global Financial Stability Report*, April 2008

[61] OECD, *The Subprime Crisis: Size, Deleveraging and Some Policy Options*, April 2008

[62] Assuming 40% recovery on defaulting loans and an economic and house price scenario benchmarked against previous episodes.

[63] The IMF states, however, that some UK banks appear to have significant exposure to unsecurtised loans

The CRD provisions[64] with regard to the capital treatment for securtisations to a large extent mirror the related requirements of the new Basel II Accord and were adopted in 2006. Their application became mandatory only from 2008 when an option for banks to use the old credit risk provisions based on the old Basel I Accord expired. Even if the regulatory situation for banks certainly improved, the implementation of the CRD is very recent and it is important that the CRD is rigorously implemented. The current market turmoil has revealed the need to provide clarifications on certain provisions in the CRD; it has also raised the question on whether more stringent capital requirements should be imposed with regard to the 'originate to distribute' model.

3.8. Is action necessary at EU level?

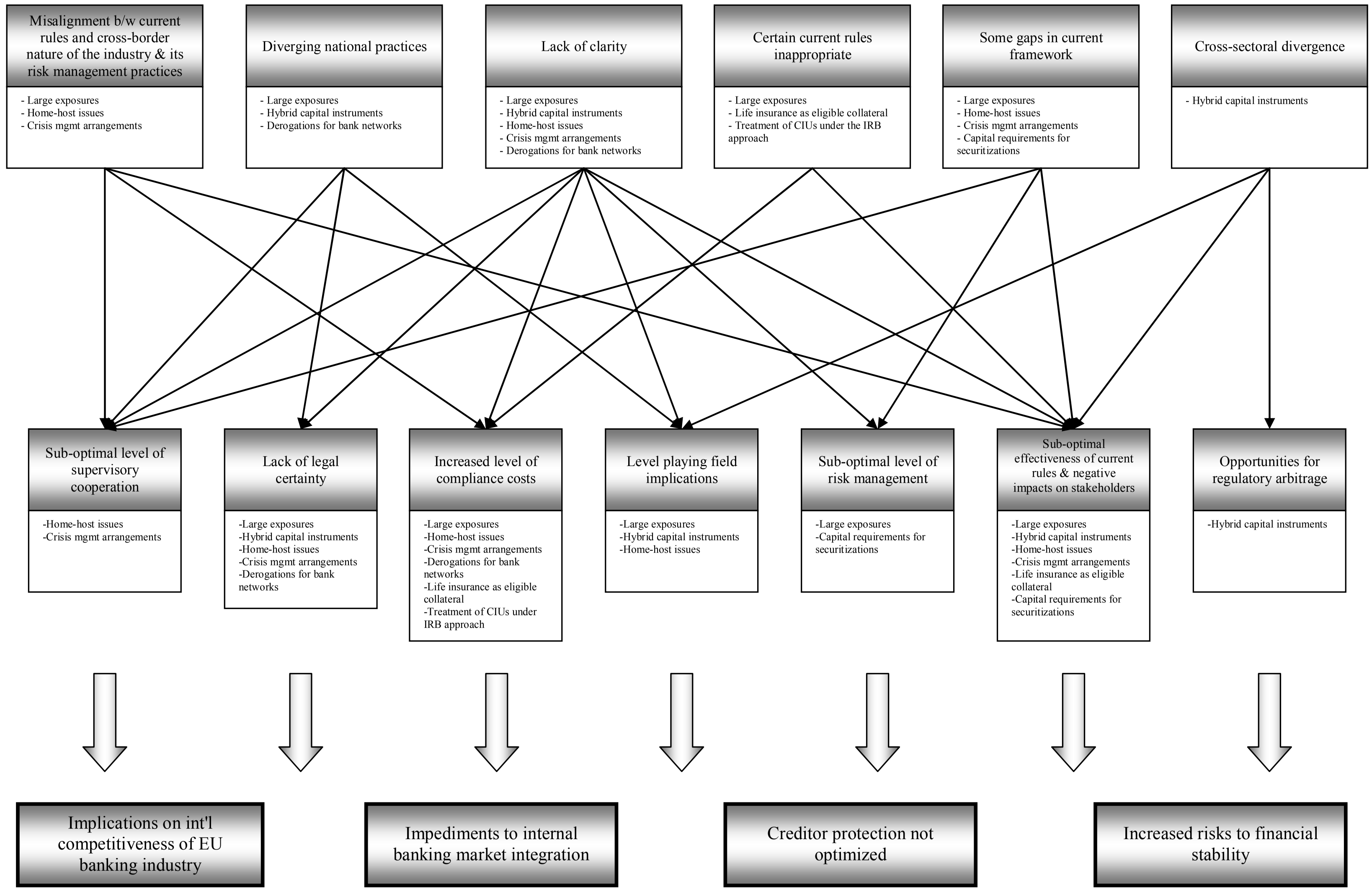
Based on the nature of problems outlined in the above analysis, several major justifications for action at the EU level become apparent. In certain areas (such as home-host issues and crisis management arrangements[65]), policy tools providing for stronger Member State cooperation are essential given potentially detrimental implications for EU citizens if Member States were to act on a predominantly individual basis. Secondly, in the majority of the examined areas, level playing field issues have been flagged. In this respect, action needs to be taken at EU level, to ensure that a more harmonized framework is put in place promoting further single market integration. Thirdly, in several areas (large exposures, treatment of CIUs under the IRB, derogations for bank networks from certain prudential requirements, eligibility of life insurance as collateral) elements of regulatory shortcomings have been identified, imposing unwarranted compliance costs on stakeholders. They need to be rectified in a way that successfully delivers a corrective action without compromising the effectiveness of the EU prudential framework.

---

[64] Articles 94 to 101 of Directive 2006/48/EC set out the capital treatment for securitisations. In addition, Annex V specifies how banks have to treat securitisation-related risk in their internal risk management.

[65] The need for EU action was recognized by the conclusions of October 2007 Ecofin Council that endorsed further work in the areas where current supervisory arrangements were deemed to be sub-optimal. The Commission has been requested "to propose ways to clarify cooperation obligations including possible amendments to EU-banking legislation, especially to: clarify the existing obligations for Supervisory Authorities, Central Banks and Finance Ministers to exchange information and to cooperate in a crisis situation; increase the information rights and involvement of host countries; clarify the role of the consolidating supervisors and facilitate the timely involvement of relevant parties in a crisis situation; and examine whether, to this end, legislative changes are necessary, including to reinforce the legal requirements for supervisory collaboration and information sharing."

PROBLEM TREE: AMENDMENTS TO CRD



4. OBJECTIVES

The overarching goal of this initiative is to ensure that the effectiveness of the Capital Requirements Directive is not compromised. This implies the facilitation of attaining the following four general policy objectives to:

– Enhance financial stability (G-1);

– Enhance safeguarding of creditor interests (G-2);

– Ensure international competitiveness of EU banking sector (G-3);

– Further promote the internal banking market integration (G-4).

In light of the problems presented in sections 3.1 through 3.7, seven sets of operational objectives have been identified to address the specific problem drivers. Effective realization of such operational objectives should contribute to the achievement of the following longer-term specific objectives to:

– Enhance legal certainty (S-1);

– Enhance supervisory cooperation (S-2);

– Enhance level playing field (S-3);

– Reduce compliance burden (S-4)

– Promote cross-sectoral convergence (S-5);

– Reinforce risk management (S-6);

and, in turn, should facilitate the attainment of the four general policy objectives.

Table 1 provides an overview of the identified problems, drivers underlying them as well as operational, specific and general objectives, by indicating linkages between them.

Table 1: Summary of problems and objectives

Problems	Problem Drivers	Operational Objectives	S-1 Enhance Legal Certainty	S-2 Enhance Supervisory Cooperation	S-3 Enhance Level Playing Field	S-4 Reduce Compliance Burden	S-5 Cross – sectoral Convergence	S-6 Reinforce Risk Management	G-1 Enhance Financial Stability	G-2 Enhance Safeguarding of Creditor Interests	G-3 Ensure Int'l Competitiveness of EU Banking Sector	G-4 Further Promote Integration in IM
Large Exposures -Increased level of compliance costs for the industry -Unwarranted compliance costs for certain types of investment firms -Sub-optimal effectiveness of the regime with potential cost implications for stakeholders -Unlevel playing field conditions -Higher burden for taxpayers and allocative capital inefficiencies	Misalignment between large exposures regime and industry risk management practices	Align LE regime more closely with other requirements in the CRD and industry management practices				√		√				
	Current regime inappropriate for certain specialized firms	Improve relevance for specialized firms				√						
	Incomplete or unclear definitions	Provide precise definitions	√		√			√	√	√	√	√
	National options	Harmonize LE regime	√	√	√	√						
	Current regime does not effectively address market failures pertaining to certain exposure types	Adjust the treatment of exposures to institutions			√			√				
Hybrid Capital Instruments -Unlevel playing field conditions -Regulatory arbitrage opportunities	-Lack of EU definition of assessment criteria and characteristics for eligibility -Divergence of national regimes with regard to quantitative limits -Cross-sectoral divergence (insurance and banking) in recognizing hybrids within own funds	Harmonized interpretation of assessment criteria to determine if instruments fulfil permanence, loss absorption and flexibility of payments requirements	√		√	√	√	√				
		Set appropriate and harmonized limit for non-common share capital reserves within own funds	√		√	√	√		√	√	√	√
		Transitional provisions to allow grandfathering of instruments that are currently recognized as hybrids	√		√							
Home-Host Issues & Crisis Management -Extra compliance costs and unlevel paying field for cross-border financial groups in going concern situations -Sub-optimal effectiveness of supervisory arrangements in prevention of crisis situations -Costs to creditors, employees and shareholders of cross-border groups as well as taxpayers in case of bank failure -Increased financial stability risks for host Member States of systemically relevant branches -Potentially higher direct and indirect costs for the industry and EU economy in case of broader crisis	-Misalignment between nationally-based supervision and cross- border nature of banking groups -Lack of clarity in the coordination role of the consolidating supervisor	Clarify and define rules and appropriate structures for cooperation and information sharing between home and host supervisors in going concern situations	√	√	√	√						
	Misalignment between nationally-based supervision and cross- border nature of banking groups, impeding efficient and effective crisis management	Clarify and define appropriate rules for cooperation and information sharing between home and host supervisors in crisis situations	√	√					√	√	√	√
	Legal obstacles to information sharing between supervisors, central banks and finance ministries	Remove impediments to information sharing between supervisors, central banks and finance ministries	√	√								
	Informational asymmetries between supervisors of systemically relevant branches and home Member State supervisors	Allow host supervisors to be better informed	√	√								

Problems	Problem Drivers	Operational Objectives	Specific Objectives						General Objectives			
			S-1	S-2	S-3	S-4	S-5	S-6	G-1	G-2	G-3	G-4
			Enhance Legal Certainty	Enhance Supervisory Cooperation	Enhance Level Playing Field	Reduce Compliance Burden	Cross – sectoral Convergence	Reinforce Risk Management	Enhance Financial Stability	Enhance Safeguarding of Creditor Interests	Ensure Int'l Competitiveness of EU Banking Sector	Further Promote Integration in IM
Derogations for bank networks from certain prudential requirements -Higher compliance costs for cooperative bank networks in the post 1979-accession Member States -Cost increases for cooperative banks using the derogations if the directive provisions are enforced	-Necessary adaptations of the eligibility dates have not been provided for in the accession treaties -Incorrect transposition of 'eligibility dates' by certain Member States	Enable eligible banks in post-1979 accession Member States to benefit from the Article 3 derogations	√		√	√						√
Life insurance as eligible collateral -Higher compliance costs for the industry -Potentially higher costs for insurers and borrowers	Reliance on the life insurer's general ability to meet its financial obligations when recognizing life insurance policies as collateral	Enable a more risk-sensitive recognition of life insurance as collateral			√	√		√	√		√	
Treatment of CIUs under the IRB Approach -Higher compliance costs for the IRB approach banks due to capital requirements disproportionate to risk -Negative implications for the CIU managers	Excessive penalization of banks that should but cannot apply the IRB approach to their exposures in the CIUs	Provide sound risk-based alternative treatment of exposures in the CIUs for the IRB banks				√		√	√			
		Produce adequate incentives to adopt the more risk sensitive IRB approach						√				
Capital requirements and risk management for securtisation positions -Potential risks not well addressed by specific aspects of banking regulation might affect banks and financial markets more generally	Specific aspects of regulatory treatment of securtisations need to be refined in light of the lessons of market turmoil	Ensure that banks maintain adequate capital and apply sound risk management for securtisation risks						√	√	√		

5. POLICY OPTIONS, IMPACT ANALYSIS AND COMPARISON

This section summarizes the policy options and their impacts on stakeholders for each of the seven areas. Due to the number of the areas covered, the analysis of policy options and the comparison thereof have been combined for each area.

Where necessary, sub-issues have been addressed by separate policy options.

In the areas 'left open' at the time of the adoption of the CRD in 2006 i.e. hybrids and large exposures the impact assessment considers alternative, non-legislative policy instruments.

As the impact assessment pertains to the provisions of existing EU legislation, the analysis of the type of policy instrument was assumed to be superfluous.

5.1. Large exposures

In reviewing the current large exposure regime, eighteen policy options have been considered, analysed and compared (see Annex 1). They were split into first- and second-level options. First-level options were designed with a view to identifying an overall approach that would be the most effective in attaining the relevant objectives. Once this phase was completed, second-level policy options were developed to elaborate on the features of a preferred first-level option and accommodate the specificities of different types (banks vs. investment firms) and sizes of institutions. Second-level policy options in five areas, where the most material changes vis-à-vis the current regime are expected, were examined.

The following table summarizes policy options by ranking them within the respective option set in terms of their relative effectiveness, efficiency and consistency with regard to achieving the relevant objectives. A preferred policy option for each policy option set is highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
First-level policy options					
General approach for large exposure monitoring	S-1 Enhance legal certainty S-3 Enhance level playing field S-4 Reduce compliance costs S-6 Reinforce risk management G-1 Enhance financial stability	1.1 Retain current approach	4	3	2
		1.2 No specific regime with market discipline enforced by rating agencies **	3	1	5
		1.3 Regime based on firms' own assessments and supervisory review (Pillar 2)	2	2	3
		1.4 Market discipline imposed by disclosure requirements (Pillar 3)	3	1	4
		1.5 Amended limit based backstop regime	1	2	1
Second-level policy options					
Investment firms	S-4 Reduce compliance costs S-6 Reinforce risk management	2.1 Retain current scope of application	2	2	2
		2.2 Exempting certain investment firms from the LE regime	1	1	1
Interbank exposures	G-1 Enhance financial stability G-2 Enhanced safeguarding of creditor interests	3.1 Retain current approach	3	1	3
		3.2 Apply the LE limit to all exposures to institutions	1	3	1
		3.3 Apply the LE limit to all exposures to institutions, with flexibility of alternative threshold for smaller institutions.	2	2	2
Intra-group exposures	G-1 Enhance financial stability G-2 Enhanced safeguarding of creditor interests G-4 Further promoting of the internal banking market integration	4.1 Retain current approach	2	1	1
		4.2 Impose the LE limit on all intra-group exposures	1	3	3
		4.3 Mandatory exemption of those intra-group exposures from the LE limit which fulfil a set	2	2	2

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
		of conditions			
Reporting	G-1 Enhance financial stability G-2 Enhanced safeguarding of creditor interests S-4 Reduce compliance costs	5.1 Retain current approach (a number of national discretions)	2	2	2
		5.2 Harmonised reporting	1	1	1
Calculation of exposures values	G-1 Enhance financial stability G-2 Enhanced safeguarding of creditor interests S-4 Reduce compliance burden S-6 Reinforce risk management	6.1 Retain current approach	2	3	2
		6.2 Full alignment with the solvency regime	3	1	3
		6.3 Partial alignment with the solvency regime	1	2	1

** Non-legislative option
Scale of option ranking: 1=highest, 5=lowest

The analysis of the first-level policy options showed that removing the current large exposures regime under policy options 1.2 (No specific regime with market discipline enforced by rating agencies), 1.3 (Regime based on firms' own assessment and supervisory review) and 1.4 (Market discipline imposed by disclosure requirements) would bring an on-going reduction in systems and regulatory reporting costs (objective S-4). However, benefits for the industry would have to be carefully weighed against potential costs that arise from the loss of critical regulatory information on large exposures. This might result in inefficient direction of supervisory resources and, in turn, have adverse implications on the likelihood of timely detection and resolution of large exposure risks. Allowing banks, subject to supervisory review, to manage large exposures using internal models and practices (policy option 1.3) would create stronger incentives to improve risk management practices with respect to unforeseen event risk, effectively mitigating the risks arising from the loss of standardized regulatory information. In this regard, option 1.3 could be considered more effective with respect to reinforcing risk management (objective S-6) and enhancing financial stability (objective G-1) than policy options 1.2 and 1.4 that rely more extensively on market mechanisms to address unforeseen event risk. Policy option 1.5 (Amended limit based backstop regime), on the other hand, is effective with regard to all relevant objectives as it is specifically tailored to respond to the identified shortcomings of the current regime and, therefore, is retained as the preferred option. Of equal importance, the distribution of costs and benefits among stakeholder groups under this option is the most consistent: while certain amendments are expected to bring cost savings for the industry, others might impose costs on it that, however, would be offset by societal benefits resulting from reduced contagion risk and increased systemic stability.

The Commission has welcomed the debate on the second-level policy options facilitated by the online public consultation. As a result, it has incorporated, where appropriate, modifications to its draft proposal. Notwithstanding, interbank exposures are of particular importance requiring prudent management (see section 3.1). For this reason, the Commission maintains a 25% limit of own funds on interbank exposures and will not propose any other quantitative threshold (policy option 3.2).

The most significant impacts of both first- and second-level preferred options (1.5, 2.2, 3.2, 4.1, 5.2 and 6.3) on the key stakeholders can be summarised as follows:

– For the banking industry, the proposed revisions will likely result in a decrease of the administrative burden (by estimated €15-77 million, or 4-20% of the respective baseline) as reduction in numerous national options will result in a more harmonised regime. Additional tangible savings will be brought about by further alignment of the calculation of exposure values, including the recognition of credit risk mitigation effects, with the solvency regime (options 5.2 and 6.3). These savings, however, will be to a certain degree diminished by an increase in compliance costs due to the more prudent approach embedded in the proposed treatment of interbank exposures (option 3.2), the mandatory application of a 100% credit conversion factor, and recognition of the risks that derive from the liability / funding side of 'connected' clients.

– The proposed set of preferred options will result in a decrease (by estimated €60 million, or 100% of the respective baseline) of the administrative burden as well as other types of compliance costs incurred by certain types of investment firms that the Commission proposes to exempt from the scope of the regime (option 2.2).

– The proposed revisions will enhance the effectiveness of supervisors' monitoring of large exposures by providing for a better comparability of reporting (option 5.2) and increased certainty regarding the maximum risk that an institution might take, as certain gaps of the current regime are closed.

– Borrowers will benefit from increased competition in large credit market, as more harmonised large exposure rules should enhance the level playing field conditions.

– Protection of banks' creditors will be enhanced as improved effectiveness of the large exposures regime will lead to a reduction of default risk.

– Importantly, the proposed set of preferred options will work to enhance financial stability. This will be brought about, in particular, by the certainty that a maximum exposure of a given institution to a third party is limited. Furthermore, closing some other specific prudential gaps in the current regime by removing the national option to exempt or assign various risk weights to exposures and taking into account risks that derive from the liability / funding side of 'connected' clients, will increase the overall effectiveness of the regime.

5.2. Hybrid capital instruments

Similarly to the large exposures regime, policy options considered in developing the common European framework for hybrids were split into first- and second-level options. First-level options were designed with a view to identifying an overall approach that would be the most effective in attaining the relevant objectives, while second-level policy options were developed to elaborate on the features of a preferred first-level option and accommodate the specificities of national approaches currently in place (institutions in Member States with a hybrid regime vs. institutions in Member States without a hybrid regime). Second-level policy options in five areas, where the most material changes vis-à-vis the current situation are expected, were examined.

The following table summarizes the nineteen policy options analysed (see Annex 2). Individual options within each set are ranked in terms of their relative effectiveness, efficiency, and consistency with regard to achieving the relevant objectives and preferred policy options are highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
First-level policy options					
Common	S-1 Enhance legal certainty	1.1 Multiple national frameworks	3	3	3

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
European framework for hybrids	S-3 Enhance level playing field S-4 Reduce compliance costs S-5 Cross-sectoral convergence G-1 Enhance financial stability	1.2 Common regulatory European framework	1	1	1
		1.3 Self-regulation based framework**	2	2	2
Second-level policy options					
Eligibility criteria: *permanence*	S-1 Enhance legal certainty S-3 Enhance level playing field S-5 Cross-sectoral convergence S-6 Reinforce risk mgmt G-1 Enhance financial stability	2.1 Prescriptive rules	3	3	
		2.2 Principle-based approach	2	2	
		2.3 Economic principle-based approach	1	1	
Eligibility criteria: *flexibility of payments*	S-1 Enhance legal certainty S-3 Enhance level playing field S-5 Cross-sectoral convergence S-6 Reinforce risk mgmt G-1 Enhance financial stability	3.1 Principle-based approach	2	1	
		3.2 Principle-based approach with limitations	1	2	
		3.3 Principle-based approach with limitations and prescriptive rules for payment in-kind features	3	3	
Eligibility criteria: *loss absorption*	S-1 Enhance legal certainty S-3 Enhance level playing field S-5 Cross-sectoral convergence S-6 Reinforce risk mgmt G-1 Enhance financial stability	4.1 Prescriptive rules	3	3	
		4.2 Principle-based approach with limitations	2	2	
		4.3 Principle-based approach	1	1	
Quantitative limits	S-1 Enhance legal certainty S-3 Enhance level playing field S-4 Reduce compliance costs G-1 Enhance financial stability	5.1 The dual option	2	1	
		5.2 The full-fledged 'bucketing' option	2	2	
		5.3 The simplified 'bucketing' option	1	1	
Grandfathering provisions	S-1 Enhance legal certainty S-4 Reduce compliance costs G-1 Enhance financial stability	6.1 Grandfathering for a pre-set time	3	3	2
		6.2 Grandfathering until the first call date	3	3	2
		6.3 Permanent grandfathering	2	1	3
		6.4 Gradual 'amortisation plan'	1	2	1

** Non-legislative option
Scale of option ranking: 1=highest, 3=lowest

In the process of the first-level policy option analysis, option 1.1 (Multiple national frameworks) was discarded due to its ineffectiveness with regard to attaining majority of the relevant policy objectives. Although option 1.3 (Self-regulation based framework) would not require legislative measures at the EU level to address regulatory concerns relating to the inclusion of hybrids within own funds, it suffers from several fundamental shortcomings. First, banks' individual capital adequacy assessments are not yet sufficiently advanced to determine the level of hybrid capital that would be appropriate for prudential purposes (objective G-1). Second, industry's response to the shortcomings of the status quo scenario would not necessarily facilitate convergence with other sectors of the financial services industry (objective S-5). Third, a number of Member States already have national regulatory frameworks for hybrids, therefore, an industry-led solution would require these Member States to dismantle their respective regimes, likely leading to significant disruptions in the market for hybrids.

Policy option 1.2 (Common regulatory European framework) would address the shortcomings of the current situation by facilitating convergence between Member States and sectors, consequently contributing to stronger level playing field conditions within the single market (objective S-3). It would contribute positively to the stability within the sector (objective G-1) by ensuring that credit institutions have sufficient share capital and reserves to handle stressed circumstances as uniform and appropriate limit on hybrid capital would be applied. This approach would also include 'grandfathering' provisions allowing for a smooth transition from multiple national frameworks to a common EU-wide regime for hybrids. In this respect, option 1.2 is more consistent than option 1.3 as the industry in Member States with a national regime for hybrids will be able to minimize its compliance (with a proposed regime) costs (objective S-4) by making use of grandfathering provisions. By allowing institutions to phase out the proportion of no longer eligible hybrids, such provisions would also minimise the risk of disruptions in the market for hybrids and capital markets more generally (objective G-1).

Overall, the most significant impacts of both first- and second-level preferred options (1.2, 2.3, 3.2, 4.3, 5.3 and 6.4) on the key stakeholders can be summarized as follows:

– For the industry, the proposed options would ensure adequate sources of capital funding and broadened investor basis (option 1.2). The harmonised EU framework would promote legal certainty and minimise potential competitive distortions. The quality of capital will be improved by distinguishing hybrid instruments depending on their equity-like nature during crisis situations (option 5.3).

– Supervisors will benefit from a harmonised principle-based regulatory approach built upon CEBS' agreement (options 2.3, 3.2 and 4.3). Possible differences of implementation at national level will be minimized as supervisory tools available to comply with the EU regulation will be clarified.

– Investors will benefit from the harmonised EU regulatory framework that should work to enhance the liquidity of hybrid instruments and, ceteris paribus, reduce the associated risk. In addition, they should benefit from a reduction in compliance risk stemming from enhanced legal certainty and curbed national discretions.

– 3rd country institutions should see gains deriving from reduced differences in national supervisory treatments and closer alignment of EU legislation with the G10 agreement.

– The financial stability will be enhanced as the preferred options clarify the functioning of hybrid instruments and, as regards limits, focus on their equity-like nature, particularly during crisis situations, effectively broadening investor base that could help address banks' financial needs. The increased liquidity of hybrid instruments and strengthened supervisory convergence should also work to improve the efficiency of financial markets.

5.3. Home-host issues and crisis management arrangements

Potential policy tools in this area were considered and analysed separately for going-concern and crisis situations, as the rules and cooperation structures that are effective in the former context might not necessarily lend themselves to crisis situations, where supervisors are accountable to national parliaments and where different national players (i.e., finance ministries, central banks) are likely to step in. As a result, one policy option set was analysed in the context of the supervisory arrangements in going-concern situations while four policy option sets were considered to achieve the relevant objectives in the crisis management area. The following table summarizes the seventeen policy options analysed (see Annex 3). Individual options within each set are ranked in terms of their relative effectiveness, efficiency, consistency and acceptability with regard to achieving relevant objectives and preferred policy options are highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria			
			Effectiveness	Acceptability	Consistency	Efficiency
Going-concern situations						
Improving cooperation arrangements in going-concern situations	S-1 Enhance legal certainty S-2 Enhance supervisory cooperation S-3 Enhance level playing field S-4 Reduce compliance burden G-1 Enhance financial stability	1.1 Retain current approach	5	2	4	
		1.2 Formal colleges of supervisors	4	2	2	
		1.3 Formal colleges of supervisors with involvement of CEBS	2	1	1	
		1.4 Develop a lead supervisor model	3	2	4	
		1.5 Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor	1	2	3	
		1.6 EU financial supervision authority**				
Crisis situations						
Improving supervisory cooperation in crisis situations	S-1 Enhance legal certainty S-2 Enhance supervisory cooperation G-1 Enhance financial stability G-2 Enhance safeguarding of creditor interests	2.1 Retain current approach	4	3	2	
		2.2 Assign responsibility and leading role to the consolidating supervisor	3	3	2	
		2.3 Specification of tasks and mandates of home and host supervisors	2	1	1	
		2.4 Specification of tasks, mandates and colleges for crisis situations	2	2	1	
		2.5 Specification of tasks, mandates and interaction with other forums	1	1	1	
Access to information for host supervisors of systemically relevant branches	S-1 Enhance legal certainty S-2 Enhance supervisory cooperation G-1 Enhance financial stability	3.1 Retain current approach	3	2		2
		3.2 Further access to information in crisis situations	2	1		1
		3.3 Further access to information in crisis situations by involvement in colleges	1	1		2
Determination of which branches are systemically relevant	S-1 Enhance legal certainty S-2 Enhance supervisory cooperation G-1 Enhance financial stability	4.1 Limited list of criteria	2	1		2
		4.2 Open list of criteria and determination by host supervisor	1	2		2
		4.3 Open list of criteria and determination by home supervisor	2	2		1
Exchange of information b/w central banks, finance ministries and supervisors	G-1 Enhance financial stability	5.1 Retain current approach	2			
		5.2 Require supervisors to exchange information with central banks and finance ministries	1			

** Option not ranked as it was discarded early in the analysis as not feasible
Scale of option ranking: 1=highest, 5=lowest

The combined impact of the preferred policy options (1.5, 2.5, 3.3, 4.2 and 5.2) on the main stakeholder groups is expected to yield the following effects:

– For the cross-border banking groups, the proposed options will increase the overall efficiency of supervision in going-concern situations by limiting conflict and overlap of requirements; supervisors will be required to consistently apply key supervisory principles within a banking group. This would be underpinned by a clear decision making process; the latter would allow the consolidating supervisor to have the last say in case of disagreement on additional capital requirements for subsidiaries (Pillar 2 measures) and reporting requirements (option 1.5). Moreover, stronger supervisory convergence ensuing from CEBS' involvement in the monitoring of colleges' practices should enhance level playing field conditions for the cross-border banks. In crisis situations, the banking industry will benefit from enhanced supervisory cooperation and more clear allocation of responsibilities among various actors involved as more optimal crisis management solutions are facilitated (option 2.5).

– For supervisors, the preferred options first and foremost will work to increase their cooperation both in going-concern (option 1.5) and crisis situations (option 2.5) by allowing for better access to information and involvement in colleges of host supervisors (option 3.3), while ensuring the effectiveness of supervisory measures where key cross-border supervisory issues are at stake. The tasks of the consolidating home supervisors chairing colleges will be clarified (option 1.5). Operational efficiency of colleges in part will be controlled by the consolidating supervisors' right to determine which authorities participate in individual meetings and activities. The introduction of a mediation mechanism in case of disagreements between competent authorities would provide comfort to host authorities (option 1.5).

– The proposed changes will also enhance financial stability, as signs of stress will be detected earlier in a college-type environment. This will allow the development of joint contingency plans and crisis assessments, reinforcing the EU system of crisis prevention (option 1.5). Although colleges of supervisors will have a part to play in crisis situations, work of other forums such as cross-border stability group established under the EFC's[66] Memorandum of Understanding and involving finance ministries and networks of central banks would take the lead in reaching certain decisions (option 2.5), underpinned by improved information exchange between supervisors, central banks and finance ministries in crisis situations (option 5.2). Financial stability in host Member States of systemically relevant branches will be enhanced by better access to the relevant information on behalf of host supervisors (options 3.3 and 4.2). More concerted responses to crisis situations will effectively help to minimize the ensuing economic and social costs for bank creditors, employees and shareholders, and, eventually, taxpayers.

5.4. Derogations for bank networks from certain prudential requirements

The derogations from certain prudential requirements, according to the Article 3 of Directive 2006/48/EC, may only be granted to banks that were established by 15 December 1977 while meeting the eligibility criteria by 15 December 1979. As described in the problem definition (section 3.4), certain Member States have transposed these dates as the date of their accession to the EU or other dates differing from those set out in the article. Although this approach is in line with the spirit of the directive, from a legal point of view, granting these exemptions after the time limits constitutes a breach of the directive.

In this context, three policy options have been examined (see Annex 4) and are summarized below. They are ranked in terms of their relative effectiveness, efficiency and consistency with regard to attaining relevant objectives with the preferred option highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
Derogations for bank networks from certain prudential requirements	S-1 Enhance legal certainty S-3 Enhance level playing field S-4 Reduce compliance burden G-4 Further promote IM integration	1 Retain and enforce current text of Article 3	3	3	3
		2 Amend Article 3	2	2	2
		3 Remove 'eligibility dates' from Article 3	1	1	1

[66] EFC - the Economic and Financial Committee conducts preparatory work for the Council of the European Union on the economic and financial situation, the euro exchange rate and relations with third countries and international institutions. This advisory committee also provides the framework for preparing and pursuing the dialogue between the Council and the ECB.

Scale of option ranking: 1=highest, 3=lowest

Strict application of the eligibility dates under option 1 (Retain and enforce current text of Article 3) would prevent banks in Member States that have joined the EU after 1979 from using the derogations, even if they were organized in networks meeting the qualitative eligibility criteria laid down by Article 3, and effectively would subject them to higher compliance costs. Therefore this option was discarded due to its ineffectiveness with respect to objectives S-3, S-4 and G-4. Option 2 (Amend Article 3) aims at amending the article by introducing the respective accession dates as 'eligibility dates' for the Member States that have joined the EU after 1979. However, this would not resolve the discussed problems for all Member States concerned, as some of them have introduced the regime after their accession date. As a result, this option is only marginally more effective than policy option 1. Option 3 (Remove 'eligibility dates' from Article 3), on the other hand, is effective in contributing to all four objectives and, therefore, was retained as the preferred option. Moreover, it is expected to achieve better consistency across Member States, as it minimizes the current distributional imbalances between the institutions from the pre-1979 and the post-1979 accession Member States.

The preferred option would regularize the situation in the Member States that have implemented Article 3 in their legal systems after the time limits (ES, FI, CY and RO). As a consequence, all bank organisations that are currently using the exemption regimes, would be able to continue using them, benefiting from more flexible capital management. Other post-1979 accession Member States that have not yet implemented Article 3 could do so irrespective of the date of their accession. This would open a possibility for EU bank networks with assets over €311 billion and representing more than 5 million members to become subject to the supervisory treatment under the article - assuming they meet the eligibility criteria - effectively reducing their compliance costs and enhancing the level playing field conditions in the internal banking market. As a result, in post-1979 accession Member States, extension of the derogations to cooperative banks should strengthen their competitiveness vis-à-vis domestic and cross-border commercial banks.

5.5. Life insurance as eligible collateral

Current CRD provisions allow for life insurance policies pledged to the lending credit institution to be recognised as collateral, enabling them to reduce their capital requirements for credit risk. However, such recognition is limited to life policies underwritten by the insurer that is externally rated, implicitly treating them as a normal unsecured exposure provided by the company. In the problem definition (section 3.5) this approach has been shown to be sub-optimal as it does not provide for the recognition of life insurance policies in all prudentially justified cases, leading to higher compliance costs for the industry and exerting negative impacts on borrowers (such individuals and SMEs) and insurers.

In this context, two policy options have been examined (see Annex 5) and are summarized below. They are ranked in terms of their relative effectiveness, efficiency and consistency with regard to attaining relevant objectives with the preferred option highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
Life insurance as eligible collateral	S-3 Enhance level playing field S-4 Reduce compliance burden S-6 Reinforce risk management	1 Retain current treatment as normal exposure to the life insurer	2	2	2
		2 Preferential treatment of life insurance policy holders claims	1	1	1

Scale of option ranking: 1=highest, 2=lowest

Option 1 (Retain current treatment as normal exposure to the life insurer) was discarded as its implied treatment lacks risk-sensitivity with regard to the special protection that life insurance policies are subject to, imposing higher than prudentially warranted compliance costs for the industry (objective S-4). It is also ineffective with respect to objective S-3 (Enhance level playing field) as smaller insurers without an external credit rating are competitively disadvantaged vis-à-vis rated companies. By making the recognition of life insurance collateral independent of the existence of an external rating of the insurer, option 2 (Preferential treatment of life insurance policy holders claims), would work to enhance the level playing field for life insurers and reinforce banks' risk management (objective S-6) as incentives to make use of credit risk mitigation are created. In turn, banks will be able to recognize life insurance policies as collateral on a scale that is commensurate with prudential rationale, effectively optimizing their regulatory capital level. Importantly, impacts on various stakeholders under the preferred option are distributed more consistently, as in addition to banks and insurers, borrowers would gain as well, as their ability to obtain a loan in general or on better terms from a bank is aided by the possibility to secure it with a life insurance policy.

5.6. Treatment of Collective Investment Undertakings under the IRB Approach

Generally, a credit institution that uses the IRB approach has to apply it to all its exposures. For exposures in CIUs banks in principle should 'look through' to the investments that the CIU has made and apply the IRB approach to them individually. The CRD also provides for the alternative 'Standardized Plus' Approach (SPA) that is simpler to apply but calibrated to incentivise banks to apply the IRB approach. As was shown in the problem definition (section 3.6), the alternative approach penalises banks excessively and could exert a negative impact on CIU managers, if, prompted by the absence of adequate treatment, credit institutions were to avoid investments in CIUs and manage investments on their own balance sheets instead.

In this context, three policy options have been examined (see Annex 6) and are summarized below. They are ranked in terms of their relative effectiveness, efficiency and consistency with regard to attaining relevant objectives with the preferred option highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
Treatment of Collective Investment Undertakings under the IRB approach	O-1 Sound risk-based alternative treatment of exposures in CIUs O-2 Adequate incentives to adopt the IRB approach S-4 Reduce compliance burden S-6 Reinforce risk management	1 Retain current SPA treatment	2	3	2
		2 Applying more targeted increases in the standardized risk weights	1	2	1
		3 Allowing the use of external ratings as an input in the IRB formula	2	1	1

Scale of option ranking: 1=highest, 3=lowest

The analysis showed that option 1 (Retain current SPA treatment) does not provide for a reasonable alternative to applying the IRB to the underlying exposures in the CIUs as the resultant capital requirements are excessively penal (objective S-4). In addition, this option does not produce risk sensitive outcomes as well-rated exposures are penalised more strongly than unrated or inferiorly rated ones (objective O-1). Option 3 (Allowing the use of external ratings as an input in the IRB formula) entails a possibility to utilize in the IRB formula historic default rates published by rating agencies. For banks, it would present a reasonable alternative to applying their own IRB approach as their compliance costs would decrease while the resulting risk weights would be comparable to those under their own IRB. Such approach, however, would not provide banks with adequate incentives to apply the IRB approach. Rather, they could move everything they do not want to rate internally into specifically set up CIUs, which is not desirable from a prudential point of view (objective S-6).

In comparison, option 2 (Applying more targeted increases to the Standardised risk-weights) is effective in contributing to all objectives. This option provides for a sound and risk-sensitive alternative treatment of exposures in CIUs, whereby the percentage increase in risk weights are lower for well rated exposures and higher for the unrated ones (objective O-1). As long as the CIU manager invests in rated securities and does not incur high risks on behalf of the investing bank – which would be undesirable from a prudential standpoint – the resulting increase in risk weights would be low, effectively enabling banks to minimize their compliance costs (objective S-4). At the same time, this option would establish incentives to adopt the IRB by targeting exposures that pose the highest prudential concern (objectives O-2 and S-6). Furthermore, negative implications of the baseline scenario for CIU managers will be contained under this option, as the suggested alternative to the IRB approach will enable banks to continue to transact with CIUs due to the comparative advantage of the latter in conducting investment management activities.

5.7. Capital requirements and risk management for securitisation positions

Although the regulatory treatment of banks' securitisation positions certainly improved with the implementation of the CRD in 2008, in light of the lessons drawn from the current market turmoil it is clear that specific aspects of the current approach need further clarification.

Hence, three policy options have been examined (see Annex 7) and are summarized below. They are ranked in terms of their relative effectiveness, efficiency and consistency with regard to attaining relevant objectives with the preferred option highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
Capital requirements and risk management for securtisation positions	S-6 Reinforce risk management G-1 Enhance financial stability G-2 Enhance safeguarding of creditor interests	1 Retain current treatment	3	1	3
		2 Targeted changes where clarification and improvements are needed	1	2	1
		3 Complete review of existing requirements	2	3	2

Scale of option ranking: 1=highest, 3=lowest

In comparing the options, it has to be noted that the CRD requirements where not yet widely applied when the current financial turmoil started. One may argue that the extent of losses incurred by EU banks - which as of April 2008 exceeded €45 billion[67] - is to some degree owed to inadequacies in capital standards and risk management requirements of the **legislation that preceded the current rules**. In this respect, option 1 (Retain current treatment) might appear to be conducive to enhancing the risk management (objective S-6) as the new and more prudent CRD rules are implemented. However, in view of the current turmoil it is important to ensure that further clarification and reinforcement of the existing provisions is provided.

Option 3 (Complete review of existing requirements) would entail a complete review of the existing requirements in the securitisation field at the EU level. While it could be argued that such review should lead to more adequate capital requirements and enhanced risk management, this is not certain, as the Basel II framework itself is the outcome of years-long deliberations on devising a more risk sensitive framework than its predecessor. At the same time, any divergence from the Basel Committee's work could damage the competitiveness of the internationally active EU banks.

[67] Source: Bloomberg

In comparison, option 2 (Targeted changes where clarification and improvements are needed) envisages a limited number of changes that reflect concrete lessons from the crisis. These changes would imply that banks:

– as lenders, apply more due diligence when granting loans, even if they pass the risk on to investors;

– as investors, are required to improve their understanding of the securitisation investments and are able to avail themselves of the necessary information to understand the risks of their investments;

– as sponsors, enhance their management of liquidity risks pertaining to contingent liquidity support for securitisations.

Potential conflicts of interest and misalignment of incentives that transpired in the 'originate to distribute' model should be addressed by making sure originators of credit risk transfer products share risks with investors. In its online public consultation, the Commission has asked for stakeholders' comments on proposed changes, including a requirement that originators hold capital for at least 15% of the exposures that they securitize. The feedback from the industry and Member States showed that such measure would place EU originating banks at a competitive disadvantage globally and may be capable of being contravened through financial engineering.

