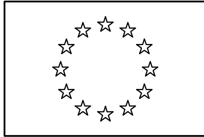

EUROPEAN COMMISSION
Internal Market and Services DG

FINANCIAL INSTITUTIONS
Banking and financial conglomerates

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Supervisory arrangements: the next five years

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OBJECTIVE OF THIS PAPER

1. Further to the roundtable discussion on home/host issues at the last EBC meeting, EBC members will be invited to discuss how the discussion on possible evolution of EU supervisory arrangements should be considered over the next five years in order to keep pace with increasing pan-EU integration. It is explicitly not the intention to consider the possible ideal *structure* that should result. That discussion is, in the view of the Commission's services, premature, is still some time away and rests firmly in the domain of political decision makers. Nevertheless, and as will be explained, without a thorough analysis and upstream and early discussion of the many complex underlying issues that need to be addressed, such a political discussion and decision making process would be inadequately prepared. This paper therefore intends to be a first attempt at a more in-depth overview of the entirety of issues that require attention.

2. It is structured as follows. The Introduction sets a framework for this debate, recalls the Commission's earlier views in its Green Paper, and discusses objectives for supervision. Section I outlines the existing legislative environment and the obligations that this environment creates. Section II of the paper provides background on the EU banking industry, including important developments in recent years that may question the limits of the present arrangements. Section III discusses some of the problems, as perceived by different stakeholders, which arise from the current supervisory arrangements. Section IV presents a variety of solutions proposed by various interested parties. Section V concludes and provides some proposals for future action.

3. Note that this paper discusses only prudential supervision arrangements for credit institutions and for investment firms in the EU. The arrangements for the prudential supervision of (re-)insurance undertakings, financial conglomerate groups and financial markets do not fall within the scope of this paper. On the one hand, those arrangements may require different issues to be addressed, possibly even within a different time-frame. On the other hand, attempting to draw those institutions and markets into the discussion at this juncture would introduce an unnecessary level of complexity and confusion into an issue that is already sufficiently deep and complex.

INTRODUCTION

4. "Are supervisory arrangements in the EU appropriate for the challenges of the years ahead?" Many interested parties have expressed views on this question, not least during the roundtable discussion that the European Banking Committee (EBC) held on 5 July. The increasing trend towards consolidation, concentration and centralisation of business functions in large banking groups engaged in cross-border operations continues to raise questions about the optimal supervision of such groups.

5. This paper for the EBC is a first contribution to the discussion on how that evolutionary change process for supervisory arrangements could be fostered in the time-span of the next years. In doing so, the key difference between this paper and other contributions on the same subject is to emphasize the supervisory <u>objectives</u> and to then to consider how these goals could continue in parallel to meet the expectations of the financial sector.

6. Indeed, most of the previous discussions of the issue of supervisory arrangements centre on what they should look like: the supervisory *architecture*. The Commission services take the view that this is a second-order question. The more important questions are about what supervision is for – the *objectives and goals* of prudential supervision. It is theoretically possible that a number of different supervisory architectures could deliver satisfactory results. In reality, supervisory architecture is a *political* choice. Making such a choice requires an understanding of the consequences of change and of the introduction of new architectures.

7. Appropriate supervisory arrangements – those that can best achieve the objectives and goals of supervision – are in the interest of all stakeholders. Inappropriate arrangements increase the risk of financial instability and crises (with consequent effects in the real economy); they can impose unnecessary cost on industry, passed on to consumers in higher costs for financial services; they can encourage inappropriate and excessive risk-taking, or allow regulatory arbitrage.

8. The objective of this paper is to identify those questions that may suggest avenues of work in response. Ultimately, whatever the political choice for redesigning the EU supervisory architecture may be – reinforced powers of home/consolidating powers or even a centralised EU authority or any permutation inbetween– the questions identified in this paper will need to be addressed. No fundamental decisions to change the present arrangements, whatever those changes may be, will be able to be taken at the political level in the EU without responding to those questions.

Green paper[1]

9. The European Commission's views on how to approach this subject have been clear and consistent. The Green paper on the a possible follow-up to the Financial Services Action Plan published in May included an important section[2] setting out the Commission's initial thinking on the development of supervisory arrangements over the period to 2010. Three steps were set out.

Step 1: Agreement on overall policy objectives

The Commission's policy objectives were described as:

- to advance the Lisbon agenda by enhancing the competitiveness of EU financial markets and institutions. To the extent possible, activities should be subject to the same supervisory requirements both on a cross-border and cross-sectoral basis. All Member States must ensure in their implementation processes that their supervisors have the necessary powers to supervise and cooperate as required in the Directives. Avoiding unnecessary duplication in regulation and supervision will reduce industry burdens and foster expansion of cross-border financial services; and
- to maintain the highest, most up-to-date standards of regulation, oversight and supervision for EU financial institutions, systems and markets to ensure financial stability, market integrity and consumer protection. Supervisory requirements should accurately reflect the risks run in the market while converged supervisory practices and powers are crucial to ensure a level playing field and to avoid regulatory arbitrage.

Step 2: Maximise current framework, identify gaps and develop existing tools

Under this second step, three particular areas of action were set out:

- Removing inconsistencies within and between Directives, paying particular attention to cross-sectoral issues;
- Greater clarity in the roles and responsibilities of supervisors; and
- Convergence of supervisory practices.

The Green paper particularly noted that home country control is still the core concept for supervision in Europe, and that before making any change to this concept, the respective roles and responsibilities of supervisors need to be reinforced and a number of key underlying and interrelated issues need to be addressed (liquidity, crisis management, lender of last resort, deposit guarantees, and winding-up and bankruptcy proceedings).

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1 Green Paper on Financial Services Policy (2005-2010), published on 3 May 2005.

2 Annex I, Section III - 'Efficient and effective supervision'

Step 3: Development of new structures

Under the third step, the Green paper noted that new supervisory structures should only be developed if the possibilities to improve the current framework have been exhausted and it is clear that the existing framework cannot fulfil its financial stability and integration objectives or meet the requirements of European legislation.

10. This paper and the expected discussion in the EBC is situated in the *second* of the three steps. The final outcome of the Commission's suggested financial policy, the White Paper which will be published towards the end of November, will confirm this overall approach. An 'evolutionary', not 'revolutionary' approach is considered to be the appropriate way forward.

Objectives of supervision

In his presentation to the EBC on 5 July, Alessandro Profumo[3] characterised this as:

" a framework which ensures a level playing field among financial firms throughout the single market, whilst meeting the criteria of efficiency and effectiveness. Where efficient means it should minimise supervisory costs, either direct or indirect, and effective means it should guarantee the objective of financial stability, by lowering the probability of ineffective monitoring and inconsistent decisions … equal treatment for all firms across the EU irrespective of the country of origin … neutrality towards strategic and organisational choices of financial firms. Regulatory and supervisory requirements should not create incentives which might distort the behaviour of private actors."

11. There is general agreement amongst stakeholders that prudential supervision, in the EU, should:

a) ensure financial stability of the (banking) system as a whole through a focus on the safety and soundness of individual institutions;

b) protect consumers through the oversight of individual institutions and the provision of safety nets;

c) include clear arrangements for crisis management;

d) provide a level playing field, to ensure that competition and innovation can flourish;

e) respond to market developments in a timely manner;

f) not disadvantage EU institutions in their global operations;

g) be carried out in a transparent manner with appropriate accountability arrangements;

h) be cost-effective and efficient.

Underlying issues: why are they important?

12. The green paper mentioned five issues that need to be considered in the period ahead. These are liquidity/emergency liquidity assistance, crisis management, lender of last resort, deposit guarantees, and winding-up and bankruptcy proceedings. The key concerns of national supervisory authorities relate to their statutory responsibilities for the safety and soundness of licensed institutions in their jurisdiction. These responsibilities will, importantly, involve a going-concern situation within firms as well as times of failures. The present roles and responsibilities in EU banking legislation dictate the supervisory arrangements. There are important differences in responsibilities and powers depending on the legal status of the firm they supervise: branch or subsidiary. Any further fundamental change to those responsibilities should therefore only be considered through a fuller understanding of what those

[3] CEO, Unicredit.

changes entail and the impact of any change on those responsibilities. A misalignment between the formal responsibility for the supervision of a bank and for the financial consequences in the event of its failure will be a source of difficulty and potential instability in the EU financial sector. The simplicity for firms that would be achieved by having only one regulatory authority for its EU-wide operations may be highly desirable from the perspective of efficiency, but requires answers to a number of legitimate and fundamental questions first. Essentially, these issues concern the question "Who pays the bill if a financial firm fails?" That is why liquidity, crisis management, lender of last resort, deposit guarantees, and winding-up and bankruptcy proceedings are inter-related issues. It does mean that any of these issues should dictate the speed of progress, but their inter-dependence cannot be ignored. The questions are pertinent at all times – and often difficult – but are particularly difficult in the cross-border context. What arrangements should be in place? Whose tax payers should pick up the bill? Who should make decisions on whether to bail out a cross-border bank? Is there a clear and unambiguous legal basis to take those necessary decisions?

13. Unless these questions, and others, can be answered, it is neither sensible, nor desirable to make the political choices referred to above – on architecture. As with any sound construction, the foundations should be solid – addressing these issues on the legal, organisational, political and ultimately financial consequences of cross-border crisis will provide solid foundations.

SECTION I: THE LEGISLATIVE BACKGROUND

14. Under the legislation put in place over the past twenty years, financial institutions can choose between a number of ways to provide and market services to customers in another Member State. These include:

a) establishing a branch;
b) establishing a subsidiary;
c) providing services on a cross-border basis; and
d) entering into strategic partnerships or joint ventures with institutions in another Member State.

