

CHAMBER OF DEPUTIES  
14 Commission  
European Union Policies

**Preliminary review of the “Proposal for the Directive amending directives 2006/48 and 2006/49 with respect to banks affiliated to central institutions, specific elements of own funds, large exposures, supervision mechanisms, and crisis management (COM(2008)602) and of the “Communication from the Commission; Review of the Lamfalussy process. Strengthening supervisory convergence (COM(2007)727 def.)”**

25 February 2009

Hearing of the General Manager of ABI  
Mr. Giuseppe Zadra

I would like to take the opportunity of this Hearing on the review of the directive on the capital requirements of banks, the Lamfalussy process, and the strengthening of supervisory convergence to analyze the problems connected with the current fragmented supervisory system, and to compare the different proposals for reform of the European supervisory frameworks.

It is my opinion that the issue pertaining to the reform of the European supervisory structure should be addressed by using a systemic approach that, in the final analysis, encompasses the European regulatory *framework* as a whole, with respect to financial services and their supervisory structure.

My contribution will be divided into two parts: in the first part, I will illustrate the limits of the current supervisory structure, as well as the measures that have been implemented to date by EU Institutions; in the second part, I will illustrate our proposals for an overall reform of the European supervisory structure.

### ***The limits of the current European supervisory structure***

The recent crisis highlighted the problems connected to the dichotomy between the increasing consolidation of international markets and the supervisory structures developed on a national basis.

This dichotomy had the effect of creating several obstacles that prevent European banking groups from developing economies of scale and scope, thus defeating one of the potential purposes of the single market; furthermore, these obstacles give rise to significant *compliance* costs, as well as creating barriers to access specific markets. This translates into direct disadvantages for consumers, both in terms of costs and quality of services offered.

As a matter of fact, cross-border banking groups must often meet unnecessary and inconsistent requirements in different Member States as a consequence of the national discretions and options included in the *Capital Requirements Directive* (CRD), in addition to national interpretations and *gold plating* of EU regulations <sup>(1)</sup>.

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<sup>(1)</sup> An example of the abovementioned is represented by the reporting framework for solvency requirements issued by the CEBS (*Common Reporting – COREP*), whose implementation was not consistent. The CRD establishes that reports on prudential supervision issues should be made based on accounting data; thus, all attempts at building a common reporting framework have failed to produce satisfactory results by reason of national discretions included in the CRD, the different supervisory approaches and national interpretations provided by national authorities, and the different information base to refer to.

The problem is also perceived by banks that operate in a single Member State, since they are not in the position of taking advantage of the internalization opportunities offered by the single European market, by reason of the obstacles created by the significant costs originating from the complexity of being required to conform to different supervisory rules and procedures.

The current fragmented supervisory structure has generated phenomena of regulatory competition among national authorities; the desire to attract players to local financial centres has driven certain national authorities to establish particularly favourable regulatory conditions, so as to develop the national industry, and, to some extent, hinder foreign competition.

During the recent crisis, the fragmented EU supervisory framework, and the resulting inconsistency in terms of supervisory reporting, rules, and procedures, has made it even more complicated to obtain consistent data for conducting solvency analysis and systemic risk assessments on a European basis.

In this respect, an additional complexity factor was triggered by the impossibility of obtaining timely information on the solvency situation of those segments of the financial market that are not subject to regulatory supervision, even if they are large enough to overwhelm the regulated bank sector.

### ***The evolutionary approach adopted by EU Institutions***

To date, resistance from national *regulators* and strong opposition from the majority of Member States have paralyzed the process of reform of the European supervisory structure. EU Institutions have thus decided to adopt an evolutionary approach, so as to achieve a number of practical improvements.

Reform measures followed two main directions: (i) strengthening the level of cooperation between national authorities and convergence authorities for supervisory practices and (ii) achieving harmonization of rules and reform of supervisory structures.

In the current regulatory framework, the European committees uniting national supervisory authorities (*Lamfalussy* third level committees – 3L3) are in charge of strengthening the cooperation between national authorities and convergence authorities for supervisory practices.

The results achieved by these committees thus far were not fully adequate in the context of the single market, due to a number of problems essentially connected to their governance structure, as well as to the fact that they do not have legal status. In particular, these aspects may be explained by the

following reasons: (i) the tasks that they are assigned are not defined, (ii) the decision-making procedure is based on consensus, and, above all, (iii) the adopted decisions are of a non-binding nature.

Strengthening of the 3L3 <sup>(2)</sup>, which took another step forward on 26 January 2009 with the reform of their Decisions, culminated in the assignment of specific tasks with respect to protecting the financial stability of the single market, and in the reform of their internal *governance*, intended to overcome the decision-making procedure based on consensus by way of adopting a qualified-majority voting mechanism (according to the resolutions of the Treaty of Nice) if it is impossible to reach a joint agreement.

