



FEDERATION BANCAIRE DE L'UNION EUROPEENNE

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19th MEETING OF THE ASSOCIATES
- Brussels, Belgium, 9 December 2004 -

ITEM 5 OF THE AGENDA: LATEST DEVELOPMENTS IN THE EU FINANCIAL SERVICES AREA

At the meeting, Mr. Elmars KRONBERGS, the FBE Adviser will report on the latest developments in the EU legislation concerning the financial sector.

Report will cover the following legislative measures:

- 1) Regulation endorsing IAS 39 on Financial Instruments;
- 2) Recommendation on directors' remuneration;
- 3) Recommendation to reinforce the presence and role of independent non-executive directors on listed companies' boards;
- 4) EC strategy paper on preventing financial and corporate malpractice;
- 5) Proposal for a Directive on formation, maintenance and alternation of capital;
- 6) Proposal for 4 key revisions of the EU's Accounting Directives;
- 7) Proposal for new capital requirements framework for banks and investment firms;
- 8) Proposal to update the anti-money laundering Directive;
- 9) Consultation on shareholders' rights;
- 10) Call to Committee of European Securities Supervisors for technical advice on possible measures concerning Credit Rating Agencies.

This report will be followed by Mrs. Caitriona O'KELLY insight in the BASEL II process and Capital Adequacy Directive, as well as in the Financial Conglomerates Directive.

The speech of Herman Mulder before the EP ECON Hearing on the BASEL II process is enclosed (22 November 2004).

The list of measures taken by the European Commission under the Financial Services Action Plan (FSAP) with their adoption and implementation dates is enclosed.

The relevant PowerPoint presentations will be available from the FBE MemberNet shortly after the meeting.

Enclosures: 1 – Speech of Mr. Mulder
2 – List of the FSAP measures

Briefing for Hermann Mulder at ECON Hearing, 22 November

- I am honoured to be here today to represent the views of the European Banking Federation, or FBE, which represents the interests of 26 national banking associations with a membership of approximately 4500 European banks both large and small with 2.5 million employees. For the purposes of today's hearing I will focus on the issues relating in particular to the business of cross-border banks. I would like to thank the Rapporteur, Mr Radwan, for inviting the FBE to participate in this important hearing.
- My presentation is divided into three parts. I will make some general observations on the proposed Directive, I will then address some of the public concerns and finally I would like to highlight the areas of the Directive which remain problematic for Europe's commercial banks.
- Firstly I would like to emphasise the importance of rapid agreement of this legislation. It is essential for the benefits of the legislation to be realised as quickly and as prudently as possible. Industry has already prepared itself for the new framework, including significant expenditure on improvement of risk management systems to deliver a safer, more risk-sensitive, banking system.
- A delay in implementation would put the European banking industry at a disadvantage on the global market which would not be in the interests of European depositors and borrowers. We urge both co-legislators to ensure that the European process is in line with the implementation of the new Basel framework on a global basis, and in particular in the US, whilst at the same time we welcome the democratic input from the European Parliament. I am sure that this concern is shared by my colleagues from the cooperative and savings banks.
- Beginning with general observations, I would like to congratulate the Commission for the high quality of the proposal for a Directive which reflects the unprecedented level of consultation with industry. The process has been as transparent as we would have wished.
- The Commission has also achieved a high level of parallelism with the new Basel framework whilst taking account of European specificities. This parallelism is necessary if European banks are to enjoy a level playing field with their competitors in other jurisdictions, in particular, in the US.
- We feel that the wider scope of the Directive in the EU is in the interests of both Europe's consumers and its industry at large. A well-managed and well-capitalised banking system will deliver greater stability in the banking sector, providing a sound platform for businesses to expand and innovate.

In general, a disparity in the US between banks applying Basel I and those applying the new Basel framework is neither in the interests of industry nor consumers and it does not enhance prudential supervision.