15. Each of these choices has consequences in terms of the supervisory regime the financial institution faces.

The home/host principle for branches

16. The current EU system of prudential supervision is founded on the principle of home country control combined with minimum standards and mutual recognition. A financial institution is thus authorised and supervised in its home country and can expand throughout the EU without additional supervision (with a limited number of exceptions, see below). The host country must recognise the supervision exercised by the home country authorities. That mutual recognition is possible because of the minimum harmonisation across the EU of essential prudential requirements.

17. Home country control promotes supervisory effectiveness: the home supervisor is best able to make a group-wide assessment of the risks that financial institutions face (that is, the concept of consolidated supervision). It also promotes supervisory efficiency: financial institutions are not automatically faced with different supervisors, which could result in duplication of efforts and a higher regulatory burden.

18. Home country control applies to financial institutions that offer cross-border services to other Member States or establish branches in these countries. The Commission, Council and European

Parliament took a clear and deliberate decision to limit the concept of home country control to *branch* establishments when they adopted the Second Banking Coordination Directive 89/647/EC in 1989. Although consideration had been given in the legislative process to extending this to subsidiaries of a banking group that had been legally incorporated in another Member State, this extension was rejected because (i) the degree of dependency between a branch and its parent did not apply to a parent-subsidiary relationship and (ii) because the legal responsibility for a subsidiary lies with the authority that authority that grants its banking license.

19. Host authorities may impose statistical reporting requirements to foreign credit institutions and investment firms operating within their territory provided they are treated on the same footing as locally registered institutions. There are additional provisions which, if invoked, would transfer supervisory responsibility from home to host (e.g. for branches). Directive 2000/12/EC provides a mechanism for the host supervisor to raise prudential concerns with the home supervisor and, where appropriate action is not taken, the host supervisor has a power to intervene. The use of these provisions is envisaged only in extreme circumstances and where the home supervisor has not been fulfilling its obligations under EU law.

20. Any increase in formal host supervisor responsibility for branches would to some extent cut across the Single Market principle of freedom of establishment for firms from their home country, including those based on "passporting" rights provided in directives.

"Host" country prudential control over subsidiaries

21. Financial institutions also operate through subsidiaries in other Member States for a variety of reasons, which include taxation, limitation of liability, market perception and, at least historically, in response to supervisory pressure to establish subsidiaries rather than branches.

22. Subsidiaries are separately licensed and supervised by the "host" country authorities. They are, in effect, subject to "another" home country regime. It is important to note that the scope for control of subsidiaries by host countries is somewhat limited in practice. Key decisions are often taken by the parent institution and the financial health of the subsidiary is closed linked to the well-being of the group as a whole. This means that the failure of a financial institution in one country may cause problems in other countries. The crucial difference with a branch is the fact that a subsidiary has been authorised in its country of legal incorporation and is a separately supervised entity – even though it may be equally dependent on its parent in a stress situation as a branch. This is reflected in the current arrangements for supervision on a consolidated basis. Since 1987, and more recently 1993, through more detailed arrangements in Directive 92/30/EC, the prudential requirements for banking groups reflect the fact that the financial position of a subsidiary presents only part of the picture: the financial health of its parent and other group entities is at least as important.

23. Any increase in formal home supervisor responsibility for subsidiaries would cut across the legal responsibilities of host supervisors for authorising subsidiaries, and would break the connection established in EU legislation between responsibility and authority in respect of particular institutions.

What legal obligations are placed on supervisors?

24. EU legislation places a considerable number of requirements on supervisors to cooperate, to exchange information, to consult, and provides for a number of situations in which supervisors are under a legal obligation to should work together. It is inappropriate in this paper to provide an exhaustive overview of the provisions in the EU Directives but a broad summary is given below.

25. The counterweight to the significant role given to the home supervisor for branch supervision and for consolidated supervision of the prudential situation of subsidiaries of banking groups is that they are under an obligation to cooperate and transmit information to the 'host' Member State authorities.

The EU Directives provide for the need to transmit essential information (without a request being necessary) and relevant information (on request). Consultation is required in respect of certain application for authorisation, in relation to the approval of shareholders and of directors, and in other situations. And on-site inspections can involve home and host supervisors working together.

26. It is clearly important that the transposition of EU legislation into national law provides supervisors with all the tools to carry out the range of tasks and responsibilities that the Directive gives them.

The European Company Statute

27. Financial institutions now have the option of becoming a European Company, or Societas Europeae (SE). There are two points of particular relevance here. Firstly, becoming a SE allows the conversion of subsidiaries into branches. Secondly, a SE can much more easily transfer the legal seat of the company. Over time this could have the effect of increasing the incidence of important branches in EU markets.

28. Two major financial institutions are in the process of becoming SEs. Nordea's transformation into an SE is well known, as are some of the consequences, both for deposit guarantee arrangements and for financial stability issues arising from substantial branch operations. Allianz has also decided to opt for SE status, although it will not transform its bank subsidiaries into branches, only its insurance subsidiaries.

Changes introduced by recent legislation

29. The Financial Conglomerates Directive[4] introduced two important new concepts in the prudential supervision of financial institutions:

a) The concept of the '*coordinator*'. This supervisory authority is identified according to a process set out in the Directive, and has a number of responsibilities, in both going concern and crisis situations, including the dissemination of information to other supervisors. The coordinator also has a role to try to prevent duplication of supervisory work;

b) The concept of '*relevant competent authorities*', meaning those supervisors of subsidiaries which are particularly important in the financial market of a Member State. This has been the first acknowledgment in EU legislation that the responsibilities of 'host' jurisdiction authorities must be given due account.

30. The Capital Requirements Directive CRD[5] has made further changes to supervisory arrangements. In particular, Article 129 of the proposal will further extend the role and legal responsibilities of the "consolidating" supervisor. That authority will be given decision-making powers in relation to validation of internal models in subsidiaries in other Member States, to be exercised only where supervisors cannot reach a collective agreement. The Directive further specifies that additional tasks may be entrusted to the consolidating supervisor.

31. In terms of information exchange, the CRD contains provisions to prevent duplication of reporting requirements. Supervisors should exchange information rather than seeking it again from

[4] Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council.

[5] Proposal for Directives of the European Parliament and of the Council re-casting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions. COM(2004) 486 final.

financial institutions. The proposal also defines the 'essential' information that should be exchanged. Importantly, the Directive introduces an obligation on the consolidating supervisor to inform the authorities in other Member States of any material developments in the subsidiaries for which they are responsible.

32. The proposal also confirms the possibility to delegate tasks from one supervisor to another. This is already provided for in the existing banking legislation, although this provision has never been used (and indeed it has not been transposed in all Member States – an example of supervisors not having the full range of tools available).

33. All of these provisions will be adopted formally shortly and will come into effect at the start of 2007.

Future requirements

34. There are a number of provisions in existing and forthcoming legislation that will require further review of the legislation that underpins prudential supervision. These include:

a) the Financial Conglomerates Directive should be reviewed before August 2007;
b) during 2007 there will be a review of the Lamfalussy committee arrangements;
c) the Capital Requirements Directive will contain a number of review clauses, on both general and specific issues. The most important of these, in relation to this paper, is set out below:

Article 156, paragraph 2a

35. In terms of all of these current supervisory arrangements it is important to note that in the CRD a review clause has been agreed between the European institutions. The Commission is required four years after the date of implementation of [all of] the CRD, i.e. by 1 January 2012, to review and report to the European Parliament and the Council, together with any appropriate proposals, on the application of the Directive with particular attention to the following aspects:[6]

a) scope and level of application of capital requirements;
b) intra-group exposures;
c) the decision-making power of the consolidating supervisor.

36. This particular review clause reflects the interest of a variety of stakeholders to move to a situation where capital requirements apply only at the EU level, and where the consolidating supervisor has more powers (at the expense of the subsidiary, or host, supervisors). In many respects this review clause represents an end-point for any work that is put in train to enhance supervisory arrangements in the short-term.

SECTION II: THE EU BANKING INDUSTRY

37. This section provides some data on the EU banking industry and highlights a number of trends in terms of industry structure. The section also covers a number of trends in the management of banks, some of which throw up challenges for existing supervisory arrangements. These trends are important in order to determine whether the current supervisory arrangements have developed in step with market developments.

[6] Articles 68 to73, 80(7), 80(7a) and 129 of CRD

38. Data on investment firms is less readily available than data on credit institutions. Nonetheless, data from 2004 shows that there are over 2,000 such firms authorised in the EU.

Overall data

39. The number of credit institutions in the EU has been declining since 1997. In 2004 the total number of EU credit institutions stood at 8,372, a fall of 2.8% (Annex 1, Table 1). There continues to be evidence of cost cutting and downsizing in some countries. This seems to be driven mostly by large banks and leads to a reduction in staff levels, but less so in terms of reduction of branch networks (Annex 1, Tables 1 and 2).

40. Significant differences in terms of banking market structures remain between Member States. Table 1 below describes the provision of similar services in a sector that shares a common technology. If a country's banking sector is characterised by a dense branch network, a high number of employees, and at the same time operates a dense network of ATMs, this may point to overcapacity in distribution channels.