For this reason, the proposal was amended and consulted further with the public. The adjusted proposal requires from investors to make sure that originators and sponsors retain a fixed share of the risks so that, effectively, equally originators and sponsors that are regulated by the CRD and those that are not regulated by it retain a fixed share of the risks.

Since due diligence and rigour are essential to securitisation, option 2 would not entail additional costs for banks that manage the securitisation risk well; in terms of the regulatory framework this option maintains the CRD provisions, fine tuned for certain specific shortcomings. It should also help to restore the confidence in the European securitisation market whose activity has declined significantly since the start of the financial market turmoil.

It is evident that in the past 'short cuts' were taken without applying the necessary rigour or conducting the appropriate level of due diligence. Additionally, broader costs in terms of <u>society and financial stability</u>, have been borne both by markets and consumers. A stronger and more rigorous securitisation framework would help in avoiding these costs in the future.

5.8. Cumulative impact of the proposed amendments

It is important to note that the CRD framework came into full effect in January 2008. The current turmoil broke out in the summer of 2007, i.e., at a time when full implementation of the CRD was still not in place. Turmoil in financial markets is often created as a result of irrational exuberance and over optimism in up-turns; likewise negativity and over pessimism in times of a down turn are symptoms of economic cycles. Hence, while it is difficult to assume that such turmoil would not have arisen had the framework been fully in place, certain targeted revisions aimed at enhancing its prudential soundness are warranted.

From a regulatory perspective, it is also important that any framework is applied with demonstrable rigour. Any major fundamental re-think on provisions that have only recently come into force will have to be considered once an operational track record is established. However, while the implementation of the framework continues there are certain changes that should be introduced straight away. These relate to:

– Areas where the CRD does not have up-to-date provisions but where 'old', or even the absence of, provisions were carried forward;

– Specific points where the transposition of the CRD has detected some practical inconsistencies.

It is also important to note that work is continuing on other issues such as liquidity management at other fora. The Commission will therefore need to remain alert as well as flexible to bring in the changes proposed internationally into the EU framework as and when appropriate.

5.8.1. Overall benefits

The improvements that are being proposed aim to render the CRD framework more robust; in addition it is intended to allow the prudential framework to be more responsive to market developments.

It is estimated that between €270 billion and €600 billion ($420 billion and $940 billion) could be lost in the world wide financial system as a result of the current turmoil. While it is difficult to determine how much of that could have been avoided if the regulatory framework were in full force, it is important to modify specific regulatory aspects in light of the lessons learned. The proposed changes are expected to result in improvements in risk management (large exposures regime, risk management for securitisation positions), quality of capital (hybrid capital instruments) and crisis prevention and management (home-host issues and crisis management) and, therefore, should cumulatively contribute to the robustness of the prudential framework, helping to contain risks to the financial stability and the concomitant costs to society in the future.

The proposed amendments are also expected to strengthen the competitiveness of small banks in co-operative structures vis-a-vis large banks. A level playing field and the removal of arbitrage opportunities within the EU will allow for more consistency and would eventually benefit institutions as well as the stakeholders such as clients and borrowers and other counter parties. On hybrids, it is clear that there will be a better appreciation across the EU of the characteristics of an instrument.

A further important proposal that is EU specific concerns the supervisory arrangements for cross-border groups. It is important that supervisors co-operate with each other and remain sensitised to the developments in jurisdictions that go beyond their frontiers. This is a proposal that takes due account of the current functioning of supervisory practice in the EU and endeavours to render the process more efficient from the perspective of cross-border banking groups and more 'collegial' and 'co-operative' to eventually enhance the financial stability of the system and the interests of the consumer and tax payer.

5.8.2. Compliance costs

The overall cumulative impact on compliance costs, including administrative burden (a sub-set of compliance costs, see section 5.8.3), is expected to be positive for the industry. As shown in the summary table that follows, the most material implications in terms of compliance costs emanate from the following changes:

– Large exposures regime. Net decrease in costs is anticipated for institutions as a reduction in administrative burden will be partially offset by increased compliance costs stemming from a more prudent approach in the area of interbank exposures and some other requirements. Importantly, an estimated 80% of investment firms that are proposed to be exempt from the scope of the regime would save 100% of their current compliance costs.

– Home-host issues. Cross-border banking groups should see a reduction in their compliance costs due to improved efficiency of supervision as a result of fewer conflicting and overlapping requirements.

– Further compliance cost savings in areas such as eligibility of life insurance as collateral, derogations for bank networks from certain prudential requirements (applicable mostly to cooperative bank networks in post 1979 accession MS) are anticipated as well.

– In the area of securitisation risk management, where due diligence and rigour are of essence, the proposed changes should not entail material incremental costs for banks that manage this type of risk well. For others, any increase in direct compliance costs should be offset by the benefits of a more prudent risk management.

5.8.3. Impact on administrative burden

The Commission's Better Regulation strategy is aimed at measuring administrative costs and reducing administrative burden. The distinction between the two is that the latter denotes costs linked to providing the information that businesses would not incur in the absence of legislation. In the area of prudential banking regulation, certain information requirements are necessary to provide for the desired level of financial stability and creditor protection and, hence, should be set at a level that ensures an equilibrium between ensuing administrative burdens and the benefits that they yield.

Areas where the proposed changes might have implications on reporting obligations for stakeholders have been flagged throughout the report and evaluated, where material:

– Large exposures regime. The most material impact, in relative terms, is anticipated for investment firms that fall in the limited activity and limited license categories as they are proposed to be exempt from the regime, resulting in savings of 100% of the respective administrative burden (equivalent to some €60 million annually). The cumulative effect of regime harmonization by removing numerous national discretions was estimated to fall in the range of 4%-20% of the administrative burden baseline for banks (€15-77 million annually). If combined, estimated savings for banks and investment firms fall in the range equivalent to 17-30% of the administrative burden baseline. A third layer of savings that is assumed to be material stems from a closer alignment of large exposures and solvency regimes. The proposed changes also introduce several additional reporting requirements. However, they are mostly deemed to be immaterial.

– Home-host issues and crisis management arrangements. With regard to costs for supervisors, net impact is expected to be marginal as the proposed changes merely clarify the already existing requirements in the CRD on information exchange. The cross-border groups, on the other hand, are expected to see some savings stemming from closer supervisory coordination.

The CRD is part of the Commission's Action Programme for reducing administrative burdens in the EU which has the goal of administrative burden reduction of 25% by 2012. With regard to the legislative changes brought forward with this initiative, it has to be noted that they were undertaken with a view to achieving multiple operational, specific and general objectives (see section 4) and had to be designed accordingly. Any substantial modifications (with regard to reducing administrative burden) to the provisions that have only recently come into force ideally should be considered once an operational track record of the regime is established so that effectiveness of the regime is maintained. To this end, the outcome of the ongoing administrative burden measurement exercise carried out for the Commission by external consultants will help identify additional reduction possibilities.

The following table lays out the expected net effect of the proposals on various stakeholders.

Issue Areas \ Key Stakeholders	Banking Industry	Other Financial Sectors	Supervisors	Borrowers	Investors / Creditors	Financial Stability
Large Exposures	+ (↓ admin burden ↑↓ other compliance costs)	+ (↓ admin burden for investment firms)	+ (↑ effectiveness of monitoring)	+ (↑ competition in large credit market)	≈	+ (↑ clarity, ↑ harmonization, ↓ prudential gaps)
Hybrids	+ (↑ investor basis, ↓ competitive distortions, ↑ capital quality)	+/- (↑ cross-sectoral convergence with insurance firms)	+ (→harmonized regulatory approach)	≈	+ (↑ liquidity in hybrids market, ↓ compliance risk for investors)	+ (↑ clarity, ↑ investor basis, ↑ liquidity in hybrids market)
Home-host issues and crisis management arrangements	+ (↓ compliance costs, ↓ competitive distortions, ↑ optimal crisis mgmt solutions for cross-border groups)	+ (indirect benefits from enhanced financial stability)	+ (↑ access to info & involvement in colleges for host supervisors, ↑ clarity of tasks for home supervisors)	+ (indirect benefits from enhanced financial stability)	+ (↓ potential economic and social crisis-related costs for both investors and creditors)	+ (↑ effectiveness of EU crisis prevention system, ↑ info exchange b/w parties in crisis situations, ↑ access to info for host Member States of systemically relevant branches)
Derogations for bank networks from certain prudential requirements	+ (↓ compliance costs, ↑ legal clarity for cooperative bank networks)	≈	≈	+ (↑ benefits from lower compliance costs for cooperative clients and members)	+ (↑ benefits from lower compliance costs for cooperative members)	≈
Life insurance as collateral	+ (↓ compliance costs)	+ (↑ level playing field for life insurance companies)	≈	+ (↑ ability to obtain loan in general or on better terms for individuals and SMEs)	≈	≈
Treatment of CIUs under the IRB Approach	+ (↓ compliance costs)	+ (↓ indirect costs for CIU managers)	≈	≈	≈	≈
Capital requirements for securtisation positions	+ (→ new rules for securtisations, indirect benefits from enhanced financial stability)	+ (indirect benefits from enhanced financial stability)	+ (↑ effectiveness of rules for securtisations)	+ (indirect benefits from enhanced financial stability)	+ (indirect benefits from enhanced financial stability)	+ (↑ prudence and effectiveness of rules for securtisations)

Legend: + overall positive effect, - overall negative effect, +/- overall mixed effect, ≈ effect not significant, ↓ decrease, ↑increase, → introduction

6. MONITORING AND EVALUATION

It is expected that the proposed amendments to the Capital Requirements Directive will enter into force in 2010. Since they are tightly inter-linked with other provisions of the CRD, that are already in effect since 2007/2008, a preliminary assessment of impact of some of the proposed amendments could be carried out at the time of the evaluation of the CRD (comprised of Directives 2006/48/EC and 2006/49/EC), which is required by 1 January 2012.

The Commission, in co-operation with Member States will monitor the effectiveness of the proposals once implemented. The Commission will also have regard to other stakeholders such as industry and consumers while assessing if the objectives outlined in this impact assessment are fulfilled. It will also take account of the macro-prudential indicators already developed and utilized by the ECB to monitor the stability of the banking sector[68].

[68] The ECB's work in this area is supported by the use of the macro-prudential indicators with the underlying data requirements covered by a mix of sources that include:

–Indicators that are based on national supervisory data or harmonised banking statistics and that include, for instance, non-performing and doubtful assets' percentage of own funds, Tier 1 ratio, a number of banks with overall solvency ratio below 9% (appropriate for measuring the extent of achieving objectives G-1 and G-2), cost-to-income ratio as % of income, profits as % of total assets (ROA) (appropriate for measuring the extent of achieving objective G-3) and others.

–Forward-looking market-based indicators such as distance to default of major EU banks, credit default swap spreads or number of bank rating downgrades within the observation period (appropriate for measuring the extent of achieving objectives G-1 and G-2) and others.

For the most recent analysis, please see: http://www.ecb.int/pub/pdf/other/eubankingsectorstability2007en.pdf

ANNEXES

TABLE OF CONTENTS

1. LARGE EXPOSURES

1.1. Background

The large exposures (LE) limits have constituted an integral part of the international prudential framework since 1991 when the Basel Committee on Banking Supervision published a paper on good practices regarding measuring and controlling large exposures[69]. In 1997, these recommendations were included in the Basel Core Principles[70], and have been retained with slight amendments in the recent review[71] of the Basel Core Principles that took place in 2006. Five years before the first Basel paper the limits were included in the European prudential framework through the 87/62/EEC Recommendation issued by the Commission. But even before that, a large number of MS already had large exposures limits as part of their national prudential frameworks.

Recently the international prudential framework has been substantially reviewed by the new Basel Accord, which in Europe has been adopted through the CRD. Given the far reaching character of this change it was deemed necessary to check to what extent other elements of the prudential framework (including large exposures limits) outside the Basel Accord are still justified, and whether they need some adjustment in order to exist in harmony with the revised rules on capital adequacy.

Hence, some limited technical changes were made to the large exposures rules already when the CRD was adopted (such as the recognition of the use of certain credit mitigation techniques), but given the limited number and extent of these amendments, they cannot be said to constitute a review of the large exposures rules themselves. In recognition of this fact, Article 119 of 2006/48/EC and Article 28(3) of 2006/49/EC required a more in-depth review of the existing requirements "together with any appropriate proposals" to be submitted to the European Parliament and to the Council.

1.2. Procedural issues and consultation of interested parties

The Commission and Member States' Finance Ministry representatives meeting in the European Banking Committee (EBC) have been working on this review since 2005. In December 2005 a first call for advice for a stock-take of current supervisory and industry practices relating to the large exposures regime was issued to the Committee of European Banking Supervisors (CEBS). The advice received and the results of a parallel industry consultation highlighted certain shortcomings of the current regime.

At its meeting on 14 November 2006, the EBC agreed to extend the timetable for the large exposures review beyond December 2007 in order to facilitate a more wide-ranging review. As a result, in January 2007, the second Call for Technical Advice was issued to CEBS, seeking CEBS' advice on substantive aspects of the large exposures framework. The Call for Advice was structured into two parts: Part 1 basically covered the purpose and objectives of the large exposures regime, recognition of credit quality and calculation of the metrics. Part 2 covered a number of technical issues, including the treatment of credit risk mitigation techniques, intra-group exposures, indirect concentration risk, credit risk management etc.

[69] http://www.bis.org/publ/bcbsc121.pdf
[70] http://www.bis.org/publ/bcbs30a.pdf
[71] http://www.bis.org/publ/bcbs129.pdf

CEBS submitted the first part of the advice to the Commission in November 2007[72], while the final advice was submitted to the Commission in April 2008[73].

CEBS developed its advice in a manner consistent with the Commission's better regulation agenda by following the impact assessment guidelines that have been developed by CEBS together with the other two Lamfalussy Process[74] Level 3 committees. Effective stakeholder consultation is a central part of the guidelines. Market participants' views have been gathered at various stages of the advice development process (e.g. survey of industry practices, two public consultations and two public hearings in the context of developing the final advice as a response to the second call for advice etc).

In parallel to the work and consultation of CEBS, the Commission has been consulting the industry on a number of issues relevant to the LE review. In addition, in mid April 2008 the Commission launched a two month public consultation on the draft of possible changes to the CRD in order to collect comments from the industry and other stakeholders on these modifications.

1.3. Problem definition

1.3.1. Large exposures and why their regulation is necessary?

The aim of the large exposures regime is to protect against the risk of a regulated institution incurring traumatic loss that is likely to threaten its solvency as a result of the failure of an individual client or group of connected clients due to the occurrence of unforeseen events[75]. Ensuring that any negative impacts arising from large exposures to individual clients or group of connected clients are contained to an acceptable level and within the institution concerned is part of the overarching principles of prudential supervision. In this context, there are three main types of market failures that regulatory intervention aims to address:

- Negative externalities associated with systemic risk and market confidence, as an unexpected default of a single counterparty might result in the failure/traumatic losses of a financial institution and, via contagion, lead to a wider systemic crisis.
- Moral hazard, as institutions may invest less resource in single-name exposure risk management systems or allow larger exposures than they would without the perception of implicit state support. In addition, counterparties exposed to firms that could in certain circumstances pose a systemic threat may themselves invest less resource in managing counterparty credit risk.
- Information asymmetry, as institutions' private incentives might not lead them to publicly disclose the size, nature and details of their large exposures to individual counterparties. Also, even the most well-informed depositors are not able to continuously monitor their banks' large exposures even if such information were made available to them at the time of making their (initial) deposit. As a result, depositors and other creditors might not know the extent to which a firm may be exposed to a particular single large counterparty, and even knowing it, they can not assess its impact. In the event of the failure of a major

[72] http://www.c-ebs.org/Advice/documents/LE_Part1adviceonlargeexposures.pdf
[73] http://www.c-ebs.org/press/20080403_LE.htm
[74] For more on Lamfalussy Process please see Annex A
[75] "Unforeseen events" are events which are outside the parameters of portfolio capital allocation and, therefore, might trigger unexpected default of an institution or cause it to experience difficulties, regardless of the performance of the rest of the portfolio. Such events include a sudden drying up of market liquidity, internal fraud, government action, loss of a major customer or market and are usually not reflected in *ex ante* credit quality assessments.

counterparty institution rumoured to be financed by a particular bank they may pre-emptively withdraw funds thereby triggering or worsening a financial crisis. Conditions in European money markets in late summer of 2007 demonstrated that uncertainty regarding potential counterparties' exposures (single-name or otherwise) can prevent markets from functioning properly.

The existence of these market failures points out to the fact that there are circumstances under which institutions' own risk management systems may not be effective in dealing with the risk of traumatic loss arising from large exposures to individual clients and/or group of connected clients due to unforeseen events. This conclusion suggests that there is a need for regulatory intervention to achieve the above stated aim.

1.3.2. Existing large exposures regime

In 1987, the European Commission issued a Recommendation 87/62/EEC 'on monitoring and controlling large exposures of credit institutions'. The large exposures regime has constituted an integral part of the international prudential framework since 1991, when the Basel Committee on Banking Supervision issued a guide to best practice for bank supervisors in the monitoring and control of large credit exposures. In 1992, an EU directive[76] on large exposures was introduced. One notable development from the recommendation issued in 1987 was the inclusion of a significant number of national discretions. Eight years later, for credit institutions, this Directive was consolidated into Directive 2000/12/EC[77].

The current large exposures regime applies to all credit institutions and investment firms falling within the scope of the CRD (both Directives 2006/48/EC and 2006/49/EC). This includes the full range of banks from large systemically important institutions to small banks and the full range of investment firms from large broker-dealers to small brokers and asset managers.

The existing regime defines a large exposure as any exposure to a client or group of connected clients where its value is equal to or exceeds 10% of its own funds. The regime imposes regulatory limits in terms of maximum individual and aggregate exposures of an institution to a client and/or group of connected clients, expressed as a percentage of its own funds:

- A credit institution may not incur an exposure to a client or group of connected clients the value of which exceeds 25% of its own funds. Where that client or group of connected clients is the parent undertaking or subsidiary of the credit institution and/or one or more subsidiaries of that parent undertaking, the maximum exposure is reduced to 20% or may be exempted on the basis on national discretions, subject to requirements for specific monitoring of such exposures.
- A credit institution may not incur large exposures which in total exceed 800% of its own funds.

As mentioned above, the CRD offers a number of "discretions" (or options) as to how each MS may treat a certain type of exposure. For example, MS can choose to recognise less than 100% of the exposure value by applying a less than 100% risk weighting or exempt it altogether.

[76] Directive on the monitoring and control of large exposures of credit institutions 92/121/EEC.
[77] Directive relating to the taking up and pursuit of the business of credit institutions 2000/12/EC.

It has been suggested that there are not many compelling examples of bank failures due to large exposures. In 1999, Groupe de Contact completed a study[78] of the causes of banking failures and difficulties[79] in the EEA in 1988-1998. The case study sample comprised 117 cases contributed by 17 countries. Although credit risk problems had been found to be a significant factor in a number of difficulties, single name concentration risk did not appear to have been a significant factor within this risk category. The report indicates that only in 3 out of 117 cases considered was concentration risk to small number of counterparties or failure of a main creditor cited as a causal factor. Furthermore, CEBS has indicated that it has not found evidence of significant number of bank failures and difficulties caused by a single name concentration risk in the period from 1999 to 2007. It may be therefore argued that the large exposures regime that has been in place since 1992 played a key role in preventing failures due to single name risk concentration.

1.3.3. Weaknesses of the current regime

Driver: Misalignment between large exposures regime and industry risk management practices Problem: Increased level of compliance costs for the industry

In general, larger and more complex firms highlighted that the current rules do not adequately reflect industry practice in measurement, management and reporting of single name concentration risk. The methods of calculation of exposures used in the context of the large exposures regime significantly vary from methods used for internal risk management purposes. In addition, there is a general sense from financial groups that intra-group exposure limits are unduly constraining, given that risk management is conducted at the group level. Firms have complained about high compliance costs that this brings:

<u>1. Reporting costs</u>. Several studies and surveys of costs pertaining to reporting requirements under the current large exposures regime have been carried recently, producing a wide range of estimates, likely driven by sampling and methodological differences:

- In February 2008, WiFo and CEPS completed a measurement[80] of administrative costs related to reporting requirements of the existing large exposure regime in the context of the Commission's Action Programme for Reducing Administrative Burden in the EU[81]. The analysis which was based on the extrapolation of the baseline measurements in four MS (DK, AT, UK and DE) estimated the administrative burden of relevant information obligations, net of the estimated business-as-usual (BAU) factor of 20%, in EU27 to be in the range of €16-90 million. According to the report, financial institutions considered large exposure calculations imposed by regulators to be not in line with those processed internally, the latter being more optimal for their specific needs and strategies, giving rise to additional workload. Some of the institutions indicated that national discretions

[78] Groupe de Contact Paper for the Banking Advisory Committee: The Causes of Banking Difficulties in the EEA 1988-1998; unpublished.

[79] 'Difficulties' covered a wide range of events including bankruptcy, payment default, forced merger, capital injection, temporary state support, significant falls in overall profits or profits in particular areas of business.

[80] WiFo (Austrian Institute of Economic Research), CEPS, *Measurement of Administrative Burdens from Large Exposures Regime*, April 2008.

[81] On January 21, 2007, the Commission presented its 'Action Programme for reducing administrative burdens in the EU'. In the area of financial services, the large exposures regime has been targeted as one of the areas under this initiative that may offer an opportunity for reducing administrative burden. For more information on the initiative please see http://ec.europa.eu/enterprise/regulation/better_regulation/docs/com_2007_23_en.pdf

embedded in different national rules was another important factor contributing to the level of costs.

- The results of the CEBS' 2007 survey[82] assessing various costs arising from the current large exposures regime indicated that the average total costs of gathering and reporting data were just under €100k for banks and approximately €75k for all firms (including banks and investment / investment management firms). The same survey showed, however, that between one half and two thirds of such costs would be incurred by firms even if there were no large exposure regime in place, implying the BAU factor of 50-66% and incremental costs of the regime of €33-50k for banks and €25-38k for all firms. As shown in section 1.5.7, at the EU level, these estimates are equivalent to annual net administrative burden of roughly €460 million. The survey also showed that reporting costs varied across institutions, evidenced by the fact that while the sample average full time equivalent (FTE) persons dedicated to the task of gathering and reporting data was 0.86 FTE, the respective indicator for banks with assets in excess of €100 billion was 2.3 FTE.

- Finally, a survey that looked at 30 leading financial institutions and was conducted by International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and British Banking Association (BBA) in August 2006, showed that for large and internationally active institutions average annual reporting-related[83] costs at a firm level were in the region of €2.5 million[84]. This figure, while being noticeably above the estimated range of each of the other two exercises, suggests that reporting costs for large cross-border institutions are (the most) material and in this respect is in line with the findings of the CEBS' survey.

2. Opportunity costs. These costs are generally defined as profits foregone due to having to comply with the large exposure regime.

- While the institutions in the CEBS' survey generally found it very hard to estimate opportunity costs, the survey revealed that the firms rejected or partially rejected on average 3.5 transactions[85] because to enter into them would have resulted in breaching large exposures regulatory limits.

- The ISDA/LIBA/BBA survey of 30 leading financial institutions pegged an estimate of opportunity costs at €6 million per financial group. According to the survey, these costs are incurred mainly due to the regulatory limits placed directly on subsidiary groups and the existence of limits constraining intra-group exposures. As a result of the latter, institutions are unable to put parental guarantees in place due to their home country intra-group limits, effectively constraining their subsidiaries' business growth and thus restricting earnings growth. The survey highlighted the difficulties in estimating the opportunity costs in particular, pointing out to a lack of their precision.

[82] In total, 163 completed responses were received from market participants and included 106 banks and 57 investment and investment management firms across 15 EEA Member States. More details can be found in Annex 2 of the second consultation paper on CEBS' technical advice on the review of the Large Exposures rules available at: http://www.c-ebs.org/press/documents/LE_Part%202_07122007.pdf

[83] These costs included reporting and policy personnel, IT/systems and system depreciation costs.

[84] No estimate of the BAU factor was given.

[85] However this average masked the fact that only 31 out of total 163 respondents across different types and sizes of institutions gave non-zero answers and 8 gave numbers greater than 10.

Driver: Current regime inappropriate for certain specialized firms Problem: Unwarranted compliance costs for certain types of investment firms

The appropriateness and the relevance of the current rules to certain specialised firms have also to be reviewed. Industry consultation revealed concerns, among others, of certain types of investment firms, such as investment managers, that the regime was not 'fit for purpose' in relation to their business.

The large exposures of these firms take the form of accrued fees to their clients. Unpaid fees may qualify as large exposures, but has the effect of punishing success, since the better the investment has performed, the larger the fee, and therefore the larger the exposure. In addition, certain types of investment firms do not pose a direct risk to depositors since they are not able to take deposits. Also, in case of investment managers, client assets are segregated from the assets of the firm, for example, under the custody of an independent custodian, and if an investment manager were to fail, they would continue to belong to the clients.

As a result, the current large exposures rules appear to create an unwarranted compliance burden for these firms. The application of the large exposure regime in this case might be an example of a regulatory failure since the regime imposes compliance cost burden on these firms without delivering any apparent societal benefits.

Driver: Incomplete or unclear definitions Problem: Sub-optimal effectiveness of the regime with potential cost implications for stakeholders

There are also uncertainties related to definitions such as what constitutes a 'credit exposure', who can be considered a 'counterparty' and when can clients be considered 'connected'. Industry has in particular expressed concerns about the difficulties they face in establishing the existence of an economic relationship between clients. Clarity in these areas is important to reflect lessons drawn from the market turbulence as requested by the Ecofin Council of October 2007.

For example, in terms of the concept of connected clients, until now, the supervisory authorities have focused only on the asset side of the entities in question in order to identify whether one entity may encounter repayment difficulties because of the financial problems of the other entity. The financial market turmoil in the second half of 2007 has shown that two or more undertakings can be financially dependant because they are funded by the same vehicle. For example, in Germany, Rhineland Funding issued commercial paper in order to finance a number of conduits (off-balance sheet structured investment vehicles). As the asset quality of one conduit deteriorated, Rhineland Funding was unable to issue new commercial paper and provide the necessary funds to all the conduits. Therefore, IKB Bank as the main provider of liquidity facilities had to fund the whole structure. Although the different conduits did not invest in the same assets and were legally independent, it became obvious that the different conduits constituted a group of connected clients as they formed a single risk. As a result, there is a clear need to clarify the concept of connected clients, by taking into account not only the risk that derives from the business and assets of two entities but also from their liability or funding side.

Driver: Numerous national discretions Problem: Increased compliance costs for the industry and unlevel playing field in the internal market

There is a high level of divergence in how the rules are applied by the national supervisory authorities. This is a result of the numerous options offered (there are 20 national options for MS in Article 113(3) only), the number of permutations of the take up of these options that is possible, and some differences and difficulties arising from inconsistent interpretations of definitions. The result is that while all MS have a supervisory treatment that appears to be legally compliant, any given exposure might receive very different treatments from MS to MS which creates an uneven playing field. The lack of a consistent approach across the EU is a major concern for industry as the effects of disparate approaches to large exposures has a direct effect on a firms' ability to properly and fairly compete in another MS. The different applications of the legislation in different MS are particularly burdensome for firms operating cross-border. For instance, the aforementioned CEBS' survey showed that the average share of reporting costs due to differences between the large exposure regulatory requirements applied in different MS was 2.5% for all firms, while some cross-border firms indicated that for them it was equivalent to over 50% of their large exposure costs. As a result, diverging national treatments represent a significant barrier to doing business across borders within the EU and thus restrict progress in achieving a truly single European financial market.

Driver: Current regime does not effectively address market failures pertaining to certain exposure types Problem: Higher burden for taxpayers and allocative capital inefficiencies

The current CRD provisions allow a national discretion to exempt claims on other institutions (credit institutions and investment firms; in the following text referred as 'interbank exposures' or 'exposures to institutions') with a maturity of one year or less, and has a complex structure of risk weights for claims on other banks, which are different for different maturities above one year. Alternatively, MS may use a general derogation to simply apply a 20% risk weight to all interbank exposures, regardless of the maturity thereof.

However, interbank exposures signify a real risk and unforeseen events arising at major bank counterparties can give rise to negative externalities. Systemic risk and moral hazard issues also apply to interbank exposures, including short term exposures. This risk must be dealt with either ex-ante measures, or official intervention to prevent bank failures ex-post. The latter scenario implies higher burden on taxpayers and contributes to moral hazard for banks' creditors, resulting in allocative inefficiencies as implicitly supported banks obtain funds on better terms than those institutions without state support.

1.4. Objectives

The general objectives are the overall goals of this exercise and, therefore, they are fully aligned with the original long-term policy objectives of the CRD to:

- Enhance financial stability (G-1);
- Enhance safeguarding of creditor interests (G-2);
- Ensure international competitiveness of EU banking sector (G-3);
- Further promote of the internal banking market integration (G-4).

In light of the problems presented in the previous section, a set of operational objectives has been identified to address the associated problem drivers. Effective realization of such operational objectives should contribute to the achievement of longer term specific and, in turn, the aforementioned general policy objectives.

The following table lists problem drivers, operational and specific objectives and indicates linkages between them.

Problem Drivers	Operational Objectives	Specific Objectives				
		S-1 Enhance legal certainty	**S-2** Enhance supervisory cooperation	**S-3** Enhance level playing field	**S-4** Reduce compliance burden	**S-6** Reinforce risk management
Misalignment between large exposures regime and industry risk management practices	**O-1** Align the LE regime more closely with other requirements in the CRD and industry management practices				√	√
Current regime inappropriate for certain specialized firms	**O-2** Improve relevance for specialized firms				√	
Incomplete or unclear definitions	**O-3** Provide precise definitions	√		√		√
National options	**O-4** Harmonize the LE regime	√	√	√	√	
Current regime does not effectively address market failures pertaining to certain exposure types	**O-5** Adjust the treatment of exposures to financial institutions			√		√

1.5. Policy option analysis and comparison

A number of policy options have been considered, analysed and compared in reviewing the current large exposure regime. They have been split into first- and second-level options. First-level options (sub-section 1.5.1) were designed with a view to identifying an overall approach that would be the most effective in attaining the discussed objectives. Once this phase was completed, second-level policy options were developed to elaborate on features of a preferred first-level option. Second-level policy options pertaining to the areas, where the most material changes vis-à-vis current regime are expected, are presented in sub-sections 1.5.2-1.5.6.

1.5.1. General approach for large exposure monitoring

The first-level policy options regarding the large exposures can be summarised and will be referred to in the rest of this analysis as follows:

- **Policy option 1.1:** Retain current approach
- **Policy option 1.2:** No specific regime with market discipline enforced by rating agencies
- **Policy option 1.3:** Regime based on firms' own assessments and supervisory review (CRD Pillar 2)
- **Policy option 1.4:** Market discipline imposed by disclosure requirements (CRD Pillar 3)
- **Policy option 1.5:** Amended limit based backstop regime

Policy option 1.1 Retain current approach

The current regime is essentially a backstop limits based regime. It is being used as the baseline against which the high level description of costs and benefits of the various policy options have been considered. The current regime exhibits some instances of regulatory failure in that it covers certain types of exposures or types of firms for which there is no good case to suggest that material market failures exist. In addition, there are some areas that are or can be currently exempted from the LE regime but for which there is a case to include them in the regime. Further information on the costs associated with the current regime is presented in section 1.3.3. Due to its shortcomings, policy option 1.1 can be discarded as a nonviable approach with regard to overseeing LE on a go-forward basis.

Policy option 1.2 No specific regime with market discipline enforced by rating agencies

This policy option entails removing the existing LE regime altogether[86] and relying only on market forces to influence risk management of LE. The impacts are informed, in large part, by understanding of how rating agencies approach the evaluation of LE risk and the role this plays in influencing firms' decisions under the existing regime. Under this option, institutions would be free to operate within their own internal practice. The degree to which firms expose themselves to unforeseen event risk with respect to single name counterparties would not be constrained by regulatory limits. Instead, such exposures would depend on, among other things, firms' risk appetite and risk management and corporate governance practices (including systems and controls). Exposures may also be influenced by supervisory oversight as well as market discipline imposed, for example, by credit rating agencies or key counterparties. Because institutions' cost of capital depends, in part, on external credit ratings, and management may often target a particular rating, they are motivated to satisfy rating agencies about systems and controls over LE and their risk management practices in this area more broadly[87].

Rating agencies indicate, however, that the regulatory and supervisory setting in which a financial institution conducts business is a material consideration in their assessments. This makes it difficult to disentangle the effects of the rating agencies from the regulatory framework on firms' management practices surrounding concentration risks.

Under this option, supervisors would incur costs that may derive from the loss of key regulatory report information and ensuing sub-optimal direction and use of supervisory resources. If supervisors were to rely on internal, firm-specific management information reports to monitor concentration risk and LE risk in particular, there could be an increase in processing costs which could in turn have repercussions for institutions due to an increased number of questions and requests for delivery of such data.

To the extent that supervisors place more reliance on credit rating agencies in disciplining risk taking by firms, there might be an increase in costs associated with interacting with rating agencies to gain a better understanding of their assessment processes and to evaluate the efficacy of their rating processes.

The loss of key information on breaches of LE limits may also cause supervisors to lose information deemed useful for assessing wider control issues. This could lead to increased losses and the likelihood of insolvency by institutions more broadly.

---

[86] This would effectively involve the removal of Title 5, Chapter 2, Section 5 of the Directive 2006/48/EC and Chapter V, Section 4 of the Directive 2006/49/EC.

[87] Concentration risk forms an important part of rating agencies' assessment of a financial institution's risk profile. Rating agencies adopt a mixture of quantitative and qualitative approaches when making such assessments. The assessment commences with a review of a list of LE to counterparties or groups of related counterparties, where exposure is measured as gross exposure (i.e., independent of collateral or the credit quality of the counterparty). The list forms the basis for initial discussions with management. In these two regards, it is not significantly different from the information and use of regulatory report information under the existing LE regime. On the other hand, rating agencies indicate that it is important also to take into account the credit quality of single name counterparties on this list when assigning their overall ratings.

The loss of standardized reporting information would reduce the ability of supervisors to monitor and evaluate concentrations of bilateral exposures among financial institutions and therefore systemic risk. This could reduce their ability to monitor unforeseen event risk to single name counterparties on a timely basis, which could reduce the chance of identifying and mitigating problems before they crystallise and increase the expected costs of bank failures.

For the industry, this policy option implies a reduction in compliance costs given that firms will no longer be required to comply with the current regime. These benefits could be limited for smaller firms that tend to rely on the existing LE regime as a framework for measuring, monitoring, and managing LE. For large firms that typically manage LE using systems that are separate and distinct from the current regime, the benefits of this option would be limited to the reduction in unnecessary systems and reporting costs to comply with regulatory requirements. However, additional time and resources associated with potentially more on-site supervision or in dealing with increased supervisory data requests to offset loss of regulatory reporting data might be necessary.

To the extent that the existing regime constrains firms' abilities to lend or forces them to turn away business a reduction in such opportunity costs could materialize. More generally, the lack of a LE regime of any kind could adversely affect the benefits that underlie the purpose of the regime. Those benefits include a reduction in the likelihood of a significant disruption to the business operations and credit facilitation processes of banks due to unforeseen event risk and exposures to single name counterparties in particular. To the extent that the existing regime lessens this chance and is more effective than market discipline instilled by credit rating agencies, then this probability could increase bringing about cost implications for the economy more broadly.

In case the credibility of credit rating agencies was undermined, the resultant loss of market confidence could negatively impact institutions' cost of capital[88].

The effectiveness of this policy option may be negatively affected to the extent that rating agencies themselves rely on the regulatory limits and reporting requirements in making judgments about firms' financial condition, concentration risk and exposure to single name counterparties.

Finally, competition in the market for large credits might intensify as there would be no regulatory lending limits beyond those imposed by regulatory capital constraints, internal lending standards or market discipline. This could potentially reduce borrower costs.

Policy option 1.3 Regime based on firms' own assessments and supervisory review (Pillar 2)

Similarly to policy option 1.2, this option entails removing the existing LE regime altogether. It would allow firms to manage LE and unforeseen event risk under their own process subject to supervisory review. Under this option, institutions would be free to operate within their own internal practice but would be expected, in their capital planning and assessment process, to consider concentration and unforeseen event risk associated with exposure to single name counterparties. They would be required to demonstrate how these considerations are reflected in their capital assessments and make adjustments on the basis of supervisors' assessments of that process under Pillar 2.

[88] Recent market turmoil suggests that 'missed' or incorrect credit ratings can have significant implications for the market confidence in these assessments which can have more widespread market confidence problems.

The degree to which firms expose themselves to unforeseen event risk with respect to single name counterparties would not be constrained by regulatory limits, but instead, would depend on, among other things, firms' risk appetite and risk management and corporate governance practices (including systems and controls). Such exposure would also be influenced by supervisory oversight as well as market discipline imposed, for example, by credit rating agencies or key counterparties. For supervisors this option entails costs that stem from the loss of key regulatory report information: sub-optimal direction and use of supervisory resources, need for additional supervisory review staff, increased supervisory resources to deal with the transitory and highly complex nature of many LE. This may require significant specialist supervisory resources to review these exposures effectively, e.g., M&A exposures are typically short-lived and Pillar 2 reviews may be after the event in many cases.

For the industry this option implies higher costs associated with additional resources and time necessary to deal with increased supervisory reviews and information requests. The details and the amount of information required by supervisors would change in nature. More senior involvement would be required to address Pillar 2 requirements. A higher reporting frequency may be warranted and so higher on-going compliance costs may arise. The industry might also face an increase in capital compliance costs compared with a regime that does not deal with single name counterparty risk in Pillar 2 to the extent that regulators might impose extra requirements (e.g., extra capital charge) for risks arising from exposures to single name counterparties or concentration risks as such.

Furthermore, variations in implementation of Pillar 2 across MS may inevitably lead to competitive distortions with a possible mixture of capital and non-capital supervisory treatment, especially during the early stages of the new Pillar 2 regime.

There may be uncertainty among market participants over the potential maximum exposure size of banks' counterparties since different institutions would inevitably come to different conclusions with individual supervisors on the maximum acceptable size of exposures allowed. This may cause institutions to unduly restrict their large lending giving rise to additional opportunity costs. However, opportunity costs might be mitigated as new business opportunities materialise due to more tailored assessment by supervisors, allowing institutions to take on larger exposures than is currently the case. This may increase the quantity of large lending to the extent that current limits 'bite' on institutions. In addition, the structuring of deals (e.g., monthly payments instead of half yearly payments) would be in accordance with business needs as opposed to being motivated by attempts to circumvent the LE limits, possibly lowering opportunity costs further.

There is a risk that a Pillar 2 regime might not be able to constrain large exposure lending to the same extent as hard limits and this may result in a greater probability of firm failure and associated economic costs due to unforeseen event risk with regards to single name counterparties.

On the other hand, approach based on Pillar 2 may provide firms with more flexibility in their management of LE, although this benefit may be limited to the extent that firms already rely on their own internal processes and assessments in managing this type of risk. It could also encourage on-going improvement in the risk measurement, monitoring and management practices of firms with regards to unforeseen event risk, which could, in turn, strengthen financial stability. This option may also provide increased incentives to firms to improve market disclosures surrounding their LE risk management. To the extent that this is information is timely and useful it could lead to increased market confidence.

Policy option 1.4 Market discipline imposed by disclosure requirements (Pillar 3)

This option entails removing the existing LE regime altogether and requiring firms to disclose their LE to the market through Pillar 3 disclosure mechanisms. Under this scenario, institutions would be free to operate within their own internal practice but would be required to disclose their LE to the market on a timely basis.

The degree to which firms expose themselves to unforeseen event risk with respect to single name counterparties would not be constrained by regulatory limits, but instead, would depend on, among other things, firms' risk appetite and risk management and corporate governance practices (including systems and controls). Their exposures would also be influenced by the market discipline imposed by key stakeholders, including depositors, debt holders and stockholders, as well as by ratings agencies.

This option entails additional costs for supervisors who would be required to monitor the Pillar 3 disclosures to ensure that firms are complying with the disclosure requirements. However, there may be some cost reductions to the extent that supervisors do not need to focus on LE issues as they let market discipline take its course.

To the extent that market participants require greater amounts of information to be disclosed additional compliance costs may arise for the industry. The format for disclosure may need to change to suit the needs of the market while higher disclosure frequency may also be warranted, leading to additional staff and systems costs. To the extent that disclosure requirements will differ between jurisdictions, additional costs might be incurred by cross-border financial institutions.

This option might be less effective for small institutions with less actively traded shares as they are not exposed to significant level of market discipline, potentially increasing the chance that they could fail due to unforeseen event risk associated with large, single name borrowers.

There may be a reduction in opportunity costs for the industry if the market judges that exposures can be greater than those allowed under the current limits, also allowing for new business opportunities to materialize. In addition, the structuring of deals may be better aligned with business needs as opposed to being motivated by attempts to circumvent the impact of the LE limits.

More importantly, the maximum exposure to a unique counterparty would be determined by private market players, so its level may not necessarily take into account the externalities associated with a failing counterparty for the whole system. Moreover, depositors will not necessarily play a role as they may find it difficult to understand the associated risk, and act accordingly. To the extent that these two issues mean that market discipline does not result in socially optimal levels of large exposure lending then there may be additional costs through increased risk of bank failure and the economic costs that this may involve.