- Delivering a level playing field across the EU is in all our interests but the current level of inconsistency in interpretation of the rules will have a material impact on the capital of banks. Industry welcomes the willingness in CEBS to work towards supervisory convergence. Inconsistent implementation within the EU goes beyond the national discretions in the proposal for a Directive. In this context I would like to welcome the inclusion in the proposal of the Supervisory Disclosure regime which will be vital in encouraging supervisory convergence

END OF GENERAL OBSERVATIONS

ADDRESSING CONCERNS OF MEPs

- I would like now to address some of the concerns which I feel that the Members of the European Parliament may hold regarding the proposal, specifically on the availability of credit both to consumers and to SMEs and the related issue of the impact on smaller banks.
- Concerns have been raised that the new rules could impact on the price of lending to individuals and to SMEs. I would like to reassure you that banks take many more elements than regulatory capital into account when making a lending decision. Furthermore retail lending is carried out on a pooled basis. This means it is the average risk of the portfolio as a whole which contributes to the capital calculation.
- Remember that banks are required to hold capital to ensure that they can repay their depositors. The objective of this Directive is to enhance the already high level of safety of European citizens' deposits.
- On SMEs, the Commission has incorporated the changes which were made to the Basel framework regarding the treatment of SMEs. These changes include a reduction of the capital charges for loans to small businesses through a flattening of the retail curve, the elimination of the granularity requirements, and the wider recognition of collateral and guarantees.
- The Commission's text provides a menu of options for both banks and investment firms. I believe that this optionality is consistent with a proportionate framework which takes account of the constraints on small banks to implement expensive and complex systems whilst providing incentives to move to the more advanced approaches over time.

- The proportionality of the Commission's proposals in combination with the changes to the treatment of SMEs will allow smaller credit institutions to continue to operate successfully in the markets in which they are active.

END ADDRESSING CONCERNS

MOVE ONTO CONCERNS OF INDUSTRY

- I would now like to move on to the specific concerns of the commercial banks. The areas which I will highlight are absolute priority concerns which we believe will have considerable impact on the ability of cross-border banks to operate in the European Union. You will have seen the full list of FBE concerns in the priority issues note which was sent to you prior to the hearing.
- The three top concerns of European commercial banks are interrelated and I will therefore treat them together. They are the role of the consolidating supervisor, the level of application of the rules and the risk weighting of intra-group exposures. I will also discuss the Trading Book Review.
- We see this Directive as a unique opportunity to deliver a coherent risk sensitive supervisory framework for banks in the EU. The current fragmented framework is an impediment to the Single Market which the FSAP aims to deliver. In this context, we are supportive of the Commission's inclusion of the consolidating supervisor model.
- The approach in the Commission's proposal respects the role of national competent authorities whilst providing a single point of application for institutions for approval of their advanced models.
- Although we welcome the consolidating supervisor model, we feel strongly that this model does not go far enough in delivering a practical supervisory framework. European banks organise risk management on a centralised group basis. This reality is not reflected in the proposal for a Directive. In particular, the consolidating supervisor model must not only be applied to Pillar 1 but also to Pillar 2 if the objective of those pillars is to be met. The risk profile of the group cannot be understood by the group itself, its supervisors, or the market, if Pillar 2 are allowed to apply at the level of each entity within the group.
- Let me first clarify that European banks *do* understand and appreciate the legal responsibilities of national supervisors and we do not advocate stripping supervisors of their ability to ensure the financial soundness of the banks active in their jurisdiction.

- The consolidating supervisor model as it is now proposed does not allow the home supervisor to take a decision except for in cases of extended disagreement. The role is therefore one of coordination of the cooperation between the various supervisors. We believe that this is a sensible approach and that this model of coordination should be extended to Pillar 2 once there is adequate allocation of capital within the group.
- Moving on, my comments on the level of application of the rules and on the risk-weighting of intra-group exposures relate to two national discretions which we strongly believe will distort the Single Market for banks with cross-border operations in Europe. They will have a serious and costly impact on the European banking industry. Let me repeat, this is not a question of *may* have an impact; these discretions *will* have a material impact.
- The proposal currently requires credit institutions to apply own funds requirements at the level of each entity within the group. It then allows Member States to waive this requirement within the home Member State if the group meets the conditions on the allocation of capital. As a result there is a massive competitive distortion between those banking groups domiciled in Member States whose competent authorities do not choose to apply the waiver and those groups in Member States whose competent authorities do apply the waiver.
- The Commission will say that this waiver is not new. That is true. However, the strict conditions which banking groups must meet to be eligible for the waiver are new and significantly change the nature of the waiver. There is no prudential justification for not applying the waiver when those new conditions are met. It would run counter to the goal of creating a level playing field in Europe if the fundamental rule determining the level at which the new capital requirements are met was not consistent for all banking groups.
- Furthermore the proposals are restricted to within single member states and do not allow banks to apply the rules at the top level within the EU. Again, this is not consistent with Single Market objectives. This limitation will lead to a competitive distortion between, on the one hand, internationally active groups with subsidiaries in host member states and, on the other hand, domestic banks. Internationally active banks would be subject to materially different treatment on the level of application in different jurisdictions.
- The solution is to remove the national discretion in Article 69 and apply the waiver at an EU level.