Table 1: EU banking sector capacity indicators relative to population (2004)

	2004	2004	2003	2004	2004	2004
	Pop. per CI	Pop. per branch	Pop. per ATM*	Pop. per employee	Population density	Assets per employee
BE	100 173	2 154	1 468	146	315	12818.4
CZ	150 031	5 715	4 000	264	129	2237.8
DK	26 748	2 673	1 876	123	125	12368.4
DE	38 408	1 813	1 613	114	231	8812.0
EE	193 714	6 680	2 096	304	30	1475.2
GR	178 082	3 245	2 008	186	84	3883.8
ES	123 238	1 050	785	173	84	6981.0
FR	69 317	2 358	1 464	146	113	9397.3
IE	50 702	4 390	2 070	114	58	16130.1
IT	74 021	1 882	1 490	173	193	6753.1
CY	17 140	1 474	1 938	87	80	4501.6
LV	100 557	3 967	2 681	240	36	1156.6
LT	46 473	4 537	3 484	473	53	1171.1
LU	2 794	1 789	1 161	20	175	30826.3
HU	47 451	3 384	3 401	279	109	1793.0
MT	25 094	6 373	2 674	120	1 255	6081.4
NL	35 369	4 468	2 151	141	399	14551.9
AT	10 270	1 875	1 078	112	97	8720.3
PL	58 448	7 624	5 051	255	118	881.7
PT	53 329	1 943	871	199	114	6546.6
SI	83 225	2 829	1 610	172	99	2108.4
SK	256 303	4 836	3 571	295	110	1590.3
FI	14 400	3 298	2 604	206	15	8370.8
SE	42 425	4 422	3 344	230	20	14877.6
UK	145 336	4 287	1 277	117	245	12334.4
MU12	48 666	1 857	1 347	142	121	9.332*
EU25	52 663	2 306	1 523	150	115	9.174*

Source: ECB. Note *: data for the year 2003. MU12 and EU25 are weighted averages. Population density is expressed as inhabitants per square kilometre.

41. The vast majority of the 8,372 credit institutions in the EU operate on a national or sub-national (regional or local) scale. Less than 50 groups have significant cross-border operations.[7] Although integration is progressing, national differences remain relevant and are likely to persist, especially in retail banking: there are social, cultural and legislative barriers.

Cross-border business

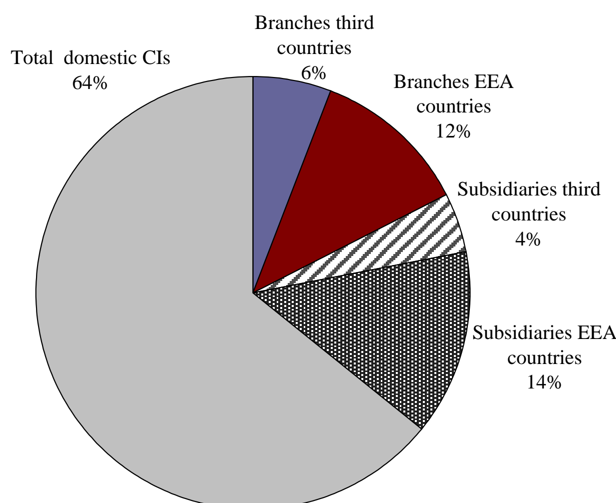
42. Cross-border firms play a particularly important part in integrating the EU's financial markets. Notwithstanding technological change in recent years, the provision of financial services - in all market

[7] But these groups account for a large share of financial sector assets. In 2003 the top 50 EU banks accounted for more than 60% of total EU bank assets. There is not a perfect match between the top 50 EU banks and those with significant cross-border activity, but there is considerable overlap.

segments - still predominantly requires personal contact between customers and services providers. Hence, integration is advanced particularly by those firms that have distribution points – in whichever form – in more than one Member State. In addition, these institutions almost exclusively account for cross-border business and are therefore prime channels for the distribution of capital and associated financial risk across borders in the EU.

43. The market share of foreign branches and subsidiaries in the EU as a whole stood at 36% at the end of 2004 (see Chart 1). This is much higher than the comparable figure for 2003 because of the inclusion of the new Member States, whose banking sectors are generally characterised by a large foreign ownership.

Chart 1: Share of foreign bank branches and subsidiaries in the EU (2004, % total assets)

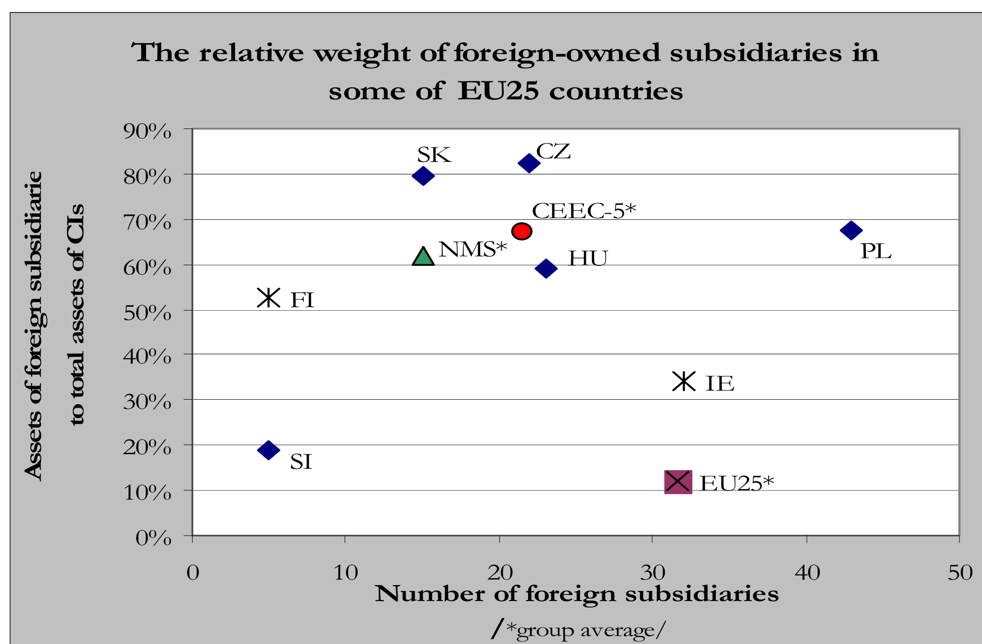


Source: ECB.

44. A high ratio of foreign ownership in terms of total assets prevails in almost all Central and Eastern European ('CEE') countries. In these countries the development of the financial sector has evolved along with the gradually growing share of foreign ownership. Much of the investment has come from Member States adjoining the CEE countries: Germany, Austria, and Italy. Many other large EU investors are from the Netherlands or Belgium. While in most cases, the value of a foreign banking group's investment in a single CEE country's local market does not represent a significant amount compared to the whole portfolio of the group, the group's local subsidiary might be a significant player in the host country.

45. There are already cases where the weight of the foreign subsidiaries in the whole group's portfolio is significant: as regards profitability, in most of the cases the earning capacity of foreign subsidiaries exceeds that of the parent bank (for example in the case of Erste group and its CEE subsidiaries). Chart 2 below provides an important insight into the importance of foreign-owned subsidiaries in the markets of a number of the new EU-Member States. It also provides an interesting contrast with the average foreign ownership across the entirety of the EU-25.

Chart 2: Relative weight of foreign-owned subsidiaries in some MS



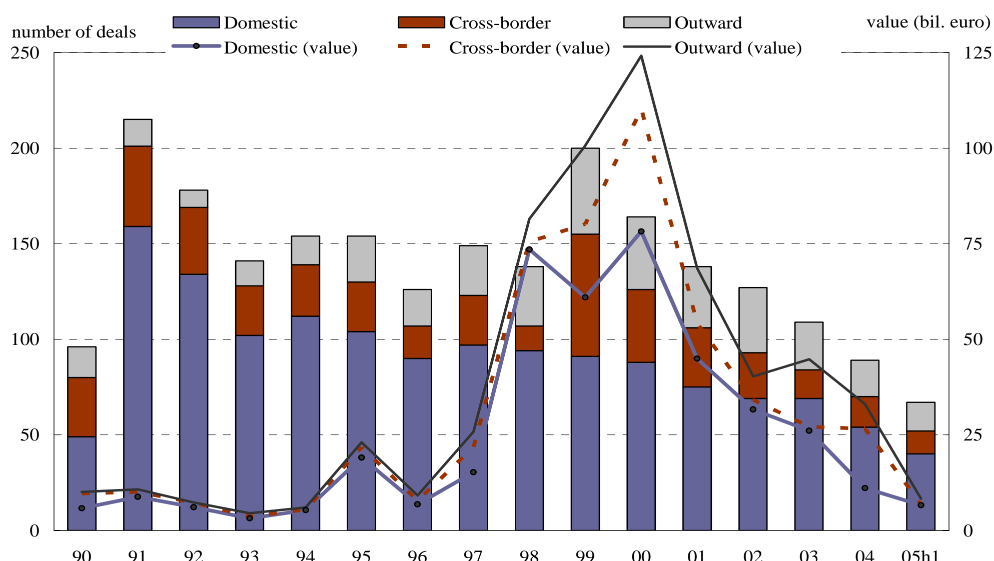
Source: ECB.

46. Annex 1, Tables 3 to 6 gives more details on the number, and total assets, of branches and subsidiaries of EEA and third country credit institutions.