Key stakeholders may incur costs from analysing the data that is disclosed. In particular, small investors or depositors may find it difficult to interpret properly the publicly available data.

On the other hand, confidence in the market may increase if market participants are able to properly evaluate the information, that is more relevant and reliable and disclosed on a timely basis, and price contracts to influence lenders' behaviour. Benefits might arise to the extent that the probability of failure is reduced and a 'safer' financial system leads to a lower cost of capital for market participants.

Policy option 1.5 Amended limit based backstop regime

Under this option, adjustments to the types of exposures and/or the types of firms that are covered by the LE regime are being proposed in order to address the shortcomings identified in the current regime. However, regulatory limit would still apply where firms continue to be covered by the LE regime.

This option would entail two types of amendments:

- Those increasing the requirements in areas (e.g. treatment of the exposures to institutions, deletion of a number of exemptions, taking into account also the risks that derive from the liability/funding side of connected clients), where the analysis of the current regime has identified a sub-optimal level of its effectiveness;
- Those decreasing the requirements in areas (e.g. exempting certain types of investment firms, harmonisation of reporting requirements, deletion of a number of national discretion and therefore reducing the administrative burden) where the analysis has shown that the current regime could be made more efficient while maintaining its effectiveness and where certain regulatory failures are present.

Possible impact of the above policy options on the stakeholders

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
1.1: Retain current approach	Industry – large banks	Increased compliance (reporting and opportunity) costs due to misalignment of the regime with industry practices; Cross-border institutions face yet higher costs due to national options	Direct	-	High	Permanent
	Industry – small firms	Increased in compliance costs less pronounced than for large banks	Direct	-/≈	High	Permanent
	Supervisors	Rely on regime to conduct LE monitoring	Direct	≈	High	Permanent
	Specialized investment firms	Current LE regime imposes unwarranted compliance costs	Direct	-	High	Permanent
	Borrowers	Sub-optimal competition in large credit market (due to a number of national options) increases costs	Indirect	-	Medium	Permanent
	Creditors	Some risks to the level of protection due to certain gaps in the regime (unclear definitions, exposures to institutions)	Indirect	-	Medium/High	Permanent
	Financial stability	Risks due certain gaps in the regime	Indirect	-	Medium/High	Permanent
	EU economy	Risks in case of financial instability	Indirect	-/≈	Medium/High	Permanent
1.2: No specific regime with market discipline enforced by rating agencies	Industry – large banks	Reduced compliance (reporting and opportunity) costs	Direct	+	High	Permanent
	Industry – small firms	Reduction in compliance costs less pronounced than for large banks	Direct	≈/+	High	Permanent
	Supervisors	Increase in costs due to lower efficiency; Possible loss in effectiveness of LE monitoring and bank failure prevention	Direct	-	High	Permanent
	Borrowers	Benefit from increased competition in large credit market	Indirect	≈/+	Medium	Permanent
	Creditors	Negatively impacted if bank failures prevented less effectively by supervisors	Indirect	-/≈	Medium/High	Permanent
	Financial stability	Some risks due to supervisors' inability to effectively monitor bilateral LE among banks	Indirect	-/≈	Medium/High	Permanent
	EU economy	Risk of disruption of credit facilitation processes	Indirect	-/≈	Medium	Permanent
1.3: Regime based on firms'	Industry – large banks	Net impact on compliance costs positive although new requirements might offset savings from removal of current regime	Direct	≈/+	High	Permanent

Policy Option	Party Affected	Impact				
		Description	Type (D/I)	Effect (-/≈/+)	Likelihood (L/M/H)	Timing (S/L/P)
own assessments and supervisory review (Pillar 2)	Industry – small firms	Net impact on compliance costs positive although new requirements might offset savings from removal of current regime	Direct	≈/+	High	Permanent
	Supervisors	Increase in costs due to lower efficiency	Direct	-	High	Permanent
	Borrowers	Possible benefits from increased competition in large credit market	Indirect	≈/+	Low	Permanent
	Creditors	Possibly better protected assuming risk management is incentivized	Indirect	≈+	Medium	Permanent
	Financial stability	Possibly strengthened assuming risk management is incentivized; possibly weakened assuming not all institutions would have a robust framework for credit concentration risk management	Indirect	≈/+	Medium	Permanent
	EU economy	Depending on the net impact on the financial stability	Indirect	≈	Medium	Permanent
1.4: Market discipline imposed by disclosure requirements (Pillar 3)	Industry – large banks	Net impact on compliance costs positive although new disclosure requirements might offset savings from removal of current regime	Direct	≈/+	High	Permanent
	Industry – small firms	Net impact on compliance costs more positive than for large banks due to lower level of market discipline	Direct	≈/+	High	Permanent
	Supervisors	Increase in costs due to monitoring of disclosures to the market offset by cost reductions if more reliance on market discipline	Direct	-/≈	High	Permanent
	Borrowers	Benefit from increased competition in large credit market	Indirect	≈/+	Medium	Permanent
	Creditors	Net impacts will depend on how effectively underlying market failures (information asymmetry, moral hazard and negative externalities) are mitigated	Indirect	≈	Medium	Permanent
	Financial stability		Indirect	≈	Medium	Permanent
	EU economy		Indirect	≈	Medium	Permanent
1.5: Amended limit based backstop	Industry – large banks	Reduced compliance (reporting and opportunity) costs; less compliance burden for cross-border banks due to alignment of national regimes; reduced costs due to a further alignment of the metrics with the solvency regime Possible increase in compliance costs due to the proposals regarding the treatment of interbank exposures, application of a 100% CCF and taking into account also the risks that derive from the liability/funding side of connected clients.	Direct	≈/+	High	Permanent
	Industry – small firms	Reduction in compliance costs less pronounced than for large banks Reduced costs due to a further alignment of the metrics with the solvency regime Possible increase in compliance costs due to the proposals regarding the treatment of interbank exposures, application of a 100% CCF and taking into account also the risks that derive from the liability/funding side of connected clients.	Direct	≈/+	High	Permanent
	Supervisors	Costs due to implementation of amendments; but better effectiveness of LE monitoring as certain gaps in the current regime are closed	Direct	≈	High	Permanent
	Specialized investment firms	Reduced compliance costs	Direct	+	High	Permanent
	Borrowers	Benefit from increased competition in large credit market (due to a reduction in a number of national options)	Indirect	+	High	Permanent
	Creditors	Better protected as effectiveness of LE monitoring improves due to closure of certain gaps in the current regime	Indirect	+	High	Permanent
	Financial stability	Risks to financial stability lowered as	Indirect	+	High	Permanent

Policy Option	Party Affected	Impact				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
regime		effectiveness of LE monitoring by supervisors improves				
	EU economy	Risks of disruption of credit facilitation processes lowered	Indirect	+	High	Permanent

Conclusion

A common benefit of removing the LE regime under policy options 1.2 (No specific regime with market discipline enforced by rating agencies), 1.3 (Regime based on firms' own assessment and supervisory review under Pillar 2) and 1.4 (Market discipline imposed by Pillar 3 disclosure requirements) would be an on-going reduction in systems and regulatory reporting costs. Therefore, these options could be deemed to be effective in achieving objective S-4 (Reduce compliance costs) to the extent that these savings are not fully offset by additional costs imposed by alternative requirements.

The benefits for the industry need to be weighed carefully in the light of costs that could arise from the loss of critical regulatory information on large exposures. That is, the loss of such information may adversely impact supervisory resource allocation and approaches. To the extent that the lack of these data results in inefficient direction of supervisory resources, this shortfall could reduce the likelihood of timely detection and resolution not only of large exposure risks but also other systemically important risks. Both effects could translate into higher expected resolution costs.

Allowing banks to manage LE using internal models and practices as set out in policy option 1.3 may facilitate greater flexibility in the management of large exposures and better align the management of this risk with internal economic capital models. Because this process would be subject to supervisory review, it would create stronger incentives to improve risk management practices and economic capital planning with respect to unforeseen event risk, effectively mitigating the risks arising from the loss of routine, standardized regulatory report data described above. As a result, this option could be considered more effective with respect to attaining objectives S-6 (Reinforce risk management) and G-1 (Enhance financial stability) than options 1.2 and 1.4 which rely on market mechanisms to address unforeseen event risk and are effective to the extent to which market discipline could address the underlying market failures and to which banks are exposed to market discipline.

Distribution of costs and benefits among stakeholder groups under option 1.5 (Amended limit based backstop regime) depends on exactly how the current limit based regime is amended, i.e., while certain amendments may lead to cost savings for the industry, others might impose costs which, however, are expected to be offset by societal benefits resulting from increased systemic stability and reduced risk of failure and contagion. In light of the above assessment of first-level policy options it can be concluded that option 1.5 (Amended limit based backstop regime) is the most effective option as it is specifically tailored to respond to the identified shortcomings of the current regime. As a result, it is not only effective with regard to abovementioned objectives S-4 (Reduce compliance costs), S-6 (Reinforce risk management) and G-1 (Enhance financial stability), but also S-3 (Enhance level playing field) and S-1 (Enhance legal certainty). Policy option 1.5 shall be also favoured to other policy options due its more consistent impact distribution across stakeholder groups.

Policy Option	Relevant Objectives				
	S-1 Enhance legal certainty	S-3 Enhance level playing field	S-4 Reduce compliance costs	S-6 Reinforce risk management	G-1 Enhance financial stability
	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
1.1: Retain current approach	≈	≈	≈	≈	≈
1.2: No specific regime with market discipline enforced by rating agencies	≈	≈/+	+	≈/+	≈
1.3: Regime based on firms' own assessments and supervisory review (Pillar 2)	≈	≈	≈/+	++	≈/+
1.4: Market discipline imposed by disclosure requirements (Pillar 3)	≈	≈	+	≈/+	≈
1.5: Amended limit based backstop regime	+	++	≈/+	+	++

1.5.2. *Investment firms*

The current LE regime applies not just to credit institutions but also to investment firms. Pursuant to Articles 28-32 and Annex VI of Directive 2006/49/EC investment firms fall within the scope of the LE regime. Article 28(1) provides that 'institutions' shall monitor and control their LE in accordance with Articles 106-118 of the Directive 2006/48/EC. The result is that there is a large category of investment firms that are captured by the current LE regime via Directive 2006/49/EC and the cross reference in Article 3(1)b of this Directive to Article 4.1(1) of Directive 2004/39/EC ("MiFID").

Two policy options were considered with respect to relevance of the current regime to investment firms:

- **Policy option 2.1:** Retain current approach
- **Policy option 2.2:** Exempting certain investment firms from the LE regime

Policy option 2.1: Retain current approach

The application of the large exposures regime to all types of investment firms could be considered to be a regulatory failure since the regime imposes an unnecessary burden on specific types of investment firms (including a reporting burden) without delivering benefits to consumers. Investment firms with "limited licence" and with "limited activity" have been identified as those firms for which the case for including them within the scope of the large exposure regime has not been made.

Policy option 2.2: Exempting certain investment firms from the LE regime

A differentiated market failure analysis carried out based on the possible existence of negative externalities and information asymmetry has shown that these types of investment firms do not appear to represent a significant risk of contagion because of the nature of their contracts. Instead, they act as agents for an investor who has delegated portfolio selection and administration to the asset manager. Exposures taken by an investment manager itself (as opposed to exposures incurred on behalf of a client or fund) are generally incidental to its investment management business. They do not tend to have large unsecured exposures. Their large exposures are often accrued management and performance fees against which they are likely to have recourse to the assets under management (as the result of a client agreement/ contract).

The costs associated with failures of investment firms are likely to be relatively limited as they are not funded by depositors. The MiFID also requires client assets to be held separately from the firm's assets. Provided that asset managers do not take positions on their own account, interlinkages between firms are likely to be limited and so the collapse of an asset manager would not be expected to impact or have wider implications for consumer protection.

Possible impact of the above policy options on the stakeholders

Policy Option	Party Affected	Impact				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
2.1: Retain current approach	Supervisors	Current LE regime imposes unwarranted monitoring costs also to supervisors	Direct	-	High	Permanent
	Specialized investment firms to be exempted (with 'limited license' and 'limited activity')	Current LE regime imposes unwarranted compliance costs to these firms	Direct	-	High	Permanent
	Other investment firms or institutions	Compliance and monitoring costs	Direct	-	High	Permanent
2.2: Exempting certain investment firms from the LE regime	Supervisors	Reduction in monitoring costs for supervisors	Direct	+	High	Permanent
	Specialized investment firms to be exempted (with 'limited license' and 'limited activity')	Reduction in compliance costs	Direct	+	High	Permanent
	Other investment firms or institutions	Potential competitive disadvantage vis-à-vis the exempted investment firms	Indirect	-/≈	Low/Medium	Permanent

Conclusion

A benefit of removing the LE regime under policy option 2.2 would be an on-going reduction in compliance and reporting costs for those investment firms that would be exempted from the LE regime. Therefore, the Commission suggests that Policy option 2.2 should be favoured as it appears to be more effective to achieve the objectives of the LE review, in particular with respect to objectives S-4 (Reduce compliance costs) and S-6 (Reinforce risk management).

As a result, the Commission proposes that those investment firms with "limited licence" as referred to in Article 20(2) of Directive 2006/49/EC, that is those investment firms providing only one or more of the services referred to in points, 1, 2, 4, 5, 7 and 8 of Section A of Annex I of MiFID[89], should be fully exempted from the LE regime. The Commission also proposes a full exemption from the LE regime for those firms with "limited activity" referred to in Article 20(3) of Directive 2006/49/EC.

1.5.3. Interbank exposures

The current Directive allows a national discretion to exempt claims on other institutions (credit institutions and investment firms; in the following text referred as 'interbank exposures') with a maturity of one year or less, and has a complex structure of risk weights for claims on other banks, which are different for different maturities above one year.

[89] Activities listed are: (1) reception and transmission of orders in relation to one or more financial instruments; (2) execution of orders on behalf of clients; (4) portfolio management; (5) investment advice; (7) placing of financial instruments without a firm commitment basis; (8) operation of multilateral trading facilities.

Alternatively, Member States may use a general derogation to simply apply a 20% risk weight to all interbank exposures, regardless of the maturity thereof.

Three policy options were considered with respect to treatment of interbank exposures:

- **Policy option 3.1:** Retain current approach
- **Policy option 3.2:** Apply the LE limits to all exposures to institutions
- **Policy option 3.3:** Apply the LE limits to all exposures to institutions, with flexibility of alternative threshold for smaller institutions

Policy option 3.1: Retain current approach

As argued in the problem definition, interbank exposures signify a real risk as unforeseen events arising at major bank counterparties can give rise to negative externalities. Systemic risk and moral hazard issues also apply to interbank exposures, including short term exposures. CEBS considers that, although it might be less likely that a prudentially regulated institution could unexpectedly default due to an unforeseen event, it remains a plausible scenario[90]. For instance, BCCI (in 1991) and Barings (in 1995) failed after fraud was uncovered and, more recently, external intervention was required to support Northern Rock, IKB and Sachsen LB after their business models suddenly became, at least temporarily, unviable. The large losses recently made by Societe Generale on its equity derivatives portfolio also demonstrate the potential for banks to make sudden, large and unforeseen losses.

A study carried out by Fitch Ratings[91] demonstrates that, although the average one year default rate of banks and other financial institutions is three times lower than that of industrial and commercial companies (0.27% vs. 0.77%), it remains significant. Importantly, banks are almost three times more likely to fail and be supported than they are to default (due to ex-post measures taken or facilitated by the public authorities to prevent the failure of banks that would otherwise have defaulted), which means that effectively they are equally as likely to fail as corporates, i.e., have one year failure rate of 0.77%.

This risk must be dealt with either by ex-ante measures, or by official intervention to prevent bank failures ex-post. However, the latter scenario implies higher burden on taxpayers and contributes to moral hazard for banks' creditors, resulting in allocative inefficiencies as implicitly supported banks obtain funds on better terms than those institutions without state support.

On this basis, the current treatment of interbank exposures offering the possibility for the competent authorities to exempt interbank exposures with maturity below 1 year or to assign a set of different risk weights to interbank exposures (with regard to or regardless the maturity of the respective exposure) appears to be inappropriate from the prudential perspective.

Policy option 3.2: Apply the LE limits to all exposures to institutions

While the costs and benefits of imposing a 25% limit on unsecured interbank exposures would vary significantly between banks and Member States, this option should make a positive net contribution to the reduction of systemic risk.

The *benefits* of imposing the LE limit on all interbank exposures would be found in reduced exposure to *unforeseen event* risks; reduced systemic risk and hence potentially less need for

[90] CEBS, *Second part of CEBS' technical advice to the European Commission on the review of the large exposures rules*, March 2008

[91] Fitch Ratings, *Fitch Bank Failures Study 1990-2003*, March 2005

the authorities to intervene to prevent a systemic crisis, and reduced moral hazard, resulting in a shift of the systemic risk burden from taxpayers to banks themselves. This would produce better incentives for banks to diversify their funding sources in day-to-day operations, to strengthen their contingency funding plans and/or to increase their stocks of liquid assets.

The *costs* of imposing interbank limits would be associated with their potential impact on banks' liquidity management, particularly in stressed circumstances, increased operating costs – for some, smaller, banks at least – associated with dealing with a wider range of counterparties, and the costs associated with increased use of secured, rather than unsecured, markets. Banks whose liquidity management is *structurally* reliant on a small number of bank counterparties, that is, where there is a long-standing and persistent[92] large net exposure in one direction, would be most affected by a backstop limits regime. Banks in this position may need to adjust their liquidity management practices to comply with a backstop limit.

It would be reasonable to expect, however, that banks with robust contingency funding plans would not be reliant on a limited number of counterparties to provide very large amounts of liquidity. Importantly, this option would represent a shift in the burden of systemic risk from the taxpayer to the banks because there would be less need for ex-post official intervention.

Based on the assumption that banks would generally be able to diversify or collateralize their large exposures, CEBS[93] has estimated that a conservative estimate of the annual opportunity cost of introducing a limit of 25% of own funds on unsecured interbank exposures for the eleven countries[94] analysed is €89 million. The approximate benefit of imposing such a limit on all interbank exposures is estimated to lie between €33 and €402 million per year.

Policy option 3.3: Apply the LE limits to all exposures to institutions, with flexibility of alternative threshold for smaller institutions

The costs identified under option 3.2 would fall primarily, but not exclusively, on smaller rather than larger banks, as many smaller banks rely on being able to place large deposits with a limited range of high quality, typically but not exclusively, domestic, banks.

Limits could restrict interbank liquidity in stressed circumstances if banks do not strengthen their contingency funding plans.

For some small banks, interbank assets constitute the majority of their assets by value as they engage in little or no lending to the real economy. Depending on the calibration of the large exposures limit and therefore the extent to which they were obliged to diversify or take collateral against their interbank exposures, the smallest banks may be unable to obtain an economically sustainable spread on placements in interbank markets because wholesale counterparties demand a premium for dealing in what are, to them, very small amounts. However, this problem may be at least partially mitigated by the fact that the introduction of interbank limits could prompt a structural shift in the interbank market and a reduction in the premium for accepting small placements of funds.

Therefore, under this option all interbank exposures would be subject to the 25% limit or the threshold[95] of €[X][96] million, whichever is higher. The aim of introducing the threshold of

[92] But not necessarily long maturity: exposures could be rolled over at short maturities.
[93] CEBS, *Second consultation paper on CEBS' technical advice to the European Commission on the review of the large exposures rules*, December 2007
[94] BE, FI, EL, HU, IE, IT, LT, NO, SK, ES, UK.
[95] Supervisors could downwardly but not, in normal circumstances, upwardly adjust the thresholds at their discretion to allow for differences in the absolute size of Member States' banking systems. The threshold would need to be periodically adjusted for inflation and / or changes in market structure.

€[X] million would be to avoid a restrictive impact on small and medium sized banks who may have difficulties in accessing deep and liquid interbank markets to manage their liquidity.

Public Consultation

In the online public consultation, the stakeholders were asked for their comments on the above policy alternatives. With regard to options 3.2 and 3.3, the consultation has shown that suggested tightening of the treatment of interbank exposures is a cause for concern for the industry. The concerns have centred around the potential negative consequences on the ability of institutions to manage their liquidity and the impact on interbank markets. On this basis, a number of stakeholders, while recognising that interbank exposures are not risk-free, argued that a removal of the current, widely-adopted exemption for exposures with less than 1 year maturity (option 3.1) and applying a 25% limit would not be desirable. Given that most interbank exposures take place in the context of liquidity management and are therefore short-term, a number of respondents argued that a maturity dimension and / or application of a higher limit is needed. However, only a very limited number of these stakeholders provided more detailed information or comprehensive evidence justifying these arguments in a sufficiently robust manner.

With regard to the effectiveness of option 3.3, stakeholders' views were split as a number of smaller and medium size institutions argued that the concept suggesting the introduction of a quantitative threshold would not work in practice.

As a result of the debate, some **modifications to policy option 3.2** were incorporated in order to accommodate the specificities of certain stakeholder groups' business model:

– The European Association of Co-operative Banks requested the retention of the exemption currently provided in Article 113(3)(n)[97] as conditions for exemptions stipulated in Article 80(8) do not appear to cover all decentralised sectors sufficiently. In addition, co-operative banks also requested the extension of this exemption to exposures arising from participations or other holdings in entities within the respective network;

– Some institutions offering clearing and / or settlement services requested exemption of very short-term exposures arising from operations related to the clearing and settlement of securities for clients, including exposures resulting from their clients' activity, as well as exemption of undrawn credit facilities that are offered by these institutions to facilitate the settlement and clearing of the respective transactions; and

– The European Association of Public Banks and Funding Agencies requested either to carve-out the exposures of state development banks to commercial banks from the limit or to subject them to a 20% risk weight (i.e., higher limit). It was argued that this measure would be necessary to avoid distortions of the specific business model of development banks, whose customer base primarily comprises of other (commercial) banks to which development funds in the form of credits are directed to.

[96] In its final advice to the Commission, CEBS suggested an amount of €150 million as a value for this threshold; CEBS indicated that this limit needed further work to ensure that "this does not allow potentially systemic banks to have interbank exposures greater than 25% of own funds".

[97] Exposures to institutions with which the lending credit institution is associated in a network in accordance with legal or statutory provisions and which are responsible, under those provisions, for cash-clearing operations within the network.

Conclusion

Based on the above analysis, it could be concluded that policy options 3.2 (Apply the LE limits to all exposures to institutions) and 3.3 (Apply the LE limit to all exposures to institutions, with flexibility of alternative threshold for smaller institutions) are more appropriate than policy option 3.1 (Retain current approach) as the ex-ante approach should be favoured so that the burden on taxpayers is lower and market functioning is more efficient than it is under the alternative ex-post approach.

It is likely that the introduction of a quantitative threshold under option 3.3 would not provide for a correct mechanism to moderate the impact of the suggested approach (to treat interbank exposures as any other exposures) on smaller and some medium size banks.

Moreover, in terms of their performance in relation to the relevant objectives, a modified option 3.2 is more effective than option 3.3 in achieving objectives G-1 (Enhance financial stability) and G-2 (Enhanced safeguarding of creditor interests) and, therefore, has been retained as the preferred option.

Also, it is important to note that as a result of the abovementioned modifications to option 3.2, concerns of a number of smaller institutions have been addressed.

Possible impact of the above policy options (as modified) on the stakeholders

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
3.1: Retain current approach	Industry – large banks and large investment firms	Possibility to exempt or risk weight interbank exposures if national option is exercised	Direct	≈	High	Permanent
	Industry – small firms	Possibility to exempt or risk weight interbank exposures if national option is exercised	Direct	≈	High	Permanent
	Supervisors	Increased uncertainty about the risks undertaken by institutions and hence increased additional monitoring costs.	Direct	-/≈	High	Permanent
	Borrowers	Sub-optimal competition in large credit market increasing costs	Indirect	-/≈	Medium	Permanent
	Creditors	Risks to the level of protection due to certain gaps in the regime	Indirect	-	High	Permanent
	Financial stability	Risks due certain gaps in the current regime	Indirect	-	High	Permanent
	EU economy	Risks in case of financial instability	Indirect	-/≈	Medium/High	Permanent
3.2: Apply the LE limit to all	Industry – large banks and large investment firms	Increased costs related to diversification or collateralisation of exposures; possible opportunity costs Benefits arising from strengthening institutions' contingency plans, diversification of their funding sources in day-to-day operations and/or increase their stock of liquid assets	Direct	-/≈	High	Permanent
	Industry – small firms	For certain non-exempt firms: increased costs related to diversification or collateralisation of exposures; possible opportunity costs; costs in terms of restricting interbank liquidity in stressed circumstances if banks do not strengthen their contingency funding plans Benefits arising from strengthening institutions' contingency plans, diversification of their funding sources in day-to-day operations and/or increase their stock of liquid assets	Direct	-/≈	High	Permanent
	Supervisors	Benefits arising from greater certainty of a maximum exposure the given supervised institution may incur	Direct	+	High	Permanent

Policy Option	Party Affected	Impact				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
exposures to institutions	Borrowers	Increase in competition in large credit market due to a harmonisation of the treatment of exposures to institutions	Indirect	+	Medium	Permanent
	Creditors	Benefits – increased level of protection of depositors and other creditors	Indirect	+	High	Permanent
	Financial stability	Benefits in terms of a reduction in unforeseen event risks, reduced systemic risk and hence potentially less need for the authorities to intervene to prevent a systemic crisis and reduced moral hazard	Indirect	+	High	Permanent
	EU economy	Risks of disruption of credit facilitation processes lowered Reduction in unforeseen event risks, reduced systemic risk and hence potentially less need for the authorities to intervene to prevent a systemic crisis and reduced moral hazard; thus reduction in the risk that a real economy would be impacted by such crisis	Indirect	+	High	Permanent
3.3: Apply the LE limit to all exposures to institutions, with flexibility of alternative threshold for smaller institutions	Industry – large banks and large investment firms	Increased costs related to diversification or collateralisation of exposures; possible opportunity costs Benefits arising from strengthening institutions' contingency plans, diversification of their funding sources in day-to-day operations and/or increase their stock of liquid assets	Direct	-/≈	High	Permanent
	Industry – small firms	Increased costs related to diversification or collateralisation of exposures; possible opportunity costs; costs in terms of restricting interbank liquidity in stressed circumstances if banks do not strengthen their contingency funding plans. Benefits arising from strengthening institutions' contingency plans, diversification of their funding sources in day-to-day operations and/or increase their stock of liquid assets	Direct	-/≈	High	Permanent
	Supervisors	Benefits arising from greater certainty of a maximum exposure the given supervised institution may incur Costs arising from determining an alternative amount for smaller institutions, if applicable	Direct	≈	High	Permanent
	Borrowers	Increase in competition in large credit market due to a harmonisation of the treatment of exposures to institutions	Indirect	+	Medium	Permanent
	Creditors	Benefits – increased level of protection of depositors and other creditors	Indirect	+	High	Permanent
	Financial stability	Benefits in terms of a reduction in unforeseen event risks, reduced systemic risk and hence potentially less need for the authorities to intervene to prevent a systemic crisis and reduced moral hazard. However, less effective outcome than under policy option 3.2	Indirect	+	High	Permanent
	EU economy	Risks of disruption of credit facilitation process lowered Reduction in unforeseen event risks, reduced systemic risk and hence potentially less need for the authorities to intervene to prevent a systemic crisis and reduced moral hazard; thus reduction in the risk that a real economy would be impacted by such crisis	Indirect	+	High	Permanent

1.5.4. *Intra-group exposures*

The analysis carried out in the context of the LE review revealed that the basic market failure applies to exposures to group companies where (a) there are practical or legal impediments to the transfer of capital, or (b) where there is doubt that the group would elect to support the debtor entity should the latter encounter solvency problems or where the debtor entity is not subject to an equivalent level of prudential supervision as the creditor entity of a solo basis (e.g. it is a non-financial undertaking or is a bank in a third country whose prudential regulation is not CRD-equivalent).

Specifically, it can be concluded that:

- The basic market failure does not apply (on a solo basis) to entities that are part of sub-consolidations in which capital is fungible and common risk evaluation, measurement and control procedures are in place, or between branches and their parents.
- However, the basic market failure applies to cross-border intra-group exposures, in particular but not exclusively to those outside the EEA, where national borders could impose practical or legal impediments to the prompt transfer of capital. In addition, there could also be further negative externalities that arise as consequences of the insolvency of a cross-border group, because of the potential for large intra-group exposures to give rise to co-ordination failures between groups of depositors, creditors, national authorities and deposit guarantee schemes. Such failures could inhibit the timely and efficient resolution of a crisis afflicting one or more cross-border banking groups, to the detriment of systemic stability and depositors' interests.

Against this background, three policy options were considered with respect to treatment of intra-group exposures:

- **Policy option 4.1:** Retain current approach
- **Policy option 4.2:** Impose the LE limit on all intra-group exposures
- **Policy option 4.3:** Mandatory exemption of those intra-group exposures from the LE limit which fulfil a set of conditions

Policy option 4.1: Retain current approach

Currently, a limit of 20% of own funds applies to intra-group exposures. Member States may exempt intra-group exposures from the 20% limit if they monitor intra-group exposures by other means or if the debtor and creditor are part of the same consolidated group. In addition, MS may exempt intra-group exposures incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject, in accordance with the Directive or with equivalent standards in force in a third country.

In this context, it should be noted that there is some similarity between the condition that allows the credit institutions to exempt their intra-group exposures based on the current Directive with the conditions that have been outlined in the above analysis under which there are no or only insignificant market failures associated with intra-group exposures. In this respect, the current Directive requires that the respective entities, between which the intra-group exposures limits can be waived, be subject to the supervision on a consolidated basis to which the credit institution itself is subject.

The current regime allows the Member States to fully or partially exempt these exposures, based on the assessment of specific risks inherent in the group and structure of the exposures.

The supervisors have argued that such flexibility is of an immense importance in meeting the objectives of enhancing the stability of the group as well as that of the financial system.

Policy option 4.2: Impose the LE limit on all intra-group exposures

Under this option, intra-group exposures are aligned as far as is appropriate with the treatment of third party exposures. This includes exposures to unregulated group entities (e.g. industrial or commercial companies), and exposures to group entities where the presence of minority interests, in the opinion of the competent supervisory authority places a material potential barrier to the transfer of own funds or repayment of liabilities.

Also, the rules on connected counterparties, as currently set out in Article 4 (45), are also applied to intra-group large exposures under this option. That is, unless it can be proven that two group counterparties do not constitute a single (unforeseen event) risk, despite their common ownership or relationship of control, exposures to them must be aggregated. In this respect, the current 20% limit does not appear to be justified. Therefore, the option introduces a qualitative principle designed to ensure that firms are managing all exposures to entities outside their consolidated group, whether exempted or not, on an arm's length basis. If these intra-group exposures are not exempted, the 25% limit would apply under this option.

Benefits of imposing limits on large intra-group exposures

The benefits of imposing the LE limit on all intra-group exposures are found in the mitigation of the two groups of market failures (a) and (b) outlined above. Their strength depends on whether capital is fungible, the extent to which groups can credibly pre-commit to supporting a particular entity and whether all counterparties in the group share the same risk characteristics. They are likely to be strongest when the counterparty is an unrelated non-financial unregulated group company that does not benefit from a group capital guarantee.

Intra-group exposures limits could prompt banks to take ex-ante action to make their contingency funding plans more robust and / or hold greater stocks of liquid assets at group and entity levels, making them less dependent upon uncommitted intra-group liquidity and, in the case of banks operating with cross-border subsidiaries, less dependent upon host authorities to provide emergency liquidity assistance to subsidiaries that the group itself may be unwilling to assist but which are important to the stability of the banking systems in which they operate. They could also lead to an ex-ante moderation in groups' risk-taking behaviour.

If there were barriers to the prompt transfer of capital or repayment of liabilities, limiting intra-group exposures would provide a benefit in terms of protecting parts of a diverse group from problems arising in others. On one hand, the marginal benefit of intra-group exposure limits may be weaker if there is likely to be reputational or brand contagion arising from the failure of a group entity, which could cause difficulties for the wider group with or without the intra-group large exposures. On the other hand, a transparent system of intra-group limits could reduce indirect contagion as wholesale counterparties would know that the rest of the group's credit exposure to the stricken entity is limited. The relative strengths of these offsetting factors will vary considerably from case to case.

The benefits are likely to be weakest, but still potentially significant, within the same legal jurisdiction. Within a single legal jurisdiction, it is more likely that competing claims can be co-ordinated by a single lead liquidator for all of the entities within the group. The problems associated with burden-sharing do not arise, as the same deposit guarantee scheme and / or taxpayers will share the burden of compensating depositors / providing emergency liquidity assistance. The benefits will be weaker still in countries with no depositor-preference laws and where corporate law exists to protect against the risk that -in an unusual and stressed situation- a banking group could be faced with perverse incentives to create large intra-group exposures by transferring all of the low quality assets into one entity and then letting that entity fail[98]. However, large intra-group exposures could still frustrate the quick sale of an otherwise sound entity[99] and could, depending on the liquidation procedure used, prejudice the interests of (some) depositors.

The benefits will be stronger for intra-group exposures between jurisdictions where no robust ex-ante loss sharing arrangements are in place and a co-ordination failure – between liquidators, courts, groups of creditors, or financial sector authorities – is a strong possibility. They will be strongest when the intra-group exposures are to entities in regimes that apply a "separate entity" approach to resolution. Such regimes will ring-fence all local assets for the benefit of local depositors, before making assets available to a lead liquidator in the group's home country.

Costs of imposing limits

The potential costs of intra-group exposure limits arise from potential efficiency losses for banks, and therefore the wider economy and from potential risks to stability that they may raise. They are both associated with the capacity of banking groups to manage risk and liquidity on an integrated and centralised basis. Intra-group limits could also affect the way in which groups choose to structure themselves.

For the industry, efficiency costs could arise as a result of banks being unable to present a single "face" to the market when raising wholesale funds, being compelled to run multiple liquidity and risk management operations or being unable to employ funds raised in one part of the group to fund business in another of the group. They would particularly affect smaller entities which depend on their parents for low-cost funding in order to compete with larger firms.

Intra-group limits could make it necessary to raise funds in multiple entities or jurisdictions and they would also be less able to opportunistically raise wholesale funding wherever it happens to be cheapest at any particular point in time. This means the price they are able to obtain may be less competitive. From an economy-wide perspective, all else being equal, this would make markets less efficient.

Needing to raise funds and hold risky assets in multiple jurisdictions restricts the extent to which groups can centralise their liquidity and risk management operations. They would therefore need to bear the additional fixed costs of running multiple operations in different parts of the group. This could mean that they are less able to obtain a group-level perspective of the risks within the group. This could lead to less efficient risk decisions.

Intra-group limits would, however calibrated, ultimately place a restriction on the capacity of the group to use funding raised in one entity to fund risk-taking behaviour in another part of the group. This means that the group would be obliged, to some extent, to raise funds in the entity which is taking the risks. This implies efficiency cost if it the group's best source of, for example, retail funding is divorced from its most profitable lending activity.

Stability costs could arise from intra-group limits if segmentation of liquidity and risk management across the group were to prevent groups from obtaining an overview of their

---

[98] This scenario could possibly imply that the local deposit insurance scheme and unsecured creditors bear losses beyond the entity's own funds, instead of using group resources to absorb the losses.

[99] This was identified in the Basel Committee's 2001 *Report from the taskforce on the winding down of large and complex financial institutions* as an obstacle to restructuring the exposures of an LCFI.

group risk profile, making them more vulnerable to shocks, or if groups were prevented from supporting illiquid but otherwise sound subsidiaries in stressed circumstances.

Running multiple risk and liquidity management operations across the group could contribute to vulnerabilities to liquidity and other risks at the group level if (and only if) groups were unable, as result, to gain a group-level perspective on the risks being run.

Even if intra-group limits were not binding on a day-to-day basis, they could become binding in stressed circumstances[100]. In this case, they could prevent liquidity from flowing from parts of the group with surplus liquidity to (otherwise sound, and solvent) parts of the group suffering liquidity strain. This could, *in extremis,* lead to the unnecessary failure (or costly intervention of host authorities to prevent failure) of group entities.

If they were to be binding in stressed circumstances, all else being equal and compared to a situation where there were no intra-group limits, there would be increased dependence on the interbank markets. Intra-group restrictions therefore potentially interact with any restrictions placed on interbank exposures. This could result in additional banking system capital being required to retain the same level of business and robustness to shocks.

The imposition of intra-group exposure limits could affect the way in which groups structure themselves (e.g. the choice of whether to use branches or subsidiaries), and the extent to which groups that use subsidiaries provide cross-bank capital guarantees. The net benefits / costs of these changes are ambiguous.

A group for whom intra-group limits would impose high costs might choose, in response, to structure itself using branches instead if the relevant competent authorities were to permit it to do so. It would then only have to comply with most prudential regulations on a consolidated basis and so be less constrained in its liquidity and risk management. It might have to bear higher tax costs (e.g. groups operating in Member States with low flat-rate taxes would no longer be able to benefit from them) and could be perceived as more "distant" from host markets, which could be damaging to its business. However, there would be no post-insolvency co-ordination failures (at least between jurisdictions subject to the Winding Up Directive).

If it chose not to move to a branch structure for tax or other reasons, the group could become less integrated as a result of the limits, meaning that it may become less willing to support stricken entities within the group. This could be a problem for countries where subsidiaries are systemic from a national perspective. Alternatively, it could become more integrated in order to meet the conditions set out for exemption of intra-group exposures, for example the group may put in place cross-group capital guarantees. In this case, capital support is more likely to be forthcoming to stricken entities, but on the downside the scope for poorly managed or supervised subsidiaries to bring down the entire group is increased.

Policy option 4.3: Mandatory exemption of those intra-group exposures from the LE limit which fulfil a set of conditions

As stated in policy option 4.2, intra-group exposures that are not exempt from the limits should be aligned as far as is appropriate with the treatment of third party exposures. In this respect, the current 20% limit might appear to be not justified. Instead, this option introduces

[100] Whether they would become binding would depend crucially on a) continued compliance with local prudential liquidity standards in all parts of the group, b) ability of the group to provide liquidity support given that most or all other parts of the group may be suffering simultaneous liquidity strain, c) the possibility that some jurisdiction may impose ex-post restrictions on cross-border transfers and d) the willingness of the group to provide liquidity support to stricken entities.

a qualitative principle designed to ensure that firms are managing all exposures to entities outside their consolidated group, whether exempted or not, on an arm's length basis. If these intra-group exposures are not exempted, the 25% limit would apply under this option.

In terms of application of the single 25% limit, any costs of imposing limits on large intra-group exposures are likely to exceed the benefits in cases where (i) the supervisor of the creditor entity judges that capital is fungible, that groups can credibly pre-commit to supporting a particular entity and that all counterparties in the group share the same risk characteristics; or (ii) where exposures are not within the same legal jurisdiction but there are robust loss sharing and other arrangements for dealing with a stricken or failed cross-border banking group. Benefits are low because there is no credit risk – capital is fungible, the entity is an integral part of the group and is subject to appropriate prudential requirements; and there are no cross-border co-ordination concerns – and marginal costs of limits are relatively high. Therefore, where conditions (i) and (ii) are met, the large exposures limit would not apply under this option.

In this context, the above mentioned conditions are already covered in the current Directive by Articles 80(7) and 80(8). For the purpose of this analysis, point (d) shall not be considered. It can be therefore concluded that where any of the conditions in Article 80(7)(a), (b), (c), or (e) or any of the conditions in Article 80(8) are not met, exposures shall be subject a backstop limit.

The public consultation results showed that stakeholders' views on this option are mixed. While a number of stakeholders strongly supported this approach, others raised concerns and requested a clarification regarding the possibility to meet the above conditions in Articles 80(7) and 80(8).

The concerns centred mainly around the uncertainty that within this option there is scope for supervisors to make practical interpretations of 'material' and 'current or foreseen' in the condition outlined under Article 80(7)(e) which maintains that there should be 'no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the credit institution'.

In this respect, some respondents reasoned that there was a trade-off between achieving efficiency of supervision at group level and maintaining the soundness of individual group members and that ability to transfer assets from one entity to another was key.