- The risk weighting for domestic intra-group exposures is related. Intra-group exposures will receive a capital charge unless the national supervisor applies the waiver which I have already discussed. Applying the waiver would dispense with capital requirements for domestic intra-group exposures whilst not exercising it would lead to much higher capital charges. However, Member States can choose whether to allow groups to apply a 0% risk weight to domestic intra-group exposures once strict criteria have been met. Not only is this a national discretion, but the restriction to domestic intra-group exposures does not make prudential sense and is contrary to the idea of a single European credit market.
- In view of the conditions regarding the distribution of capital within the group, I believe that a 0% risk weighting is the correct reflection of the essentially mitigated risk associated with all intra-group exposures. It should, therefore, be applied to intra-group counterparties within the EU as a whole. To illustrate this point, I believe that for UK banks alone – the only jurisdiction for which I have data - the impact of weighting domestic intra group exposures would be nearly 24 billion euro and the cost of non-domestic intra-group exposures would be a further 6 billion euro of capital. This would be a major impediment to capital flows within the EU affecting banks and businesses.
- The Commission argues that these national discretions are necessary to reflect the differences between national markets. We do not agree. Certain national discretions can be justified where there are historical differences between specific products. However, this is not the case here. These national discretions relate to the treatment of banks with cross-border activities in the EU. Differences in the structures of the domestic markets in the EU are not a justification for inconsistent treatment of cross-border banks. Furthermore these discretions would hamper the efficient flow of funds within and between Member States
- Moving on to the Trading Book Review which is particularly relevant to the larger banking groups. The Review, which is being carried out by the Basel Committee and the IOSCO, includes 3 separate work streams. Workstreams 1 and 2 are on counterparty risk and double default with appropriate adjustment for maturity below 1 year. Progress has been very good on both of these workstreams.
- The third workstream is on the capital treatment of illiquid assets, and is sometimes referred to as the boundary between the banking book and the trading book. There has been less progress on workstream 3 which is both complex and very important.
- There have been concerns voiced that the proposal for a Directive is not complete without the inclusion of the Trading Book Review, however we

do not believe that this is the full picture. Overall industry has welcomed the regulatory work on the Review. The first two work streams address the treatment of credit risk in the trading book and are thus fully complementary to the work of the overall revision of the capital framework. For this reason we expect that the results of workstreams 1 and 2 to be incorporated into the Directive as soon as they become available so that the Trading Book changes are implemented at the same time as the rest of the revised framework. If the results are not incorporated either before implementation, it will put European banks at a significant competitive disadvantage and will have a negative impact on European investors.

- Some regulators may feel that all three workstreams must be treated as a package if capital neutrality is to be achieved. However we would argue that it is not wise to rush the results of the third workstream. This work touches on market risk issues which are far reaching and therefore warrant the allocation of sufficient time and resources to ensure that appropriate results are delivered. It would be more prudent to deal with the risk associated with illiquid assets through the Supervisory Review Process under Pillar 2 until such a time as an appropriate treatment can be achieved.
- To summarise our key points in brief, the consolidating supervisor model, combined with the role of CEBS in supervisory convergence, is a step in the right direction. However, the role of the consolidating supervisor should be extended to Pillar 2. The waiver in Article 69 should be applied as a rule at the top level in the EU once the conditions are met and intra-group exposures should be risk-weighted at 0%. On the Trading Book Review we believe that workstream 3 on illiquid assets requires more time.
- In conclusion delivering a level playing field within the EU would send a positive message to the rest of the world that consistency in application is of paramount importance. If the objectives of the Lisbon Agenda are to be achieved the EU must be at the forefront in implementing global standards such as the new Basel framework.