Mergers and Acquisitions

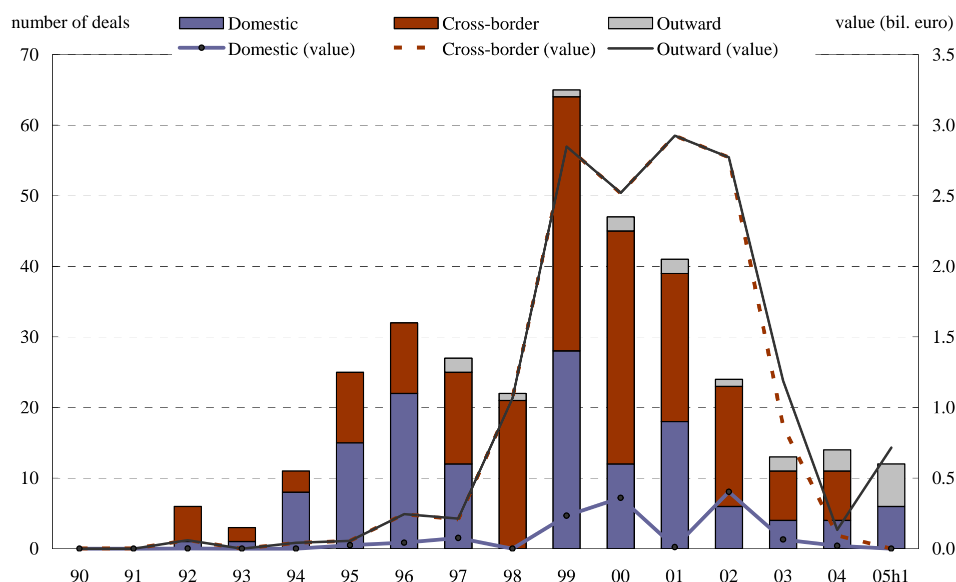
47. M&A activity has been declining since 1999: this trend continued in 2004 and in the first half of 2005. This suggests consolidation is proceeding, but at a slower pace than previously (Chart 3 and 4).

Chart 3: Number and value of banking sector M&As in EU-15 (1990-2005h1)



Source: Thomson Financial SDC.
Note: 2005 figures are annualised. Cross-border M&A refers to transactions in EU-15 involving a non-domestic acquirer. Outward M&A refers to non-EU acquisitions of EU-15 banks (only up to 2005Q1). The number of deals is shown on the left-hand scale. Value of deals is represented as stacked lines on the right-hand scale.

Chart 4: Number and value of banking sector M&As in EU-10 (1990-2005h1)



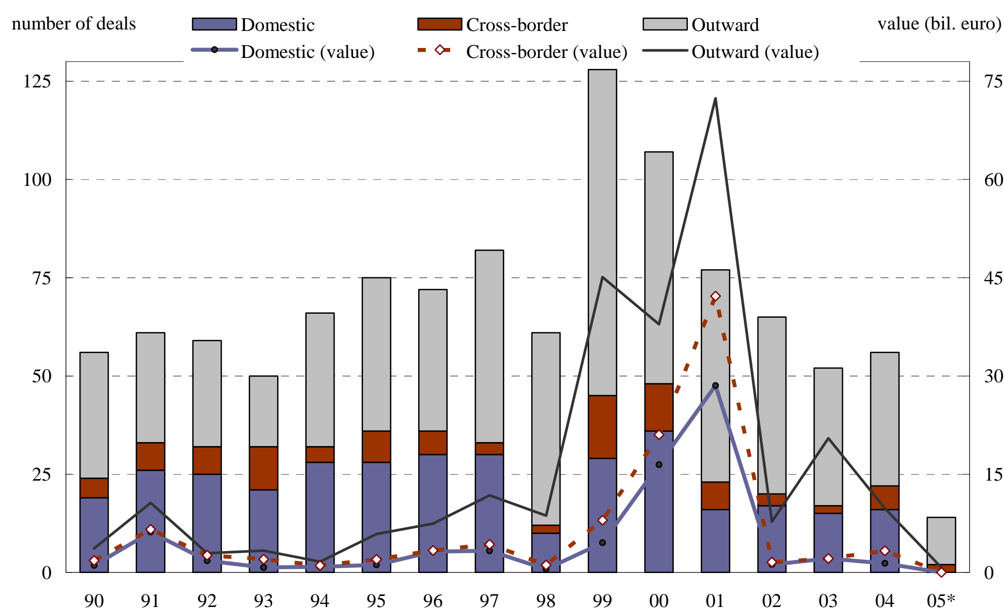
Source: Thomson Financial SDC. See notes to Chart 3.

48. This decline can be explained mainly by a slowdown in domestic M&As. Cross-border M&As have increased relative to the period 1993-1998, both in absolute and relative terms, accounting for about 30% of the number and 24% of the value of all deals in the more recent period. Increased financial market integration, higher competition, and limits to domestic concentration, as well as the introduction of the euro are possible explanations. Annex 1, Tables 7 and 8 gives more detail.

Conglomeration

49. Although outside the direct scope of this paper, it is of interest to note that cross-sector consolidation between banks and insurance companies remained low in 2004 relative to the peaks in deal value seen between 2000 and 2001 but was in line with the level of market activity seen in the last two years (Chart 5).

Chart 5: Bancassurance M&As in the EU-25 (1990-2005Q1)



Source: Thomson Financial SDC. Note: Bancassurance refers to banks acquiring insurance companies and insurance companies acquiring banks. See also notes to Chart 3.

50. It is important to note the extent of conglomeration because, by definition, most conglomerates are significant players in banking markets. Data for 2001 showed that 27% of EU-15 banking deposits were held by conglomerates.

Industry trends: risk management

51. One of the most notable advances in risk management is the growing emphasis on developing a firm-wide assessment of risk.[8] These approaches to risk management aim to ensure a comprehensive and systematic approach to risk-related decisions throughout the financial group. Although costly to put in place, once groups have a centralised risk function in place, they should expect to reap economies of scale in risk management.

52. On the basis of a survey of 31 financial institutions in 12 jurisdictions, the Joint Forum observed two important trends:

a) (i) greater emphasis on the management of risk on an integrated firm-wide basis; and

b) (ii) related efforts to "aggregate" risk through mathematical risk models.

53. These integrated risk management systems seek to have in place management policies and procedures that are designed to help ensure an awareness of, and accountability for, the risk taken throughout the financial group, and also to develop tools needed to address those risks. A key objective of integrated risk management systems is to ensure that the firm does not ignore any material source of risk. The Joint Forum study shows that in order to accomplish this, many firms have increased the share of firms resources devoted to risk management activities and/or created a dedicated risk management function.

54. It is perhaps difficult to tell which forces are driving developments in this area, and which are following. The potential capital reductions that can be achieved by applying the advanced approaches of the Capital Requirements Directive could encourage banking groups to organise their risk management more centrally. Nevertheless, these centralised systems still rely on local branches and subsidiaries for local market data. But the CRD (and Basel II) are at least in part a response to developments already in place in the industry.

Industry trends: centralisation

55. In addition to risk management, there is a clear trend towards centralisation of management functions that previously belonged with the separate entities of a financial group. Centralisation implies that strategic decision-making is transferred from the functional or sectoral entities of the group to the level of the group as a whole (that is, the holding level). The centralisation of activities (such as asset management) and key management functions results from the drive of financial groups to reap the benefits from synergies.

56. Increasingly functions are being centralised and these cut across the entire structure of the group, whether subsidiaries or branches. This type of centralisation is well known as far as functions like risk management, internal audit, compliance and so on are concerned. But back office functions, data processing and accounting are also involved, as well as 'business' functions like asset management. The phenomenon extends to investment products, especially investment funds, which are being organised in one entity, and assembled and packaged often under local names, or even different formulas, in other jurisdictions.

Industry trends: outsourcing

57. In contrast to the trend of centralisation is the tendency to outsource activities. This has two facets: firstly, the outsourcing of activities outside the group, often to locations that are lower-cost; this

[8] See, for example, 'Trends in Risk Integration and Aggregation'; Joint Forum; 2003.

development and its consequences have been much discussed elsewhere. But secondly (and supportive of the other trends) outsourcing within the group, where particular entities carry out activities on behalf of the whole group. These entities are not necessarily at the holding level, but could be subsidiaries, often in another jurisdiction. Examples of this include all the retail banking processing for a banking group being carried out by one particular banking subsidiary.

Industry trends: consequences

58. The inevitable consequence of these trends is a dislocation between operational structures, in particular for risk management, and legal structure. A large difference between the legal structure and the operational structure will complicate the execution of supervision, since supervision is based on statutory power to supervise legal entities and this may not correspond to where activities actually take place. This tension between operationally integrated financial groups looking for synergies and legally constrained supervisors looking for an effective lever on key decision-makers in those financial groups poses a challenge for policy.

59. The consequences of the trends in the data on the EU banking market are an increase in cross-border business and, crucially, cross-border ownership, an increase in concentration, the increasing importance of branches in some markets and the continuing importance of conglomeration. All of these trends pose challenges to the allocation of supervisory responsibilities and the effectiveness with which supervision can be carried out.

SECTION III: CHALLENGES FOR CURRENT SUPERVISORY ARRANGEMENTS

General

60. Given the home/host principle, it is no surprise that supervisory authorities are still nationally rooted. The national base of supervisors is related to questions of legitimacy, of sovereignty and, more practically, to the issue of jurisdiction. Jurisdiction is necessary to enforce regulations, for liquidation and winding-up procedures, and for taxation.

61. However, a clear consequence of this structure is the potential difficulty in managing cross-border issues in times of crisis. National supervisors are not inclined (they have no, or little, incentive) to take into account spillover effects beyond their borders created by the (potential) failure of financial groups that operate on an EU-wide basis. There is evidence[9] that the incidence of such large groups is increasing, as would be expected given the increasing financial integration of EU markets. So there is an argument that financial stability can no longer be managed at the national level.