Possible impact of the above policy options on the stakeholders

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
4.1: Retain	Industry – large banks and large investment firms	If not exempted by a national option: Increased opportunity costs; Cross-border institutions face higher costs due to national options	Direct	-/≈	High	Permanent
	Industry – small firms	If not exempted by a national option: Increased opportunity costs; Cross-border institutions face higher costs due to national options Costs less pronounced than for large institutions/institutions operating cross-border	Direct	-/≈	High	Permanent
	Supervisors	Provides flexibility to supervisors to exempt or not intra-group exposures from the LE limit (based on a national option)	Direct	≈/+	High	Permanent
	Borrowers	Possibly sub-optimal competition in large	Indirect	-/≈	Medium	Permanent

Policy Option	Party Affected	Impact				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
current approach		credit market increasing costs				
	Creditors	Approach potentially effective in addressing market failures	Indirect	≈	High	Permanent
	Financial stability	Approach potentially effective in addressing the identified market failures; the flexibility to supervisors allows to better capture the circumstances / features of the specific group	Indirect	≈/+	High	Permanent
	EU economy	Approach potentially effective in addressing market failures; flexibility available to supervisors allows to better capture the circumstances / features of the specific group	Indirect	≈	Medium/High	Permanent
4.2: Impose the LE limit on all intra-group exposures	Industry – large banks and large investment firms	Costs arising from the loss in efficiency (running multiple liquidity and risk management operations) Costs more pronounced in particular for large institutions operating cross-border Benefits – possible strengthening of contingency funding plans	Direct	-	High	Permanent
	Industry – small firms	Costs arising from the loss in efficiency (running multiple liquidity and risk management operations) Costs less pronounced than for large institutions/institutions operating cross-border Benefits – possible strengthening of contingency funding plans	Direct	-/≈	Medium	Permanent
	Supervisors	Reduces flexibility by supervisors	Direct	-	High	Permanent
	Borrowers	Increase in competition in large credit market due to a harmonisation of the treatment of intra-group exposures	Indirect	≈/+	Medium/High	Permanent
	Creditors	Benefits – increased level of protection of depositors and other creditors	Indirect	+	High	Permanent
	Financial stability	In normal circumstances (provided that the LE limit applies, i.e. the set of conditions for exemption is not met) : Benefits – mitigation of the pre- and post-insolvency market failures, i.e. reduction in risks that a failure of one entity of the group would endanger the solvency of another entity in the group or even the group itself, reduction in the impact of a failure of a cross-border European banking group. In stressed circumstances: Possible stability costs, making groups possibly more vulnerable to shocks if groups were prevented from supporting illiquid but otherwise sound subsidiaries in stressed circumstances. At the same time, financial stability might be enhanced due to a limited risk of contagion within a group	Indirect Indirect	+ ≈	High Low/Medium	Permanent Permanent
	EU economy	Net impact would depend on the impact on the financial stability	Indirect	≈	Medium	Permanent
4.3: Mandatory exemption of those intra-group	Industry – large banks	To the extent that the set of conditions for exemptions is met: Reduction in costs arising from the loss in efficiency (running multiple liquidity and risk management operations) and reduction in opportunity costs Reduction in these costs more pronounced in particular for large institutions operating cross-border If the set of conditions for exemptions is not met:	Direct	≈	High	Permanent

Policy Option	Party Affected	Impact				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
exposures from the LE limit which fulfil a set of conditions		Increase in costs and reduction of the ability to efficiently manage liquidity within the group; impact more pronounced on institutions operating cross-border				
	Industry – small firms	To the extent that the set of conditions for exemptions is met: Reduction in costs arising from the loss in efficiency (running multiple liquidity and risk management operations) and reduction in opportunity costs If the set of conditions for exemptions is not met: Increase in costs and reduction of the ability to efficiently manage liquidity	Direct	≈	High	Permanent
	Supervisors	Increase costs related to the need to determine if the set of conditions is met	Direct	-/≈	Medium	Permanent
	Borrowers	Increase in competition in large credit market due to a harmonisation of the treatment of intra-group exposures	Indirect	≈/+	Medium	Permanent
	Creditors	Benefits – increased level of protection of depositors and other creditors	Indirect	+	Medium/High	Permanent
	Financial stability	In normal circumstances (provided that the LE limit applies, i.e. the set of conditions for exemption is not met) : Benefits – mitigation of the pre- and post-insolvency market failures, i.e. reduction in risks that a failure of one entity of the group would endanger the solvency of another entity in the group or even the group itself, reduction in the impact of a failure of a cross-border European banking group. In stressed circumstances: Possible stability costs, making groups possibly more vulnerable to shocks if groups were prevented from supporting illiquid but otherwise sound subsidiaries in stressed circumstances. At the same time financial stability might be enhanced due to a limited risk of contagion within a group	Indirect Indirect	+ ≈	High Low/Medium	Permanent Permanent
	EU economy	Net impact would depend on the impact on the financial stability	Indirect	≈	Medium	Permanent

Conclusion

A common benefit of all policy options would be an ongoing enhancement of financial stability (objective G-1) and enhanced safeguarding of creditor interests (objective G-2). In light of the feedback gathered in the context of the public consultation, the implementation of policy option 4.3 appears to be problematic with respect to the feasibility of satisfying some of the conditions defined therein, in particular, the condition requiring that there should be no current or foreseen material practical or legal impediment to the prompt transfer of own funds or repayment of liabilities from the counterparty to the credit institution (Article 80(7)(e)).

In this respect, in the context of the Ecofin Council roadmap on crisis management, the Commission has been requested to carry out a feasibility study by end 2009, that would identify (i) which concrete obstacles for asset transfers for financial groups exist (ii) how significant they are and (iii) what needs to be done to remove these obstacles in order to progress in the EU on the supervision of cross-border banking groups. Therefore, in order not to pre-empt the outcome of this analysis, the Commission has concluded not to follow policy option 4.3.

With respect to policy option 4.2, the costs imposed on institutions would be extremely severe, considerably hampering their ability to efficiently manage liquidity within the groups. Against this background and the feedback from the public consultation, policy option 4.1 was identified as the preferred policy option.

In order to ensure a consistent approach in the treatment of intra-group transactions and exposures in the solvency and large exposures regimes, the Commission, on top of the approach outlined under policy option 4.1, further suggests to exempt exposures referred to in Articles 80(7)[101] and 80(8), provided that these exposures are also exempted in the solvency regime (i.e., those that would be assigned a 0% risk weight under Articles 78 to 83). The alignment of the large exposures and solvency regimes is analysed in more detail in sub-section 1.5.6.

1.5.5. Reporting

Two options were considered to address the issues pertaining to reporting of large exposures:

- **Policy option 5.1:** Retain current approach
- **Policy option 5.2:** Harmonised reporting

Policy option 5.1: Retain current approach (a number of national discretions)

Reporting requirements for large exposures laid down in Article 110 of the CRD contain a few national discretions. The reporting format, content, frequency differs across the EU. As described in Section 1.3.3 this creates an additional administrative burden and costs to institutions, in particular to those operating cross-border.

Policy option 5.2: Harmonised reporting

This option would allow supervisors to analyse on a horizontal basis the large exposures of the institutions and make comparison between them. In addition, the internal processing of all data received by the supervisors would be facilitated. Finally, the reporting burden for the institutions could be minimised by installing a harmonised reporting at the EU level, meaning an identical template with unique definitions for the information requested.

On this basis, the Commission proposes installing a more harmonised reporting at the European level. Harmonisation can only be successful if an identical template with common definitions for the information requested can be agreed among the supervisors of the MS. Against this background, the Commission has given some consideration to the minimum elements which need to be reported within a regime for large exposures (included in the Directive). Nevertheless, in order to reach the desired outcome in a satisfactory manner, the Commission acknowledges the need for further guidelines to be developed by CEBS, which would develop a complete list of elements deemed necessary to be reported.

The harmonised templates for reporting defined by the supervisors would allow them to analyze the large exposures of the institutions on a horizontal basis and to make comparisons between different institutions. Furthermore, the definitions/risk metrics used in the reports of different institutions would be identical[102], and the internal processing of all data received by the supervisors would be facilitated.

Apart from the reporting of all large exposures, the Commission proposes that the reporting requirements should also include reporting the 20 largest exposures on a consolidated basis,

[101] Including point (d) that requires that the respective counterparty is established in the same Member State.
[102] That would not be the case if the internal reports of institutions were used.

however only for institutions relying on the IRB approaches. That is because the 10% threshold in the definition of large exposures is considered to be high from the risk management point of view (and more important from the systemic point of view) and especially when larger institutions are concerned, the reporting of large exposures consists of only few clients or groups of connected clients. Extending the reporting to the 20 largest exposures would give the supervisors useful information on the risk profile of the institution. It appears that there are MS where the information in question is available tor the supervisors through other channels e.g. credit registers. In those cases the reporting of the 20 largest exposures should not be requested (in line with the objective to reduce the administrative burden).

In addition to the regular prudential reporting, the immediate reporting of breaches of the backstop limit would be necessary. Institutions should be obliged to notify their supervisor as soon as they become aware of a breach of the limit, defining the size of the exposure and the cause of the breach together with their plans to rectify the situation.

Finally, in order to minimise the administrative burden related to reporting imposed on the industry by the LE regime, the Commission proposes a deletion of the requirement to report all new large exposures and any increases in existing large exposures of at least 20% with respect to the previous communication as currently stipulated by Article 110(1)(a).

Possible impact of the above policy options on the stakeholders

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
5.1: Retain current approach (a number of national discretions)	Industry – large banks and large investment firms	Increased compliance/reporting costs due to misalignment of the regime with industry practices; Cross-border institutions face yet higher costs due to national options	Direct	-	High	Permanent
	Industry – small firms	Increased compliance/reporting costs less pronounced than for large banks	Direct	-/≈	High	Permanent
	Supervisors	Rely on regime to conduct LE monitoring	Direct	≈	High	Permanent
	Borrowers	Sub-optimal competition in large credit market (due to a lack of harmonisation) increasing costs	Indirect	-/≈	Low	Permanent
	Creditors	Awareness of risks by supervisors might result in an increased protection of creditors	Indirect	≈	Medium	Permanent
	Financial stability	LE reports used for the analysis of the system's financial stability	Indirect	≈	Low	Permanent
	EU economy	Indirect effects via the financial stability	Indirect	≈	Low	Permanent
5.2: Harmonised reporting	Industry – large banks	Reduced compliance (reporting and opportunity) costs	Direct	+	High	Permanent
	Industry – small firms	Reduction in compliance costs less pronounced than for large banks	Direct	≈/+	High	Permanent
	Supervisors	Possibility to compare reports Possible increases in effectiveness of LE monitoring and bank failure prevention	Direct	+	High	Permanent
	Borrowers	Possible benefits from increased competition in large credit market	Indirect	≈/+	Low	Permanent
	Creditors	Awareness of risks by supervisors might result in an increased protection of creditors	Indirect	≈/+	Medium	Permanent
	Financial stability	Enhanced financial stability in the EU, as the harmonised template for reporting would allow for comparability	Indirect	+	Medium/High	Permanent
	EU economy	Indirect effects via the financial stability above	Indirect	≈	Low	Permanent

Conclusion

A common benefit of policy options 5.1 (Retain current approach based on a number of national discretions) and 5.2 (Reporting based on harmonised template) would be an ongoing enhancement of financial stability and enhanced safeguarding of creditor interests. As a result, both policy options could be deemed to be effective in achieving both objectives G-1 (Enhance financial stability) and G-2 (Enhanced safeguarding of creditor interests).

In order to address a significant need for the harmonisation of LE reporting requirements (in terms of the content of the reporting) policy option 5.2 should be favoured to policy option 5.1. The common reporting standards to be applied in the EU would help to *reduce administrative burden* for the institutions, in particular, those operating cross-border. Therefore, comparing policy options 5.1 and 5.2, the latter could be deemed more effective in achieving objective S-4 (Reduce compliance burden).

1.5.6. Calculation of exposures values

Three options were considered to address the issues pertaining to calculation of large exposure values, including the effects of credit risk mitigation techniques:

- **Policy option 6.1:** Retain current approach
- **Policy option 6.2:** Full alignment with the solvency regime
- **Policy option 6.3:** Partial alignment with the solvency regime

Policy option 6.1: Retain current approach (based on a number of national options and exemptions)

One of the features of the current LE regime is that, in comparison to the solvency regime, there are differences in the calculating the exposure values, including the effects of the credit risk mitigation techniques. Although some changes were introduced in the LE regime in the CRD (a more extensive recognition of credit risk mitigation techniques), important differences between the two regimes still remain.

One important difference is that in the current LE regime, the credit quality of the counterparty can not be recognised. As a result, the current LE regime does not, in general, consider any risk weights or degrees of risks related to the respective exposures[103].

This implies that an institution could at present need three different calculations (taking into account the credit risk mitigation effects): one for the minimum capital requirements, another for LE requirements and potentially a third for internal purposes.

Policy option 6.2: Full alignment with the solvency regime

This option would mean to accept all the approaches and methods allowed in the solvency regime defining how to calculate the exposure value and the effect of credit risk mitigation. In terms of the latter, the eligibility, minimum requirements and the effects would be exactly the same in the solvency and in the LE regime.

This option would imply reduced compliance costs for institutions given that only one calculation would be needed for both the LE and the solvency regime to comply with the rules. A full recognition of credit risk mitigation techniques as currently allowed by the solvency regime would likely result in reduced opportunity costs given that they could enter in a broader range of operations than under the current regime.

[103] There are, nevertheless, some exceptions to this approach, such as in case of the treatment of interbank exposures and some other (Article 113, 115 and 116).

However, given the fact that the objectives for the solvency regime and the LE regime differ (further below), this policy option would also imply that the probability of an institution suffering traumatic losses (or even a probability of systemic crisis) as a consequence of an unforeseen event risk would be greater than under the current regime and possibly unacceptable from the prudential perspective.

Policy option 6.3: Partial alignment with the solvency regime (promoting harmonisation by deleting a number of national options)

This option would mean a further alignment of the current LE regime with the methods and approaches used for the solvency purpose, however only in those cases, where the objectives of the LE regime would not be compromised.

In particular, the Commission identified the following main areas, where an alignment with the approaches used under the solvency regime is possible:

(i) accepting the full range of methods of calculating the exposure values for financial derivatives and securities financing transactions;

(ii) the recognition of funded or unfunded credit protection in the LE regime shall be subject to compliance with the same eligibility requirements and other minimum requirements as under the solvency regime[104];

(iii) the full acceptance of and an explicit permission to use 'on balance sheet netting' and 'master netting agreements', i.e. the full acceptance of and an explicit permission to use the 'fully adjusted exposure value' for the purpose of calculating the exposure values in the LE regime[105];

(iv) removing the requirement for the excess value of the securities that might be under the current LE regime recognised as a collateral and requiring the market value of the collateral issued by a third party instead[106].

At the same time, the Commission identified the following main areas, where the calculation of exposure values, including the recognition of the effect of credit risk mitigation techniques, can not be fully aligned with the approaches used under the solvency regime:

(i) No recognition of credit quality of the counterparty;

The aim of the LE regime is to protect against the impact of unforeseen events. The risks of unforeseen event risks are by their very nature not related with the 'a priority quality' of the counterparty (e.g. the default of counterparty due to fraud, government action, loss of a major customer or market, or breakdown of a business model for an unforeseen reason is usually not reflected in ex-ate credit quality assessments). As a result, it can be concluded that the introduction of counterparty credit quality so as to relax or remove the regulatory LE limit for highly rated counterparties does not fully address the identified market failures. The implication of this conclusion is that no risk weighting or any other degrees of risks of the respective exposures shall be considered in the LE regime[107].

---

104 With the exception of receivables, other physical collateral and equipment leasing as mentioned further below.

105 The current LE regime allows using the Financial Collateral Comprehensive Method only on the basis of a national option.

106 For the purposes of the substitution approach stipulated in Article 117.

107 Another implication of this conclusion is that a 100% credit conversion factor would apply to all off-balance sheet items as specified in Annex II of Directive 2006/48/EC.

(ii) Exposure values for on-balance sheet items (net of accounting specific provisions and value adjustments);

The exposure value for on-balance sheet items should be net of accounting specific provisions and value adjustments for *both* institutions using standardised and institutions using IRB approaches. This approach is consistent with the general approach that items that are deducted from own funds should not be recognised for the LE purposes (as provisions reduce the profits and so reduce own funds)[108].

(iii) No recognition of receivables, other physical collateral and equipment leasing as collateral.

The carried out analysis has revealed that in the LE regime it is especially crucial that the recovery of the collateral is certain and timely. Any mistake in the valuation of the collateral or, more importantly, a difficulty to realise the respective collateral could have more dramatic implications than under the scenario assumed for the solvency regime. In the LE regime, given the size of the exposures, the realisation of the collateral would be very likely more urgent than in other circumstances. The above instruments could be deemed as not sufficiently liquid for these purposes.

However, in order to reach a balanced solution and reflecting costs and benefits of all available alternatives[109], the Commission concluded that real estate collateral, including leasing transactions under which the lessor retains full ownership of the property leased, could be possibly eligible under the LE framework, provided that certain prerequisites are fulfilled[110]. Nevertheless, given the lower liquidity of the respective markets and the lack of standardisation and the uncertainty surrounding the estimations, a simpler and more conservative approach than under the solvency regime can be justified. On this basis, the Commission proposes to maintain the current treatment of the real estate collateral in the LE regime.

Possible impact of the above policy options on the stakeholders

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
6.1: Retain current	Industry – large banks and large investment firms	Compliance costs (admin burden) due to misalignment of the regime with industry practices	Direct	-	High	Permanent
	Industry – small firms	Compliance costs (admin burden) due to misalignment of the regime with industry practices	Direct	-	High	Permanent
	Supervisors	Supervision and monitoring costs (due to two different calculations)	Direct	-/≈	High	Permanent
	Borrowers	Sub-optimal competition in large credit market (due to a number of national options) increases costs	Indirect	-/≈	Medium	Permanent
	Creditors	Some risks to the level of protection due to	Indirect	-	Medium/High	Permanent

[108] As a consequence of this approach, for the purposes of the LE regime, the calculation of own funds shall not take into account items referred to in Article 57(q) and items referred to in Article 63(3).

[109] Based on the analysis carried out by CEBS, it seems that removing real estate collateral from the LE eligibility list would have a large disproportionate effect on those institutions currently using real estate as collateral.

[110] Among others: application of a 50% haircut and certain valuation standards must apply; the commercial property needs to be fully constructed and can be recognised only if the respective exposures would receive a 50% risk weight under Articles 78 to 83.

Policy Option	Party Affected	Impact				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
approach		a gap in the current regime (allowing a number of exemptions or risk weighting)				
	Financial stability	Some risks due to the above mentioned gap in the current regime	Indirect	-	Medium/High	Permanent
	EU economy	Risks in case of financial instability	Indirect	-/≈	Medium	Permanent
6.2: Full alignment with the solvency regime	Industry – large banks and large investment firms	Reduction in compliance costs, possible new business opportunities	Direct	+	High	Permanent
	Industry – small firms	Reduction in compliance costs, possible new business opportunities	Direct	+	High	Permanent
	Supervisors	Reduction in supervision and monitoring costs	Direct	+	High	Permanent
	Borrowers	Benefits from increased competition in large credit market (due to an increased harmonisation by deleting a number of the existing national options and exemptions)	Indirect	≈/+	Medium	Permanent
	Creditors	Some risks to the level of protection due to possible prudential gaps in the regime	Indirect	-	High	Permanent
	Financial stability	Risks to financial stability	Indirect	-	High	Permanent
	EU economy	Risks in case of financial instability	Indirect	-	High	Permanent
6.3: Partial alignment with the solvency regime	Industry – large banks and large investment firms	Reduction in compliance costs, but less pronounced than under option 6.2 Increase in compliance costs (100% CCF) to the extent that national options in Article 113 were applied	Direct	≈/+	High	Permanent
	Industry – small firms	Reduction in compliance costs, but less pronounced than under option 6.2 Increase in compliance costs (100% CCF) to the extent that national options in Article 113 were applied	Direct	≈	High	Permanent
	Supervisors	Some reduction in supervision and monitoring costs	Direct	≈/+	High	Permanent
	Borrowers	Benefits from increased competition in large credit market (due to an increased harmonisation by deleting a number of the existing national options and exemptions)	Indirect	≈/+	Medium	Permanent
	Creditors	Better protected as effectiveness of LE regime (in terms of metrics) improves	Indirect	≈/+	Medium	Permanent
	Financial stability	Risks to financial stability lowered as effectiveness of the LE regime (in terms of metrics) increases	Indirect	≈/+	Medium	Permanent
	EU economy	Risks lowered (dtto)	Indirect	≈/+	Medium	Permanent

Conclusion

A common benefit of policy options 6.2 (Full alignment with the solvency regime) or 6.3 (Partial alignment with the solvency regime) would be an ongoing reduction in compliance burden. In the former case, the reduction would be significantly more pronounced than under policy option 6.3. These benefits would be arising from (i) further alignment with the solvency regime and (ii) harmonised approach to calculate the exposure value including the effects of credit risk mitigation techniques[111]. At the same time, however, it is important to note that policy option 6.3 might simultaneously imply a certain increase of compliance cost[112]. The extent of this increase would depend on the level of take up of the national options currently provided in the CRD (Article 113).

While allowing banks to use the same methods and approaches for the LE regime as for the solvency regime appears to be appealing mainly from the perspective of the reduction of

[111] As noted above, the current LE regime is based on a significant number of national options and exemptions.
[112] Due to a mandatory application of a 100% credit conversion factor.

compliance costs and thus achieving the policy objective S-4 (Reduce compliance burden) , policy option 6.2 does not appear to be acceptable from the prudential perspective. Policy option 6.2 can not be accepted as it could not be deemed effective in achieving objectives G-1 (Enhance financial stability) or G-2 (Enhanced safeguarding of creditor interests). In this respect, policy option 6.3 appears to achieve these two general objectives in a more satisfactory manner. As a result, policy option 6.3 (Partial alignment with the solvency regime) is favoured to the other listed policy options.

1.5.7. Administrative cost savings

The proposed preferred options are expected to reduce the administrative burden in the area of large exposures for both banks and investment firms. These cost savings are summarized in the Standard Cost Model format in the tables below. The main inputs into the model were taken from the industry's responses to CEBS' questionnaire on costs of the existing large exposure regime, conducted in 2007[113].

For banks, the main savings would come from harmonization and elimination of exemptions with regard to various parameters: limits, recognition of CRM, exposure weighting, reporting requirements, etc. The estimated savings fall in the range of €15-77 million per year or 4%-20%[114] of banks' baseline reporting costs, net of the business-as-usual (BAU) factor of 50%. Some banks have indicated that the proposed changes might enable them to switch to centralized reporting, effectively yielding even higher than 20% savings.

For investment firms that fall in the 'limited activity' or 'limited licence' categories, as argued in sub-section 1.5.2, there should be an ongoing reduction in reporting costs. Assuming that 80% of all investment firms fall in these two categories[115], the administrative cost savings for them are estimated to fall in the region of €60 million per year.

A third layer of savings that is assumed to be material stems from a closer alignment of large exposures and solvency regimes.

The proposed changes also introduce several additional reporting requirements. However, they are mostly deemed to be immaterial, for instance, reporting of the breached exposure (given that reporting of breaches is already a requirement in the CRD).

---

[113] In total, 163 completed responses were received from market participants and included 106 banks and 57 investment and investment management firms across 15 EEA countries. For more details please see: http://www.c-ebs.org/press/documents/LE_Part%202_07122007.pdf

[114] The CEBS' survey asked companies to indicate the percentage of administrative costs that would no longer be incurred if there were no differences between the large exposure regulatory requirements applied in different MS. The average reply for banks that gave an answer higher than zero was 20%, while the average including 'zero' answers was 4%. Some 'zero' answers, however, were driven by banks' inability to come up with an estimate. Therefore, harmonization-driven savings can be assumed to fall in the range between these two averages.

[115] Working Group's on Operational Risk survey of investment firms, 2002

LARGE EXPOSURE REGIME ADMINISTRATIVE BURDEN SAVINGS

LARGE EXPOSURES REGIME						Tariff (€ per hour)		Time (hour)		Price (per action or equip)	Freq (per year)	Nbr of entities	Total nbr of actions	Total cost	Regulatory origin (%)				Comments & Assumptions
No.	Ass. Art.	Orig. Art.	Type of obligation	Description of required action(s)	Target group	i	e	i	e						Int	EU	Nat	Reg	
1	N/A		Non-labelling information for third parties	Other	Banks	37		956		35.190	1	7.658	7.658	269.485.020		100%			Total administrative costs: €100K per bank. Of which remuneration: 1,2 FTE per year @ €80K compensation for EU15; 0,3 FTE per year @ €25K compensation for EU12. The business-as-usual (BAU) factor 50%. Credit institution EU15/EU12 split 80% / 20%.
2	N/A		Non-labelling information for third parties	Other	Banks					14.810	1	7.658	7.658	113.414.980		100%			
3	N/A		Non-labelling information for third parties	Other	Investment Firms	48		281		13.500	1	4.549	4.549	61.404.750		100%			Total administrative costs: €29K per investment firm. Of which remuneration: 0,25 FTE per year @ €90K compensation. The business-as-usual (BAU) factor 40%. Number of firms: 4135 (in 2002), increased by 10% to account for accession MS.
4	N/A		Non-labelling information for third parties	Other	Investment Firms					3.900	1	4.549	4.549	17.739.150		100%			
													Total administrative costs - <u>BASELINE</u> (€)	**462.043.900**					
													Administrative costs by origin (€)		0	462.043.900		0	
SAVINGS - LOW END SCENARIO: 4% savings of baseline costs for banks due to harmonization																			
1	N/A		Non-labelling information for third parties	Other	Banks	37		-38		-1.408	1	7.658	7.658	-10.779.401		100%			**4% of baseline costs** due to harmonization and exemption elimination with regard to various parameters: limits, collateral recognition, exposure weighing, reporting templates, etc. This might enable some companies to switch to centralised reporting, effectively bringing substantially higher savings.
2	N/A		Non-labelling information for third parties	Other	Banks					-592	1	7.658	7.658	-4.536.599		100%			
3	N/A		Non-labelling information for third parties	Other	Investment Firms	48		281		13.500	1	-3.639	-3.639	-49.123.800		100%			100% of costs for "limited activity" and "limited license" firms (**80% of all investment firms**)
4	N/A		Non-labelling information for third parties	Other	Investment Firms					3.900	1	-3.639	-3.639	-14.191.320		100%			
													Total administrative costs - <u>SAVINGS</u>(€)	**-78.631.120**					
													Administrative costs by origin (€)		0	-78.631.120		0	
SAVINGS - HIGH END SCENARIO: 20% savings of baseline costs for banks due to harmonization																			
1	N/A		Non-labelling information for third parties	Other	Banks	37		-191		-7.038	1	7.658	7.658	-53.897.004		100%			**20% of baseline costs** due to harmonization and exemption elimination with regard to various parameters: limits, collateral recognition, exposure weighing, reporting templates, etc. This might enable some companies to switch to centralised reporting, effectively bringing substantially higher savings.
2	N/A		Non-labelling information for third parties	Other	Banks					-2.962	1	7.658	7.658	-22.682.996		100%			
3	N/A		Non-labelling information for third parties	Other	Investment Firms	48		281		13.500	1	-3.639	-3.639	-49.123.800		100%			100% of costs for "limited activity" and "limited license" firms (**80% of all investment firms**)
4	N/A		Non-labelling information for third parties	Other	Investment Firms					3.900	1	-3.639	-3.639	-14.191.320		100%			
													Total administrative costs - <u>SAVINGS</u>(€)	**-139.895.120**					
													Administrative costs by origin (€)		0	-139.895.120		0	

<u>Sources:</u>

CEBS' industry costs questionnaire, 2007

ECB, EU Banking Structures, October 2007

Working Group on Operational Risk survey of investment firms, 2002

1.5.8. *Summary of preferred policy options and their impacts on stakeholders*

The following table summarizes the policy option sets discussed in the previous sections. Individual options within each set are ranked in terms of their relative effectiveness, efficiency and consistency with regard to achieving the relevant objectives. Preferred policy option(s) for each policy option set are highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
First-level policy options					
General approach for large exposure monitoring	S-1 Enhance legal certainty S-3 Enhance level playing field S-4 Reduce compliance costs S-6 Reinforce risk management G-1 Enhance financial stability	1.1 Retain current approach	4	3	2
		1.2 No specific regime with market discipline enforced by rating agencies **	3	1	5
		1.3 Regime based on firms' own assessments and supervisory review (Pillar 2)	2	2	3
		1.4 Market discipline imposed by disclosure requirements (Pillar 3)	3	1	4
		1.5 Amended limit based backstop regime	1	2	1
Second-level policy options					
Investment firms	S-4 Reduce compliance costs S-6 Reinforce risk management	2.1 Retain current scope of application	2	2	2
		2.2 Exempting certain investment firms from the LE regime	1	1	1
Interbank exposures	G-1 Enhance financial stability G-2 Enhanced safeguarding of creditor interests	3.1 Retain current approach	3	1	3
		3.2 Apply the LE limit to all exposures to institutions	1	3	1
		3.3 Apply the LE limit to all exposures to institutions, with flexibility of alternative threshold for smaller institutions.	2	2	2
Intra-group exposures	G-1 Enhance financial stability G-2 Enhanced safeguarding of creditor interests G-4 Further promoting of the internal banking market integration	4.1 Retain current approach	2	1	1
		4.2 Impose the LE limit on all intra-group exposures	1	3	3
		4.3 Mandatory exemption of those intra-group exposures from the LE limit which fulfil a set of conditions	2	2	2
Reporting	G-1 Enhance financial stability G-2 Enhanced safeguarding of creditor interests S-4 Reduce compliance costs	5.1 Retain current approach (a number of national discretions)	2	2	2
		5.2 Harmonised reporting	1	1	1
Calculation of exposures values	G-1 Enhance financial stability G-2 Enhanced safeguarding of creditor interests S-4 Reduce compliance burden S-6 Reinforce risk management	6.1 Retain current approach	2	3	2
		6.2 Full alignment with the solvency regime	3	1	3
		6.3 Partial alignment with the solvency regime	1	2	1

** Non-legislative option
Scale of option ranking: 1=highest, 5=lowest

The expected and most material impacts of the proposed set of preferred options (1.5, 2.2, 3.2, 4.1, 5.2 and 6.3) on the key stakeholders can be summarised as follows:

- For the banking industry, the proposed revisions will likely result in a decrease of the administrative burden (by estimated €15-77 million, or 4-20% of the respective baseline) as reduction in numerous national options will result in a more harmonised regime. Additional tangible savings will be brought about by further alignment of the calculation of exposure values, including the recognition of credit risk mitigation effects, with the solvency regime (options 5.2 and 6.3). These savings, however, will be to a certain degree diminished by an increase in compliance costs due to the more prudent approach embedded in the proposed treatment of interbank exposures (option 3.2), the mandatory application of a 100% credit conversion factor, and recognition of the risks that derive from the liability / funding side of 'connected' clients.

- The proposed set of preferred options will result in a decrease (by estimated €60 million, or 100% of the respective baseline) of the administrative burden as well as other types of compliance costs incurred by certain types of investment firms that the Commission proposes to exempt from the scope of the regime (option 2.2).
- The proposed revisions will enhance the effectiveness of supervisors' monitoring of large exposures by providing for a better comparability of reporting (option 5.2) and increased certainty regarding the maximum risk that an institution might take, as certain gaps of the current regime are closed.
- Borrowers will benefit from increased competition in large credit market, as more harmonised large exposure rules should enhance the level playing field conditions.
- Protection of banks' creditors will be enhanced as improved effectiveness of the large exposures regime will lead to a reduction of default risk.
- Importantly, the proposed set of preferred options will work to enhance financial stability. This will be brought about, in particular, by the certainty that a maximum exposure of a given institution to a third party is limited. Furthermore, closing some other specific prudential gaps in the current regime by removing the national option to exempt or assign various risk weights to exposures and taking into account risks that derive from the liability / funding side of 'connected' clients, will increase the overall effectiveness of the regime.

2. HYBRID CAPITAL INSTRUMENTS

2.1. Background

Hybrid capital instruments (hybrids) are securities that contain features of both equity and debt. The ultimate purpose of issuing such instruments is to cover economic capital needs and to provide support in the event of financial stress or potential losses. They help to diversify both the investor and capital base of a bank, and are often structured to qualify as 'original own funds'[116] (together with share capital instruments) on the one hand and achieve tax deductibility (together with bonds) on the other.

The CRD does not establish an EU framework for the recognition of hybrid capital instruments within banks' original own funds. The criteria related to *loss absorption*[117], *flexibility of payments*[118] and *permanence*[119] are critical for determining an instrument's inclusion as a component of original own funds. They were agreed at G10 level and announced in the Sydney Press Release[120] in 1998, but have never been transposed into EU directives. As a result, several MS (non-members of G10) do not have a regime for including hybrids within original own funds, while supervisors in jurisdictions with a regime have the discretion to assess whether instruments satisfy the criteria agreed at G10 level.

According to CEBS' quantitative analysis[121], the outstanding amount of hybrids in the EEA at the end of 2006 was approximately €213 billion. Financial institutions from eight countries (UK, DE, ES, FR, NL, IE, BE and IT) represented 89% of this amount[122]. Chart 1 below illustrates the distribution of hybrids by country, also showing their composition in terms of three broad categories: innovative instruments[123], non-innovative instruments and perpetual non cumulative preference shares.

---

[116] Original own funds is the most reliable and liquid element of a bank's capital. It comprises share capital, retained earnings and hybrid capital instruments which meet the criteria agreed at G10 level. Subject to technical differences, 'original own funds' correspond to the Basel Accord terminology of Tier 1 capital.

[117] Loss absorption: the instrument must be available to absorb losses, both on a going concern basis and in liquidation, and to provide support for depositors' funds if necessary.

[118] Flexibility of payments: the instrument must contain features permitting the noncumulative deferral or cancellation of payment of coupons or dividends in times of stress.

[119] Permanence: the instrument must be permanently available so that there is no doubt that it can support depositors and other creditors in times of stress.

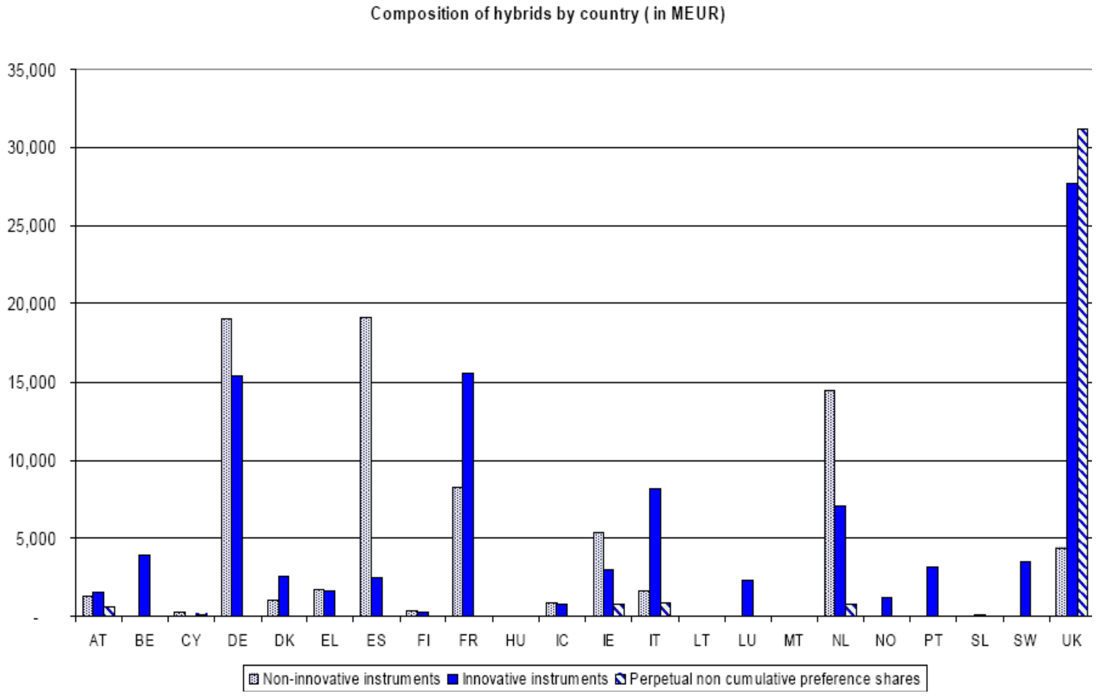
[120] http://www.bis.org/press/p981027.htm

[121] CEBS, *Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA)*, March 2007

[122] CEBS, *Quantitative analysis of eligible own funds in the EEA*, June 2007

[123] The term innovative is used within the meaning of the Sydney Press Release and refers to a specific type of hybrid instruments which include an incentive to redeem, like a step-up or other features. Innovative instruments are usually limited to 15% of original own funds. Non-innovative instruments are hybrid instruments with no incentive to redeem.

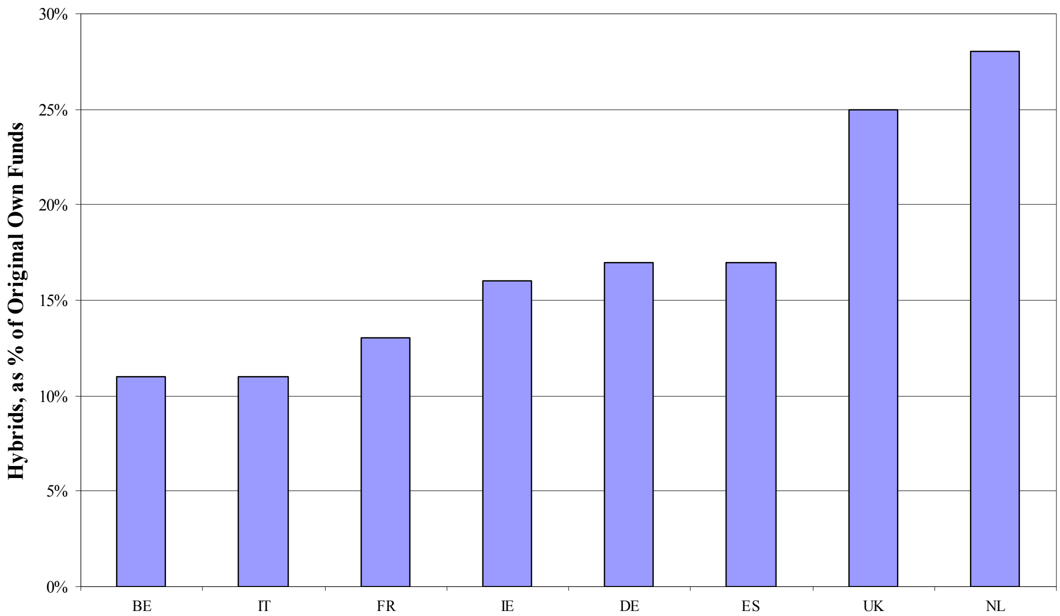
Chart 1: Distribution of hybrids by country[124]



Source: CEBS

At the same time, the share of hybrids within banks' original own funds was material. For the aforementioned eight MS that account for 89% of outstanding hybrid instruments, the average level of this indicator stood at 18% at the end of 2006[125] (see Chart 2).

Chart 2: Hybrids' share of original own funds (selected MS)



Source: CEBS

[124] In certain countries (BG, CZ, EE, LV, LI, SK, PL and RO), hybrid instruments are not recognised as eligible original own funds.

[125] CEBS, *Quantitative analysis of eligible own funds in the EEA*, June 2007

2.2. Procedural issues and consultation of interested parties

The European Banking Committee (EBC) has been working on the definition of banks' own funds since 2004. In June 2005 the Commission issued a call for advice to Committee of European Banking Supervisors (CEBS) for (i) a stock-take of current national rules on own funds; (ii) an analysis of the capital instruments recently created by the industry; (iii) the development of guiding principles behind own funds and (iv) a quantitative analysis of the types of capital held by credit institutions within the EU. In 2006, the Commission asked CEBS to conduct an additional specific quantitative analysis on hybrids instruments as well as a technical assessment of the relevant characteristics which should underpin prudential recognition of hybrids in banks' original own funds. CEBS' contributions pertaining to parts (i) and (ii) were completed in June 2006, followed with analysis relating to part (iv) in June 2007.

CEBS developed its advice in a manner consistent with the Commission's better regulation agenda by following the impact assessment guidelines that have been developed by CEBS together with the other Lamfalussy Process Level 3 committees. Effective stakeholder consultation is a central part of the guidelines. Key stakeholders' views have been gathered at various stages of the advice development process, e.g., via questionnaires on own funds to market participants (November 2005) and on current regimes for own funds to MS (first half of 2007), a public consultation on CEBS' proposals for a common EU definition of hybrids (December 2007) and two public hearings (June and November 2007).

2.3. Problem definition

The approach of not incorporating the G10 agreement into EU legislation has proved inadequate in preventing divergence within the EU. As hybrids represent an important source of capital in some MS, it is critical that banks can operate within a single market framework which provides clarity on the G10 agreement and its application.

Drivers: - Lack of EU definition of assessment criteria and characteristics for eligibility;
- Divergence of national regimes with regard to quantitative limits.
Problem: Unlevel playing field conditions for banks operating in the single market

The lack of an EU-wide legislative text has entailed a wide dispersion of national approaches. Treatment across the EU differs in terms of characteristics that a hybrid instrument must meet in order to be eligible for inclusion within original own funds.

For instance, several economic characteristics could be considered to evaluate whether the flexibility of payments criterion is met, including a 'payment-in-kind' feature that allows the issuer to suspend coupon payments by delivering newly issued shares. With regard to this feature, CEBS' analysis[126] showed that 10% of outstanding hybrids had it (mostly in UK, BE and NL) while 90% did not. For more details on the distribution of economic characteristics pertaining to the criteria of loss absorption, flexibility of payments and permanence please see Table 1.

Moreover, when MS recognize hybrid instruments as eligible, they apply diverging limits to their inclusion in original own funds. For instance, some countries do not allow any hybrid capital instruments to count towards original own funds, whereas others allow up to 50% of original own funds to consist of hybrids (see Table 2).