The Commission nonetheless, in line with the mandate received by ECOFIN, did not change the non-binding nature of the decisions made by the 3L3, and thus there is no guarantee that the changes made by the recent reform alone are able to ensure that different national authorities will in fact adopt consistent supervisory approaches. In this respect, adopting the "*comply or explain mechanism*" does not appear to be a sufficient measure to oblige national authorities to comply with the decisions taken by the European committees, seeing that the responsibility regime at the national level remains fragmented.

With respect to the harmonization of rules and the reform of supervisory structures, the Commission proposed a series of reforms to EU regulations. Among them, the one with respect to establishing a number of Boards formed by all supervisors involved in the supervisory process of cross-border groups is of particular relevance. The Boards should facilitate management and cooperation among the national authorities in charge of monitoring different aspects of a single cross-border group, as well as guarantee effective and efficient exchange of information, both under normal conditions and during a crisis.

The Commission, for the purpose of increasing the level of coordination and cooperation among the different competent authorities, put forth the following suggestion in the proposal for the directive amending the CRD, which at present is being discussed by the European Parliament (EP) co-legislators: entrusting the power of final decision making to the supervisory authority of the holding company (*consolidating supervisor*), if an agreement cannot be reached with respect to reporting issues and to determining the internal capital adequacy of the group, so as to be in a position to face the risks described under the second pillar.

Nonetheless, the ECOFIN Board and the EP, in their role as co-legislators, reached a compromise, thus abolishing the binding force of the

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<sup>(2)</sup> The 3 third level Lamfalussy committees are: CEBS for the banking sector, CEIOPS for the insurance sector, and CESR for the financial sector.

*consolidating supervisor's* powers with respect to the supervision of cross-border banking groups.

This agreement became necessary so as to overcome the blocking of a number of Member States, according to which supervisory powers can be delegated only on condition that all liabilities are also delegated in the event of a crisis.

It is important to remember that the provisions of the CRD only apply to investment firms that are part of a banking group, <sup>(3)</sup> and, thus, the boards of supervisors would not have jurisdiction over independent investment firms or investment firms belonging to groups that do not include banks <sup>(4)</sup> and, of course, over parties who do not fall within the scope of supervision.

The Council and the EP are reaching an agreement with respect to regulating — within the Solvency II proposal for directive — the establishment and administration of the boards of supervisors for monitoring cross-border insurance groups, for the purpose of enabling insurance firms to achieve a satisfactory level of consistency with the banking sector.

Past experiences have shown that in the absence of rigorous *governance*, the boards of supervisors lose their effectiveness to a great extent, especially during a crisis situation. In this respect, the situation that occurred on occasion of the recent crisis, and the resulting government rescue of the Fortis group is of particular relevance.

### ***Limits to the evolutionary approach***

Given the current EU regulatory framework, the establishment of the boards of supervisors can be expected to be a buffer arrangement, also because the foreign subsidiaries of the group and the branches continue to be subject to the liquidity supervision practices adopted in the host country.

The problems of this fragmented approach with respect to liquidity supervision were emphasized by the recent crisis; the impossibility of obtaining timely information on the liquidity of cross-border groups (micro-supervision) has proven to be a factor of complexity with respect to the supervision of systemic liquidity (macro-supervision) by central banks.

Furthermore, the reform of the supervisory structure that is emerging does not seem to resolve the conflict of interest that would originate between supervisory authorities and central banks, in the event of a crisis. As a

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<sup>(3)</sup> See article 2 of the 2006/49/EC Directive on the capital adequacy of investment firms and banks (recast).

<sup>(4)</sup> By taking into consideration no. 28 of the Directive 2006/49/EC.

matter of fact, in the event of a crisis, supervisory authorities are interested in saving the banks with liquidity injections by central banks, as opposed to taking measures intended to strengthen capitalisation; this, for the purpose of passing rescue costs onto central banks.

This conflict of interest has the effect of interfering with the exchange of information between supervisory authorities and central banks, especially at cross-border level. As different parties have observed <sup>(5)</sup>, this is an obstacle with respect to adopting timely measures, as well as greatly complicating the task of central banks, as it forces them to make decisions without having a comprehensive vision of the solvency situation of banking groups, particularly if cross-border.

To conclude, it is important to emphasize that the proposals for reform that are under discussion do not allow achieving the goal of ensuring a more effective supervision of the investment firms in financial conglomerates, and of the market segments that at present are not subject to regulatory supervision.