62. Further, a challenge to the current arrangements arises from the increase in the incidence of branches that are major players in the Member State where they operate. The host supervisor has little authority over the branch, but will have at least some responsibility for financial stability in that market. This issue could be exacerbated if more financial groups decide to make use of the European Company Statute.

63. The increasing recognition of the role that financial services can play in maximising the competitiveness of the EU economy (helping to achieve the goals of the Lisbon agenda) has increased the pressure for more cost-effective supervision.

[9] See, for example, 'Financial Supervision in an Integrating Europe: Measuring Cross-Border Externalities'; Schoenmaker, D. & Oosterloo, S.; International Finance 8:1, 2005: pp. 1–27.

64. A wide range of stakeholders have expressed a wide range of opinions on the challenges facing supervision and the problems caused by current arrangements. This section provides a brief summary of some of the main issues raised.

Industry perspective

65. There is growing demand from cross-border groups for more streamlined supervision. This is driven by a number of factors:

a) groups would prefer supervision to be organised along the same lines that they organise themselves. It is argued that this would lead to more effective supervision, preventing gaps and avoiding overlaps;

b) current arrangements lead to a multiplicity of formal reporting requirements for cross-border groups, with significant differences from one supervisor (and one Member State) to the next;

c) supervisory activity is seen as being duplicative, and badly coordinated; and

d) groups face having to contact multiple supervisors about a particular issue.

66. Industry is also concerned about global competitiveness, particularly given the significant volume of new regulation that has emerged under the Financial Services Action Plan.

67. However it is the divergence between the way groups organise and run themselves (business lines, centralisation), and the way supervisors are organised (legal entity, national) that is the biggest problem. To quote from a recent industry report: [10]

> "*For internationally active groups, supervisory responsibilities no longer coincide with, nor are they suited to the reality of those groups. The institutional set-up of financial supervision in Europe currently is a patchwork of different and largely incompatible regimes, where responsibilities, procedures and incentive structures are unclear.*"

Finance Ministry perspective

68. The FSC has recently looked at the question of supervision and produced a report (the 'Francq report[11]). This identifies a number of immediate challenges for supervision, arising from the increasing and accelerating pace of financial integration in the EU. The solutions identified in the FSC paper are concrete and practical, mostly focusing on short to medium term issues arising from the convergence of supervisory practices, supervisory tools, and a 'common supervisory culture'. However, most of these issues do not relate to the direct responsibility of finance ministries at all but focus on the responsibilities of other authorities: those responsible for exercising prudential supervision.

69. The area that is of more direct concern to finance ministries relates to their role in event of financial crises and failure/rescue of distressed firms. This specific responsibility has only recently received attention. First, in EU banking legislation, and more particularly the CRD which contains an obligation on supervisory authorities to cooperate and share information with finance ministries in time of pending crises. Second, and more recently, the extension of the MoU information exchange arrangements between central banks and supervisors to include also finance ministries in particular as regards crisis management situations.

[10] 'On the lead supervisor model and the future of financial supervision in the EU'; European Financial Services Round Table; June 2005.

[11] Report on Financial Supervision; FSC/4155/1/05 REV 1.

Consumer perspective

70. For consumers, the key issue is, as always, having the confidence to purchase the financial products of cross-border firms and feeling comfortable about supervisory arrangements. Consumers also need to know that they may have recourse to the necessary safety net mechanisms if required.

Supervisory perspective

71. Supervisors also see challenges to the current arrangements. The fact that there is an increasing divergence between financial group organisation and supervisory organisation calls for extensive co-operation between home and host authorities, with extensive and two-sided exchanges of information. This is resource intensive for supervisors. But it is essential if supervisors are to respond effectively to business and market developments.

72. The key issue is how effective this would be in dealing with risks arising from cross-border business and how effectively cross-border crises could be resolved. Crisis management is obviously hugely important, but the vast majority of supervisory resource is devoted to day-to-day supervision of financial institutions. In addition, the recent adoption of the CRD will of necessity be the key focus of supervisory attention. A discussion about future supervisory structures may be viewed by many supervisory authorities as an interesting topic, but also as an unwelcome distraction from their core work on which they are judged in the first instance.

73. Supervisors could face particular difficulties in situations where a subsidiary (or branch, as may be the case in the Nordea banking group) is of particular importance in that Member State, but is not important for the group as a whole. The host country might operate under the legitimate expectation that, in the event of a liquidity or solvency crisis in a subsidiary, the parent would support its subsidiary. But this may be incorrect. In addition, whether or not any one institution is important, there are situations where much of the host country's banking system is foreign-owned. In aggregate its authorities will have limited responsibility for supervision within their financial market.

74. A further challenge for supervisors arises from the recent trend towards outsourcing of certain functions from host country banks to undertakings in home countries or in third countries. While this is part of the centralisation discussed in Section II, in some respects it goes further. Certain functions can end up being performed at two or three steps from the authority of the host supervisor. In this case there is a significant onus on the consolidating supervisor to ensure that there is adequate flow of information.

75. There is a clear trend to centralise key management functions, as discussed in Section II. A large difference between the legal structure and organisational structure will complicate the execution of supervision, since supervision is based on statutory power to supervise legal entities and this may not correspond to where activities actually take place. This tension between operationally integrated financial groups looking for synergies and legally constrained supervisors looking for an effective lever on key decision-makers in those financial groups poses a challenge for policy.

76. A misalignment between the formal responsibility for the supervision of a bank and for the financial consequences in the event of its failure will be a source of immense difficulty and potential instability in the EU financial sector. EU supervisors have argued that the limits of home country control have been reached under the present arrangements. Any further shift in responsibilities without consideration of fundamental underlying issues would risk misalignment between the formal responsibility for the supervision of a bank and for the financial consequences in the event of its failure. This would be a potential source of great difficulty and instability in the EU financial sector.

SECTION IV: SOLUTIONS PROPOSED BY STAKEHOLDERS

77. A wide range of stakeholders have proposed ways in which the current supervisory arrangements can be enhanced. This section provides a brief summary of some of the main proposals.

General

78. There is consensus that the following actions must be taken:
   a) better implementation and enforcement of EU measures affecting the financial sector;
   b) ensuring supervisors have the appropriate tools to carry out their roles;[12]
   c) improved cooperation and coordination between supervisors;
   d) convergence of supervisory practices, leading to more consistent decision-taking;
   e) moves towards more common reporting requirements, and more efficient data collection and sharing;
   f) increase the transparency of supervision in some areas; and
   g) the development of a common supervisory culture across the EU.

79. There is also consensus that the following avenues should be explored:
   a) the delegation of tasks between supervisors in a pragmatic way, within the existing legal framework;
   b) peer reviews to establish the degree of convergence achieve in practice;
   c) joint working, including joint investigations.

80. All of these can be taken forward without the need for new EU legislation. An important paper presented by the UK Treasury, the FSA and the Bank of England in January 2005, analyses the possible extent of new regulatory initiatives to reach these objectives and comes to the conclusion that the present arrangements suffice. They do not impact on the present structure of supervision but seek to ensure that the structure operates as efficiently as possible. Obviously any new legislation would need to ensure that it did not create new obstacles to more effective supervisory arrangements.

Regulatory competition

Another issue raised in the debate on supervisory arrangements is the extent to which regulatory competition is desirable.

In the US both federal and state banking supervisors try to offer high-quality supervision at a reasonable cost because banks may switch from a state to a federal charter and vice versa. This element of choice does not exist in the EU. Regulatory competition in the US is constrained by federal law, which determines the room for manoeuvre of regulatory agencies and state regulators. With regard to the EU, it should be noted that, if properly applied, minimum harmonisation and mutual recognition provide room for regulatory competition among Member States, which may be induced by the mobility of financial intermediaries to transfer their headquarters from one Member State to another.

Industry perspective

81. It is important to recognise, as highlighted in Section II, that the voices in the industry seeking substantial change represent only a very small proportion of credit institutions and investment firms in the EU. However, this segment of Europe's financial sector also represents a significant proportion of financial sector assets in the EU. It is also the case that there are elements of the industry agenda that would be supported by all financial institutions.

82. Most of the large cross-border groups advocate a radical reallocation of supervisory responsibilities. This is sometimes called a 'lead supervisor' model, sometimes strengthening the role of

[12] This is less of an issue for prudential supervision than in other areas. The long history of cooperation between supervisors and of EU banking legislation has led to fairly similar tools and powers being available to EU supervisors.

the consolidating supervisor. The EFSRT proposes that the lead supervisor should be responsible for the prudential supervision not only of branches in other EU member states, but also of fully owned (fully controlled) subsidiaries in other EU member states.

83. The lead supervisor would have the following rights and obligations with respect to a financial institution's EU operations:

a) it would be the single point of contact for all issues of prudential supervision;
b) the lead supervisor would coordinate all reporting duties and, to the extent that there still are national discretions, decide on the reporting format;
c) the lead supervisor would be responsible for model validation and authorisation to the extent that these models are used group-wide;
d) the lead supervisor would decide about pillar II issues at group level;
e) it would approve capital allocation at group level and liquidity rules at group and branch level;
f) it would decide upon and coordinates all on-site inspections;
g) it would approve the cross-border set-up of central functions;
h) it would coordinate licensing procedures.

84. Under this model, the lead supervisor would not only have rights, but would have obligations, as well. In particular, the creation of the lead supervisor would be accompanied by the setting-up of a "college of supervisors", which would include at a minimum representatives of the supervisory authorities of those countries where the institution has substantial operations. Industry argues that the interests of supervisors in Member States, where systemically important branches and subsidiaries are located, should be taken adequately into account by their being represented in the "college of supervisors". Thus, the lead supervisor concept explicitly recognises the value of intensive dialogue between supervisors and of the input host authorities provide.