---

[126] CEBS, *Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA)*, March 2007

Table 2: Overview of maximum supervisory limits on hybrids within original own funds (selected MS)

Member States	Limit
BG, CZ, PL, SK, EE, LV, RO	Does not exist in legislation
LU	15%
AT, ES	30%
BE	33%
IE, SI	49%
DE, FI, FR, NL, UK	50%

Source: CEBS

Diverging eligibility criteria and limits have created an unlevel playing field for banks operating within the single market area as the differences in treatment between MS impact the relative issuance costs associated with hybrid capital instruments. This is because regulatory treatment affects the inherent risk of hybrids, and, consequently, their pricing.

Currently, banks may also overestimate the amount of hybrid capital that would be available when loss absorption and recapitalisation is most needed, for instance during crisis situations. This is due to the fact some hybrid instruments are in effect quasi-debt instruments that may not serve all purposes that original own funds are meant to serve in the event of a crisis. Consequently, in order to ensure that overall capital is of sufficient quality, an appropriate limit on hybrid capital instrument within original own funds is needed.

Driver: Cross-sectoral divergence in recognizing hybrids within own funds

Problem: Regulatory arbitrage opportunities giving rise to unlevel playing field and posing risks to the effectiveness of supervision

The Commission's recent proposal for insurance regulation (Solvency II) includes a European legal framework for the recognition of hybrids within own funds. Inconsistent banking and insurance frameworks would provide opportunities for regulatory arbitrage, especially for financial conglomerate groups operating in both sectors, as they could opt to apply a more lenient set of sectoral rules. This would not only aggravate the unlevel playing field issues discussed above but also pose risks to the effectiveness of supervision. Cross-sectoral divergence may also create undue regulatory burden. As a result, the banking sector needs to move in parallel with the insurance sector on this issue by introducing a compatible framework for hybrids.

Table 1: Economic characteristics of hybrid instruments in EEA (by main categories)

HYBRIDS reported as original own funds as of 31 December 2006	**All types (%)**	**Non-innovative instr. (%)**	**Innovative instr. (%)**	**Non-cumulative perpetual preference shares (%)**
Pari passu with ordinary share capital	5%	7%	4%	4%
Senior to ordinary share capital only	75%	71%	72%	91%
Senior to other instruments in addition to ordinary share capital	20%	22%	24%	5%
With voting rights (similar to those of ordinary shareholders)	12%	1%	2%	69%
to be exercised after a period without payment of dividends	*9%*	*0%*	*1%*	*52%*
to be exercised after other trigger event				
Other	*7%*	*1%*	*1%*	*36%*
Without voting rights	88%	99%	98%	31%
Convertibility into ordinary shares				
Conversion	1%	1%	0.4%	4%
on a trigger event	0.3%	1%		
at a fixed time (mandatory)	0.6%	0%		3%
at the initiative of the issuer	0.2%	0%		1%
at the initiative of the holder	0.6%	1%	0%	
No conversion feature	99%	99%	99.6%	96%
Convertibility into preference shares				
Conversion	18%	16%	25%	1%
on a trigger event	*18%*	*16%*	*25%*	
at a fixed time (mandatory)				
at the initiative of the issuer				
at the initiative of the holder				1%
No conversion feature	82%	84%	75%	99%
Undated	95%	99%	90%	100%
Dated	5%	1%	10%	0%
Without call	10%	11%	4%	22%
With call	90%	89%	96%	78%
Step-up at the time of issue < or = 100 bps	36%	0%	75%	3%
Step-up at the time of issue > 100 bps	6%	1%	12%	1%
No step-up	58%	99%	12%	96%
Write down of principal on a going concern basis	39%	55%	39%	3%
Principal written down and up before the share capital is serviced	17%	21%	19%	0%
Principal written down permanently	13%	27%	7%	0%
Other	10%	7%	14%	3%
Principal cannot be written down	61%	45%	61%	97%
Cumulative	7%	4%	11%	0%
Cash	*3%*	*1%*	*5%*	*0%*
Kind	*4%*	*3%*	*6%*	*0%*
Non cumulative	93%	96%	89%	100%
Issuer may not suspend payments (e.g. in case of dividend pushers)	19%	18%	25%	1%
Issuer may suspend payments in case of				
Breach of regulatory solvency limits	*68%*	*71%*	*73%*	*50%*
Breach of other limits fixed by supervisors	*18%*	*9%*	*21%*	*28%*
Dividends not paid on other security class	*44%*	*49%*	*43%*	*35%*
Solvency difficulties	*28%*	*20%*	*32%*	*32%*
Other	*61%*	*66%*	*57%*	*61%*
Coupon payment in kind feature	10%	11%	8%	11%
No coupon payment in kind feature	90%	89%	92%	89%
Principal Stock settlement feature	4%	2%	5%	3%
Subject to limit	*0%*	*0%*	*1%*	*0%*
Not subject to limit	*3%*	*2%*	*4%*	*3%*
No Principal Stock settlement feature	97%	98%	95%	97%
Issued directly	50%	34%	45%	98%
Issued through SPV	50%	66%	55%	2%
Denominated in				
EUR	56%	72%	56%	21%
GBP	14%	6%	15%	25%
USD	28%	20%	26%	52%
JPY	1%	0%	1%	0%
Other	1%	1%	2%	2%

Source: CEBS

2.4. Objectives

The general objectives are the overall goals of this exercise and, therefore, they are fully aligned with the original long-term policy objectives of the CRD to:

- Enhance financial stability (G-1);
- Enhance safeguarding of creditor interests (G-2);
- Ensure international competitiveness of EU banking sector (G-3);
- Further promote the internal banking market integration (G-4).

In light of the problems presented in the previous section, a set of operational objectives has been identified to address the associated problem drivers. Effective realization of such operational objectives should contribute to the achievement of longer term specific and, in turn, the aforementioned general policy objectives.

The following table lists problem drivers, operational and specific objectives and indicates linkages between them.

Problem Drivers	Operational Objectives	Specific Objectives				
		S-1 Enhance legal certainty	**S-3** Enhance level playing field	**S-4** Reduce compliance burden	**S-5** Cross-sectoral convergence	**S-6** Reinforce risk management
Lack of EU definition of assessment criteria and characteristics for eligibility Cross-sectoral divergence (insurance and banking) in recognizing hybrids within own funds	**O-1** Harmonized interpretation of assessment criteria to determine if instruments fulfil permanence, loss absorption and flexibility of payments requirements	√	√	√	√	√
Divergence of national regimes with regard to quantitative limits	**O-2** Set appropriate and harmonized limit for hybrids within own funds	√	√	√	√	
Lack of EU definition of assessment criteria and characteristics for eligibility Divergence of national regimes with regard to quantitative limits	**O-3** Transitional provisions to allow grandfathering of instruments that are currently recognized as hybrids	√		√		

2.5. Policy option analysis and comparison

A number of policy options have been considered, analysed and compared in designing the common European framework for hybrids. They have been split into first- and second-level options. First-level options (sub-section 2.5.1) were designed with a view to identifying an overall approach that would be the most effective in attaining the discussed objectives. Once this phase was completed, second-level policy options were developed to elaborate on features of a preferred first-level option. Second-level policy options pertaining to the areas, where the most material changes vis-à-vis current regime are expected, are presented in sections (sub-sections 2.5.2-2.5.4).

2.5.1. Common European framework for hybrid capital instruments

Eligibility criteria and limits for hybrid capital instruments were agreed at G10 level in 1998, but no common European framework has ever regulated the inclusion of hybrid capital instruments within original own funds. Some MS have no framework at all, whereas others have implemented the G10 agreement in different ways. In this context, the following broad first-level policy options regarding new framework were considered:

- **Policy option 1.1**: Multiple national frameworks (no change)

- **Policy option 1.2**: Common regulatory European framework

- **Policy option 1.3**: Self-regulation based framework

Policy option 1.1 Multiple national frameworks (no change)

Under the 'no change' scenario, MS would be allowed to decide whether to implement the G10 agreement as well as how to implement it. Having multiple diverging national frameworks within the single market has already been shown (see section 2.3) to have implications for the industry and financial stability in general. This option impedes the level playing field conditions in the single market by failing to facilitate convergence in supervisory practices. Under it, there is also a risk that banks may overestimate the amount of hybrid capital that would be available in stressed circumstances. Moreover, the approach is inconsistent with the recent proposal for the insurance regulation (Solvency II) which introduces a legal European framework for hybrids, effectively giving rise to regulatory arbitrage opportunities. Due to its shortcomings, this policy option can be discarded as a nonviable approach with regard to achieving majority of the identified objectives.

Policy option 1.2 Common regulatory European framework

This policy option would involve a common regulatory framework governing the inclusion of hybrid capital instruments within original own funds. Credit institutions from MS that do not currently have national frameworks for hybrids would be able to use such instruments as a source of original own funds in line with the current practice in other MS. All MS would be required to apply the same eligibility criteria for including hybrids within own funds, as well as uniform limits on the proportion of hybrids permitted.

This policy option would address the shortcomings of the status quo. It would facilitate convergence between MS and sectors, consequently contributing to stronger level playing field conditions within the single market. In this respect it should be noted, however, that issuance of hybrid instruments is guided not only by regulatory requirements but also by other considerations, such as tax and company law, which fall outside the scope of this policy option. The weight of these factors in the industry's capital-raising decisions might limit the resultant effectiveness of the level playing field conditions.

This option also entails setting a uniform and appropriate limit on hybrid capital that would ensure that credit institutions have sufficient share capital and reserves to handle stressed circumstances, thus, positively contributing to stability within the sector.

This approach would also include grandfathering provisions allowing for a smooth transition from multiple national frameworks to a common EU-wide regime for hybrids. Grandfathering provisions that permit credit institutions to phase out the proportion of no longer eligible hybrids would minimise the risk of disruptions in the market for hybrids and capital markets more generally. It should be noted that this option would give credit institutions more time to fully comply with a common European framework, hence delaying the realisation of a level playing field within the single market. However, a common framework for hybrids would enhance liquidity in the market for new instruments and in turn encourage issuers to voluntary replace those instruments that may benefit from grandfathering provisions with new ones.

Policy option 1.3 Self-regulation based framework

This policy option would rely on an industry-led solution to address the shortcomings of the status quo, such as a self-enforced industry code of conduct.

Although this option would not require legislative measures at the European level to address regulatory concerns relating to the inclusion of hybrids within own funds, it suffers from several fundamental shortcomings. First, banks' individual capital adequacy assessments are not yet sufficiently advanced to determine the level of hybrid capital that would be appropriate for prudential purposes. Second, industry's response to the shortcomings of the status quo scenario would not necessarily facilitate convergence with other sectors of the financial services industry. Third, a number of MS already have national regulatory frameworks for hybrids, therefore, an industry-led solution would require those MS to dismantle them. This would likely cause significant disruptions in the market for hybrids and, effectively, would reduce legal certainty for the industry.

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
1.1 Multiple national frameworks	Industry – MS with hybrid regimes	Lack of level playing field to the extent that eligibility characteristics and limits differ from one MS to another	Indirect	-	High	Permanent
	Industry – MS without hybrid regimes	Competitive disadvantage vis-à-vis institutions from MS with hybrid regimes	Indirect	-	High	Permanent
	Financial conglomerates	Potentially able to take advantage of regulatory arbitrage opportunities	Indirect	+	Medium	Permanent
	Supervisors	Effectiveness of supervision burdened by lack of cross-sectoral alignment	Indirect	-	Medium	Permanent
	Investors	Limited choice to the extent that lack of legal certainty and/or national regimes restrains growth of the hybrids market	Indirect	-/≈	Medium	Permanent
	Financial stability	Some risks stemming from lack of legal certainty and regulatory arbitrage	Indirect	-	Low	Permanent
1.2 Common regulatory European framework	Industry – MS with hybrid regimes	Level playing field to the extent that eligibility characteristics and limits harmonized; Compliance costs with new regime minimized via application of grandfathering provisions	Direct/ Indirect	+	High	Permanent
	Industry – MS without hybrid regimes	Enhanced competitiveness vis-à-vis institutions from MS with hybrid regimes	Indirect	+	High	Permanent
	Financial conglomerates	Limited regulatory arbitrage opportunities	Indirect	-	Medium	Permanent
	Supervisors	Improved effectiveness due to cross-sectoral alignment; New regime implementation costs	Direct/ Indirect	≈	Medium	Permanent
	Investors	Improved choice due facilitated growth of the hybrids market	Indirect	≈/+	Medium	Permanent
	Financial stability	Benefits from improved legal certainty and enhanced liquidity	Indirect	+	Low	Permanent
1.3 Self-regulation based framework	Industry – MS with hybrid regimes	Level playing field to the extent that eligibility characteristics and limits harmonized; Compliance costs with a new solution might be material, if current national regimes dismantled	Direct/ Indirect	≈	High	Permanent
	Industry – MS without hybrid regimes	Enhanced competitiveness vis-à-vis institutions from MS with hybrid regimes	Indirect	+	High	Permanent
	Financial conglomerates	Risk that regulatory arbitrage opportunities is not eliminated	Indirect	≈	Medium	Permanent
	Supervisors	Effectiveness of supervision burdened if industry solution is not appropriate for prudential purposes	Indirect	≈	Medium	Permanent
	Investors	Improved choice due facilitated growth of the hybrids market	Indirect	≈/+	Medium	Permanent
	Financial stability	Risks to financial stability remain if cross-sectoral divergence remains or industry solution is not appropriate for prudential purposes	Indirect	≈	Low	Permanent

Conclusion

Policy option 1.1 (Multiple national frameworks) was discarded because it was deemed to be ineffective with regard to attaining majority of the relevant policy objectives. **Policy option**

1.2 (Common regulatory European framework) has been retained as the preferred option since it addresses the shortcomings of the current situation, while allowing for a smooth transition to a new framework. At the same time, it is more effective than policy option 1.3 (Self-regulation based framework) in contributing to objectives S-1 (Enhance legal certainty), S-3 (Enhance level playing field), S-5 (Cross-sectoral convergence) and G-1 (Enhance financial stability). It is also more efficient and consistent than option 1.3 as it would allow the industry to minimize ensuing compliance costs by enabling MS to make use of grandfathering provisions.

Policy Option	**Relevant Objectives**					
	S-1 Enhance legal certainty		S-3 Enhance level playing field	S-4 Reduce compliance burden	S-5 Cross-sectoral convergence	G-1 Enhance financial stability
	Effectiveness (≈/+/++)	Efficiency (≈/+/++)	Effectiveness (≈/+/++)	Consistency (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
1.1 Multiple national frameworks	≈	≈	≈	≈	≈	≈
1.2 Common regulatory European framework	++	++	+	+	+	++
1.3 Self-regulation based framework	≈	+	≈	≈	≈	+

2.5.2. *Eligibility criteria*

The Committee of European Banking Supervisors (CEBS) has advised the Commission on the design of a possible European framework for hybrids. Its advice proposed to prescribe in EU legislation, among other things, detailed characteristics that hybrids must have in order to qualify as original own funds, i.e. permanence, loss absorption and flexibility of payments.

For each of the above items, careful consideration should be given to the appropriate level of detail included in the EU legislation: on one hand, clear and objective legal provisions on hybrids would facilitate cross-country convergence throughout the EU. On the other hand, however, if forms of hybrid instruments are created through ***prescriptive rules***, they will still work differently in different jurisdictions due to diverse legal and accounting frameworks, hence failing to achieve the objective of a level playing field.

A high level ***principle-based approach*** would focus on the functions that hybrids are meant to serve and let credit institutions determine the most appropriate means to reach that end. Such an approach would encourage consistency in substance rather than form. It would consequently encourage financial innovation by permitting all structures that meet the prudential objectives which hybrids within original own funds are expected to serve. It would also permit credit institutions to participate in the process of determining how capital should be managed for prudential purposes, hence reinforcing risk management within firms.

The shortcoming of this approach is that there is scope for subjectivity when applying principles in the different MS, which could undermine supervisory convergence within the EU. Credit institutions could also face higher legal uncertainty and compliance costs, as they would be required to understand exactly how their hybrids deliver the outcomes required.

Another option would be to use a ***combination of the above two approaches*** based on the key components of CEBS' advice reflecting those areas where detailed provisions are better suited than high level rules, and vice versa. This option would ensure that the benefits of carefully choosing legislative approaches were fully taken advantage of.

CEBS advice represents the outcome of high quality work made by the supervisory community and allows the Commission to extract only the principles which are deemed material for a level 1 legislative text under the Lamfalussy process. CEBS' agreement will provide for the implementation tool to fill any possible interpretation gap in the legislative text.

2.5.2.1. Permanence

The criterion of permanence constitutes a primary feature of common equity which has no maturity and as such poses no refinancing risk to the issuer in a time of financial stress. Even if common equity can be repurchased, thus potentially reducing its theoretical permanence, the sole initiative for such repurchases rests with the issuing institution. There is a common understanding among supervisors and market participants that permanence is a key feature for a hybrid instrument to be eligible as original own funds as it provides the bank with the greatest flexibility and ensures that capital is available in stress situations.

CEBS identified three main principles for instruments to meet the 'permanence' test: (i) they must be undated; (ii) they can be callable subject to the supervisory approvals; (iii) they may include contractual incentives to redeem (e.g., pre-determined increase of the coupon rate, if they are not redeemed). CEBS also clarified a possible list of incentives (i.e., 'moderate') to redeem together with a possible assessment of relevant levels of acceptability to supervisors.

As shown in Table 1, 95% of all hybrids in the EEA in 2006 were undated, 90% had a call option. At the same time, 47% of all outstanding hybrids had incentives to redeem, i.e., were the so-called innovative instruments[127].

Against this backdrop, the following three options have been considered:

- **Policy option 2.1**: Prescriptive rules

- **Policy option 2.2**: Principle-based approach

- **Policy option 2.3**: Economic principle-based approach

Policy option 2.1 would incorporate all the above aspects into the EU regulation, including the list of existing 'incentives to redeem' and corresponding levels which are acceptable to the supervisory community. It would therefore fully reflect technical discussion at supervisory levels and would ensure maximum harmonisation within the EU. On the other hand, the proposed legislation would be too detailed for level 1 legislative text under the Lamfalussy structure. Furthermore, the inclusion of the list of incentives to redeem would not allow the EU directive to cope with future financial innovation.

Policy option 2.2 would consist of listing only the main three principles (i), (ii) and (iii). It would be consistent with the principles of the better regulation agenda and could allow for an adequate flexibility to incorporate any future financial innovation. It would not, however, allow for the acceptability of additional types of instruments, which are similar in economic terms to the undated ones. One example is given by dated instruments, the redemption of which may be suspended by the competent authority (the so-called 'lock-in clause') if they are concerned with the issuer's financial situation[128].

[127] CEBS, *Report on a quantitative analysis of the characteristics of hybrids in the European Economic Area (EEA)*, March 2007

[128] Instruments subject to 'lock-in clause' are already referred to in the EU regulation; in particular, consistently with the agreement at G10 level, subordinated loan capital is eligible for covering capital requirements for market risk provided they comply with the conditions set out in the EU regulation (see Article 13 paragraph 2, point (c) of Directive 2006/49/EC)

Policy option 2.3 would therefore allow for the recognition of this additional type of instruments and combine the pros of the second option with the maximum flexibility given to the industry for their capital management purposes. The introduction of the lock-in clause would also ensure adequate prudential conservatism by giving the competent authority the discretion to suspend the redemption in case of both financial and solvency concerns. Recognition of dated instruments would also ensure cross-sectoral consistency insofar the Solvency II framework includes a similar provisions.

2.5.2.2. Flexibility of payments

The criterion of flexibility of payments is closely interlinked with loss absorption: non-cumulative cancellation of the payment of coupons in stressed situations increases the capacity of the instrument to absorb losses on an on-going basis. The instruments must permit the institution to preserve cash by not paying out coupons if the financial situation of the institution requires it. The non-payment of coupons must not lead to a default on payment either. Furthermore, the coupon payment on the instrument must not lead to liabilities exceeding assets and thereby trigger legal insolvency.

CEBS identified two key principles for this eligibility criterion: (i) the issuer's full discretion over the timing and the amount of any payment due and (ii) non-cumulativeness of any suspended payments. As shown in Table 1, 93% of all hybrids in the EEA in 2006 were non-cumulative. There were a variety of circumstances under which issuers are obliged to suspend payments, such as breach of regulatory solvency limits (68% of outstanding hybrids).

As regards principle (i), CEBS also identified three possible limitations, i.e. the mandatory cancellation of coupon if the issuer does not comply with minimum capital requirements and the possible supervisory intervention in case of any solvency concerns (i.e. 'obligations to not pay') as well as the requirement to pay the coupon to hybrid holders if the issuer has already paid dividends to ordinary shareholders ('obligation to pay').

As regards principle (ii), CEBS also agreed on the possibility for the issuer to adopt 'payment-in-kind' features which could replace the suspended coupon payments (e.g., by delivering newly-issued shares) subject to a set of condition determined by the competent authorities.

Against this backdrop, the following three options have been considered:

- **Policy option 3.1**: Principle-based approach

- **Policy option 3.2**: Principle-based approach with limitations

- **Policy option 3.3**: Principle-based approach with limitations and prescriptive rules for 'payment-in-kind' features

Policy option 3.1 would include only the above two principles without any reference to the agreed-upon limitations. This would minimise the level of detail of legislative text and the associated prescriptiveness and thus allow the competent authorities to agree on a case by case basis on the relevant operational mechanisms. On the other hand, this would not ensure adequate harmonisation across the EU on some important key aspect of this criterion, in particular with reference to the possibility of accepting 'payment-in-kind' features and thus possibly keep the current wide dispersion of national treatments.

Policy option 3.2 would include both the principles and corresponding three limitations as well as the regulatory acceptance of payment-in-kind features. It would entail an appropriate level of detail which would provide both the industry and supervisors with an adequate level of legal certainty and would ensure maximum harmonisation within the EU.

Policy option 3.3 would include both the principles and relevant limitations as well as the detailed set of pre-determined supervisory conditions with which payment-in-kind features must comply in order to obtain regulatory recognition. This option would ensure maximum legal certainty but would effectively limit any future change in supervisory practices due to financial innovation.

2.5.2.3. Loss absorption

With regard to this eligibility criterion, CEBS agreed on the principle that eligible instruments must absorb losses both in going-concern situations and in liquidation. It also clarified further what this principle may mean in practice for the supervisory community: on an ongoing basis, instruments must absorb losses to help the institution to continue operations as a going-concern which means that they should help to prevent its insolvency (deep subordination will not help to prevent insolvency and only absorbs losses in a winding up) and that they should make the recapitalisation of the issuer more likely. In cases of liquidation, losses are absorbed in accordance with the degree of subordination. In this regard the instruments must always rank junior to depositors, general creditors and the subordinated debt of the institution, i.e. hybrids should be senior only to ordinary shares.

CEBS also identified some possible operational mechanisms which the competent authorities may develop in order to ensure that the contractual features of eligible instruments properly implement the above principles. For example, CEBS referred to the possibility of requiring writing-down (either temporarily or permanently) of the principal amount of hybrid instruments as well as inclusion of convertibility features. The need to limit future financial outflows to hybrid holders was also referred to as a possible feature to not hinder future recapitalisation of distressed issuers.

In this context the following three options have been considered:

- **Policy option 4.1**: Prescriptive rules

- **Policy option 4.2**: Principle-based approach with limitations

- **Policy option 4.3**: Principle-based approach

Policy option 4.1 would include the principles, the additional clarifications as well as the operational mechanisms together with the corresponding conditions to be met and the circumstances which may trigger those mechanisms. Such prescriptive approach would indeed ensure legal clarity and maximum harmonisation within the EU. On the other hand, it could not be properly implemented in all MS since the operational mechanisms may differ due to structural differences in national company laws (for example, in some countries it may not be possible to write down the principle amount for some hybrid instruments).

Policy option 4.2 would limit the legislative reference to both the above principles and the additional reference to possible operational mechanisms. This policy option would address some of the shortcomings of the previous option, whilst ensuring adequate legal certainty, but would limit the possible development of any other operational mechanisms.

Policy option 4.3 would limit the legislative reference to the principles. This would ensure maximum flexibility in the legal text allowing for the possibility of applying different operational mechanisms across the EU that are consistent with the domestic legal systems.

2.5.2.4. Summary and comparison of eligibility criteria options

The below table provides a comparison of policy options pertaining to the eligibility criteria of hybrid instruments for the original own funds. The table effectively represents both the impacts for key stakeholders as well as comparison of options with respect to attainment of the relevant objectives.

The impact for the industry in terms of compliance costs could be in part assessed in terms of embedded acceptance level of inherent debt vs. equity economic characteristics by the proposed options, as the costs of raising the former type of capital for businesses are generally lower, but the associated effectiveness of loss absorbency features may also be lower. This impact should be implicitly captured by both the objective S-4 (Reduce compliance burden) and G1 (Enhance financial stability). The interpretation of remaining specific objectives from the industry's standpoint is more straightforward.

The most principle-based options (options 2.3, 3.1 and 4.3) therefore, should impose the least compliance burden on the industry due to the flexibility allowed for in the legislation and represent the principles which may be implemented in different ways according to the national legal system. However, this effect might be dampened by costs linked to higher legal uncertainty, as principle-based options would not be as effective as the most prescriptive options (options 2.1, 3.3 and 4.1) with respect to objective S-1 (Enhance legal certainty). On the other hand, by allowing banks to participate in the process of determining how much capital should be managed for prudential purposes, principle-based options would be more effective than the most prescriptive options with regard to objective S-6 (Reinforce risk management).

The effectiveness of options that combine elements of principle-based approaches and prescriptive rules (options 2.2, 3.2 and 4.2) could be seen as falling in between that of the other two groups with respect to aforementioned objectives S-1, S-4, and S-6. These options would be the most effective with regard to objective S-3 (Enhance level playing field), as prescriptive rules would still work differently in different jurisdictions due to diverse legal and accounting frameworks, whereas principle-based rules in this context could result in too much room for subjectivity in principle application. As a result, with regard to the **eligibility criterion of *flexibility of payments*, 'combination' option 3.2** is retained as the preferred option.

For the **eligibility criteria of *permanence* and *loss absorption*, the principle-based approaches, captured by options 2.3 and 4.3**, were retained, as they would not only be effective with regard to attaining all relevant objectives, but also more efficient than their alternatives in doing so.

Policy Sets and Options		Relevant Objectives					
		S-1 Enhance legal certainty	S-3 Enhance level playing field	S-4 Reduce compliance burden	S-5 Cross-sectoral convergence	S-6 Reinforce risk management	G-1 Enhance financial stability
		Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
Permanence	2.1 Prescriptive rules	++	+	+	+	+	+
	2.2 Principle-based approach	+/++	+	+/++	+	++	+
	2.3 Economic principle-based approach	+	+	++	++	++	++
Flexibility	3.1 Principle-based approach	+	+	++	+	++	+
	3.2 Principle-based approach with limitations	+/++	++	+/++	+	+/++	++

Policy Sets and Options		Relevant Objectives					
		S-1 Enhance legal certainty	S-3 Enhance level playing field	S-4 Reduce compliance burden	S-5 Cross-sectoral convergence	S-6 Reinforce risk management	G-1 Enhance financial stability
		Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
Flexibility	3.3 Principle-based approach with limitations and prescriptive rules for payment in-kind features	++	+	+	+	+	+
Loss absorption	4.1 Prescriptive rules	++	+	+	+	+	+
	4.2 Principle-based approach with limitations	+/++	++	+/++	+	+/++	++
	4.3 Principle-based approach	+	+	++	+	++	+

2.5.3. *Quantitative limits*

Currently, the overall limits on hybrid inclusion in the original own funds (or, subject to some technical differences, Tier 1 capital under Basel Accord terminology) range from 15% to 50% of firms' original own funds in MS that have applicable regimes (see Table 2). As argued in the problem definition (see section 2.3), banks' regulatory capital ratios should be met without undue reliance on hybrid instruments. The advice provided by CEBS confirmed that common shareholders' funds (common shares and disclosed reserves or retained earnings) are the key elements of banks' regulatory capital.

Building on CEBS' advice, three policy options were considered with the view to achieve a EU-level harmonised sets of limits and strengthen institutions' original own funds:

- **Policy option 5.1**: The dual option

- **Policy option 5.2**: The full-fledged 'bucketing' option

- **Policy option 5.3**: The simplified 'bucketing' option

Under policy option 5.1, original own funds' hybrids may not at any time represent more than 30% of the minimum original own funds[129]. If a bank operates above its minimum original own funds, hybrids may represent up to a maximum of 50% of original own funds. The limit for hybrid instruments with incentives to redeem would be at all times 15% of total original own funds and would be included in the assessment of the limits above.

Under policy option 5.2, within the 50% limit indicated under option 5.1, there would be three buckets:

- Instruments which have features that make them behave in a way similar to equity must not – together with all other hybrid instruments – at any time exceed 50% of the total original own funds. Examples of such features are mandatory conversion into a pre-determined amount and number of shares established at the moment of the issue of the instrument or write-down of principal *pari passu* with shareholders. The loss absorption

[129] Minimum original own funds are at least equal to half the sum of minimum capital requirements and deductions from original and additional own funds (referred to in article 57 points (l) to (r) of Directive 2006/48/EC.

mechanism shall be activated when the bank is in breach of capital requirements as defined by Article 75 of Directive 2006/48/EC;

- All other hybrid instruments must not at any time exceed 25% of the total original own funds;
- As in option 5.1, the limit for hybrid instruments with incentives to redeem would be at all times 15% of total original own funds.

Policy option 5.1 would determine the incentive for less capitalised banks to improve their quality of capital. The suggested overall limit of 50% would however not result in any significant change in current market practices for firms which comply with the minimum capital requirements set out in the CRD. It would therefore limit significantly the potential impact on both financial markets and banks' capital management. On the other hand, this option would not ensure supervisory convergence, nor the level playing-field, as different types of hybrids might be subject to the same 50% limit even if their equity-like nature is different.

Policy option 5.2 aims at defining a set of limits which could reflect the equity-like nature of hybrid instruments, which should work to improve capital quality for all banks. On the other hand, it would add complexity to the framework, since it would be difficult to draw a clear line on the different detailed criteria which instruments need to comply with, thus undermining the desired increased regulatory and supervisory convergence.

Based on the above considerations, neither option lacks technical shortcomings and would not represent the best possible option from the point of view of different stakeholder groups. For example, option 5.1 looks more conservative for less capitalised banks, but does not create any change to the current situation for those credit institutions which comply with the minimum capital requirements.

Policy option 5.1 may also implicitly increase minimum capital requirements due to the need for banks to hold additional buffer of original own funds to cope with possible sudden reduction of core capital. This could become quite material for subsidiaries of banking groups which may not need to hold high amount of capital in excess of their minimum capital requirements due to the parent company's decision on capital allocation which usually aims at optimising capital buffers across different legal entities belonging to the group. Furthermore, the expected incentive for less capitalised banks may also be replaced by the on-going supervisory tasks of promptly detecting any serious deterioration of banks' quality of capital and the corresponding need to require them to develop a proper restoration plan.

The need to develop a clear calculation formula for both the core capital and the minimum capital requirements in terms of original own funds may also open the policy discussion on the broader definition of regulatory capital (for example on the inclusion/exclusion of some items like participations held in financial institutions) which was not intended to be covered under the current project.

On the other hand, option 5.2 entails a quite complex set of additional criteria to identify the quantitative limit associated with different types of instruments. It also introduces an intermediate limit (i.e. 25%) for those hybrids which do not provide for incentives to redeem or do not contain the above equity-like features. However, it introduces the principle of having different limits based on the capital quality of hybrid instruments.

Policy option 5.3 retains the key principle of option 5.2 (i.e. providing for different limits based on the equity-like features of hybrids) but simplifies it by identifying a single, clear criterion to identify hybrids which may be eligible up to 50% of original own funds, i.e., the mandatory conversion into capital items included in the definition of core capital (share capital, reserves and retained earnings) during crisis situations. It also increases from 25% to 35% the intermediate limit which instruments that do not fulfil that criteria must be subject to.

In particular, it would require:

- Instruments with incentives to redeem to be less than 15% of original own funds (same as under options 5.1 and 5.2);
- Instruments which will be converted into core capital during crisis situations to be less than 50% of original own funds;
- All other instruments to be less than 35% of original own funds.

All the three limits would be subject to the overall 50% limit mentioned above. The decision of allowing the highest limit for convertible instruments, which comply with the criterion under the second bullet point, arises from the prudential consideration that in case of crisis these instruments will be converted into core capital, thus improving significantly banks' quality of capital and the associated legal certainty. These characteristics are not shared by instruments falling within the 35% bucket since they basically include either fixed-income instruments which keep their debt features or convertible instruments which may not be converted when it is needed.
Using the convertibility feature as the driving factor for the bucketing of hybrids also reflects the current differentiation of investor bases – and relevant risk appetites - within the broader hybrid market, i.e., equity investors on one hand and fixed income investors on the other. Given that currently only 1% of outstanding hybrids can be converted into ordinary shares and only 18% into preference shares (see Table 1), this policy option is likely to change the current supply and demand dynamics for hybrids with specific characteristics, and therefore might have implications on their pricing.

Conclusion

Based on the above arguments, policy option 5.3 (The simplified 'bucketing' option) is retained as preferred policy option as it is the only option that is effective with regard to all the relevant objectives: S-1 (Enhance legal certainty), S-4 (Reduce compliance burden), S-3 (Enhance level playing field) and G-1 (Enhance financial stability).

Policy Option	**Relevant Objectives**			
	S-1 Enhance legal certainty	S-3 Enhance level playing field	S-4 Reduce compliance burden	G-1 Enhance financial stability
	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
5.1 The 'dual' option	+	≈	+	+
5.2 The full-fledged 'bucketing' option	≈	+	≈	++
5.3 The simplified 'bucketing' option	++	++	+	+

2.5.4. Grandfathering provisions

Grandfathering provisions aim at limiting the impact on financial markets of the proposed common regulatory approach. Hybrid instruments are currently included in Tier 1 on the basis of the eligibility criteria at the time of their issuance. In order to achieve convergence across the EU, MS will have to amend their current rules on hybrids to some degree. Although not all existing hybrids will lose their eligibility, the volume of hybrid instruments in the market that may cease to qualify under the revised rules could be substantial.

Therefore, the Commission deems it appropriate to develop adequate provisions that will soften the impact of the new rules on the market and allow for an adequate transition period. To this end, the following four options have been considered:

- **Policy option 6.1**: Grandfathering for a pre-set time
- **Policy option 6.2**: Grandfathering until the first call date
- **Policy option 6.3**: Permanent grandfathering
- **Policy option 6.4**: Gradual 'amortisation plan'

Option 6.1 might cause problems with outstanding instruments which have no option to redeem. Furthermore, it effectively makes all hybrid instruments dated and, as a consequence, would cause turbulence in financial markets because of the inevitable re-pricing of instruments which would lead to unanticipated mark to market profits or losses.

Option 6.2 would allow existing instruments to count as Tier 1 capital up to the point that the bank is first able to redeem the instrument. It effectively makes instruments with a call feature dated, whether or not there is an incentive to redeem and leads to the same issues as outlined in option 6.1. Moreover, this option does not address instruments without a call.

Option 6.3 would allow all existing instruments to count as Tier 1 capital indefinitely. Permanent grandfathering does not effectively create a market with implicitly dated instruments.

According to option 6.4, the existing instruments would gradually lose their eligibility for inclusion in Tier 1 over a certain period of time. This option aims at striking the right balance between the prudential concerns to stop the recognition of instruments which do not comply with the new regulatory framework and market concerns that a too abrupt grandfathering rule may cause market disruption.

The suggested text also requires firms to agree with the competent authorities on the necessary measures to address possible lack of compliance with the new regulation. The introduction of a harmonised set of principles is intended to create the possible right set of incentives for firms to anticipate the replacement of the grandfathered instruments, or rather, to reduce the materiality of those instruments sooner than the suggested transitional period.

Conclusion

Based on the above arguments, policy option 6.4 (Gradual 'amortisation plan') is retained as the preferred policy option as it is the only option that is effective with regard to all the relevant objectives: S-1 (Enhance legal certainty), S-4 (Reduce compliance burden) and G-1 (Enhance financial stability). This option is the most consistent, as it allows to minimize distributional implications between two groups of banks: banks that currently have hybrids included in their original own funds and banks that do not. It will ensure that the former group is not subjected to material compliance costs as some of the held hybrids might become ineligible under the proposed regime, yet provide for improved level playing field conditions for the latter group by gradually aligning old and new treatments.

Policy Option	Relevant Objectives			
	S-1 Enhance legal certainty		S-4 Reduce compliance burden	G-1 Enhance financial stability
	Effectiveness (≈/+/++)	Consistency (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
6.1 Grandfathering for a pre-set time	+	+	≈	≈
6.2 Grandfathering until the first call date	+	+	≈	≈
6.3 Permanent grandfathering	+	≈	++	+
6.4 Gradual 'amortisation plan'	+	++	+	++

2.5.5. *Summary of preferred policy options and their impacts on stakeholders*

The following table summarizes the policy option sets discussed in the previous sections. Individual options within each set are ranked in terms of their relative effectiveness, efficiency, and consistency with regard to achieving the relevant objectives. Preferred policy option for each policy option set is highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria		
			Effectiveness	Efficiency	Consistency
First-level policy options					
Common European framework for hybrid capital instruments	S-1 Enhance legal certainty S-3 Enhance level playing field S-4 Reduce compliance costs S-5 Cross-sectoral convergence G-1 Enhance financial stability	1.1 Multiple national frameworks	3	3	3
		1.2 Common regulatory European framework	1	1	1
		1.3 Self-regulation based framework**	2	2	2
Second-level policy options					
Eligibility criteria: permanence	S-1 Enhance legal certainty S-3 Enhance level playing field S-5 Cross-sectoral convergence S-6 Reinforce risk mgmt G-1 Enhance financial stability	2.1 Prescriptive rules	3	3	
		2.2 Principle-based approach	2	2	
		2.3 Economic principle-based approach	1	1	
Eligibility criteria: flexibility of payments	S-1 Enhance legal certainty S-3 Enhance level playing field S-5 Cross-sectoral convergence S-6 Reinforce risk mgmt G-1 Enhance financial stability	3.1 Principle-based approach	2	1	
		3.2 Principle-based approach with limitations	1	2	
		3.3 Principle-based approach with limitations and prescriptive rules for payment in-kind features	3	3	
Eligibility criteria: loss absorption	S-1 Enhance legal certainty S-3 Enhance level playing field S-5 Cross-sectoral convergence S-6 Reinforce risk mgmt G-1 Enhance financial stability	4.1 Prescriptive rules	3	3	
		4.2 Principle-based approach with limitations	2	2	
		4.3 Principle-based approach	1	1	
Quantitative limits	S-1 Enhance legal certainty S-3 Enhance level playing field S-4 Reduce compliance costs G-1 Enhance financial stability	5.1 The dual option	2	1	
		5.2 The full-fledged 'bucketing' option	2	2	
		5.3 The simplified 'bucketing' option	1	1	
Grandfathering provisions	S-1 Enhance legal certainty S-4 Reduce compliance costs G-1 Enhance financial stability	6.1 Grandfathering for a pre-set time	3	3	2
		6.2 Grandfathering until the first call date	3	3	2
		6.3 Permanent grandfathering	2	1	3
		6.4 Gradual 'amortisation plan'	1	2	1

** Non-legislative option
Scale of option ranking: 1=highest, 3=lowest

The expected most material of the proposed preferred options (1.2, 2.3, 3.2, 4.3, 5.3 and 6.4) on the key stakeholders can be summarized as follows:

- For the industry, the proposed options would ensure adequate sources of capital funding and broadened investor basis (option 1.2). The harmonised EU framework would promote legal certainty and minimise potential competitive distortions. The quality of capital will be improved by distinguishing hybrid instruments depending on their equity-like nature during crisis situations (option 5.3).
- Supervisors will benefit from a harmonised principle-based regulatory approach built upon CEBS' agreement (options 2.3, 3.2 and 4.3). Possible differences of implementation at national level will be minimized as supervisory tools available to comply with the EU regulation will be clarified.
- Investors will benefit from the harmonised EU regulatory framework that should work to enhance the liquidity of hybrid instruments and, ceteris paribus, reduce the associated risk. In addition, they should benefit from a reduction in compliance risk stemming from enhanced legal certainty and curbed national discretions.
- 3rd country institutions should see gains deriving from reduced differences in national supervisory treatments and closer alignment of EU legislation with the G10 agreement.
- The financial stability will be enhanced as the preferred options clarify the functioning of hybrid instruments and, as regards limits, focus on their equity-like nature, particularly during crisis situations, effectively broadening investor base that could help address banks' financial needs. The increased liquidity of hybrid instruments and strengthened supervisory convergence should also work to improve the efficiency of financial markets.