In other words, attracting these intermediaries or otherwise to an integrated supervisory system is intrinsically restricted to the exclusion of insurance firms and market components that are not included in the scope of application of the regulatory legislation.

The abovementioned shows that the evolutionary approach that was adopted thus far with respect to the reform of European supervision is not sufficient; even when the last planned measures will have been implemented, the regulatory framework will nonetheless not be able to meet the needs of the European financial sector.

### ***The needs of the European financial sector***

It is our opinion that an effective and efficient reform of the European supervisory structure should achieve the following goals:

- Simplification. Cross-border groups should compare and contrast themselves with a single point of contact with respect to regulatory issues, both at cross-border and cross-sector level. In other words, the obligation to meet the specific requests of different *host supervisors* would no longer be required;
- Legal certainty. Supervisory decisions should be adopted in a timely manner, and should not be discussed by other authorities once they have been implemented. What is thus important is not "who" makes

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<sup>(5)</sup> See Group of Thirty, *The structure of financial supervision. Approaches and challenges in a global market e infra*, José Manuel González-Páramo.

the decisions, but the speed with which they are made and the regulatory framework governing them;

- Reduction of compliance costs. Cross-border banking groups should be enabled to prepare a single *reporting package* at consolidated level with respect to the risks described under the first pillar (credit, market, and operational), to calculate the internal capital with respect to the second pillar at group level alone, and to issue a single report, at consolidated level, with respect to the third pillar *market discipline*;
- Ensure equal competition, at least among same sector players (cross-border groups/local players);
- Resolve conflicts of interest that occur among authorities both under normal conditions (fair competition), and in crisis situations (free riding and unclear exchange of information with monetary authorities to encourage solving financial turbulence with liquidity injections);
- Provide a reconciliation between micro and macro supervision. Supervision of single players (micro) should be complemented by supervision at systemic level (macro), both at EU and international level. This requirement becomes particularly stringent at EU level because of the single market;
- Universality. The future European supervisory structure should not only apply to banks, but also to all intermediaries who operate in the financial market.

### ***ABI proposals for an overall reform of the European supervisory structure: the European supervisory system***

The supervisory structure that would enable reaching the abovementioned goals is embodied in the creation of a new European body, the System of European Supervision (SES), resulting from the merging of the Committee of European Banking Supervisors (CEBS) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).

The SES should be in charge of: (i) coordinating cooperation and exchange of information among national authorities, and (ii) directly supervising cross-border groups.

The supervisory structure that would emerge is divided into two levels: cross-border groups on the one hand, and banks that operate in a single Member State on the other hand; national supervisors would continue monitoring the latter.

Furthermore, this would enable smaller Member States to reduce supervisory costs thanks to the economies of scale that would be created.

To enable the SES to effectively perform its prudential supervisory duties to protect stability, it appears necessary to extend its scope of supervision to all the investment firms and segments of the financial market that, at present, are not subject to regulatory supervision even if they are large enough to overwhelm the regulated bank sector. The recent crisis has in fact shown that non-regulated sectors are often harbingers of significant risk at systemic level.

The regulation and supervision of behavioural aspects (*conduct of business*) should also be centralized at the EU level. It would be possible to achieve this goal by reforming the Committee of European Securities Regulators (CESR), and therefore, within a severed framework with respect to prudential supervision duties. Achieving an even further level of centralization, encompassing all supervisory bodies, is not a goal that can be pursued at the present moment, in terms of actual feasibility, but it should be kept in consideration.

In order to fulfil its duties, the system of European supervision should have binding powers with respect to its members, the national authorities, and the cross-border groups it supervises.

From a legal viewpoint, this requires an amendment to the Treaty. The procedure for establishing the SES, therefore, should follow very similar institutional building procedures to those used, to give an example, for the establishment of the European Central Bank (ECB). Member States should find political agreements so as to regulate the process of merging the CEBS and the CEIOPS, and the gradual adjustment of the new supervisory structure.

Given the uncertainty of the present EU political framework, and the urgency for a reform of the supervisory system imposed by the current crisis, it could thus be appropriate to envision a temporary agreement intended to regulate the supervision of cross-border groups while awaiting the entry into force of the amendment to the Treaty.

The most immediate solution is entrusting the ECB with the responsibility of supervising cross-border groups while awaiting the amendment to the Treaty that will implement the SES.

This solution could be enacted quite rapidly by taking advantage of the regulatory provisions described in Art. 105, paragraph 6, of the EU Treaty. As a matter of fact, by voting unanimously on proposal of the Commission, and upon favourable opinion of the European Parliament, the Council could decide to entrust the ECB with specific duties with respect to policies on the prudential supervision of banks, not including insurance firms. The rule set

out in the Treaty seems to leave room for additional measures intended to entrust the ECB with supervisory duties with respect to other financial intermediaries.