85. The EFSRT also recommends a lender of last resort arrangement which mirrors that of the lead supervisor concept, i.e., the national central bank corresponding to the nationality of the lead supervisor would be the responsible lender of last resort. There would also be a need for EU central banks to state publicly that a workable agreement on liquidity provision in (individual and systemic) crisis situations exists between Eurozone members as well as with non-EMU members. Lastly, the EFSRT sees harmonisation of deposit guarantee schemes as unrealistic in the short term, and suggests that the Commission presents a model to which the existing system should gradually converge over a specified time period, with such model aimed at levelling the playing field without imposing additional burdens on the financial industry.

86. The EFSRT also argues that clear, workable, innovative, and forward-looking structures in the EU will strengthen Europe's position in international negotiations – not only in the ongoing negotiations in the international arena, but also in the discussions that will inevitably arise in the future on the evolution of the global system of financial supervision.

<u>Finance Ministry perspective</u>

87. The FSC's 'Francq' report advocates all of the steps listed at the start of this Section. The report also suggests:

a) there should be further analysis of missing competences in the harmonised set of minimum powers;
b) there should be an exercise to detect, rectify and prevent inconsistencies in financial service legislation.

88. Lastly, the report notes that the final solution to the problem of the prudential supervision of groups is linked to progress in developing a satisfactory framework to determine the allocation of legal and financial responsibilities in case of a distressed institution. This is of course the key point that has also been put forward by the European Commission.

Supervisory perspective

89. Supervisors argue consistently for evolution from the status quo, rather than for any more radical change in supervisory arrangements. CEBS has supported all of the steps listed in the 'General' section at the start of Section IV and has started on several of them.

90. However, CEBS has also noted that convergence of supervisory practices is not a simple endeavour: supervisors from 25 countries need to reach a consensus on very technical and complex issues, often respecting very tight deadlines. As differences remain in market structures and business practices, supervisory traditions also remain rather different. But once consensus has been achieved, all members are committed to implement the common approach.

Academic papers

91. There is considerable literature on the organisation and functions of prudential supervision, and this paper does not attempt to give a comprehensive overview. It is, however, worth noting a number of possible options for supervisory arrangements, to address some of the challenges set out in Section III.

92. Options include:

a) the status quo;
b) the lead supervisor (giving the home supervisor full responsibility for branches and subsidiaries in all member States) but with a mandate at the national level;
c) the lead supervisor (giving the home supervisor full responsibility for branches and subsidiaries in all member States) but with an explicit EU-wide mandate;
d) giving the host supervisor responsibility for all branch and subsidiary operations in its jurisdiction;
e) setting up an EU-level body responsible for supervising all the operations of cross-border groups;
f) setting up an EU-level body responsible for all prudential supervision

93. A recent analysis[13] considers the first five of these options and, against a number of criteria, rank option c) as the best. This is also close to the preferred option of the industry (EFSRT). It goes on to consider the difficult question of who should bear the costs of a possible bail-out if supervision is carried out under some form of EU-wide mandate. The analysis concludes that "the first-best solution is to keep decision-making on supervision and fiscal bail-outs at the same level. Moving the supervisory function to the European level, while leaving the fiscal function at the national level, would cause problems." But there is not an EU financial mechanism to address such cases, and putting some mechanism in place to create such a budget would lead to incentive problems between Member States.

SECTION V: THE WAY FORWARD

94. Over the coming four to five years, the primary focus for banking supervisory cross-border developments will need to be a further convergence of supervisory practices between EU supervisory authorities. This has emerged as a policy priority in the financial services sector from the Commission's imminent White Paper. The Financial Services Committee in the Council has also provided some practical thoughts on how this may proceed.

[13] 'Cross-Border Issues in European Financial Supervision'; Schoenmaker, D. & Oosterloo, S.; February 2005; *Forthcoming* in: David Mayes and Geoffrey Wood (eds), *The Structure of Financial Regulation*, London: Routledge.

95. In the field of banking supervision the key driver for this will be the implementation and application of the CRD. Work to date in CEBS accepts this and is fully focused on this challenge (see the report from CEBS to the EBC on its activities in 2005 and its work programme for 2006). The European Banking Committee will monitor progress on convergence in accordance with its tasks under the Commission's Decision creating CEBS.

2010 and beyond

96. In order to consider any further fundamental changes to the present supervisory arrangements, which would involve a shift in practical and legal responsibilities towards the 'home' branch supervisor or the 'consolidating' supervisor of the subsidiaries of a banking group, it is clear from what has been discussed in the previous sections of this paper that consideration must be given to three important issues:

a) further developments in the way in which financial institutions organise and structure their cross-border activities (outsourcing, liquidity, etc.)

b) the developments in Member States' banking sectors and in particular the emergence of important branch operations and markets dominated by foreign-owned firms

c) the need for supervisory authorities to be allowed to focus on further convergence of practices and implementation of the CRD.

97. Behind and beyond this, there is an institutional obligation to present a review to the Council and the European Parliament in five years time, which provides a horizon and a timescale for any further work. In addition, according to the 'Wise Men's' Report, the creation of single EU regulatory authority for financial services may have to be addressed in a few years if the report's recommendations cannot be implemented properly. Consequently, a successful implementation of the Lamfalussy process that leads to better rule-making, and is supported by transparency, consultation and effective implementation through supervisory cooperation, would make radical institutional reform less likely.

98. In the light of the analysis in the previous sections it is clear that the expectations of financial institutions need to be cognisant of the responsibilities of supervisory authorities and *vice versa*. There are no simple and easy ways to introduce further shifts in responsibilities between 'home' and 'host' supervisors. This can only be done by recognising and addressing the fundamental impediments to such change. It will thus be critical to introduce clarity about supervisory responsibilities, in terms of location (which authority holds responsibility for decision taking and information sharing) and scope (the precise responsibilities authorities are expected to exercise).

99. Work on any longer term agenda for possible further changes to supervisory arrangements will need to commence at a reasonably early stage. Whatever any future political choice on supervisory may be (with the exception of doing nothing and maintaining the status quo), that work needs to be conducted anyway (liquidity requirements) or is already underway (deposit guarantee scheme review, crisis management arrangements). This work requires time in view of its complexity (legal, practical and political).

100. The following areas will need to be considered. They are limited in number but both complex (substance and sensitivity) and inter-related:

a) Liquidity arrangements and requirements (going concern basis): national and EU regulatory approaches and industry practices. Few provisions exist at EU level, there is no harmonisation, work is being finalised in the Joint Forum and may be picked up in the Basel Committee. The ECB BSC has also recently started useful work in this field;

b) Liquidity arrangements in terms of emergency liquidity assistance: arrangements are in place in the Eurozone, but need to be properly integrated with the work on crisis management and on lender of last resort. And arrangements need to adequately cover the whole EU;

c) Crisis management arrangements: useful groundwork has been done recently on extending the MoUs on cooperation and information exchange to finance ministries and crisis simulation exercises are being organised;

d) Lender of last resort arrangements: there are certain arrangements within the Eurozone, where the operational term is ‘constructive ambiguity’. Outside the Eurozone and between zones there is to date little or no analysis available;

e) Deposit Guarantee arrangements: work has commenced within the Commission to review the present Directive. That work must not have a narrow focus but must take into account the broader impact that supervisory responsibilities and market structures have;

f) Bankruptcy and winding-up proceedings: there will need to be confirmation that nothing in the present EU Directive contradicts the supervisory responsibilities and arrangements.

101. Annex 2 to this paper contains more details on these important issues, including giving details of work in progress where this is relevant. In the absence of considering and addressing these important points, any discussion on amending and expanding the present supervisory arrangements in the European Union will be premature, likely to produce conceptual arrangements that present a dichotomy between practical roles and ultimate legal responsibilities, and supervisory arrangements that may fail in times of stress when robust systems are of critical importance.

102. In carrying forward this work the number and types of national authorities involved needs to be expanded. The present supervisory arrangements have been implemented focusing almost exclusively on the authorities competent for the licensing and day-to-day supervision of institutions. The roles and duties of following authorities may also need to be considered:

a) insurance supervisory authorities (where separate from the authorities responsible for the prudential supervision of credit institutions and investment firms);

b) national central banks;

c) The European Central Bank;

d) Economic and Finance Ministries; and

e) competition authorities (national and at EU-level).

Questions

I Does the Committee agree that the long term work on supervisory arrangements should commence now with a long term perspective and in view of the complexity of the issues involved?

II Are there any issues and developments other than those described in this paper that require consideration?

III Would the EBC appreciate a further discusison on the basis of a thorough workplan at its next meeting?