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Financial Services Action Plan measures

Measure	Adopted	To be implemented by
Directive on Transparency obligations for securities issuers	30 March 2004	Within 2 years
Commission Communication on Clearing and Settlement COM(2004)312	28 April 2004	-
Directive on Financial instruments markets (Update Investment Services Directive) 2004/39/EC	21 April 2004	end of May 2006
Directive on Take Over Bids 2004/25/EC	21 April 2004	Summer 2006
Directive on Prospectuses 2003/71/EC	4 November 2003	30 June 2005
Modernisation of the accounting provisions of the 4th and 7th Company Law Directives Directive 2003/51/EC	16 June 2003	1 January 2005
Directive on the activities and supervision of institutions for occupational retirement provision 2003/41/EC	3 June 2003	23 September 2005
Directive on the taxation of savings income in the form of interest payments 2003/48/EC	3 June 2003	1 January 2005
Commission Communication reinforcing the statutory audit in the EU COM(2003)286	21 May 2003	-
Commission Communication of modernising Company Law and enhancing Corporate Governance in the EU COM(2003)284	21 May 2003	-
Directive on insider dealing and market manipulation 2003/6/EC	28 January 2003	12 October 2004
Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate 2002/87/EC	16 December 2002	11 August 2004
Directive on insurance mediation 2002/92/EC	9 December 2002	15 January 2005
Directive on the distance marketing of consumer financial services 2002/64/EC	23 September 2002	9 October 2004
Regulation on the application of international accounting standards (EC)1606/2002	19 July 2002	1 January 2005

Directive on financial collateral arrangements 2002/47/EC	6 June 2002	27 December 2003
Commission Recommendation on statutory auditor's independence in the EU: A set of fundamental principles C(2002)1873	16 May 2002	-
Amendments to the solvency margin requirements in the Insurance Directives Directives 2002/12/EC and 2002/13/EC	5 March 2002	20 September 2003
Two Directives on UCITS Directives 2001/107/EC and 2001/108/EC	21 January 2002	13 August 2003
Amendment to the Money Laundering Directive	4 December 2001	15 June 2003
Political agreement on the European Company Statute Directive 2001/86/EC and Regulation (EC)2157/2001	8 October 2001	8 October 2004
Amendments to the 4th and 7th Company Law Directives to allow fair value accounting Directive 2001/65/EC	27 September 2001	1 January 2004
Creation of two Securities Committees. Decision setting up the European Securities Committee – ESC C(2001)1493 and Decision setting up the Committee of European Securities Regulators – CESR C(2001)1501	6 June 2001	-
Directive on the reorganisation and winding-up of credit institutions 2001/24/EC	4 April 2001	5 May 2005
Directive on the reorganisation and winding-up of insurance undertakings 2001/17/EC	19 March 2001	20 April 2003
Commission Recommendation to support best practice in respect of information provision (mortgage credit) C(2001)477	1 March 2001	-
Commission Action Plan to prevent fraud and counterfeiting in payment systems COM(2001)11	9 February 2001	-
Commission Communication on an e-commerce policy for financial services COM(2001)66	7 February 2001	-
Commission Communication on clear and comprehensible information for purchasers COM(2001)66	7 February 2001	-
Commission Communication on the Application of Conduct of Business Rules under Article 11 of the Investment Services Directive COM(2000)722	14 November 2000	-
Amendment of the Insurance Directives and the Investment Services Directive to permit information exchange with third countries Directive 2000/64/EC	7 November 2000	17 November 2002

Directive on the taking up, pursuit and prudential supervision of the businesses of electronic money institutions 2000/46/EC	18 September 2000	27 April 2002
Commission Recommendation on disclosure of financial Instruments - C(2000) 1372	23 June 2000	-
Commission Communication updating the EU Accounting strategy COM(2000)359	13 June 2000	-
Interpretative Communication on the freedom to provide services and the general good in Insurance C(1999)5046	2 February 2000	-
Commission Communication on a single market for payments COM(2000)36	31 January 2000	-
Commission Communication on Funded Pension Schemes COM(1999)134	11 May 1999	-
Implementation of the Settlement Finality Directive 98/26/EC of 19 May 1998		
Commission report on substantive differences between national arrangements relating to consumer-business transactions.	-	-