An alternative solution so as to implement the SES without necessarily amending the Treaty could be the option of reinforced cooperation. Counting Euro group countries alone, which as such are subject to the monetary policy of the ECB, the minimum number of eight Member States required by the Treaty would be reached regardless. It is important to note that this way Member States would retain the option of withdrawing in the event they are not satisfied.

In this case, it would be necessary to come to an understanding to enhance the advantages in terms of reputation and liquidity that the Member States that did not take part in the agreement would benefit from, but in which the subsidiaries of adhering countries are situated.

### ***ABI proposals for an overall reform of the European supervisory structure: the role of the ECB***

The proposal of entrusting a stable supervisory role of the banking system to the ECB, in spite of presenting definite strong points, has the great limit of excluding the insurance sector and the banks in countries that do not belong to the Euro zone. Furthermore, at the ideological level, this solution was strongly criticized because it would have the effect of creating a conflict of interest with monetary policies and with the principle of independence recognized in the Statute of the ECB.

The fact that supervisory authorities are generally not completely independent with respect to political power and that, in the final analysis, the banks that are suffering the crisis are rescued with the aid of public intervention, could in fact expose the ECB to unwanted political pressure.

Nevertheless, the new European supervisory structure should not exclude the ECB. The recent crisis has in fact shown that monetary policies and supervision activities are strictly related, seeing as they share the duty of monitoring liquidity, respectively, at macro and micro level.

The ECB, should therefore be assigned specific duties with respect to systemic supervision (macro- supervision) of banks, insurance firms and all investment firms, as well as of those segments of the financial market that at present are not subject to regulatory supervision; systemic supervision, and in particular liquidity supervision, is in fact a cross-cutting issue that should involve all market players, regardless of their nature.

In this respect, it is necessary to ensure close collaboration between the ECB and the SES, with the intention of conducting periodic analysis for ECOFIN.

This proposal is in line with the recommendations put forth by the *Financial Stability Forum (FSF)*, and it follows the proposal that is under discussion in the United States that is designed to put the *Federal Reserve (FED)* in charge of micro-supervision.

## ***ABI proposals for an overall reform of the European supervisory structure: the single rulebook on financial supervision***

The creation of a European supervisory authority entails the establishment of a single *set* of supervisory rules and practices, also at the European level.

The creation of a *single EU rulebook* should involve the establishment of a consolidating act at the EU level, encompassing the CRD and *Solvency 2* (currently undergoing the co-legislators' approval process) implementation provisions, and the codification of supervisory approaches and procedures. In other words, the SES should issue supervisory directives that would replace the ones, currently in force, issued by national authorities <sup>(6)</sup>. These directives would be applied and would be legally binding in member States that have signed the agreement; other States would retain the right of transposition into national law.

Over the medium term, once the insurance sector will have assimilated the changes introduced by *Solvency 2*, it would be appropriate to achieve complete harmonization of supervisory rules by replacing sector regulations with the *Lamfalussy* Regulations.

The establishment of single supervisory rules and practices at the European level also entails the creation of single reports. For this reason, we recognize the need for determining a common accounting language.

Seeing as the CRD also establishes that reports on prudential supervision issues should be based on accounting data <sup>(7)</sup>, all attempts made until the present moment by the CEBS to build a common reporting framework for all

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<sup>(6)</sup> The single rulebook cannot involve the amendment of first level legislation (the CRD in this specific case) because this issue is exclusively within the competence of co-legislators, the European Council and Parliament, nor can it provide its own interpretation, because this issue is within the competence of the Court of Justice of the European Communities.

<sup>(7)</sup> The limits of the current wording of Art. 74(1), "*Save where otherwise provided, the valuation of assets and off-balance-sheet items shall be effected in accordance with the accounting framework to which the credit institution is subject under Regulation (EC) No. 1606/2002 and Directive 86/635/EEC*" and recital 33 "*The precise accounting technique to be used for the calculation of own funds and their adequacy for the risk to which a credit institution is exposed, and for the assessment of the concentration of exposures must take account of the provisions of Council Directive 86/635/EEC or of Regulation (EC) no. 1606/2002, assuming that the latter governs the accounting of the credit institutions under national law*" answer the need of the 2006 Legislator for finding a compromise with Member States that, at the time, did not trust the solidity of IAS/IFRS standards as indicators (prudential filters for the use of IAS/IFRS standards for supervisory purposes were issued by the CEBS in December 2005) and that did not wish to distort the national indicator system by authorizing the end of the principle of acquisition accounting.