3. HOME-HOST ISSUES AND CRISIS MANAGEMENT ARRANGEMENTS

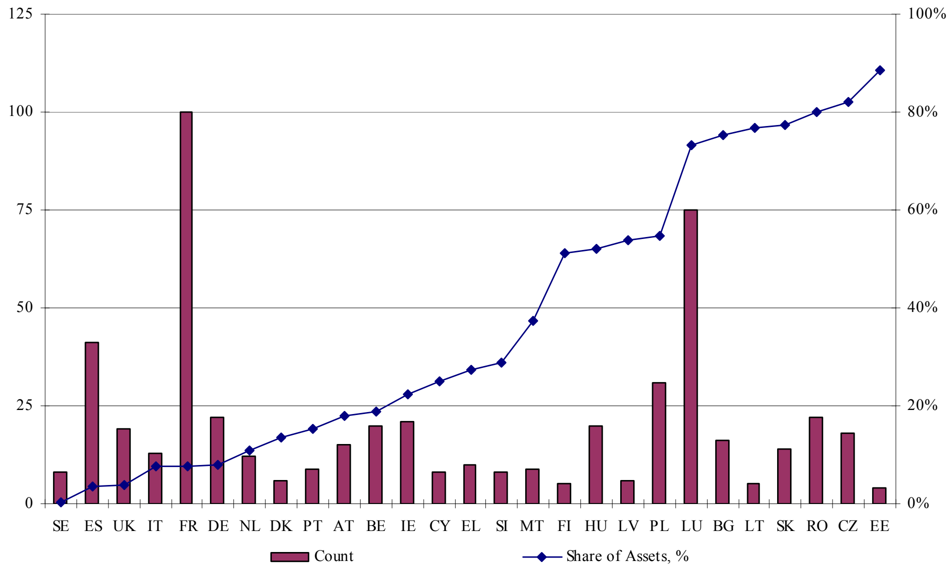
3.1. Background

The EU supervisory framework is based on the supervision on a consolidated basis and the country of origin principle. The supervision of credit institutions is carried out by both home and host member state (MS) supervisory authorities. Cross-border branches, as they do not have independent legal status, fall under the supervision of home MS of their parent institutions, with limited and residual responsibilities (e.g., liquidity) entrusted to host MS supervisors. Cross-border subsidiaries, as separate legal entities, are supervised on a solo basis by the authorities of their host MS of establishment, where they are incorporated. Home MS authorities (consolidating supervisor) are, however, responsible for the consolidated overview of the financial health of a financial group, including its parent, branches and subsidiaries.

According to the ECB[130], in 2006, total assets of credit institutions in the EU27 were €36,894 billion, with approximately 73% of the amount controlled by domestic institutions, 11% by some 540 cross-border subsidiaries with an EU parent, 8% by some 650 cross-border branches[131] with an EU parent and the remainder by cross-border entities with a non-EU parent.

At the MS level, distribution of the asset shares varied markedly, ranging from 0.3% in Sweden to 89% in Estonia for cross-border subsidiaries (see Chart 1) and from 0% in Malta to 21% in UK for cross-border branches (see Chart 2). When taken together, cross-border branches and subsidiaries controlled anywhere from 9% of total credit institution assets in Sweden to 99% in Estonia (see Chart 3) while the average of this indicator for the twelve new MS was around 63%, well above the 19% level for EU27.

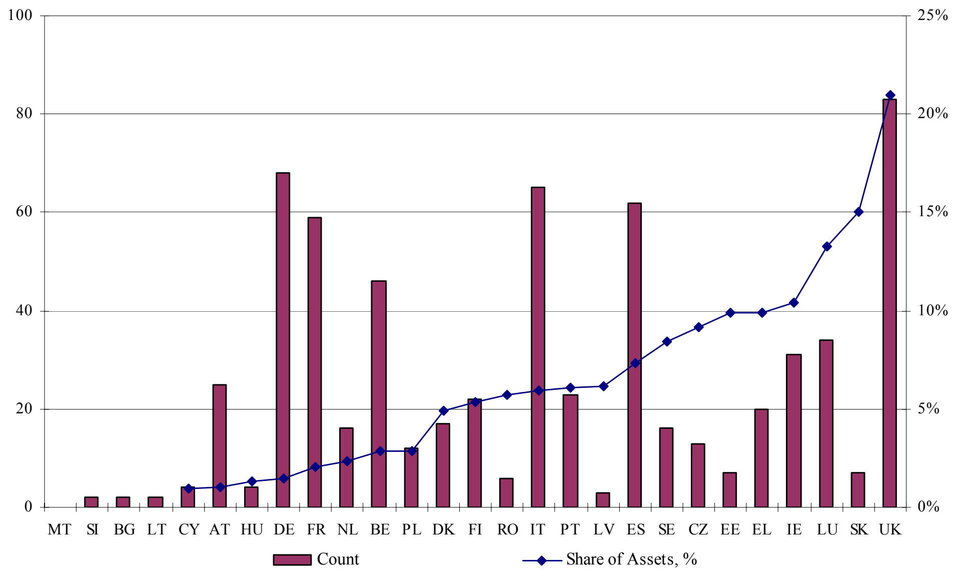
Chart 1: Subsidiaries of credit institutions from other MS and their share of total credit institution assets within a MS



Source: ECB

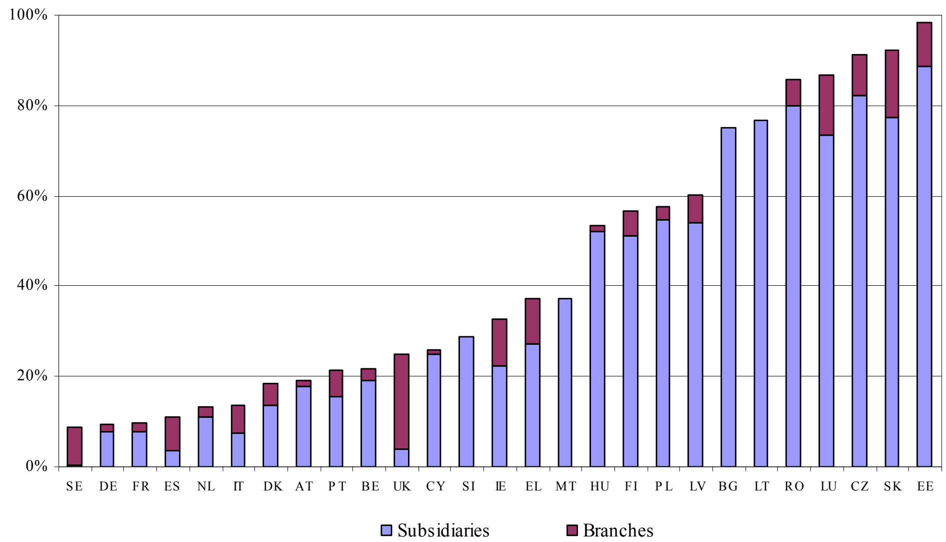
[130] ECB, *EU Banking Structures*, October 2007
[131] Where a credit institution has several branches in a given MS, they are counted as a single branch.

Chart 2: Branches of credit institutions from other MS and their share of total credit institution assets within a MS[132]



Source: ECB

Chart 3: Combined share of MS credit institution total assets by branches and subsidiaries of credit institutions from other MS[133]



Source: ECB

As a result of consolidation over the past years, large cross-border banks now dominate the European banking landscape. In 2005, 46 cross-border banking groups with significant

[132] Data on branch assets for LT, SI and BG not shown due to confidentiality reasons, as less than 3 credit institutions from other MS had branches in these MS in 2006.
[133] Data on branch assets for LT, SI and BG not shown due to confidentiality reasons, as less than 3 credit institutions from other MS had branches in these MS in 2006.

activities in other MS held about 68%[134] of consolidated EU banking assets. They were particularly active in the new MS, where their asset market share ranged from 20% in Cyprus and Slovenia to around 90% in Estonia[135].

Over the recent years financial institutions have been also reconfiguring their business strategies and reorganising their internal organisation. In pan-European institutions risk, liquidity and capital management are increasingly executed centrally for all organisational units, and groups are increasingly organized according to business lines. As a consequence, looking at individual business entities in isolation is becoming less and less meaningful from a supervisory perspective. At the same time, it is becoming increasingly difficult to organize supervision in going-concern situations as well as in crisis situations on a predominantly national basis which is misaligned with market developments and business practices.

3.2. Procedural issues and consultation of interested parties

Against this backdrop, in September 2007, the Economic and Financial Committee (EFC)[136] Ad Hoc Working Group issued a report on "Developing EU Financial Stability Arrangements" that gave rise to intensive discussions among finance ministries, supervisors and central banks. In October 2007, the Ecofin Council, having considered the recommendations of this high level working group, endorsed further work in the areas where current supervisory arrangements were deemed to be sub-optimal. The Commission has been requested "to propose ways to clarify cooperation obligations including possible amendments to EU-banking legislation, especially to: clarify the existing obligations for Supervisory Authorities, Central Banks and Finance Ministers to exchange information and to cooperate in a crisis situation; increase the information rights and involvement of host countries; clarify the role of the consolidating supervisors and facilitate the timely involvement of relevant parties in a crisis situation; and examine whether, to this end, legislative changes are necessary, including to reinforce the legal requirements for supervisory collaboration and information sharing."[137]

In November 2007, the Commission issued a Communication[138] on the review of the Lamfalussy process (see 8. Annex A: The Lamfalussy Process), which noted that cross-border group supervision and convergence in the EU supervisory system would be significantly enhanced by the existence of colleges of supervisors[139] to facilitate cooperation between supervisory authorities involved in the oversight of specific cross-border firms. In colleges of supervisors, host MS authorities would need to be strongly involved in the supervision of cross-border groups. The communication emphasized that an optimal functioning of colleges of supervisors requires a number of adjustments to the present approach, in particular, clear internal decision making procedures are needed for cases where no agreement is found.

---

[134] J-C Trichet, *Towards the review of Lamfalussy approach: market developments, supervisory challenges and institutional arrangements*, May 2007

[135] ECB, *EU Banking Structures*, October 2006

[136] The Economic and Financial Committee conducts preparatory work for the Council of the European Union on the economic and financial situation, the euro exchange rate and relations with third countries and international institutions. This advisory committee also provides the framework for preparing and pursuing the dialogue between the Council and the ECB.

[137] http://europa.eu/rapid/pressReleasesAction.do?reference=PRES/07/217&format=HTML&aged=0&lg

[138] http://ec.europa.eu/internal_market/finances/docs/committees/071120_final_report_en.pdf

[139] CEBS defines colleges of supervisors as permanent, although flexible, structures for cooperation and coordination among the authorities responsible for and involved in the supervision of the different components of cross-border banking groups.

In June 2007, the Commission services hosted a conference on the challenges for EU supervisory arrangements in an increasingly global financial environment. Key stakeholders, including industry representatives, supervisors, central bankers and regulators, were brought together with a view to discussing efficiency and robustness of supervisory arrangements in light of progressive integration of EU financial services markets. All participants underlined the need to further develop a clearer European framework for dealing with cross-border crises, and agreed that efficiency of the current arrangements had to increase. Industry representatives strongly emphasized that the nationally-based supervision is lagging behind market developments and business practices.

In addition, the Commission services discussed possible improvements to the current legislative text and obtained feedback from the representatives of MS regulators in the four meetings of the CRD Working Group held in November 2007, January, February and March 2008, and reported back to the informal Ecofin in April 2008. Furthermore, a public consultation on the proposed draft changes to the current legislation was run in April - June 2008.

An Inter-Service Steering Group (ISSG) was set up to follow progress and feed in views from other services of the Commission, including Directorates General ENTR, ECFIN, COMP, SJ and Secretariat General.

Stakeholders' feedback collected throughout the consultation process was used to inform various phases of the impact assessment process, from problem definition to policy option design and analysis.

3.3. Problem definition

This section is presented in two broad parts. The first part identifies issues pertaining to the current supervisory arrangements in going-concern situations while the second concentrates on the arrangements in place for financial crisis situations.

3.3.1. Sub-optimal supervisory arrangements in going-concern situations

Driver: Misalignment between nationally-based supervision and cross-border nature of banking groups Problems: Extra compliance costs for cross-border financial groups; sub-optimal effectiveness in prevention of crisis situations

The IMF analysis of euro area policies[140] points out that under the current nationally-based supervision authorities' desire "to maintain control to better protect national financial stability is a factor contributing to customization and "goldplating" of EU directives, which risks delivering a collection of national rather than a single set of best EU prudential policies and practices (…) and, perhaps most importantly, a reluctance to agree to EU principles and procedures for crossborder financial crisis prevention, management and resolution".

Large cross-border financial institutions argue that they have reconfigured their business strategies and have reorganised their internal organisational set-up, especially by centralising important business functions such as risk and liquidity management. They claim that these developments need to be accompanied by modernised prudential supervision, as the traditional nationally-based model no longer ensures efficient and effective supervision. More specifically, large cross-border groups point out that they "are facing a multitude of differing supervisory requirements, which stem from the divergent interpretation or implementation of

[140] IMF Country Report No. 07/260, paragraph 26

EU rules. In order to comply with all requirements, the financial group will either have to multiply its efforts, or in case the different requirements are compatible and the group prefers a single approach satisfying each supervisor's requirements have to comply with the most stringent of these requirements. This situation obviously increases the complexity of supervision, and accordingly the likelihood of errors. It requires more advanced IT solutions, it takes more time and, in general, it increases the costs of those financial groups operating across borders. As not all market players are affected in the same way, this situation creates an uneven playing field"[141].

In order to facilitate and establish effective and efficient group supervision, the Committee of European Banking Supervisors[142] (CEBS) has developed a template Memorandum of Understanding[143] (MoU), which is currently tested by colleges of supervisors of 8 out of the 46 European cross-border banking groups. However, these guidelines are not legally binding, and supervisors would implement them on a best effort basis only. As a result, the initiative might lack effectiveness in preventing the duplication of supervisory requirements for cross-border banking groups.

Driver: Lack of clarity in the coordination role of the consolidating supervisor Problem: Sub-optimal cooperation level of the current supervisory arrangements; extra compliance costs for cross-border financial groups, level-playing field implications due to diverging supervisory requirements for individual groups

Under the CRD, the consolidating supervisor has extra-territorial decision-making powers that are binding on host supervisors for validation of a banking group's internal approaches to credit, operational and market risks. In other areas such as additional capital requirements (capital 'add-on' above minimum capital requirements for subsidiaries known as Pillar 2 measure) and reporting, conflicting requirements between supervisors have been emphasised by the large cross-border financial institutions[144]. This means in particular extra IT costs, duplication of requirements and requests for information, and a possible misalignment between regulatory and economic capital at the entity level. While the consolidating supervisor is expected to coordinate all supervisory activities, this CRD requirement is not explicit in how and which activities shall be coordinated. Without specific requirements in place, supervisors are less likely to cooperate and come to a common and coordinated approach.

In addition, at the June 2007 conference on the challenges for EU supervisory arrangements in an increasingly global financial environment, industry representatives expressed doubts about the efficiency of colleges whose decision making process is not specified. Some firms claim that they have been experiencing difficulties in implementing models at every level within a group due to diverging views between national supervisors.

Reinforcing the role and powers of the consolidating supervisor should bring important efficiencies for cross-border banks and improve the overall effectiveness of the current supervisory system.

[141] The European Financial Services Roundtable (EFR), *Monitoring Progress in EU Prudential Supervision*, September 2007. EFR members are CEOs or chairmen of leading European financial institutions.
[142] CEBS – Lamfalussy process Level 3 committee
[143] MoU consists of a set of principles and procedures for sharing information, views and assessments, in order to facilitate the pursuance by participating authorities of their respective policy functions.
[144] The European Financial Services Roundtable (EFR), *Monitoring Progress in EU Prudential Supervision*, September 2007. EFR members are CEOs or chairmen of leading European financial institutions.

Nevertheless, in developing consolidating supervision, there is a risk that the level playing field between firms could be further impeded by diverging regulatory and supervisory practices between approaches adopted across colleges.

3.3.2. Sub-optimal supervisory arrangements in crisis situations

Recent research of the IMF[145] suggests that that the potential for extreme events to spill over from one bank to another appears to have increased not only among domestic banks but also across borders. The current credit market contraction has shown that supervisors should be prepared and capable to act efficiently and collectively in crisis situations, underscoring the need for greater cross-border supervisory cooperation in the EU.

Driver: Misalignment between nationally-based supervision and cross-border nature of banking groups, impeding efficient and effective crisis management

Problem: Costs to creditors, employees and shareholders of cross-border groups as well as tax payers in case of bank failure

In the nationally based supervision system, each MS is responsible for ensuring financial stability in its jurisdiction. As financial supervision is organized on a predominantly national basis, the current framework may limit the incentives to work toward a common EU-wide stability framework. This is not commensurate with the increasingly cross-border nature of banking groups and the way they organise their business.

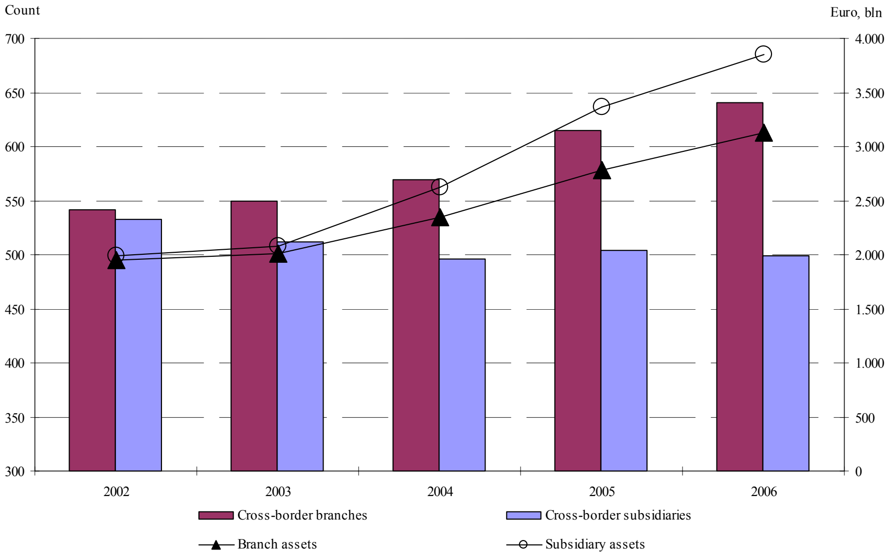
Without appropriate cooperation mechanisms, conflicts of interests may arise between authorities in different countries. For banking groups, host MS authorities could have an incentive to ring fence assets, whereas home MS authorities have an incentive to seek the centralisation of the bank's assets while keeping liabilities decentralised. This conflict is of most relevance for 'significant' subsidiaries (Chart 4 below illustrates the increasing trend towards concentration of assets into a smaller number of cross-border subsidiaries).

In this respect, the IMF[146] emphasized that "the dominant strategy for supervisors in an LCFI[147] crisis will likely be to look out for the national treasury, using informational advantages to that effect, notwithstanding MoUs on information sharing and cooperation. A scramble for assets in an LCFI crisis is thus likely and would have significant cross-border spillovers, preventing efficient and effective crisis management and resolution. In this set-up, it is natural for national prudential authorities to fear loss of control over domestically-active financial players". In other words, the current legal framework does not ensure that national authorities take into account the effect of their decisions on the financial stability of another MS. Currently, the CRD requires the consolidating supervisor to coordinate supervisory activities, but its role is not clearly defined (e.g., in terms of communication to the public, contingency plans, assessment of crisis situations).

Disincentives to cooperate might be detrimental not only to creditors, but also to shareholders and employees of cross-border banks, as uncooperative crisis management process between national authorities may undermine banks’ private crisis resolution solutions, and, eventually, to tax payers.

[145] IMF Country Report No. 07/260, paragraph 25
[146] IMF Country Report No. 07/260, paragraph 26
[147] LCFI - large and complex financial institutions

Chart 4: Branches[148] and subsidiaries of credit institutions from other MS and their cross-border assets in 2002-2006



Source: ECB

The IMF put special emphasis on the collective nature of costs facing EU states if large cross-border financial institutions were to fail. The extent of potential financial stability implications of this scenario can be estimated only roughly. A possible gauge could be, for example, the level of cross-border banking group market shares in their home and host MS. According to the ECB[149], 16 'key' banking groups that held around one third of total EU banking assets in 2005, held on average 38% of their EU assets in other MS. At the same time, in 60% of MS at least one such 'key' group accounted alone for more than 15% of domestic banking assets.

In terms of cooperation in crisis situations, the CRD only addresses it in the context of individual banking groups. It did not introduce any specific requirements where a broader crisis, e.g. turbulence in financial markets, would require supervisors of all affected entities to act collectively, and if necessary in cooperation with central banks. Recent financial market turmoil triggered by problems in the US 'sub-prime' mortgage market sector has demonstrated this to be a further shortcoming of the current supervisory structures.

Driver: Informational asymmetries between supervisors of systemically relevant branches and home MS supervisors

Problem: Increased financial stability risks for host MS

Information flows between home and host authorities required by the CRD mirror the allocation of their prudential responsibilities. Requirements in terms of information exchange on subsidiaries between the home supervisor (consolidating supervisor) and the host supervisor (supervisor of the subsidiary) in a banking group have been strongly reinforced for the purposes of establishing effective consolidated supervision.

[148] Where a credit institution has several branches in a given MS, they are counted as a single branch.

[149] J-C Trichet, *Towards the review of Lamfalussy approach: market developments, supervisory challenges and institutional arrangements*, May 2007

With regard to branches, the home supervisor is not required to provide the host supervisor of a branch with specific prudential information in a going-concern or crisis situation. Therefore, supervisors of branches that are relevant for the stability of the banking system of a host MS may receive little information about these establishments. This asymmetry of information no longer keeps pace with the increase in the number and importance of branches over the last 5 years (see Chart 4).

Furthermore, with the possibilities offered by the EU company statute, some companies are considering changing their subsidiaries into branches. This is already the case for the Nordic MS (e.g., Danske Bank and Nordea Group) and may also apply to other financial services providers throughout the EU. Whilst there may not be any real change in the way that the group functions, this would lead to an automatic shift in supervisory responsibility from the host to the home MS, and raises supervisory challenges as from a financial stability standpoint, host authorities remain responsible for maintaining the stability of the domestic financial market. This means that host authorities would normally be expected to limit the possible negative spillover effects of a systemically relevant branch[150] in their domestic market, without having access to the necessary information.

This need for information holds true in particular in 'stressed' situations. Participation of host supervisors of systemically relevant branches in colleges might effectively ensure that they receive information that is relevant for the stability of their financial system. Extending access to such information to going-concern situations might further reduce any significant asymmetries of information which may be detrimental to the financial stability system in the host MS.

Driver: Legal obstacles to information sharing between supervisors, central banks and finance ministries Problem: Potentially higher direct and indirect crisis-induced costs for the industry and EU economy as whole

While the CRD requires the home (consolidating) supervisor to alert central banks and finance ministries in emergency situations, this is subject to confidentiality safeguards. The answers of MS to a questionnaire of the European Banking Committee (EBC)[151] on this subject evidenced the existence of legal impediments to information sharing between competent authorities, and central banks and finance ministries in other jurisdictions. The CRD does not provide for clear gateways, and its implementation in this area varies from one country to another.

In the context of market turbulence, where the central banks are required to take actions through money market operations, a possible multilateral sharing of information between central banks and supervisors is of key importance. The current legal framework may be sub-optimal for a smooth crisis management process which may involve not only competent authorities but also central banks or finance ministries of MS where an entity or a systemically relevant branch is located.

[150] For instance, according to Nordea's 2007 annual report, its market share in Finland for mortgage lending was 31%, personal costumer lending - 30% and corporate customer lending – 37%; while its market share in these segments in Denmark were 16%, 14% and 18%, respectively.

[151] EBC – Lamfalussy process Level 2 committee

3.4. Objectives

The general objectives are the overall goals of this exercise and, therefore, they are fully aligned with the original long-term policy objectives of the CRD to:

- Enhance financial stability (G-1);
- Enhance safeguarding of creditor interests (G-2);
- Ensure international competitiveness of EU banking sector (G-3);
- Further promote the internal banking market integration (G-4).

In light of the problems presented in the previous section, a set of operational objectives has been identified to address the associated problem drivers. Effective realization of such operational objectives should contribute to the achievement of longer term specific and, in turn, the aforementioned general policy objectives.

The following table lists problem drivers, operational and specific objectives and indicates linkages between them.

Problem Drivers	Operational Objectives	Specific Objectives			
		S-1 Enhance legal certainty	**S-2** Enhance supervisory cooperation	**S-3** Enhance level playing field	**S-4** Reduce compliance burden
Misalignment between nationally-based supervision and cross-border nature of banking groups Lack of clarity in the coordination role of the consolidating supervisor	**O-1** Clarify and define rules and appropriate structures for co-operation and information sharing between home and host supervisors in going-concern situations	√	√	√	√
Misalignment between nationally-based supervision and cross-border nature of banking groups, impeding efficient and effective crisis management	**O-2** Clarify and define appropriate rules for co-operation and information sharing between home and host supervisors in crisis situations	√	√		
Legal obstacles to information sharing between supervisors, central banks and finance ministries	**O-3** Remove impediments to information sharing between supervisors, central banks and finance ministries	√	√		
Informational asymmetries between supervisors of systemically relevant branches and home MS supervisors	**O-4** Allow host supervisors to be better informed	√	√		

3.5. Policy option analysis and comparison

By developing common risk assessment policies and at the same time sharing relevant data concerning the financial group in question colleges of supervisors could serve as a forum to deal with the first signals of potential stress in a specific institution and, thus, improve crisis management. The key issue is whether the arrangements to reinforce cooperation in going-concern situations would also work in crisis situations. First, in crisis situations, different players (i.e. Ministries of Finance, central banks) are likely to step in. Secondly, the coordination role of the consolidating supervisor in colleges may not necessarily lend itself to crisis situations where supervisors are accountable to national parliaments. Potential policy tools, therefore, were considered and analysed separately for the going-concern and crisis situations, assuming that such approach would allow for a more effective attainment of the above-stated operational, specific and general objectives.

One policy option set was analysed in the context of supervisory arrangements in the going concern situations (sub-section 3.5.1) while four policy options sets were considered to achieve the relevant objectives in the crisis management area (sub-sections 3.5.2 to 3.5.5). Due to the number of policy sets examined, the presentation of policy option analysis and comparison has been combined by conducting them sequentially for each set. A summary of all preferred options is presented at the end of the section (sub-section 3.5.6) together with an overview of anticipated impacts on key stakeholders.

3.5.1. Improving cooperation arrangements in going concern situations

The options regarding the supervisory cooperation structure in going-concern situations will be referred to in the rest of the analysis as follows:

- **Policy option 1.1:** Retain current approach

- **Policy option 1.2:** Formal colleges of supervisors

- **Policy option 1.3:** Formal colleges of supervisors with involvement of CEBS

- **Policy option 1.4:** Develop a lead supervisor model

- **Policy option 1.5:** Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor

- **Policy option 1.6:** An EU financial supervision authority

Policy option 1.1 Retain current approach

The CRD already requires supervisors to have specific written arrangements in place in order to facilitate and establish effective supervision. As a result, CEBS has developed a template Memorandum of Understanding (MoU)[152] for colleges, which is currently tested by 8 out of the 46 European cross-border banking groups. This MoU is mainly focused on the development of a common risk assessment approach, but is not specific in other areas (e.g. common reporting framework, implementation of Pillar 2 measures, disclosure requirements on subsidiaries) where differences in supervisory approaches between home and host supervisors may turn out to be costly for cross-border groups. CEBS has been requested by the Ecofin to further develop operational guidelines for colleges. However, such guidelines are not legally binding, and supervisors would implement them flexibly and on a best effort basis only.

The current approach, therefore, does not provide supervisors with necessary incentives to develop a group-wide approach to prudential requirements. Both the home and the host supervisory authorities would be able to maintain room for manoeuvre to develop diverging national approaches. Concerns of cross-border banking groups about overlapping supervisory requirements would not be fully addressed either. As a result, the option would not significantly improve the efficiency and effectiveness of group supervision.

Policy option 1.2: Formal colleges of supervisors

The November 2007 Communication of the Commission on the Lamfalussy process review and the December 2007 Ecofin meeting emphasized the key role of colleges in improving the efficiency of group supervision. More structured multilateral cooperation between supervisors would better involve host supervisors and allow for a broader picture of a group's risks while

---

[152] http://www.c-ebs.org/press/documents/CEBS%202007%20177%20rev%202%20(template%20for%20written%20agreements)%20final%202.pdf

avoiding duplication of tasks. In terms of financial stability, this would reinforce the effective prevention of cross-border financial crises.

Under this approach, supervisors will be required to draw up 'formal colleges of supervisors'. The legislation would specify i) authorities to be involved in the college and ii) supervisory activities to be dealt with by supervisors in a collegial manner, e.g. reporting requirements, liquidity risk management, review of the internal capital of banks. Such formal colleges of supervisors would represent a significant step forward in improving the efficiency of group supervision. Under this option, the allocation of responsibilities between home and host authorities remains unchanged, while more emphasis is placed on joint responsibility as part of 'collegial' decisions. For instance, supervisors would be required to commonly agree on key aspects such as Pillar 2 measures (capital 'add-on') for subsidiaries and reporting requirements for all entities of a cross-border group. This would provide strong incentives for supervisors to carefully consider the allocation of economic and regulatory capital within the group and reduce overlapping prudential and information requirements.

A downside to this approach is a possible increase of administrative burden for supervisors as they would be required to regularly meet to come to common supervisory decisions. This shortcoming, however, should not be overestimated. The administrative burden for supervisors in terms of information exchange is already implied by the existing CRD requirements, which stipulate that supervisors exchange essential and relevant information both in going concern and in crisis situations. This exchange of information shall already be coordinated by the consolidating supervisor. Colleges as a vehicle for multilateral cooperation would only enable effective implementation of the existing information exchange requirements. Therefore, the incremental administrative burden on supervisors can be expected to be rather immaterial. Moreover, it may be argued that all cross-border banking groups might not necessarily need a strongly formalized college in place. To this end, detailed functioning arrangements of colleges under this option would not be dealt with in legislation, but rather addressed in written arrangements among home and host authorities depending on the specificities of each cross-border banking group.

Policy option 1.3: Formal colleges of supervisors with involvement of CEBS

The level playing field between firms may be impeded by diverging regulatory and supervisory practices between approaches adopted under a college of supervisors model. This may be detrimental to further convergence of practices among MS. Any reinforcement of consolidating supervision discussed above should therefore go hand in hand with further powers entrusted to CEBS, which could closely monitor the convergence of supervisory practices. In other words, the involvement of CEBS is important to deliver a coherent system of 'hub' (CEBS) and 'spokes' (supervisory colleges for individual cross-border firms).

Under this option, the consolidating supervisor would be required to keep CEBS informed of the activities of the college, or the cooperation structure in place. This would allow CEBS to effectively ensure consistency between supervisory approaches across colleges.

Policy option 1.2 discussed earlier, entails agreements on key home-host issues among supervisors. In order to fully allow for minority views to be expressed, this option (1.3) would introduce the possibility for supervisors to refer a matter to CEBS for consultation. Along the lines of the Solvency II proposal in the insurance area, legislative amendments would entrust CEBS with the 'mediation' role in situations where supervisors do not agree within colleges on key group supervisory aspects (e.g. Pillar 2 measures on subsidiaries, reporting requirements). Also, it could be expected that the possibility of CEBS' involvement should provide supervisors with stronger incentives to reach agreements within colleges.

From banks' perspective, a downside to this approach is that the mediation mechanism in case of disagreement on key supervisory issues might make the decision-making process difficult and lengthy. It must be noted that under the Solvency II proposal, the mediation mechanism is coupled with the consolidating supervisor having a last say in taking final decisions, which is subject to a specific timeframe.

Policy option 1.4: Develop a lead supervisor model

The lead supervisor model, developed by the European Financial Roundtable[153], is meant to establish a clear decision making process to allow colleges to function more efficiently. It entails significant reallocation of responsibilities from the host to the consolidating supervisor. Under this model, the lead supervisor would be the single point of contact for the credit institution and would be the sole authority for all matters of prudential supervision at the level of the group and its constituents, including, but not limited to, model validations and authorisations, Pillar 2 and Pillar 3 issues and capital allocation. The lead supervisor would make use of the expertise and knowledge of local supervisors / other members of the college and entrust tasks to them by means of the delegation of tasks and, where appropriate, responsibilities. A mediation mechanism at CEBS would be available if disagreements were to arise between the 'lead supervisor' and other members of the college.

Nevertheless, doing away with solo supervision for subsidiaries does not seem viable in the banking sector. The October 2007 Ecofin requested the Commission to address other critical issues such as asset transferability from one entity to another in a group in stressed situations, winding up and reorganisation measures tailored to banking groups first. Indeed, national supervisors remain responsible for the financial stability in their own jurisdiction. This option would result in a misalignment between the host supervisors' financial accountability and their competencies in terms of prudential requirements and, therefore, is not commensurate with the EU financial architecture. In this respect, this option has a particular impact on new MS, where the average asset market share of foreign credit institution subsidiaries (see Chart 1) in 2006 was 59% compared with 11% for EU27[154].

The scope of application of the CRD (including solo supervision for subsidiaries) will be reviewed in the report of the Commission to the Council and Parliament that is due by the end of 2011, according to Article 156 of 2006/48/EC.

Policy option 1.5: Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor

Under this option, the decision-making powers are entrusted to the consolidating supervisor not only for model validation (as it is the case under the CRD) but also in relation to the Pillar 2 process and reporting requirements, i.e., two areas where differences in national approaches are the most costly for cross-border banking groups as discussed in section 3.3.1. The consolidating supervisor would act as a moderator with the power to take decisions. Under this model, a mediation mechanism would be in place at CEBS level to allow for minority views to be taken into account. As in option 1.3, CEBS will have a key role in terms of supervisory convergence across colleges.

This option provides for a clearer decision making process to increase both the effectiveness and the efficiency of supervision while ensuring consistency across colleges. As for option 1.3

---

[153] The European Financial Services Roundtable (EFR), *Monitoring Progress in EU Prudential Supervision*, September 2007.

[154] ECB, *EU Banking Structures*, October 2007

host supervisors will be fully involved and better informed within colleges on group-related supervisory aspects. The mediation mechanisms would provide comfort to host supervisors.

Unlike option 1.4, this approach is compatible with the current supervisory accountability structure in the EU in crisis situations:

– It does not introduce a framework where host authorities would no longer be responsible for supervising subsidiaries of EU parent credit institutions. In particular, while the consolidating supervisors may have a last say in case of disagreement on Pillar 2 capital add-on for subsidiaries, the host supervisor retains the power to require an increase in own funds as part of early intervention measures.

– There would be voluntary but no 'mandatory' delegation of tasks or responsibilities.

Importantly, it must be noted that the conclusions of Ecofin of May 2008 on crisis management principles – including on burden sharing - paves the way for consideration of possible changes between home and host authorities' responsibilities[155]. The agreed Ecofin principles on burden sharing would set the right incentive structures for crisis management. At the same time, building on the progress achieved in terms of burden sharing allows for further alignment of both incentives and responsibilities between home and host supervisors.

Policy option 1.6: An EU financial supervision authority

This option entails different models of supervision (European regulatory agencies, European system of supervisors, single European supervisor). In one way or the other, these models come down to upgrading CEBS to a varying degree: i) in the form of an agency entrusted to take decisions in case of disagreement between authorities or with specific operational tasks, ii) with a particular responsibility for the supervision of large cross-border groups with national authorities being responsible for local banks, iii) a centralised supervision. Each of these sub-options presents its own pros and cons.

Upgrading CEBS to an agency might have the merit of providing further comfort to host supervisors that the consolidating supervision will duly take into account financial stability concerns in all Member States and would not result in further fragmentation. Nevertheless, it must be noted that option 1.5 already addresses these issues. The efficiency of centralised supervision is questionable if compared to that of colleges of supervisors which benefit from the expertise of local supervisors. In addition, a resulting dual' system is likely to create an uneven level playing field between institutions supervised at the European level and those supervised at the national level. Most importantly, a more centralised and direct supervision of banks by European agency does not seem commensurate with the current financial accountability structure and is likely to require a change to the Treaty. Therefore, this option does not lend itself to a thorough assessment at this juncture.

[155] The Ecofin Council of May 2008 agreed that principles and procedures of burden sharing need to be further addressed, inter alia in the implementation of the Memorandum of Understanding (MoU) on Cross-Border Financial Stability: 'Managing a cross-border financial crisis is a matter of common interest for all Member States affected. Where a bank group has significant cross-border activities in different Member States, authorities in these countries will carefully cooperate and prepare in normal times as much as possible for sharing a potential fiscal burden. If public resources are involved, direct budgetary net costs are shared among affected Member States on the basis of equitable and balanced criteria, which take into account the economic impact of the crisis in the countries affected and the framework of home and host countries' supervisory powers".

Policy Option	Party Affected	Impact				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
1.1 Retain current approach	Industry – cross-border banks	Only some improvement of supervisory cooperation for cross-border banking groups	Direct	≈	High	Permanent
	Host supervisors	Only some improvement in supervisory cooperation	Direct	≈	High	Permanent
	Home supervisor	No clarity of how the consolidating supervisor should perform its existing responsibilities and tasks (coordination of supervisory tasks)	Direct	-	High	Permanent
	Financial stability	Some risks to effectively preventing cross-border financial crises	Indirect	-/≈	Low	Permanent
1.2 Formal colleges of supervisors	Industry - cross-border banks	Improved efficiency of supervision, reduction of duplicated and conflicting requirements But risk of unlevel playing field	Direct / Indirect	≈/+	High	Permanent
	Host supervisors	Expected to be better informed and involved, but no mechanisms to ensure that minority views are taken into account	Direct	≈/+	Medium	Permanent
	Home supervisors	Clear framework underpinning the consolidating tasks and responsibilities	Direct	+	Medium	Permanent
	Financial stability	Better preparedness of supervisors for crisis situations and enhanced group-wide approach to crisis prevention	Indirect	+	High	Permanent
1.3. Formal colleges of supervisors with involvement of CEBS	Industry - cross - border banks	Improved efficiency of supervision, reduction of duplicated and conflicting requirements; Increase the level playing field	Direct / Indirect	+	Medium	Permanent
	Host supervisors	Expected to be better informed and involved; Minority views are better reflected, improving effectiveness of the decision-making process	Direct	+	High	Permanent
	Home supervisors	Clear framework underpinning the consolidating tasks and responsibilities	Direct	+	Medium	Permanent
	Financial stability	Better preparedness of supervisors for crisis situations and enhanced group-wide approach to crisis prevention	Indirect	+	High	Permanent
1.4. Develop 'lead supervisor' model	Industry - cross-border banks	Improved competitiveness (intra EU and int'l) resulting from reduced compliance burden	Direct / Indirect	+	High	Permanent
	Host supervisors	Misalignment between financial responsibility and powers	Direct	-	Medium	Permanent
	Home supervisor	Group-wide approach to risk management/prudential requirements	Direct	+	High	Permanent
	Financial stability	Not commensurate with EU financial architecture (no group-wide safety net)	Indirect	-	Medium	Permanent
1.5. Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor	Industry - cross-border banks	Improved competitiveness (intra EU and int'l) resulting from reduced compliance burden	Direct / Indirect	+	High	Permanent
	Host supervisors	Expected to be better informed and involved; Transfer of certain powers to home supervisors	Direct	-/≈	Medium	Permanent
	Home supervisor	Reinforced powers with regard to group-wide approach to risk management / prudential requirements	Direct	+	High	Permanent
	Financial stability	Better preparedness of supervisors for crisis situations and enhanced group-wide approach to crisis prevention	Indirect	+	Medium	Permanent

Conclusion

Option 1.1 (Retain current approach) is discarded as it is not effective in achieving objectives S-1 (Enhance legal certainty), S-2 (Enhance supervisory cooperation), S-3 (Enhance level playing field), S-4 (Reduce compliance burden) and G-1 (Enhance financial stability).). The remaining four options are - to varying degrees – effective with regard to the abovementioned objectives. However, only options 1.3 (Formal colleges of supervisors with involvement of CEBS) and 1.5 (Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor) are deemed to effectively contribute to all of the relevant objectives. Whereas option 1.3 entails a more acceptable approach from the point of view of MS, **option 1.5** is more effective with regard to attaining objective S-4 (Reduce compliance burden) and, therefore, **was retained as the preferred option**.

Policy Option	**Relevant Objectives**						
	S-1 Enhance legal certainty			S-2 Enhance supervisory cooperation	S-3 Enhance level playing field	S-4 Reduce compliance burden	G-1 Enhance financial stability
	Effectiveness (≈/+/++)	Acceptability (≈/+/++)	Consistency (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
1.1 Retain current approach	≈	≈	≈	≈	≈	≈	≈
1.2 Formal colleges of supervisors	+	≈	+	+	≈	+	+
1.3. Formal colleges of supervisors with involvement of CEBS	+	+	++	++	+	+	+
1.4. Develop 'lead supervisor' model	++	≈	≈	+	≈	++	≈
1.5. Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor	++	≈	≈/+	+	+	++	+

3.5.2. Improving supervisory cooperation in crisis situations

The options regarding supervisory cooperation in crisis situations will be referred to in the rest of the analysis as follows:

- Policy option 2.1: Retain current approach

- Policy option 2.2: Assign responsibility and leading role to the consolidating supervisor

- Policy option 2.3: Specification of tasks and mandates of home and host supervisors

- Policy option 2.4: Specification of tasks, mandates and colleges for crisis situations

- Policy option 2.5: Specification of tasks, mandates and interaction with other forums

Policy option 2.1 Retain current approach

This option comes down to developing non-binding agreements to underpin cooperation between supervisors and, where appropriate, with central banks in crisis situations. In other words, the existing CRD requirements to cooperate and coordinate activities in crisis situations will be fleshed out and complemented with a MoU developed by the EFC further to the October 2007 Ecofin conclusions.