ANNEX 1. DATA ON THE EU BANKING SECTOR

Table 1. Number of credit institutions and local units (branches) of CIs

	Number of credit institutions				Number of branches			
	2001	2002	2003	2004	2001	2002	2003	2004
Belgium	112	111	108	104	6,168	5,550	4,989	4,837
Czech Republic	172	83	77	68	1,751	1,722	1,670	1,785
Denmark	203	178	203	202	2,376	2,128	2,118	2,021
Germany	2,526	2,363	2,225	2,148	53,931	50,868	47,351	45,505
Estonia	7	7	7	7	210	198	197	203
Greece	61	61	59	62	3,134	3,263	3,300	3,403
Spain	366	359	348	346	39,024	39,021	39,762	40,621
France	1,050	989	939	897	26,049	26,162	25,789	26,370
Ireland	88	85	80	80	970	926	924	n.a.
Italy	843	821	801	787	29,267	29,948	30,501	30,946
Cyprus	43	46	47	43	528	521	506	500
Latvia	23	23	23	23	590	567	581	583
Lithuania	54	68	71	74	156	119	723	758
Luxembourg	189	177	169	162	274	271	269	253
Hungary	230	225	219	213	2,950	2,992	3,003	2,987
Malta	17	14	16	16	58	55	58	63
Netherlands	561	539	481	461	4,720	4,269	3,883	3,649
Austria	836	823	814	796	4,561	4,466	4,395	4,360
Poland	711	664	658	653	4,080	4,302	4,394	5,006
Portugal	212	202	200	197	5,534	5,390	5,440	5,408
Slovenia	69	50	33	24	717	721	720	706
Slovakia	20	20	21	21	1,052	1,020	1,057	1,113
Finland	369	369	366	363	1,571	1,572	1,564	1,585
Sweden	149	216	222	212	2,040	2,040	2,046	2,034
United Kingdom	452	451	426	413	14,554	14,392	14,186	14,001
MU12	**7213**	**6899**	**6590**	**6403**	**175203**	**171706**	**168167**	**n.a.**
EU25	**9363**	**8944**	**8613**	**8372**	**206265**	**202483**	**199426**	**n.a.**

Source: ECB

Note: For SI, credit institutions are banks, savings banks and savings and loan undertakings (cooperative banks). Before 2004 the savings and loan undertakings did not have the Bank of Slovenia authorisation and were not obliged to report the number of employees and local units (branches) before 2004. Therefore these figures are without the savings and loan undertakings. The figure for branches in LT in 2004 includes 61 small credit cooperatives. For CY, data refer to domestic banks and international banking units but exclude cooperative credit institutions.

Table 2. Number of employees and total assets of CIs

	Number of employees of CIs				Total assets of CIs (EUR millions)			
	2001	**2002**	**2003**	**2004**	**2001**	**2002**	**2003**	**2004**
Belgium	76,104	75,370	73,553	71,334	776,173	774,330	828,557	914,391
Czech Republic	42,999	40,534	39,658	38,666	78,188	79,232	78,004	86,525
Denmark	48,538	47,613	45,994	43,877	481,927	534,201	568,873	n.a.
Germany	766,700	747,450	725,550	712,300	6,268,700	6,370,194	6,393,524	6,584,388
Estonia	3,949	3,934	4,280	4,455	4,000	5,221	6,314	9,000
Greece	59,624	60,495	61,074	59,337	202,736	201,608	213,171	230,454
Spain	244,781	243,429	243,462	246,006	1,247,998	1,342,492	1,502,861	1,717,364
France	424,615	428,438	425,041	n.a.	3,768,943	3,831,610	3,994,237	4,415,475
Ireland	40,928	36,585	35,658	n.a.	422,106	474,630	575,168	722,544
Italy	343,812	341,584	338,288	336,979	1,851,990	2,024,156	2,125,366	2,275,652
Cyprus	8,200	8,649	8,470	8,516	36,164	33,998	34,508	38,336
Latvia	8,172	8,267	8,903	9,655	7,279	7,250	8,482	11,167
Lithuania	8,796	8,420	7,557	7,266	n.a.	5,010	6,425	8,509
Luxembourg	23,894	23,300	22,513	22,549	721,001	662,615	655,971	695,103
Hungary	34,376	35,232	36,014	36,246	39,343	46,477	52,565	64,988
Malta	3,584	3,459	3,401	3,353	13,644	15,543	17,803	20,391
Netherlands	131,230	125,911	120,539	115,283	1,265,906	1,356,397	1,473,939	1,677,583
Austria	74,606	74,048	73,308	72,858	573,384	554,528	586,459	635,347
Poland	165,225	158,697	151,254	149,610	133,476	116,044	103,659	131,904
Portugal	55,538	55,260	53,931	52,757	352,251	351,773	348,691	345,378
Slovenia	11,578	11,855	11,703	11,602	17,782	19,995	21,541	24,462
Slovakia	20,118	18,452	18,350	18,261	n.a.	21,527	20,883	29,041
Finland	26,733	27,190	26,667	25,377	163,416	165,661	185,846	212,427
Sweden	42,001	42,357	40,169	39,181	452,289	474,841	506,493	582,918
United Kingdom	506,278	501,787	500,656	511,455	5,830,158	5,854,356	6,175,311	n.a.
MU12	**2,268,565**	**2,239,060**	**2,199,584**	**n.a.**	**17,614,604**	**18,109,994**	**18,883,790**	**20,426,106**
EU25	**3,172,379**	**3,128,316**	**3,075,993**	**n.a.**	**n.a.**	**25,323,689**	**26,484,651**	**n.a.**

Source: ECB

Table 3. Number of branches of CIs from EEA and third countries

	Number of branches of CIs from EEA countries				Number of branches of CIs from third countries			
	2001	**2002**	**2003**	**2004**	**2001**	**2002**	**2003**	**2004**
Belgium	35	36	38	36	11	10	10	9
Czech Republic	9	8	8	9	1	1	1	0
Denmark	9	8	15	16	1	1	1	1
Germany	59	64	65	64	21	19	19	19
Estonia	1	1	1	3	0	0	0	0
Greece	13	14	14	19	8	7	6	4
Spain	49	51	50	54	7	8	7	7
France	55	51	52	55	28	28	28	27
Ireland	32	31	31	31	1	1	1	1
Italy	94	91	75	90	16	15	15	14
Cyprus	5	5	5	4	16	19	19	19
Latvia	1	1	1	1	0	0	0	0
Lithuania	3	3	2	2	1	1	1	n.a.
Luxembourg	55	48	43	40	8	7	7	7
Hungary	0	0	0	0	0	0	0	0
Malta	0	0	0	0	3	2	2	2
Netherlands	19	19	20	22	9	9	8	7
Austria	15	15	18	18	0	0	0	0
Poland	1	1	1	3	0	0	0	0
Portugal	23	21	22	26	2	1	1	1
Slovenia	1	1	1	2	0	0	0	0
Slovakia	1	1	2	3	1	1	1	0
Finland	18	19	18	20	0	0	0	0
Sweden	19	18	17	19	1	1	1	1
United Kingdom	87	85	84	84	115	105	97	91
MU12	**467**	**460**	**446**	**475**	**111**	**105**	**102**	**96**
EU25	**604**	**592**	**583**	**621**	**250**	**236**	**225**	**n.a.**

Source: ECB

Note: Data where the number of branches is less than three are not disclosed in the version of publication, because of confidentiality reasons.

Table 4. Total assets of branches of CIs from EEA and third countries

	Total assets of branches of CIs from EEA countries (EUR millions)				Total assets of branches of CIs from third countries (EUR millions)			
	2001	**2002**	**2003**	**2004**	**2001**	**2002**	**2003**	**2004**
Belgium	29,844	27,221	25,908	29,225	13,110	10,971	12,928	11,901
Czech Republic	9,359	7,674	7,350	8,268	39	168	229	0
Denmark	19,606	22,316	24,177	197,375	19	48	47	337
Germany	91,316	76,738	67,539	70,252	38,525	31,826	20,315	22,455
Estonia	280	394	537	806	0	0	0	0
Greece	8,934	11,489	12,769	22,634	8,911	5,881	6,383	394
Spain	49,454	61,713	85,993	122,030	2,684	3,911	2,502	2,984
France	119,647	118,053	99,917	110,543	21,112	13,701	11,351	12,591
Ireland	58,411	60,167	69,773	80,804	n.a.	n.a.	n.a.	n.a.
Italy	69,641	80,663	87,191	108,145	11,057	10,102	9,735	6,954
Cyprus	1,738	1,081	933	474	2,700	2,602	2,613	2,789
Latvia	313	288	387	567	0	0	0	0
Lithuania	210	233	421	826	83	137	134	0
Luxembourg	130,562	108,816	90,089	109,346	7,438	6,264	4,912	5,377
Hungary	0	0	0	0	0	0	0	0
Malta	0	0	0	0	2,973	3,807	4,816	6,239
Netherlands	27,626	26,600	26,091	30,283	2,107	1,795	1,582	1,198
Austria	4,458	3,242	3,363	4,298	0	0	0	0
Poland	899	771	645	828	0	0	0	0
Portugal	14,808	15,839	16,923	20,340	833	335	298	303
Slovenia	95	146	203	311	0	0	0	0
Slovakia	568	1,092	991	2,996	1,610	1,621	2,044	0
Finland	10,404	14,345	13,030	14,367	0	0	0	0
Sweden	23,245	27,581	33,281	43,369	1,599	54	25	31
United Kingdom	1,363,463	1,285,518	1,345,804	1,544,466	1,210,305	1,128,190	1,123,725	1,156,243
MU12	**615,105**	**604,886**	**598,586**	**722,267**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
EU25	**2,034,882**	**1,951,993**	**2,013,334**	**2,522,586**	**n.a.**	**n.a.**	**n.a.**	**n.a.**

Source: ECB

Note: Data where the corresponding number of branches is less than three are not disclosed in the version of publication, because of confidentiality reasons.