European banks, as was expressly requested by ECOFIN, have failed to produce satisfying results by reason of the different information base to refer to.

The most logical solution appears to be that of encouraging the use of IAS/IFRS standards as the common accounting language <sup>(8)</sup> and, accordingly, of building common reporting frameworks based on this language, which will gradually replace the national ones that are currently in force.

For the purpose of also achieving standardized financial *reporting* in technical mode, it is our opinion that the best solution would be to choose the *eXtensible Business Reporting Language* (XBRL) protocol for financial communication and for transferring data to the supervisory body.

Although the crisis has highlighted certain limits of the IAS/IFRS standards (and, in particular, of the accounting principle IAS 39 on financial instruments), these problems can be solved by introducing small adjustments, a certain number of which have been readily implemented by the *International Accounting Standards Board* (IASB). The adjustments that were already introduced and the ones that will be implemented, entail far less disadvantages when compared to the benefits originating from the use of a single accounting language, moreover recognized at the international level.

The IAS/IFRS standards could be used as the common language for supervisory reports even in the absence of their general adoption with respect to accounting reports. It is in fact our opinion, that it would be sufficient to introduce an amendment to the CRD, and in particular, to art. 74, paragraph 1 <sup>(9)</sup> intended to enforce the use of IAS/IFRS standards for the preparation of supervisory reports to all European banks (or at least to cross-border groups).

### ***ABI proposals for an overall reform of the European supervisory structure: agreements in the event of a crisis***

The abandonment of the evolutionary approach for the creation of the SES and for entrusting the ECB with duties of macro-prudential supervision

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<sup>(8)</sup> The 2002 Regulations no. 1606 (IAS Regulations) enforces the use of IAS/IFRS standards at the consolidated level only, and only for listed banking groups; the option of extending the use of IAS/IFRS standards to individual accounts was not consistently implemented in all Member States, therefore at present, there are countries like Italy, where all banks, whether listed or unlisted, are required to apply IAS/IFRS standards to individual accounts; other countries, like the United Kingdom, that leave banks the option of choosing between national accounting principles and the IAS/IFRS standards; and, lastly, countries like France that banned the application of IAS/IFRS standards to individual accounts.

<sup>(9)</sup> See above note no. 8.

entails the need for finding political agreements aimed at reforming the current liability regime as well.

As opposed to national authorities, the SES will be required to report to EU Institutions with respect to its activities; therefore, identification, management and solution of any potential crisis suffered by a cross-border group will also be planned at EU level.

A possible solution could be that of granting specific powers to the SES. In particular, the Committee should be able to take action without delay, in other words before the crisis actually takes place; for example, by appointing a special commissioner to replace the *management* of the banking group and regulate any transfers of *assets* within the group.

Furthermore, the SES should coordinate any private (use of interbank guarantee funds) or public actions (creation of a bad bank).

For this reason, it appears necessary to regulate, in a legally binding manner, the principles of burden sharing among the Member States which ratified the Memorandum of Understanding (MoU), signed in the month of June 2008 by the supervisory authorities, Ministries of Economy, and central banks of all Member States. It is understood that the principles of burden sharing would only be applied if the authority decided, under extreme circumstances, to opt for government intervention.

This solution would give EU Institutions the necessary means for (i) managing and solving a potential crisis, thus reducing as much as possible the amount of public money to be used for a potential government intervention, (ii) avoiding discrimination at the national level that could lead to ring fencing (iii) leaving the authority in charge of allocating costs among Member States, following criteria of fairness and equilibrium.

***ABI proposals for an overall reform of the European supervisory structure: recognition of central management with respect to cross-border groups***

The last item of the reform should involve the legal status of the groups subject to supervision at the EU level. Also in the light of their special liability regime, these groups are in need of some form of legal recognition.

A possible solution could be that of extending the definition of management and coordination included in the Italian Civil Code, and use it as the basis for the recognition of central management with respect to cross-border groups, which is moreover partially recognized by the CRD and *Solvency 2*, as they regulate consolidated supervision.

This proposal would have the advantage of not abolishing the existing liability regime, because foreign *subsidiaries* would still be liable for their obligations, exclusively with their own capital; on the other hand, it would enable cross-border groups to centrally manage their activities, and competent authorities to take action without delay, so as to limit damage in the event of a crisis.

The proposal also has political significance: in 1984, the European Commission had already tried to introduce the concept of group in EU company law. The proposal for a ninth directive was in fact an attempt of the Commission to extend the company law in force in Germany, at the EU level. The proposal however, was not met favourably by Member States, and was thus abandoned.