In support of this option, it may be argued that further developments and efforts are underway that make legislative changes premature. The 2007 MoU template developed by CEBS and referred to under option 1.1 which includes a section on crisis management, has not been tested yet and is still being developed. Moreover, legally non-binding arrangements might allow for the degree of flexibility required in crisis situations.

Nevertheless, following an EU-level crisis simulation exercise in April 2006, the Ecofin Council noted that efforts should be continued to further deepen the co-operation among relevant authorities. The crisis management framework was expected to evolve, as markets already have done, from purely national concerns to include cross-border component. This challenges the efficiency and effectiveness of legally non-binding approaches to cooperation in crisis situations.

Importantly, it must be noted that the MoU between supervisors, central banks and finance ministries that is being developed by the EFC and potential amendments to the CRD are different in scope and, therefore, complement each other. MoUs are i) voluntary and non-binding, ii) focus on cooperation during a crisis from an operational and practical standpoint and iii) cater for supervisory authorities, finance ministries and central banks. In contrast, the scope of the CRD is on supervisory authorities and relate to the detection of stress situations. The CRD specifies legal obligations to cooperate, to coordinate activities and to exchange information.

Policy option 2.2 Assign responsibility and leading role to the consolidating supervisor

Under this option, the consolidating supervisor would not only 'coordinate' supervisory activities in crisis situations, but also take the lead in the decision making process. While consistent with the current trend towards banking market integration, downsides to this approach are twofold. Firstly, it would not incentivise the consolidating supervisor to take into account the effects of its decision on the financial stability of the host MS. Secondly, it is not commensurate with the current financial stability architecture, where national supervisors are accountable to their national Parliament and Treasury. This issue is of particular relevance to new MS, where the average asset market share of foreign credit institution subsidiaries (see Chart 1) in 2006 was 59% compared with 11% for EU27[156].

Policy option 2.3 Specification of tasks and mandates of home and host supervisors

To cope with the supervisory dilemma (on how to reconcile the goals of stable financial system and integrated financial market with the national financial supervision), a more integration-compatible decentralized financial stability framework could rest on a foundation that places more emphasis on joint responsibility and accountability. In this regard, legislation could impose on supervisors the obligation to have regard to potential impact of their decisions on the stability of the financial system in all MS concerned. This mandate would reduce disincentives to cooperate by creating a clear legal obligation. It would indirectly contribute to minimizing the collective costs facing EU states from potential cross-border bank failures as it would help to facilitate bank crisis resolution solutions by limiting ring fencing behaviour; which may be detrimental to a group as a whole and, therefore, to its stakeholders (such as creditors, shareholders and employees).

This option is compatible with the current European financial stability framework. It addresses disincentives to cooperate, but does not modify the responsibility of home and host authorities to ensure the financial stability in domestic jurisdictions.

Consistent with this mandate, tasks performed by the consolidating supervisor in relation to host supervisors of subsidiaries and systemically relevant branches would be specified. An obligation to come to a joint assessment of a crisis situation and jointly implement contingency plans would further reduce disincentives to cooperate in crisis situation.

Policy option 2.4 Specification of tasks, mandates and colleges for crisis situations

It must be noted that a ‘crisis situation’ does not lend itself to a precise definition. In terms of supervision, crisis prevention and crisis management must be seen as a continuum. In this

[156] ECB, *EU Banking Structures*, October 2007

perspective, colleges in crisis situations would logically complement option 1.3 where colleges are established for going-concern situations. In particular, colleges are useful to best prepare crisis situations (contingency plans), and, as a crisis evolves, to perform and specify the assessment of the crisis.

The question is raised as to whether existing colleges, involving, where appropriate, central banks, can be used to identify and detect possible early sign of stress in a cross-border group and to plan and coordinate supervisory responses. Colleges are only a vehicle for supervisory cooperation and are likely to become less relevant in crisis situations as most decisions would take place elsewhere. Finance ministries are likely to step in should an insolvency crisis arise in accordance with the MoU developed by the EFC. In addition, specifying the form and the structure of cooperation between supervisors and central banks in crisis situation is likely to introduce unintended bureaucracy and reduce the flexibility that may be needed in a crisis situation where time is of essence.

Formal colleges do not seem suited to all crisis scenarios. In case of the financial market turbulence affecting a significant number of banking groups at the same time, the consolidating supervisor would have to organise and chair meetings, which may not prove very effective given the global nature of the crisis. All in all, it does not seem appropriate to require competent authorities to organise crisis management in colleges in a specific and formalised manner.

Policy option 2.5 Specification of tasks, mandates and interaction with other forums

Policy option 2.5 is designed to address the shortcomings of the policy option 2.4. Although colleges will have part to play in a crisis, under this option, legislation would make it clear that other forum (i.e. cross-border standing groups involving in particular Ministries of Finance) will take the lead in reaching certain decisions. Competent authorities participating in colleges, will be expected to have full regard to the work of other forums that will be established under the EFC MoU between supervisors, Ministries and Finance and central banks.

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
2.1 Retain current approach	Industry – cross-border banks	Bank's own crisis solutions may be hindered or prevented	Indirect	-	Medium	Permanent
	Host supervisors	Possible non-cooperative behaviour	Indirect	-	Medium	Permanent
	Home supervisor	Possible non-cooperative behaviour	Indirect	-	Medium	Permanent
	Financial stability	Possible non-cooperative behaviour of national supervisors might hinder efficient crisis resolution	Indirect	-	Medium	Permanent
	Bank creditors	Risk of losses in case of mismanaged crisis	Indirect	-	Low	Permanent
	Bank employees	Risk of losses in case of mismanaged crisis	Indirect	-	Low	Permanent
2.2 Assign responsibility and leading role to the consolidating	Industry – cross-border banks	Facilitate cross-border banks' crisis solutions	Indirect	+	Medium	Permanent
	Host supervisors	Misalignment between financial responsibility and powers	Direct	-	Medium	Permanent
	Home supervisor	May facilitate home supervisors' tasks but misfit between home's financial responsibility and powers	Direct	≈	Medium	Permanent
	Financial stability	May be detrimental to the financial stability of host country	Indirect	-	Medium	Permanent
	Bank creditors	May have negative implications to creditors in host countries	Indirect	≈/+	Low	Permanent

Policy Option	Party Affected	Impact				
		Description	Type (D/I)	Effect (-/≈/+)	Likelihood (L/M/H)	Timing (S/L/P)
supervisor	Bank employees	May have negative implications to employees in host countries	Indirect	≈/+	Low	Permanent
2.3 Specification of tasks and mandates of home and host supervisors	Industry – cross-border banks	Facilitate cross-border banks' crisis solutions	Indirect	+	Medium	Permanent
	Host supervisors	Clarified tasks	Direct	+	Medium	Permanent
	Home supervisor	Clarified tasks	Direct	+	Medium	Permanent
	Financial stability	Improved crisis management framework – coordinated decisions	Indirect	+	Medium	Permanent
	Banks creditors	Better protection due to improved crisis management	Indirect	+	Medium	Permanent
	Bank employees	Better protection due to improved crisis management	Indirect	+	Medium	Permanent
2.4 Specification of tasks, mandates and colleges for crisis situations	Industry – cross-border banks	Facilitate cross-border banks' crisis solutions	Indirect	+	Medium	Permanent
	Host supervisors	Enhanced cooperation, but possible lack of flexibility	Direct	≈/+	Medium	Permanent
	Home supervisor	Enhanced cooperation, but possible lack of flexibility	Direct	≈/+	Medium	Permanent
	Financial stability	Improved crisis management framework – coordinated decisions, but possible lack of flexibility	Indirect	≈/+	Medium	Permanent
	Bank creditors	Better protection due to improved crisis management	Indirect	+	Low	Permanent
	Bank employees	Better protection due to improved crisis management	Indirect	+	Low	Permanent
2.5 Specification of tasks, mandates and interaction with other forums	Industry – cross-border banks	Facilitate cross-border banks' crisis solutions	Indirect	+	High	Permanent
	Host supervisors	Enhanced cooperation	Direct	+	High	Permanent
	Home supervisor	Enhanced cooperation	Direct	+	High	Permanent
	Financial stability	Improve crisis management framework – coordinated decisions	Indirect	+	High	Permanent
	Bank creditors	Better protection due to improved crisis management	Indirect	+	Low	Permanent
	Bank employees	Better protection due to improved crisis management	Indirect	+	Low	Permanent

Conclusion

Option 2.1 (Retain current approach) is discarded as it is not effective in achieving objectives S-1 (Enhance legal certainty), S-2 (Enhance supervisory cooperation), S-3 (Enhance level playing field), G-1 (Enhance financial stability) and G-2 (Enhance safeguarding of creditors). Policy option 2.2 (Assign responsibility and leading role to the consolidating supervisor) is effective only with regard to objective S-1, and, in addition, not acceptable to all stakeholders. Options 2.3 (Specification of tasks and mandates of home and host supervisors), 2.4 (Specification of tasks, mandates and colleges for crisis situations) and 2.5 (Interaction between colleges and other forums) are all effective – to varying degrees – with respect to the relevant objectives shown in the below comparison table. They are also comparable in terms of consistency of their impacts across key stakeholder groups. Nevertheless, **option 2.5 (Specification of tasks, mandates and interaction with other forums)** seems to be marginally more effective with regard to attaining objectives G-1 and G-2 and is retained as the preferred option.

Policy Option	Relevant Objectives					
	S-1 Enhance legal certainty			S-2 Enhance supervisory cooperation	G-1 Enhance financial stability	G-2 Enhance safeguarding of creditors
	Effectiveness (≈/+/++)	Acceptability (≈/+/++)	Consistency (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
2.1 Retain current approach	≈	≈	≈	≈	≈	≈
2.2 Assign responsibility and leading role to the consolidating supervisor	+	≈	≈	≈	≈	≈
2.3 Specification of tasks and mandates of home and host supervisors	+	++	+	++	+	+
2.4 Specification of tasks, mandates and colleges for crisis situations	+	+	+	++	+	+
2.5 Specification of tasks, mandates and interaction with other forums	+	++	+	++	++	+

3.5.3. Access to information for host supervisors of systemically relevant branches

The options regarding asymmetries of information between home and host authorities with regard to systemically relevant branches will be referred to in the rest of the analysis as follows:

- **Policy option 3.1:** Retain current approach

- **Policy option 3.2:** Further access to information in crisis situations

- **Policy option 3.3:** Further access to information in crisis situations and involvement in colleges of supervisors

Policy option 3.1 Retain current approach

Under the CRD, specific information exchange requirements only apply to legal entities (i.e., subsidiaries) within a group. Information sharing arrangements are far less comprehensive for branches. Supervisors of branches that are significant for the stability of the banking system of a host MS may receive little information about these establishments (see section 3.3.2).

The CRD already requires host and home supervisors to collaborate, but does not specify which information shall be passed on as opposed to existing requirements for subsidiaries. This general obligation is complemented with networks of MoUs. These MoUs are not legally binding, and so they do not provide strong enough incentives to cooperate.

Policy option 3.2 Further access to information in crisis situations

As access to information by host competent authorities currently relies on the willingness of a home MS to share it, specific information requirements would reduce asymmetries of information between host and home supervisors. This holds true particularly in 'stressed' situations where informal information exchange agreements may not prove effective. Under this option, the home authority will be required in particular to pass on information pertaining to adverse developments in the credit institution.

While reducing asymmetries of information – should a crisis arise – host supervisor will have a rather passive role in receiving information, and will not necessarily be involved upstream.

Policy option 3.3 Further access to information in crisis situations by involvement in colleges of supervisors

Supervisors of systemic relevant branches might be invited to participate in meetings of colleges where the home supervisor considers in particular that its decision may impact the financial stability in the host MS. Participation of host supervisors of significant branches in colleges might effectively ensure that they receive information that is relevant for the stability of their financial system.

However, colleges involving host supervisors of systemically relevant branches in all circumstances might have negative implications on their efficiency. To counter it, host supervisors could be invited according to the relevance of the issue to be planned or coordinated, and in view of the impact of possible decisions on the financial stability in the host MS. A flexible composition of colleges, depending on the type of issues to be discussed, is needed to avoid any substantial additional administrative burden to supervisors.

In the same vein, where systemically relevant branches are not part of a cross-border banking group with subsidiaries in other MS, colleges will further enhance information exchange and cooperation between home and host authorities.

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
3.1 Retain current approach	Industry	Possibility of spill-over effects in the host MS	Indirect	-	Medium	Permanent
	Host supervisors	Asymmetries of information hinder effective execution of responsibilities	Direct	-	Medium	Permanent
	Financial stability	Asymmetries of information may give rise to uncooperative behaviour and increase risks to financial stability	Indirect	-	Medium	Permanent
3.2 Further access to information in crisis situations	Industry	Reduced risk of spill-over effects in the host MS	Indirect	+	Medium	Permanent
	Host supervisors	Reduced asymmetries of information	Direct	+	Medium	Permanent
	Financial stability	Reduced asymmetries of information lower the risks to financial stability	Indirect	+	Medium	Permanent
3.3 Further access to information by involvement in colleges of supervisors	Industry - large banks	Reduced risk of spill-over effects in the host MS	Indirect	+	High	Permanent
	Host supervisors	Reduced asymmetries of information	Direct	+	High	Permanent
	Financial stability	Reduced asymmetries of information lower the risks to financial stability	Indirect	+	High	Permanent

Conclusion

Policy option 3.1 (Retain current approach) is discarded as it is not effective in achieving objectives S-1 (Enhance legal certainty), S-2 (Enhance supervisory cooperation) and G-1 (Enhance financial stability). **Option 3.3 (Further access to information in crisis situations by involvement in colleges of supervisors)** is retained as the preferred option as it is more effective than option 3.2 (Further access to information in crisis situations) with regard to achieving objectives S-2 and G-1, even though it could be less efficient than option 3.2 due to its higher implementation costs for supervisors. Also, the acceptability of the two latter options varies across MS in each case, depending on whether they are predominantly host or home supervisors of systemically relevant branches.

Policy Option	Relevant Objectives				
	S-1 Enhance legal certainty		S-2 Enhance supervisory cooperation		G-1 Enhance financial stability
	Effectiveness (≈/+/++)	Acceptability (≈/+/++)	Effectiveness (≈/+/++)	Efficiency (≈/+/++)	Effectiveness (≈/+/++)
3.1 Retain current approach	≈	≈	≈	≈	≈
3.2 Further access to information in crisis situations	+	≈/+	+	+	+
3.3 Further access to information in crisis situations by involvement in colleges of supervisors	+	≈/+	++	≈	++

3.5.4. Determination of which branches are systemically relevant

The retained policy option 3.3 (Further access to information in crisis situations by involvement in colleges of supervisors) in the preceding discussion on systemically relevant branches raises a question as to how and by whom the systemic relevance of cross-border branches should be determined. To this end, the following options have been defined and evaluated:

- **Policy option 4.1:** Limited list of criteria

- **Policy option 4.2:** Open list of criteria and determination by host supervisor

- **Policy option 4.3:** Open list of criteria and determination by home supervisor

Policy option 4.1: Limited list of criteria

Under this option, home and host authorities would be required to liaise together to define which branch is significant based on specific criteria. Having regard to the legal obligations that a systemically relevant branch entails (i.e., possible participation in colleges, greater access to information which will be made explicit in the suggested amendments under option 3.3), there would be merit in specifying which criteria should be taken into account. On the other hand, a limited list of quantitative criteria (e.g., domestic market share in terms of deposits) or qualitative criteria (e.g., possible impact of a closure of a credit institution on the payment and settlement systems in the host MS) risks resulting in arbitrary decisions and might not necessarily address all crisis scenarios.

Policy option 4.2: Open list of criteria and determination by host supervisor

From the crisis management standpoint, the notion of a 'systemic branch' relates to the potential impact of a crisis on the financial stability in a host MS, and not to the significance of such branch to its parent credit institution. Ideally, the existence of systemically relevant branches could be determined jointly by home and host authorities. In case of disagreement, host supervisors seem to be better placed to assess the systemic relevance of branches. Downside to this approach is the risk that the effectiveness of the decision making process in colleges might be undermined if too many authorities were involved in their activities. Nevertheless, the determination of systemically relevant branches by host supervisor does not mean that all host supervisors will participate in all meetings of the colleges. The efficiency of this option would be enhanced by entrusting the consolidating supervisor with the right to choose which authority participates in college meetings depending on the relevance of the issues to be discussed. Participation of host supervisors is particularly relevant in crisis situations.

Policy option 4.3 Open list of criteria and determination by home supervisor

Entrusting the home authority with the last say in the decision making process would be consistent with the EU supervisory framework based on supervision on a consolidated basis and the country of origin principle. Nevertheless, the determination of 'systemically relevant branches' relates to the financial stability in a host country and does not pertain to the significance of a branch within a group.

Policy Option	Party Affected	Impact				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
4.1 Limited list of criteria	Host supervisors	Not all 'systemic' situations captured; preventing host supervisor from gaining access to relevant information	Indirect	-	Medium	Permanent
	Financial stability	Not all 'systemic' situations captured exposing domestic financial stability to risks	Indirect	-	Medium	Permanent
4.2 Open list of criteria and determination by host supervisor	Host supervisors	More accurate assessments of systemic relevance yielding access to necessary information	Direct / Indirect	+	Medium	Permanent
	Home supervisor	Decision making process in colleges may be impeded	Indirect	-	Medium	Permanent
	Financial stability	Risks to domestic financial stability lowered	Indirect	+	Medium	Permanent
4.3 Open list of criteria and determination by home supervisor	Host supervisors	More accurate assessments of systemic relevance yielding access to necessary information	Direct / Indirect	≈/+	Medium	Permanent
	Home supervisor	Decision making process in colleges not altered	Indirect	≈	Medium	Permanent
	Financial stability	Risks to domestic financial stability lowered to the extent that assessment of systemic relevance is effective	Indirect	+	Medium	Permanent

Conclusion

Policy option 4.1 (Limited list of criteria) could be the most effective of the three options in terms of achieving objective S-1 (Enhance legal certainty) since under it systemically relevant branches would be determined according to known specific criteria, however, it is the least effective in terms of contributing to objective G-1 (Enhance financial stability) due to its inherent lack of flexibility and accuracy. **Option 4.2 (Open list of criteria and determination by host supervisor)** is retained as the preferred option as it is effective with respect to achieving the relevant objectives shown in the below comparison table. Even though it could be less efficient than option 4.3 (Open list of criteria and determination by home supervisor) due to its implications for the decision making process in colleges, it is more effective than option 4.3 with regard to objective G-1, as host supervisors are in a position to come up with more accurate assessments of branch systemic relevance for host MS. The acceptability of the two latter options varies across MS in each case, depending on whether they are predominantly host or home supervisors of systemically relevant branches.

Policy Option	Relevant Objectives				
	S-1 Enhance legal certainty		S-2 Enhance supervisory cooperation		G-1 Enhance financial stability
	Effectiveness (≈/+/++)	Acceptability (≈/+/++)	Effectiveness (≈/+/++)	Efficiency (≈/+/++)	Effectiveness (≈/+/++)
4.1 Limited list of criteria	++	+	+	≈	≈
4.2 Open list of criteria and determination by host supervisor	+	≈/+	+	+	++
4.3 Open list of criteria and determination by home supervisor	+	≈/+	+	++	+

3.5.5. *Exchange of information between central banks, finance ministries and supervisors*

The options regarding the exchange of information between central banks, finance ministries and supervisors will be referred to in the rest of the analysis as follows:

- **Policy option 5.1:** Retain current legal framework

- **Policy option 5.2:** Allow supervisors to exchange information with central banks and finance ministries in all MS concerned

Policy option 5.1 Retain current legal framework

The current legal framework may be sub-optimal for a smooth crisis management process which may involve not only competent authorities but also central banks or finance ministries of MS where an entity or a systemically significant branch of a banking group is located. In keeping the current legal framework, the risk is run that supervisors may object to sharing information because this may be communicated to third parties (e.g. central banks and finance ministries). This would undermine the current efforts of the EFC to further enhance the European financial stability framework by developing cross-border standing groups involving central banks, finance ministries and supervisors to deal with crisis situations in line with the conclusions of October 2007 Ecofin meeting.

Policy option 5.2 Allow supervisors to exchange information with central banks and finance ministries in all MS concerned

This option is consistent with the existing obligation under Article 130 of the CRD to alert central banks and finance ministries. Under this option, competent authorities would be also required to pass on all relevant information in crisis situations. This option legally underpins the creation of cross-border standing groups between supervisors, central banks and finance ministries being led by the EFC. It is meant to reduce legal uncertainty and remove legal obstacles, and would not thus entail additional administrative burden to supervisors.

Policy Option	Party Affected	Impact				
		Description	Type (D/I)	Effect (-/≈/+)	Likelihood (L/M/H)	Timing (S/L/P)
5.1 Retain current legal framework	Central banks and finance ministries	No clear gateways and possible impediments to information exchange	Indirect	-	Medium	Permanent
	Supervisors	Ability to handle sensitive information	Direct	≈	Medium	Permanent
	Financial stability	May be detrimental to financial stability – possible source of non-cooperative	Indirect	-	Medium	Permanent

Policy Option	Party Affected	Impact				
		Description	Type (D/I)	Effect (-/≈/+)	Likelihood (L/M/H)	Timing (S/L/P)
		behaviour				
5.2 Require supervisors to exchange information with central banks and finance ministries	Central banks and finance ministries	Enhanced access to relevant information e	Indirect	+	Medium	Permanent
	Supervisors	Some information sharing costs involved; Risks pertaining to handling of sensitive information	Direct	-	Low	Permanent
	Financial stability	Clear legal framework, more effective crisis management efforts; better containment of economic / social costs for various actors	Indirect	+	Medium	Permanent

Conclusion

Policy option 5.2 (Require supervisors to exchange information with central banks and finance ministries) is retained as the preferred option as it is more effective than option 5.1 (Retain current legal framework) in contributing to the achievement of objective G-1 (Enhance financial stability) by facilitating multilateral information sharing between supervisors and central banks and finance ministries in crisis situations.

3.5.6. Summary of preferred policy options and their impacts on stakeholders

The following table summarizes the policy option sets discussed in the previous sections. Individual options within each set are ranked in terms of their relative effectiveness, efficiency, consistency and acceptability with regard to achieving relevant objectives. Preferred policy option(s) of each policy option set are highlighted.

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria			
			Effectiveness	Acceptability	Consistency	Efficiency
Improving cooperation arrangements in going-concern situations	S-1 Enhance legal certainty S-2 Enhance supervisory cooperation S-3 Enhance level playing field S-4 Reduce compliance burden G-1 Enhance financial stability	1.1 Retain current approach	5	2	4	
		1.2 Formal colleges of supervisors	4	2	2	
		1.3 Formal colleges of supervisors with involvement of CEBS	2	1	1	
		1.4 Develop a lead supervisor model	3	2	4	
		1.5 Formal colleges of supervisors with involvement of CEBS and reinforced powers of consolidating supervisor	1	2	3	
		1.6 EU financial supervision authority**				
Improving supervisory cooperation in crisis situations	S-1 Enhance legal certainty S-2 Enhance supervisory cooperation G-1 Enhance financial stability G-2 Enhance safeguarding of creditor interests	2.1 Retain current approach	4	3	2	
		2.2 Assign responsibility and leading role to the consolidating supervisor	3	3	2	
		2.3 Specification of tasks and mandates of home and host supervisors	2	1	1	
		2.4 Specification of tasks, mandates and colleges for crisis situations	2	2	1	
		2.5 Specification of tasks, mandates and interaction with other forums	1	1	1	
Access to information for host supervisors of systemically relevant branches	S-1 Enhance legal certainty S-2 Enhance supervisory cooperation G-1 Enhance financial stability	3.1 Retain current approach	3	2		2
		3.2 Further access to information in crisis situations	2	1		1
		3.3 Further access to information in crisis situations by involvement in colleges	1	1		2
Determination of which branches are systemically	S-1 Enhance legal certainty S-2 Enhance supervisory cooperation	4.1 Limited list of criteria	2	1		2
		4.2 Open list of criteria and determination by host supervisor	1	2		2

Policy Option Set	Relevant Objectives	Policy Options	Policy Option Comparison Criteria			
			Effectiveness	Acceptability	Consistency	Efficiency
relevant	G-1 Enhance financial stability	4.3 Open list of criteria and determination by home supervisor	2	2		1
Exchange of information b/w central banks, finance ministries and supervisors	G-1 Enhance financial stability	5.1 Retain current approach	2			
		5.2 Require supervisors to exchange information with central banks and finance ministries	1			

** Option not ranked as it was discarded early in the analysis as not feasible
Scale of option ranking: 1=highest, 5=lowest

The combined impact of the preferred policy options (1.5, 2.5, 3.3, 4.2 and 5.2) on the main stakeholder groups is expected to yield the following effects:

- For the cross-border banking groups, the proposed options will increase the overall efficiency of supervision in going-concern situations by limiting conflicting and overlapping requirements, as supervisors will be required to consistently apply key supervisory principles within a banking group. This would be underpinned by a clear decision making process; the latter would allow the consolidating supervisor to have the last say in case of disagreement on additional capital requirements for subsidiaries (Pillar 2 measures) and reporting requirements (option 1.5). Moreover, stronger supervisory convergence ensuing from CEBS' involvement in the monitoring of colleges' practices should enhance level playing field conditions for the cross-border banks. In crisis situations, the banking industry will benefit from enhanced supervisory cooperation and more clear allocation of responsibilities among various actors involved as more optimal crisis management solutions are facilitated (option 2.5).

- For supervisors, the preferred options first and foremost will work to increase their cooperation both in going-concern (option 1.5) and crisis situations (option 2.5) by allowing for better access to information and involvement in colleges of host supervisors (option 3.3), while ensuring the effectiveness of supervisory measures where key cross-border supervisory issues are at stake. The tasks of the consolidating home supervisors chairing colleges will be clarified (option 1.5). Operational efficiency of colleges in part will be controlled by the consolidating supervisors' right to determine which authorities participate in individual meetings and activities. The introduction of a mediation mechanism in case of disagreements between competent authorities would provide comfort to host authorities (option 1.5).

- The proposed changes will also enhance financial stability, as signs of stress will be detected earlier in a college-type environment. This will allow the development of joint contingency plans and crisis assessments, reinforcing the EU system of crisis prevention (option 1.5). Although colleges of supervisors will have a part to play in crisis situations, work of other forums such as cross-border stability group established under the EFC's[157] Memorandum of Understanding and involving finance ministries and networks of central banks would take the lead in reaching certain decisions (option 2.5), underpinned by improved information exchange between supervisors, central banks and finance ministries in crisis situations (option 5.2). Financial stability in host MS of systemically relevant

[157] EFC - the Economic and Financial Committee conducts preparatory work for the Council of the European Union on the economic and financial situation, the euro exchange rate and relations with third countries and international institutions. This advisory committee also provides the framework for preparing and pursuing the dialogue between the Council and the ECB.

branches will be enhanced by better access to the relevant information on behalf of host supervisors (options 3.3 and 4.2). More concerted responses to crisis situations will effectively help to minimize the ensuing economic and social costs for bank creditors, employees and shareholders, and, eventually, taxpayers.

4. DEROGATIONS FOR BANK NETWORKS FROM CERTAIN PRUDENTIAL REQUIREMENTS

4.1. Background

Article 3 of Directive 2006/48/EC allows Member States to establish derogations from certain requirements laid down by the directive for domestic credit institutions *permanently affiliated to a central body*, provided that:

(1) the central body fully guarantees the commitments of its affiliates or is jointly and severally liable along with them for their commitments,

(2) the central body's and affiliates' solvency and liquidity are supervised on a consolidated basis,

(3) the central body has the power to issue instructions to the management of its affiliates.

When these conditions are met, affiliated credit institutions do not have to present a business plan[158] and are not required to have two directors[159] in order to get authorized to conduct their activities. Initial and ongoing capital requirements[160] as well as provisions governing risk management, large exposures and qualified holdings may be applied to the central body and its affiliates as a group rather than individually[161]. In this case, the freedom of establishment and the free provision of services are exercised by the group as a whole.

The rationale behind the derogation is that when legally separate credit institutions are affiliated to a central body in conformance with the above conditions (1), (2), and (3), the economic behaviour of such an organizational network closely resembles that of a single entity. Therefore, from a prudential point of view, it is sensible to treat such legally separate credit institutions as branches by exempting them from the aforementioned CRD provisions.

The current Article 3 was introduced by the First Banking Co-ordination Directive 77/780/EEC and has been reproduced unchanged in the following recasts (Directive 2000/12/EC and Directive 2006/48/EC). The provision set the time limits for its application. In order to be eligible for the derogations, credit institutions had to be affiliated to a central body by 15 December 1977 and the regimes implementing it in national law had to be in place by 15 December 1979. At the time of its introduction, the proposed regime was applied to cooperative banks[162] only, therefore, it seems that the restriction of its scope to the then existing institutions was motivated by the concern of some MS that it might lead to an unrestrained increase in the number of credit institutions benefiting from it.

The above ‘eligibility dates’ imply that, unless stated otherwise in the accession treaties, the derogations can technically be applied only in those MS that joined the EU before 1980, i.e., the founding members and DK, IE and UK. Currently, the provision is applied in the EU only by cooperative bank networks.

---

[158] Article 7 of Directive 2006/48/EC

[159] Article 11 (1) of Directive 2006/48/EC

[160] Articles 9 and 10 of Directive 2006/48/EC

[161] Title 5, Chapter 2, Sections 2 to 6 and Chapter 3 of Directive 2006/48/EC

[162] The introduction of this regime was requested by the Netherlands which applied it at the time (and still is) to a co-operative bank organisation.

4.2. Problem definition

Driver: Necessary adaptations of the 'eligibility dates' have not been provided for in the accession treaties Problem: Cooperative bank networks in the post-1979 accession MS face higher regulatory compliance costs

Currently, cooperative banks located in the MS that acceded to the EU after 1979 cannot benefit from the derogations as the respective accession treaties did not include the necessary adaptations of the Article 3 'eligibility dates'[163]. As a result, cooperative bank groups/networks with assets over €477 billion and representing nearly 10 million members[164] in twelve MS (see Table 1) are potentially affected, assuming they are organized in structures meeting the aforementioned conditions (1), (2), and (3) (see section 4.1ally, such cooperative bank networks are potentially exposed to higher compliance costs than is warranted from the prudential supervision standpoint. They have to hold more initial and ongoing capital at the level of each affiliate, each affiliate is required to have at least two business directors and incurs the costs of complying with the provisions on credit risk and operational risk management, large exposures, qualifying holdings and internal assessment process at a solo level. Effectively, such direct compliance costs might get passed onto cooperative members (as both clients and owners) and non-member clients.

Table 1: Cooperative banks in post-1979 accession member states (2006)

Member State	Accession Year	Members (est. 000's)	Clients (est. 000's)	Assets (bln euro)	Asset Mkt Share, %
EL	1981	176	176	2,6	0,8%
ES *	1986	1.912	9.878	96,2	3,8%
AT	1995	2.330	5.100	287,4	36,4%
FI *	1995	1.160	4.000	59,5	23,3%
SE	1995	58	69	4,6	0,6%
CY *	2004	535	600	9,7	13,1%
HU	2004	250	1.000	4,5	4,8%
LT	2004	69	69	0,2	0,9%
PL	2004	2.500	10.500	11,0	5,8%
SI	2004	0	173	0,6	1,8%
BG	2007	6	741	0,6	2,6%
RO *	2007	760	1.104	0,2	0,3%
Total		**9.755**	**33.409**	**477,1**	**8,9%**

* Member states in breach of the directive
Source: European Association of Cooperative Banks, ECB

Furthermore, the obligation to comply with the capital requirements at an affiliate level means that each affiliate has to hold a capital base of at least 8% of its risk weighted assets. In contrast, the requirement at a group level would allow for more flexibility in financial management, resulting in greater efficiency. Therefore, the costs of compliance with capital requirements at an affiliate level can be viewed as opportunity costs as they represent a foregone possibility of a more productive use of capital.

As individual cooperative banks in most MS tend to be small, these costs are likely to be significant for them. Therefore, greater efficiency resulting from having to meet certain

163 Except for Portugal where the amendment was carried out

164 Cooperative banks are normally established based on their member capital contributions. However, some cooperative networks also access public capital markets for additional funding.

prudential requirements at a group/network level would allow them to strengthen their competitiveness against bigger domestic and cross-border banks.

Driver: Incorrect transposition of the 'eligibility dates' by certain MS Problem: Cost increases for cooperative banks using the derogation if the directive provisions are enforced

Certain MS which acceded to the EU after 1979 have implemented the derogations in their national law based on the understanding that the 'eligibility dates' could be interpreted as the date of their accession or some other date different from those set out in the article. Even though in line with the spirit of Article 3, from a legal point of view, this is in breach of the directive. According to the information made available to the Commission services, out of the ten MS that applied Article 3 in 2007, only five (BE, FR, LU, NE and DK) had joined the EU before 1980. In the case of PT, its accession treaty provides for the adaptation of 'eligibility dates' of Article 3. The remaining four MS (ES[165], FI, CY and RO) were applying it in contradiction of the directive since their EU accession treaties had not adjusted the time limits laid down in the article.

In 2007 the derogations were used by 11 cooperative bank groups: eight of them in the compliant and three in the non-compliant MS. The three cooperative networks that benefit from the regimes adopted after 1979 are shown in Table 1. In terms of their activities, some of these banks operate in the agricultural credit sector, while others operate in retail banking with private customers and SMEs. In addition, the Commission has been made aware that one more bank organisation has applied for being authorised to make use of the derogations in these MS.

The abolition of the derogations in the four non-compliant MS would negatively affect the banks using these regimes, as they would incur higher compliance costs as explained earlier. Consequently, they would be put at a competitive disadvantage vis-à-vis competitors of, in principle, comparable organizational set-up to whom the prudential requirements would not be applicable. Also, indirectly affected would be some 2.5 million members and 6 million clients (member and non-member) of the concerned cooperative banks.

4.3. Objectives

In light of the problems presented in the previous section, one operational and three specific objectives have been identified (see table below). Effective realization of the operational objective is expected to contribute to the achievement of the longer-term specific policy objectives. In turn, this should contribute to the attainment of the general policy objective of *Further promoting the internal banking market integration (G-4).*

Problem Drivers	Operational Objectives	Specific Objectives		
		S-1 Enhance legal certainty	**S-3** Enhance level playing field	**S-4** Reduce compliance burden
Necessary adaptations of the 'eligibility dates' have not been provided for in the accession treaties Incorrect transposition of the 'eligibility dates' by certain MS	**O-1** Enable eligible banks in post-1979 accession member states to benefit from the Article 3 derogations	√	√	√

[165] Spain has transposed the regime, but had no Article 3 users.

4.4. Policy option analysis and comparison

Under Article 3, the exemption may only be granted to banks that were established by 15 December 1977 while meeting the qualifying criteria by 15 December 1979. Certain MS have transposed these dates as the date of their accession to the EU or other dates differing from those set out in the article. Although this approach is in line with the spirit of the directive, from a legal point of view, granting these exemptions after the time limits constitutes a breach of the directive.

Strict application of the eligibility dates would prevent banks in MS that have joined the EU after 1979 from using the exemptions, even if they were organized in networks meeting the qualitative eligibility criteria laid down by Article 3, and would effectively subject them to higher compliance costs.

The following three policy options have been examined:

- **Policy option 1:** Retain and enforce current text of Article 3

- **Policy option 2**: Amend Article 3

- **Policy option 3**: Remove 'eligibility dates' from Article 3

Policy option 1: Retain and enforce current text of Article 3

Under this option, the current text of Article 3 of the CRD is retained. This implies that the Commission would have to enforce Article 3 in the five MS that have implemented it after the time limits.

This policy option would not be effective in ensuring a level playing field. Credit institutions organised in structures meeting the eligibility criteria laid down by Article 3 and established in the MS that have joined the EU and implemented the article before 1979 would continue to benefit from the derogations while credit institutions organised in the same way but established in the MS that acceded later would not enjoy the same treatment. As a result of lower compliance costs, the organisations that use the exemptions would have a competitive advantage vis-à-vis those that cannot use them, especially in view of the fact that the right of establishment (opening branches) and service provision in other MS belongs to a network of the central body and its affiliates as a whole, rather than its individual entities, when they are subject to supervision under Article 3.

Enforcing Article 3 does not seem to be appropriate as the regimes adopted after 1979 regulate situations that are in line with the rationale behind the original provisions of the article.

This policy option would not thoroughly provide for legal certainty throughout the EU as similar banking structures would be subjected to different capital requirements and supervisory regimes depending on the date of accession of the MS concerned.

Policy option 2: Amend Article 3

This option aims at amending Article 3 by introducing the respective accession dates as 'eligibility dates' for the MS that have joined the EU after 1979. However, this possibility would not resolve the problems discussed for all MS concerned, as some of them (e.g., FI) have introduced the regime after their accession date. In addition, other MS that have never implemented Article 3 and would be interested in implementing it - irrespective of their accession date - would be prevented from doing so.

Policy option 3: Remove 'eligibility dates' from Article 3

This option aims at deleting the time limits in Article 3 that were originally set out by the First Banking Coordination Directive. It would allow the MS that have joined the EU after 1979 to make use of the provision. Firstly, it would regularize the situation in the four MS which have implemented Article 3 in their legal systems after the time limits. As a consequence, all bank organisations that are currently using the exemption regimes, would be able to continue to use them, benefitting from more flexibility in capital management. Secondly, other MS which have not yet implemented Article 3 could implement it in their national law irrespective of the date of their accession to the EU. This would open a possibility for other bank organisations in the EU to become subject to the supervisory treatment under the article, assuming they meet the eligibility criteria, effectively reducing their regulatory compliance costs and enhancing the level playing field conditions in the internal banking market.

In post-1979 accession MS, extension of the Article 3 derogations to cooperative banks should strengthen their competitiveness vis-à-vis domestic and cross-border commercial banks.

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
1. Retain and enforce current text of Article 3	Cooperative banks - post 1979 accession MS	Higher compliance costs for banks in MS that have implemented the derogations after 1979 (resulting from the enforcement of the directive); Higher than warranted compliance costs for banks in MS where accession treaties do not provide for this possibility to use Article 3	Direct	-	High	Permanent
	Cooperative banks - prior 1980 accession MS	Competitive edge vis-à-vis cooperatives in the post-1979 accession MS to the extent that the two groups compete	Indirect	≈/+	Low	Permanent
	Cooperative bank members / clients – post 1979 accession MS	Affected negatively to the extent that higher than warranted compliance costs get reflected in pricing	Indirect	-/≈	Medium	Permanent
	Commercial banks – post 1979 accession MS	Competitive edge vis-à-vis cooperatives	Indirect	≈/+	Low	Permanent
	Supervisors - post 1979 accession MS	Cost increases in MS that are breaching the directive (resulting from its enforcement), due to more supervised institutions	Direct	-	Low	Permanent
	Economy	Forgone possibilities of a more productive use of capital in cooperative sectors	Indirect	-/≈	Low	Permanent
2 Amend Article 3	Cooperative banks - post 1979 accession MS	Level of compliance costs reduced only for institutions in those MS that implemented the regime on their accession	Direct	≈/+	High	Permanent
	Cooperative bank members / clients – post 1979 accession MS	Benefit to the extent that compliance cost level is maintained in MS that implemented the regime on their accession	Indirect	≈/+	Medium	Permanent
	Commercial banks – post 1979 accession MS	Competitiveness vis-à-vis cooperatives declines in those MS that implemented the regime on their accession	Indirect	-/≈	Low	Permanent
	Supervisors - post 1979 accession MS	Cost reduction in MS that implemented the regime on their accession due to fewer institutions supervised	Direct	≈/+	Low	Permanent
	Economy	Fewer forgone possibilities of a more productive use of capital in cooperative sector (in MS that implemented the regime on their accession)	Indirect	≈/+	Low	Long-term
3. Remove	Cooperative banks - post 1979 accession MS	Level of compliance costs reduced to the level that is warranted; Improved competitiveness vis-à-vis other banks	Direct	+	High	Permanent

Policy Option	Party Affected	Impact				
		Description	Type (D/I)	Effect (-/≈/+)	Likelihood (L/M/H)	Timing (S/L/P)
'eligibility dates' from Article 3	Cooperative banks - prior 1980 accession MS	Competitiveness vis-à-vis cooperatives in the post-1979 accession MS declines to the extent that the two groups compete	Indirect	-/≈	Low	Permanent
	Cooperative bank members / clients – post 1979 accession MS	Benefit to the extent that compliance cost level declines for banks that adopt the regime	Indirect	+	Medium	Permanent
	Commercial banks – post 1979 accession MS	Competitiveness vis-à-vis cooperatives declines	Indirect	-	Low	Permanent
	Supervisors - post 1979 accession MS	Lower costs due to fewer institutions supervised	Direct	≈/+	Low	Permanent
	Economy	Fewer forgone possibilities of a more productive use of capital in cooperative sector	Indirect	+	Low	Long-term

Conclusion

Option 1 (Retain and enforce current text of Article 3) was discarded as it is not effective with respect to objectives S-3 (Enhance level playing field), S-4 (Reduce compliance costs) and G-4 (Further promote the Internal Market integration). Option 2 (Amend Article 3) is marginally more effective than option 1 in achieving the above objectives S-4 and G-4 but is not effective with regard to attaining objective S-3.

Option 3 (Remove 'eligibility dates' from Article 3) has been retained as the best option since it is the most effective in contributing to all four objectives. Moreover, it is expected to achieve better consistency across member states, as current distributional imbalances (pre- vs. post-1979 accession MS) should effectively be minimized.

Policy Option	Relevant Objectives				
	S-1 Enhance legal certainty	S-3 Enhance level playing field	S-4 Reduce compliance costs		G-4 Further promote IM integration
	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Consistency (≈/+/++)	Effectiveness (≈/+/++)
1. Retain and enforce current text of Article 3	+	≈	≈	≈	≈
2. Amend Article 3	+	≈	+	≈/+	≈/+
3. Remove 'eligibility dates' from Article 3	++	++	++	+	++

5. LIFE INSURANCE AS ELIGIBLE COLLATERAL

5.1. Background

Article 90 of Directive 2006/48/EC allows credit institutions to recognise certain credit risk mitigation techniques to reduce their capital requirements for credit risk when they use the Standardised Approach under Articles 78 to 83 or the Internal Ratings Based (IRB) approach under Articles 84 to 89 but not using their own estimates of loss given default. Annex VIII spells out the concrete conditions and methodologies for doing so. In principle, the annex allows for life insurance policies pledged to the lending credit institution to be recognised in this context. Where they are recognised, they are treated as if they where a guarantee provided by the life insurance company. Under the Standardised Approach, the risk weight of the original exposure is replaced by that of an exposure to the life insurance company. Under the IRB approach, equally the risk weight is adjusted based on the characteristics of a direct exposure to the life insurer.

Recognition is however limited to situations where the life insurer is externally rated in a way that would qualify him for a risk weight of 50% under the Standardised Approach or less or the equivalent under the IRB approach.

5.2. Problem definition

Driver: Reliance on the life insurer's general ability to meet its financial obligations when recognising life insurance policies as collateral Problem: Life insurance cannot be recognised as collateral or does not lead to a reduction in risk weight in cases where it would be prudentially justified, resulting in higher compliance costs for the industry and potentially higher costs for the borrowers

First of all, given the eligibility requirements discussed above, life insurance policies in many cases cannot be recognised when the life insurance company does not have an external rating. In 2005, there were some 1,250 companies writing life insurance in EU25[166]. Standard & Poor's, for instance, currently rates only 103 EU life and multi-line (writing both non-life and life business) insurers. While external ratings are available from other rating providers as well, it is clear that a majority of the EU life insurers – regardless of their actual credit quality – have the competitive disadvantage that their policies cannot be used as collateral under the CRD. Note in this context that in particular smaller companies will find it prohibitively costly to have an external credit rating. In turn, the clients of these unrated insurers have the disadvantage that they cannot secure loans by their existing policies in order to improve their ability to obtain a loan or to obtain a loan more cheaply. Life insurance as collateral will be mostly relevant for loans to individuals and small or medium size businesses.

To continue with the same example, out of the 103 life and multi-line insurers rated by Standard & Poor's, only 81 are rated in a way that allows for a risk weight of 50% or less. The ratings and the risk weights derived from them depend on the general ability of the life insurance company to fulfil its financial obligations. This disregards the fact that the realisation of the claim resulting from this life insurance policy does not depend on the general ability of the life insurance company to fulfil its financial obligations but on the value of assets specifically dedicated to cover the life insurance company's liabilities from the outstanding life insurance contracts. This is because the life insurance company is required to protect the surrender values of the life insurance policies by the values of assets of a certain

[166] CEA, *The European Life Insurance Market in 2005*, April 2007

minimum quality. In addition, the company providing the life insurance is required to ensure an appropriate diversification of these assets. The respective requirements are laid out in Articles 20 to 26 of the Directive 2002/83/EC. Furthermore, Article 10 of the Directive 2001/17/EC requires that the beneficiary's claims on these assets are prior to any other claims in case of default of the life insurance company. Consequently, even where an insurance provider is not eligible based on its general financial strength, the special protection of life insurance policy holders claims will in many cases still justify the prudential recognition where these claims are used as collateral.

5.3. Objectives

In light of the problems presented in the previous section, one operational and three specific objectives have been identified (see table below). Effective realization of the operational objective is expected to contribute to the achievement of the longer-term specific policy objectives. In turn, this should contribute to the attainment of the general policy objectives of *Enhancing financial stability (G-1) and Ensuring international competitiveness of EU banking sector (G-3).*

Problem Driver	Operational Objectives	Specific Objectives		
		S-3 Enhance level playing field	**S-4** Reduce compliance burden	**S-6** Reinforce risk management
Reliance on the life insurer's ability to meet its financial obligations when recognizing life insurance policies as collateral.	**O-1** Enable a more risk-sensitive recognition of life insurance as collateral	√	√	√

5.4. Policy option analysis and comparison

The question is how a risk sensitive treatment of life insurance as collateral can be devised that at the same time does not discriminate against borrowers that offer policies of unrated insurers as collateral. To this end, the following two policy options have been examined:

- **Policy option 1:** Retain current treatment as normal exposure to the life insurer

- **Policy option 2**: Preferential treatment of life insurance policy holders claims

Policy option 1: Retain current treatment as normal exposure to the life insurer

Under this option, the treatment described in the background above is retained. This treatment does not achieve the specific objective of reinforcing risk management due to its lack of risk-sensitivity with regard to the special protection that life insurance policies are subject to. It also does not achieve the specific objective of enhancing the level playing field as particularly smaller insurers without an external credit rating and clients of these insurers who wish to offer their policies as collateral experience a disadvantage.

Policy option 2: Preferential treatment of life insurance policy holders claims

Under this option, the problem identified will be corrected by introducing separate risk weights in order to differentiate exposures resulting from life insurance policies from other exposures to life insurance companies. In order to do so, it is not necessary to reinvent the wheel. The Directive already provides a solution for determining risk weights in case credit risk is mitigated through the coverage of claims by dedicated assets instead of being only dependent on the general ability of a counterpart to fulfil its financial obligations, namely for covered bonds. Under the Standardised Approach, this implies a moderate reduction compared to the risk weight that would apply to a normal claim on the life insurer. Under the IRB approach, the only amendment necessary is to introduce a separate loss given default

(LGD) parameter that reflects the additional protection by dedicated assets, i.e. recognising that the loss given the default of the insurer will be lower for life insurance claims then for normal claims. Obviously, it is not advisable to simple copy-and-paste the risk weightings and LGD for covered bonds. Although life insurance policies and covered bonds must both be covered by dedicated assets, life insurance policies may be covered by a wider and somewhat riskier range of assets than covered bonds. Therefore, the risk weighting of life insurance policies needs to be calibrated more conservatively than that of covered bonds.

This option would make the recognition of life insurance collateral independent of the existence of an external rating of the insurer. It achieves therefore the specific objective of enhancing the level playing field as particularly smaller insurers without an external credit rating and clients of these insurers who wish to offer their policies as collateral would not experience a disadvantage anymore. This treatment furthermore achieves the specific objective of reinforcing risk management as it takes account of the special protection that life insurance policies are subject to and thereby incentivises banks to make use of this kind of credit risk mitigation which improves their risk management.

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
1. Retain current treatment as normal exposure to the life insurer	Credit institutions	Range of eligible collateral constrained without prudential reason, less risk sensitive and higher capital requirements	Direct	-	High	Permanent
	Life insurers without credit ratings	Unlevel playing field, high cost of getting a rating to become an eligible protection provider.	Indirect	-	High	Permanent
	retail and SME Borrowers	Higher borrowing cost based on non-eligible life insurance policies as eligible collateral	Indirect	-	Medium	Permanent
	Economy	Negatively impacted to the extent that credit does not get extended	Indirect	-	Low	Permanent
2 Preferential treatment of life insurance policy holders claims	Credit institutions	Wider range of eligible collateral, more risk sensitive and lower capital requirements	Direct	+	High	Permanent
	Life insurers without credit rating	More level playing field, no cost of getting a rating just to become an eligible protection provider.	Indirect	+	High	Permanent
	retail and SME Borrowers	Existing life insurance policies can be used as eligible collateral to increase availability and decrease cost of borrowing	Indirect	+	Medium	Permanent
	Economy	Positively impacted to the extent that credit is generated	Indirect	+	Low	Permanent

Conclusion

Option 1 (Retain current treatment as normal exposure to the life insurer) was discarded as it is not effective with respect to objectives S-3 (Enhance level playing field), S-4 (Reduce compliance burden) and S-6(Reinforce risk management). **Option 2 (Preferential treatment of life insurance policy holders claims)** has been retained as the preferred option since it is more effective in contributing to all objectives.

Policy Option	**Relevant Objectives**		
	S-3 Enhance level playing field	S-4 Reduce compliance burden	S-6 Reinforce risk management
	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
1 Retain current treatment as normal exposure to the life insurer	≈	≈	≈
2. Preferential treatment of life insurance policy holders claims	+	+	+

6. CAPITAL REQUIREMENTS FOR COLLECTIVE INVESTMENT UNDERTAKINGS UNDER THE INTERNAL RATINGS BASED APPROACH

6.1. Background

Article 87(11) and (12) of Directive 2006/48/EC set out the rules under which exposures in the form of Collective Investment Undertakings (CIUs) such as investment funds have to be treated under the Internal Ratings Based (IRB) approach. Generally, a credit institution that uses the IRB approach has to do so for all exposures. This general rule is meant to avoid cherry picking by institutions: otherwise a credit institution could apply the more risk sensitive IRB approach for its less risky exposures and the less risk sensitive Standardised Approach for the riskier exposures, thus gaming the capital requirements. There are only few specific exemptions to this treatment that are all subject to supervisory approval. For exposures in the form of a CIU, in principle banks should 'look through' to the investments that the CIU has made and apply its IRB accordingly to them.

The problem is that normally banks will not know of all individual items in the CIU and even if they do, they will not be able to provide an internal rating for these items. Consequently banks will have to resort to alternative solutions and the CRD provides for the possibility to have the asset manager of the CIU calculate the capital requirement for the CIU on the basis of the Standardised approach, although subject to the modification that for every exposure, the risk weight applied is that of the next riskier category ("Standardised plus" approach, SPA). For instance, an exposure subject to 20% under the Standardised approach would then be subject to a 50% risk weight if held in a CIU subject to the IRB. The purpose for this penalisation is to give incentives to banks to provide internal ratings and to dis-incentivise their use of CIU in order to benefit from a partial use of the Standardised approach where they are normally required to apply the IRB. This ensures that the CIUs not become a dumping ground in which banks hide risky exposures for which the IRB approach would deliver very high capital requirements.

6.2. Problem definition

There are a number of prerequisites that a bank has to fulfil in order to apply the IRB to exposures indirectly held via a CIU. First, the bank has to be aware of all exposures in the CIU on an ongoing basis. This is often impossible because the CIU manager will treat its investment decisions as confidential in particular vis-à-vis banks who could imitate the strategies of the CIU based on the information. Even if the bank were aware of all exposures, it would be very difficult to integrate these into their internal rating systems. Often exposures in the CIU will not be the same as those that the bank has rated internally. So it has to perform a rating process for every new exposure in the CIU, although it has no direct client relationship with, for instance, the issuer of an instrument that the CIU invests in. This means that the necessary access to information to assign the rating may be lacking.

Driver: Excessive penalisation of banks that should but cannot apply the IRB approach to their exposures in the CIUs Problem: Higher compliance costs for the IRB approach banks due to capital requirements disproportionate to risk

As in practice banks will be often unable to apply the IRB to individual exposures in the CIU, they will be forced to resort to the SPA. This approach delivers, however, extreme increase in capital requirements, for the lowest risks from 0% to 20% and for the next best still by 150%, 100%, 50% and 30% respectively. Note that these increases create the perverse effect of being higher for externally well rated, less risky exposures where there is less of a concern with them being "hidden" in the CIU. For externally unrated exposures, the percentage increase is by 50% for corporates, to take an example. This percentage increase is much lower than for a corporate rated, say, single A, which would be by 150%. Clearly, it is in particular externally unrated exposures where there should be more emphasis on incentives to provide an internal rating so that they can be covered in a risk-sensitive fashion.

It should be noted that also CIU managers are negatively affected if there is no adequate treatment for CIUs held by credit institutions that apply the IRB. As a consequence, credit institutions would have to avoid investments in CIUs and manage their investments on their own balance sheets, an activity in which some banks may have comparative disadvantages compared to CIU managers.

6.3. Objectives

In light of the problems presented in the previous section, two <u>operational</u> and two <u>specific</u> objectives have been identified, respectively (see table below). Effective realization of the operational objective is expected to contribute to the achievement of the longer-term specific policy objectives. In turn, this should contribute to the attainment of the <u>general</u> policy objective of *Enhancing Financial Stability (G-1).*

Problem Driver	Operational Objectives	Specific Objectives	
		S-4 Reduce compliance burden	**S-6** Reinforce risk management
Excessive penalisation of banks that should but cannot apply the IRB approach to their exposures in the CIUs	**O-1** Provide a sound risk-based alternative treatment of exposures in the CIUs for the IRB banks	√	√
	O-2 Produce adequate incentives to adopt the more risk sensitive IRB approach		√

6.4. Policy option analysis and comparison

The question is how a reasonable alternative can be provided without producing overly penal, not risk-sensitive capital requirements – but maintaining adequate incentives to adopt the more risk sensitive IRB approach. To this end, the following three policy options have been examined:

- **Policy option 1:** Retain current SPA treatment

- **Policy option 2**: Applying more differentiated increases to the Standardised risk-weights

- **Policy option 3**: Allowing the use of external ratings as an input to the IRB formula

<u>Policy option 1: Retain current SPA treatment</u>

Under this option, the treatment described in the background section is retained. This treatment does not provide a reasonable alternative to applying the IRB to the underlying exposures in the CIU – the banks' compliance burden is helped by the asset manager calculations, but the resultant capital requirements will be very penal. It also does not produce risk sensitive outcomes as well-rated exposures would be penalised more strongly than unrated or badly rated exposures. The treatment however encompasses strong incentives to apply the IRB to underlying exposures, but these incentives are not adequately differentiated according to risk.

Policy option 2: Applying more targeted increases to the Standardised risk-weights

Under this option, the increase in risk weights would be lower for well rated exposures and higher for unrated exposures. This is a reasonable alternative to the application of the IRB as the asset manager could carry out the calculation, effectively reducing compliance burden. As long as the CIU manager invests in rated securities and does not incur high risks on behalf of the investing bank – which would be undesirable anyway from a prudential standpoint – the resulting increase of risk weights would be low so that this alternative remains reasonably attractive. Still, there would be a moderate increase compared to the normal Standardised approach so that this treatment does not become a partial use situation – which as discussed above must be subject to supervisory approval – and so that some incentives to apply the IRB are maintained in order to avoid cherry picking. There would be a substantial increase of risk weights precisely for those high risk and unrated exposures that are of highest prudential concern. Consequently, this option would achieve the risk sensitivity objective and create adequate incentives in the sense that the incentives to adopt the IRB would not only be strong, but also targeted at the exposures that pose the highest concerns.

Policy option 3: Allowing the use of external ratings as an input to the IRB formula

This option would provide a possibility to utilize the historic default rates published by rating agencies in the IRB formula in order to arrive at the risk weight of the exposure. For banks, this would be a reasonable alternative to applying their own IRB as their compliance costs would decrease and the resulting risk weights would be similar to those under the IRB. There would be no incentives, however, to apply the IRB as banks could simply move everything they do not want to rate internally into specifically set up CIUs, achieving a similar risk weighting without having to have in place all the rating processes and risk managements standards connected to the normal IRB. This is not desirable from a prudential point of view as it undermines the incentives to enhance risk management. The risk sensitivity would be good for externally rated exposures; however, this approach would not work for the unrated ones.

Policy Option	**Party Affected**	**Impact**				
		Description	**Type** (D/I)	**Effect** (-/≈/+)	**Likelihood** (L/M/H)	**Timing** (S/L/P)
1. Retain current SPA treatment	Credit institutions	No reasonable treatment for CIUs under the IRB; increased compliance costs	Direct	-	High	Permanent
	Supervisors	Strong incentives for the normal IRB, possible problems in risk management	Direct	≈	High	Permanent
	CIU managers	Probably going to lose banks as clients when banks adopt the IRB	Indirect	-	Medium	Permanent
2. Applying more targeted increases to the Standardised risk-weights	Credit institutions	Reasonable risk-based treatment for CIUs under the IRB, capital requirements proportionate to underlying risks	Direct	+	High	Permanent
	Supervisors	Sound incentive structure and risk sensitive capital requirements	Direct	+	High	Permanent
	CIU managers	IRB banks can rely on CIUs to manage in particular rated instruments for them	Indirect	+	Medium	Permanent
3. Allowing the use of external ratings as an input to the IRB formula	Credit institutions	Reasonable treatment for CIUs under the IRB	Direct	+	High	Permanent
	Supervisors	Low quality IRB approach that undermines the incentive structures of the different approaches	Direct	-	High	Permanent
	CIU managers	IRB banks can rely on CIUs to manage in particular rated instruments for them	Indirect	+	Medium	Permanent

Conclusion

Option 1 (Retain current SPA treatment) was discarded as it is not effective with respect to objectives O-1 (Provide a sound risk-based alternative treatment of exposures in the CIUs for the IRB banks) and S-4 (Reduce compliance burden). It is strong, potentially excessive in terms of reaching objective O-2 (Produce adequate incentives to adopt the more risk sensitive IRB approach) and consequently for S-6 (Reinforce risk management). Option 3 (Allowing the use of external ratings as an input to the IRB formula) was discarded as it only delivers on O-1 and S-4 but not on O-2 and S-6.

Option 2 (Applying more targeted increases to the Standardised risk-weights) has been retained as the preferred option since it is effective in contributing to all objectives.

Policy Option	**Relevant Objectives**			
	O-1 Sound risk-based alternative treatment of exposures in CIUs	O-2 Adequate incentives to adopt IRB	S-4 Reduce compliance burden	S-6 Reinforce risk management
	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)	Effectiveness (≈/+/++)
1. Retain current SPA treatment	≈	++	≈	+
2 Applying more targeted increases to the Standardised risk-weights	++	+	+	+
3 Allowing the use of external ratings as an input to the IRB formula	+	≈	++	≈

7. CAPITAL REQUIREMENTS AND RISK MANAGEMENT FOR SECURTISATION POSITIONS

7.1. Background

According to the European Securitisation Forum (ESF)[167], European securitisation issuance totalled €481 billion in 2006 and €454 billion in 2007 (€2,456 billion and €2,405 billion, respectively, in the US), constituting an important source of funding to the markets. Mortgage market funding accounted for a significant share of the issuance, with some €307 billion of the securitisations in 2007 taking the form of residential and commercial mortgage backed securities.

At the end of the first quarter of 2008, the outstanding balance of European securitisations was €1,211 billion, while the respective figure for the US was €6,255 billion.

Articles 94 to 101 of Directive 2006/48/EC set out the capital treatment for securitisations. In addition, Annex V specifies how banks have to treat securitisation-related risk in their internal risk management. These provisions mirror to a large extent the related requirements of the new Basel capital accord ("Basel II") and were introduced into the directive in June 2006. However, their application became only mandatory in the beginning of 2008 when an option for banks to stick to the old credit risk provisions based on the old Basel accord ("Basel I") expired.

7.2. Problem definition

Driver: Specific aspects of the banking regulatory treatment of securitisations need to be refined in light of the lessons of the ongoing market turmoil
Problem: Potential risks not well addressed by specific aspects of banking regulation might affect banks and the financial markets more generally

Current estimates of the IMF[168] indicate that there may be losses of approximately €600 billion for the world wide financial system due to the current financial market turmoil, while estimates of the OECD[169] peg the subprime crisis losses at approximately €270 billion[170]. Even though the turmoil was triggered by losses on US mortgage loans, the impact on EU banks was huge as they are exposed via securitisation to the risks that originate from the US[171]. The losses of EU banks essentially raise the question if EU banks risk management and related regulations are prudent enough and if the capital requirements are commensurate with the risks.

Potential causes underlying this situation are in part in the risk management of banks, in particular related to:

– the way that mortgage loans were originated in the US without sufficiently sound underwriting standards; possibly relating to the fact that the loans themselves were originated in order to be sold to investors via securitisation under the so-called 'originate to distribute' business model. More specifically, this implies the existence of the conflict of

[167] ESF is an affiliate of the of the Securities Industry and Financial Markets Association
[168] IMF, *Global Financial Stability Report*, April 2008
[169] OECD, *The Subprime Crisis: Size, Deleveraging and Some Policy Options*, April 2008
[170] Assuming 40% recovery on defaulting loans and an economic and house price scenario benchmarked against previous episodes.
[171] Bloomberg reports losses for European banks as of April 2008 totalling over €45bln and over €155bln for banks world wide.

interests and misalignment of incentives among the parties involved in the 'originate-to-distribute' chain;

– a lack of due diligence and understanding of investments in complex securities;

– a mismanagement of commitments such as liquidity facilities for securitisations that issued short-term securities while investing in long-term assets.

It is important to note that with the CRD, in 2008 a new set of standards for regulatory capital, risk management and public disclosure became mandatory for banks that is more risk-sensitive than its predecessor and the design of which pays – also in contrast to its predecessor – specific attention to securitisation risks. However, even if the regulatory situation for banks certainly improved in this field, it is clear that specific aspects of the current approach need further clarification.

7.3. Objectives

In light of the problems presented in the previous section, one operational and one specific objective have been identified (see table below). Effective realization of the operational objective is expected to contribute to the achievement of the longer-term specific policy objective. In turn, this should contribute to the attainment of the general policy objectives of *Enhancing Financial Stability (G-1)* and *Safeguarding of creditor interests (G-2).*

Problem Drivers	**Operational Objectives**	**Specific Objectives**
		S-6 Reinforce risk management
Specific aspects of the banking regulatory treatment of securitisations need to be refined in light of the lessons of the ongoing market turmoil	**O-1** Ensure that banks maintain adequate capital and apply sound management for securitisation risks.	√

7.4. Policy option analysis and comparison

The question is if and to what extent a review of capital and risk management requirements for EU banks is warranted. The following three options exist:

- Policy option 1: Retain the current CRD treatment

- Policy option 2: Targeted changes where clarification and improvements are needed.

- Policy option 3: Complete review of existing requirements

Policy option 1: Retain the current CRD treatment

Under this option, the treatment referred to in the background above is retained. No changes would be considered. This implies that shortcomings might remain in the current rules. It has however to be noted that the current rules where not yet widely applied when the crisis occurred. It may be even argued that the crisis is to some degree owed to inadequacies in capital standards and risk management requirements of the legislation that preceded the current rules. In light of this, it appears that the operational objective of adequate capital and sound risk management may still be on the whole attained without changes, even if no specific lessons from the current market turmoil are drawn. Further enhancement of risk management (objective S-6) would certainly occur as the new, more prudent rules are implemented, but again, there may be a need to go even further in a very targeted fashion drawing lessons from the current turmoil.

Policy option 2: Targeted changes where clarification and improvements are needed

Under this option, a limited number of changes would be envisaged that reflect concrete lessons from the crisis.

First, these changes aim at ensuring that banks apply due diligence when granting loans even if they pass the risk on to investors. These strengthened qualitative requirements would be complemented by a quantitative element. At first, it was envisaged to require originators of securitisations to hold capital for at least 15% of the securitised exposures, regardless of the securitisation positions actually retained. This requirement was intended to reduce the capital incentives for originators to transfer all risks of a securitisation to investors. Originators would remain exposed to the securitisation and their incentives would thus be more aligned with those of investors, thereby addressing the incentive problem outlined in section 7.2.

Second, banks will be required to improve their understanding of their securitisation investments and the CRD will ensure that banks investing in securitisations are able to avail themselves of the necessary information to understand the risks of their investments.

Third, enhanced management of liquidity risks will be required from banks providing contingent liquidity support for securitisations.

During the public consultation, the requirement for originators of securitisations to hold capital for at least 15% of the securitised exposures regardless of the securitisation positions actually retained has met with an opposition from industry and Member States on the grounds that the suggested measure would be ineffective and could be contravened via financial engineering. Respondents also said that such a requirement would place EU banks that originated securitisations at a global competitive disadvantage. In view of the feedback received, an alternative policy measure that accounts for the above-stated drawbacks was developed. The revised measure:

– Aims at banks acting as investors, allowing them to invest only in credit risk transfer products if the originators and distributors of the credit risk retain some exposure themselves (10%) – irrespective of whether they are EU banks or not (thus addressing the level playing field concerns raised in the feedback process).

– Is broad in terms of product coverage, so as to exclude the structuring arbitrage that several respondents in the consultation have warned against. In addition, those active in the origination and distribution would need to be exposed to positions with the same risk profile so that their incentives would be aligned with those of investors.

– Provides for additional flexibility compared to the original approach: it would be left to either the originators or, alternatively, the sponsors/arrangers to retain exposure, whichever would be easier to implement, in particular if multiple originators are involved in a transaction.

The public consultation was extended to canvass the stakeholders' views specifically on the alternative policy measure and its implications for the EU banking industry. Responses received were on the whole supportive of the underlying objectives of the measure. Nonetheless, respondents deemed the proposed approach to be not appropriate for achieving them. They cited unintended consequences in terms of reduced liquidity and increased cost of credit; loss of competitiveness for EU regulated institutions in view of the fact that no other regulatory body outside of the EU has announced any similar regulatory intentions; implementation and monitoring difficulties; and inconsistency with the risk-based approach underpinning the CRD.

Many argued that in addressing the incentive problem, a greater effort must be put into ensuring increased transparency over originators' standards and collateral; and that disclosure of roles and responsibilities with regard to the credit risk transfer, improved risk management procedures, improved availability of information to investors and better due diligence would comprise a more effective response to the concerns around the 'originate-to-distribute' model.

Importantly, it must be noted that both market practices and supervisory oversight in this regard have obviously proved inadequate during the crisis. The public consultation did not bring clear evidence that reinforcing the existing qualitative requirements alone would bring about sufficient improvement. It was consequently concluded that a two-pronged approach that:

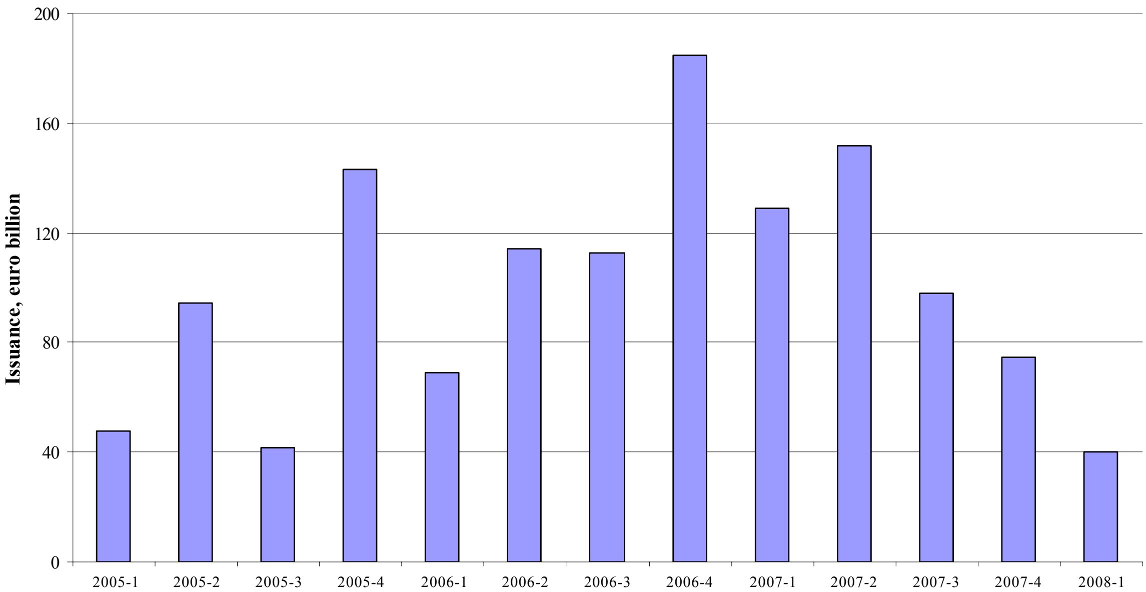
– reinforces qualitative requirements, to provide banks with a better guidance on regulatory expectations, and, at the same time

– sets a quantitative requirement

is most appropriate. The latter part of the approach is targeted at particularly intransparent and risky transactions (where investor due diligence is most difficult) to make sure incentives are aligned even in those cases between originators/sponsors and investors.

Respondents to the consultation also feared that a requirement to retain exposure would raise the cost of credit in the economy overall by reducing the availability of securitisation as a refinancing instrument. It needs to be observed, however, that since the start of the financial market turmoil, the demand for securitisations and mortgage securitisations in particular has already declined significantly as investors have reassessed risks inherent in these products (see Chart 1).

Chart 1: Quarterly issuance of European securitisations, Q1 2005 – Q1 2008



Source: ESF

According to the ESF, European securitisation issuance in the first quarter of 2008 fell by almost 70% to €40 billion from €129 billion in the first quarter of 2007 (and from €75 billion in the fourth quarter of 2007). At the same time, 84% of the issuance in the first quarter of 2008 and 75% of the issuance in the fourth quarter of 2007 were retained rather than distributed to investors.

Residential mortgage backed securities was the leading issuance sector in the first quarter of 2008 at €27 billion of which 96% percent were retained, down by two thirds from €82 billion in the first quarter of 2007. As the alternative funding forms, such as covered bonds, are not available to all lenders, such a marked reduction in available funding is likely to affect the cost of borrowing.

In this respect, rebuilding the confidence in the securitisation market is crucial and should be aided by measures that ensure originators' sharing in the risk of investors. Restoring the confidence in the market should reduce the cost of credit compared to current levels (although not to the excessively low pre-crisis levels that were determined by overconfident investor lending that ignored the inherent risks).

Policy option 3: Complete review of existing requirements

Under this option, there would be a complete review of the existing requirements in the securitisation field at European level. There is the possibility that such review would lead to more adequate capital requirements than the status quo and that it would further enhance risk management. But this is not certain as the Basel II framework is already itself the result of years-long deliberations on devising a more risk sensitive framework than its predecessor. At the same time it is certain, that a divergence from the Basel Committee's work will damage the competitiveness of EU banks if a more stringent regime is introduced and if EU banks that are also active outside the EU would be confronted with the additional administrative burden of complying with very different regulatory situations.

Conclusion

Although option 1 (Retain current treatment) might appear conducive to enhancing the risk management (objective S-6) as the new and more prudent CRD rules are implemented, it would not clarify certain aspects of the current approach in light of the lessons drawn from the current market turmoil and, therefore, is less effective than option 2 (Targeted changes where clarification and improvements are needed) and option 3 (Complete review of existing requirements) with respect to objectives G-1 (Enhance financial stability) and G-2 (Enhance safeguarding of creditor interests). Option 3 is less efficient than option 2 as it implies a more lengthy process with uncertain outcome and possibly international competitiveness implications for the EU banking industry. In this context, option 2 has been retained as the preferred option as it the most effective and consistent option with respect to the relevant policy objectives.

8. ANNEX A: THE LAMFALUSSY PROCESS

A dynamic and healthy financial sector is crucial for the proper functioning of the European economy and for global competitiveness. Financial services are extremely important for European consumers and companies, large and small, who want a wide range of financing options and to rely on high-quality and secure products and institutions that are well managed and supervised. This requires a solid European framework for the regulation and supervision of the financial sector.

The launch of the Lamfalussy[172] process in 2001 aimed at putting in place an efficient mechanism to begin converging European financial supervisory practice and enable Community financial services legislation to respond rapidly and flexibly to developments in financial markets. Under this new approach financial regulation is passed in two levels.

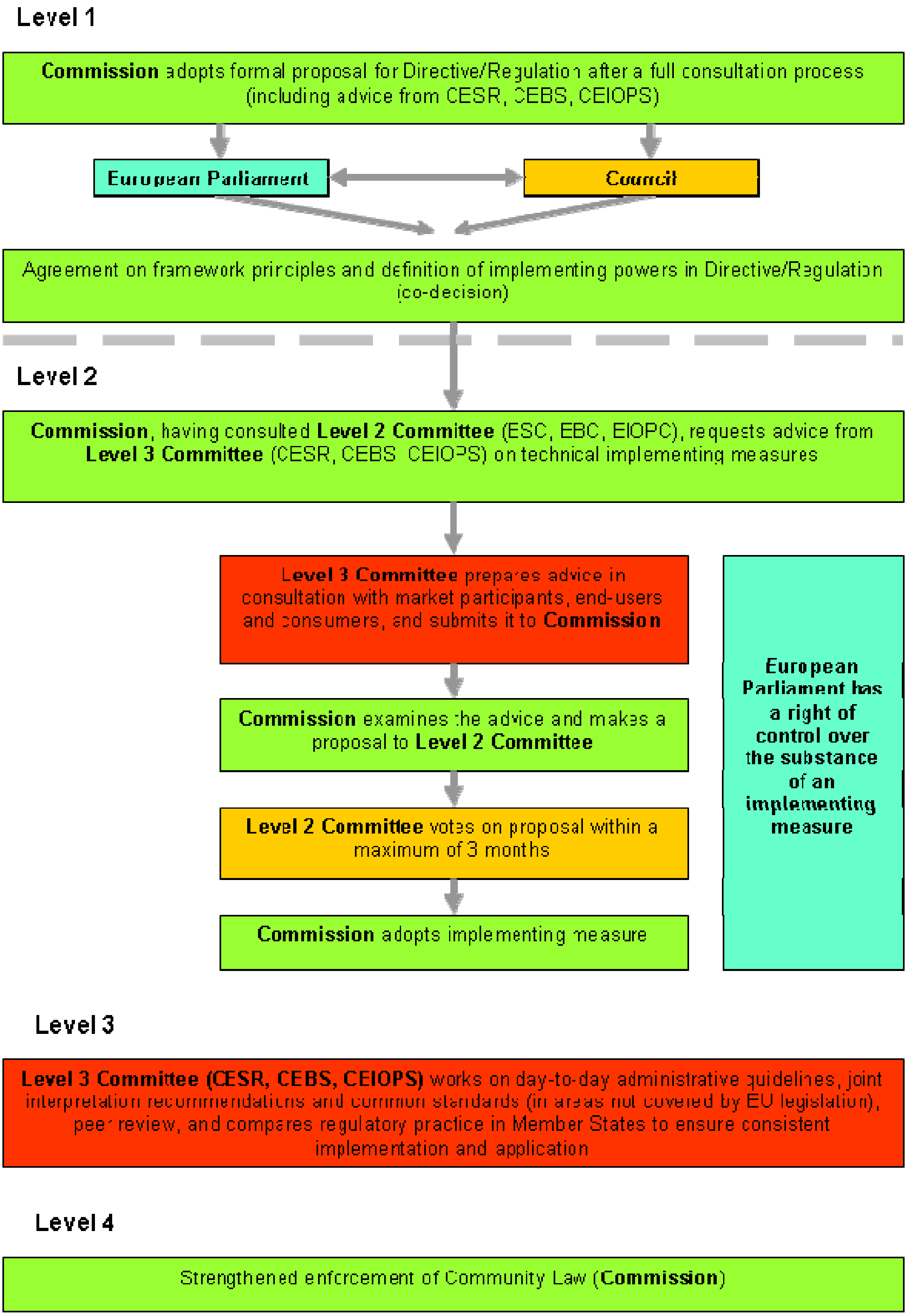
At **"Level 1"**, framework legislation setting out the core principles and defining implementing powers is adopted by co-decision after a full and inclusive consultation process in line with the better regulation disciplines.

The technical details are formally adopted by the Commission as implementing measures at **"Level 2"**, after a vote of the competent regulatory Committee (the European Securities Committee, the European Banking Committee and the European Insurance and Occupational Pensions Committee). In the Level 2 process the Commission takes careful account of the European Parliament's position. For the technical preparation of the implementing measures, the Commission is advised by Committees, made up of representatives of national supervisory bodies, referred to as the **"Level 3"** Committees – the Committee of European Banking Supervisors – CEBS, the Committee of European Insurance and Occupational Pensions Supervisors – CEIOPS and the Committee of European Securities Regulators – CESR. These Committees set up by Commission Decisions1 also have an important role to contribute to consistent and convergent implementation of EU directives by securing more effective cooperation between national supervisors and the convergence of supervisory practices. This is **"Level 3"** of the process. **"Level 4"** is where the Commission enforces the timely and correct transposition of EU legislation into national law.

This four-level comitology-based regulatory approach (see diagram) has been in place for more than five years in the securities sector and for more than two years in banking and insurance.

[172] The Lamfalussy report, published on 15 February 2001, can be found on the Commission's website: http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf

THE FOUR-LEVEL LAMFALUSSY PROCESS



9. ANNEX B: GLOSSARY

Administrative burden	Costs specifically linked to information provision that businesses would not collect and provide in the absence of a legal obligation
Business-as-usual factor	Expresses costs of providing the information that would be collected and processed by businesses even in the absence of the legislation as a percentage of total information provision-related costs
Connected clients	Two or more natural or legal persons who constitute a single risk because of the control-based relationship or likelihood that financial problems in one of them would result in financial difficulties for the other(s)
Consolidating supervisor	The supervisor responsible for the supervision on a consolidated basis of a banking group. As a rule, this is the supervisor of the Member State where the parent bank of the group is based
Credit risk	Risk of losses in on and off-balance sheet positions resulting from the failure of a counterparty to perform according to a contractual arrangement
Credit risk mitigation	Technique used by a credit institution to reduce the credit risk associated with an exposure which the credit institution holds
Economic capital	Capital held and allocated by the bank internally as a result of its own assessment of risk. It can differ from regulatory capital, which is determined according to supervisory rules
Flexibility of payments criterion	The criterion implies that the hybrid instrument must contain features permitting the non-cumulative deferral or cancellation of payment of coupons or dividends in times of stress
Funded credit protection	A technique of credit risk mitigation where the reduction of the credit risk on the exposure of a credit institution derives from the right of the credit institution — in the event of the default of the counterparty or on the occurrence of other specified credit events relating to the counterparty — to liquidate, obtain appropriation of or retain certain assets or amounts
Innovative hybrid instruments	Type of hybrid instruments which include an incentive to redeem, like a step-up or other features
Internal Ratings Based (IRB) Approach	Advanced approach by which a bank can use its own credit assessments to calculate its regulatory capital requirements for credit risk. Depending on the risk factors the bank is allowed to estimate, a distinction is made between a foundation IRB and an advanced IRB approach
Loss absorption criterion	The criterion implies that the hybrid instrument must be available to absorb losses, both on a going concern basis and in liquidation, and to provide support for depositors' funds if necessary
Loss given default (LGD)	The loss, measured as a percentage of the exposure at default, which is likely to occur in case a borrower defaults; one of the required input parameters to derive the risk weight under the internal ratings-based approach
Memorandum of Understanding (MoU)	A set of principles and procedures for sharing information, views and assessments, in order to facilitate the pursuance by participating authorities of their respective policy functions
Non-innovative hybrid instruments	Type of hybrid instruments with no incentive to redeem
Original own funds	The most reliable and liquid element of a bank's capital that comprises share capital, retained earnings and hybrid capital instruments which meet the criteria agreed at G10 level. Subject to

	technical differences, original own funds correspond to the Basel Accord terminology of Tier 1 capital
Payment-in-kind feature	A possibility to replace suspended coupon payments with the delivery of newly-issued shares
Permanence criterion	The criterion implies that the hybrid instrument must be permanently available so that there is no doubt that it can support depositors and other creditors in times of stress
Standardized Approach	Method by which a bank can use external ratings (if available) by external credit assessment institutions to calculate its regulatory capital requirements for credit risk
Standardized Plus Approach (SPA)	A modified Standardised Approach, whereby the risk weight applied to an exposure is that of the next riskier category
Systemically relevant branch	A branch that is relevant for the stability of the banking system of a host Member State
Tier 1 capital	See *Original own funds*
Unforeseen event risk	Risk of losses emanating from events which are outside the parameters of portfolio capital allocation and, therefore, might trigger unexpected default of an institution or cause it to experience difficulties, regardless of the performance of the rest of the portfolio. Such events include a sudden drying up of market liquidity, internal fraud, government action, loss of a major customer or market and are usually not reflected in ex ante credit quality assessments
Unfunded credit protection	A technique of credit risk mitigation where the reduction of the credit risk on the exposure of a credit institution derives from the undertaking of a third party to pay an amount in the event of the default of the borrower or on the occurrence of other specified credit events