Table 5. Number of subsidiaries of CIs from EEA and third countries

	Number of subsidiaries of CIs from EEA countries				Number of subsidiaries of CIs from third countries			
	2001	**2002**	**2003**	**2004**	**2001**	**2002**	**2003**	**2004**
Belgium	22	22	20	20	7	7	6	6
Czech Republic	16	18	18	19	4	4	4	3
Denmark	7	8	7	7	2	2	2	3
Germany	21	22	20	20	32	27	25	22
Estonia	3	3	3	3	0	0	0	0
Greece	2	2	3	4	2	3	1	0
Spain	44	40	44	43	12	11	10	8
France	162	146	126	108	67	62	58	58
Ireland	25	26	21	22	10	11	10	10
Italy	10	10	12	8	4	5	6	7
Cyprus	7	10	9	9	2	2	2	1
Latvia	3	3	3	5	3	4	4	3
Lithuania	2	3	3	5	2	2	2	2
Luxembourg	90	85	83	82	36	33	32	29
Hungary	26	22	23	22	5	6	6	6
Malta	8	7	8	8	2	1	1	1
Netherlands	14	14	13	13	17	17	16	16
Austria	13	13	14	13	10	10	10	7
Poland	37	35	36	35	9	10	9	8
Portugal	9	9	11	9	3	4	4	4
Slovenia	4	5	5	5	0	0	0	0
Slovakia	8	9	11	14	3	4	4	1
Finland	3	3	3	5	0	0	0	0
Sweden	12	12	14	14	7	8	9	9
United Kingdom	17	17	15	20	76	78	76	75
MU12	**415**	**392**	**370**	**347**	**200**	**190**	**178**	**167**
EU25	**565**	**544**	**525**	**513**	**315**	**311**	**297**	**279**

Source: ECB

Note: Data where the number of subsidiaries is less than three are not disclosed in the version of publication, because of confidentiality reasons.

Table 6. Total assets of subsidiaries of CIs from EEA and third countries

	Total assets of subsidiaries of CIs from EEA countries (EUR millions)				Total assets of subsidiaries of CIs from third countries (EUR millions)			
	2001	**2002**	**2003**	**2004**	**2001**	**2002**	**2003**	**2004**
Belgium	146,339	141,749	150,464	167,047	3,707	6,280	6,887	3,834
Czech Republic	43,441	63,468	64,240	66,886	3,684	4,505	4,340	4,295
Denmark	435,435	497,169	496,404	465,659	197	169	256	66,475
Germany	110,716	225,311	227,597	253,250	56,811	52,062	65,009	67,676
Estonia	3,985	4,698	5,622	7,557	0	0	0	0
Greece	19,465	24,453	27,730	34,134	1,759	1,927	2,001	0
Spain	49,426	52,897	63,731	67,405	15,397	14,436	14,310	5,237
France	298,786	301,275	287,559	303,941	74,947	54,801	46,503	74,472
Ireland	145,854	114,695	132,599	182,389	46,266	59,393	61,252	65,163
Italy	40,577	45,774	50,776	55,843	2,342	3,259	3,507	4,273
Cyprus	4,018	4,544	5,367	8,246	5,579	2,901	1,688	1,409
Latvia	1,718	1,580	1,853	4,400	1,264	1,237	1,690	455
Lithuania	1,793	2,549	3,300	6,308	1,159	1,324	1,602	0
Luxembourg	507,151	480,267	495,726	512,754	36,593	27,577	25,171	26,518
Hungary	22,752	34,788	39,950	48,724	2,857	4,244	3,203	3,929
Malta	6,685	6,502	7,050	7,970	591	518	322	418
Netherlands	96,588	94,456	126,420	151,287	16,809	16,421	19,119	19,733
Austria	102,813	112,152	107,755	116,482	4,070	3,454	4,108	2,603
Poland	79,725	68,249	60,789	77,297	11,241	10,712	9,499	11,666
Portugal	68,275	69,150	72,796	67,356	3,669	3,335	2,563	2,540
Slovenia	2,573	3,193	3,828	4,597	0	0	0	0
Slovakia	15,035	17,373	17,140	22,428	824	1,361	1,432	730
Finland	722	741	716	111,950	0	0	0	0
Sweden	2,290	2,614	3,491	4,495	1,802	2,051	2,372	2,604
United Kingdom	71,887	61,982	60,800	294,870	297,724	297,125	547,052	577,107
MU12	**1,586,712**	**1,662,920**	**1,743,869**	**2,023,838**	**262,370**	**242,945**	**250,430**	**272,049**
EU25	**2,278,047**	**2,431,630**	**2,513,703**	**3,043,275**	**589,293**	**569,092**	**823,885**	**941,137**

Source: ECB

Note: Data where the corresponding number of subsidiaries is less than three are not disclosed in the version of publication, because of confidentiality reasons.

Table 7. Number of mergers and acquisitions (M&As) in the EU banking sector

	Number of domestic M&As					Number of intra-EEA M&As					Number of M&As from third countries				
	2001	**2002**	**2003**	**2004**	**2005h1**	**2001**	**2002**	**2003**	**2004**	**2005h1**	**2001**	**2002**	**2003**	**2004**	**2005h1**
Belgium	1	1	2	1	0	0	0	0	1	0	0	0	0	0	0
Czech Republic	2	0	0	1	0	2	2	2	4	0	0	0	1	0	0
Denmark	3	0	1	1	0	1	1	1	3	0	2	0	0	0	0
Germany	9	8	14	11	6	2	5	2	0	1	1	0	1	0	0
Estonia	0	0	0	0	1	0	0	1	0	0	0	0	0	0	0
Greece	2	2	3	1	0	1	1	0	2	1	0	0	0	0	0
Spain	5	3	4	1	1	1	2	0	1	1	0	0	1	0	0
France	12	12	8	11	1	4	3	0	0	0	0	0	0	1	0
Ireland	0	0	1	0	0	1	1	0	0	1	0	0	0	1	0
Italy	24	23	22	13	5	3	3	0	2	1	1	0	2	0	0
Cyprus	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Latvia	1	0	0	0	1	0	1	0	0	0	1	0	0	2	0
Lithuania	0	0	0	1	0	3	0	0	0	0	0	0	0	0	0
Luxembourg	0	0	0	0	0	2	1	0	0	1	0	0	0	0	0
Hungary	5	1	3	1	0	3	1	3	0	0	0	1	0	0	0
Malta	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Netherlands	2	2	2	2	0	1	2	1	1	0	3	0	0	0	0
Austria	1	3	0	1	2	2	0	0	0	0	1	0	0	0	0
Poland	6	5	1	2	0	8	6	0	1	0	0	0	0	0	0
Portugal	2	0	1	0	1	1	2	4	2	0	0	0	0	0	0
Slovenia	1	0	1	0	0	3	3	0	0	0	0	0	0	0	0
Slovakia	1	0	0	0	1	3	1	0	1	0	0	0	0	0	0
Finland	0	2	0	0	0	0	1	0	0	0	0	0	0	0	0
Sweden	1	1	1	1	0	0	1	0	0	0	0	0	0	0	0
United Kingdom	13	12	10	13	4	0	1	1	2	0	4	0	2	1	0
MU12	**58**	**56**	**57**	**41**	**16**	**18**	**21**	**7**	**9**	**6**	**6**	**0**	**4**	**2**	**0**
EU25	**91**	**75**	**74**	**61**	**23**	**41**	**38**	**15**	**20**	**6**	**13**	**1**	**7**	**5**	**0**

Source: Thomson Financial SDC Platinum. ECB calculations.

Table 8. Value of mergers and acquisitions (M&As) in the EU banking sector (million euro)

	Value of domestic M&As					Value of intra-EEA M&As					Value of M&As from third countries				
	2001	2002	2003	2004	2005h1	2001	2002	2003	2004	2005h1	2001	2002	2003	2004	2005h1
Belgium	n.a.	n.a.	n.a.	n.a.	-	-	-	-	n.a.	-	-	-	-	-	-
Czech Republic	n.a.	-	-	n.a.	-	1,186	1,426	n.a.	n.a.	-	-	-	380	-	-
Denmark	3,503	-	n.a.	3	-	296	15	50	956	-	76	-	-	-	-
Germany	6,245	4,408	2,637	25	600	13	1,020	n.a.	-	n.a.	n.a.	-	389	-	-
Estonia	-	-	-	-	n.a.	-	-	n.a.	-	-	-	-	-	-	-
Greece	15	883	206	3	-	n.a.	n.a.	-	n.a.	n.a.	-	-	-	-	-
Spain	705	24	1,143	15	110	94	20	-	n.a.	n.a.	-	-	16	-	-
France	4,498	8,520	16,959	405	n.a.	1	32	-	-	-	-	-	-	n.a.	-
Ireland	-	-	9	-	-	347	165	-	-	n.a.	-	-	-	40	-
Italy	7,335	16,600	4,280	689	507	60	678	-	n.a.	119	26	-	15	-	-
Cyprus	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Latvia	n.a.	-	-	-	n.a.	-	n.a.	-	-	-	n.a.	-	-	n.a.	-
Lithuania	-	-	-	n.a.	-	89	-	-	-	-	-	-	-	-	-
Luxembourg	-	-	-	-	-	n.a.	n.a.	-	-	n.a.	-	-	-	-	-
Hungary	1	2	42	n.a.	-	n.a.	2	423	-	-	-	30	-	-	-
Malta	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
Netherlands	n.a.	n.a.	415	265	-	n.a.	134	170	n.a.	-	11	-	-	-	-
Austria	n.a.	15	-	6	715	7,809	-	-	-	-	n.a.	-	-	-	-
Poland	10	401	23	20	-	642	284	-	n.a.	-	-	-	-	-	-
Portugal	50	-	15	-	n.a.	n.a.	350	312	n.a.	-	-	-	-	-	-
Slovenia	n.a.	-	n.a.	-	-	143	586	-	-	-	-	-	-	-	-
Slovakia	n.a.	-	-	-	n.a.	n.a.	n.a.	-	n.a.	-	-	-	-	-	-
Finland	-	n.a.	-	-	-	-	n.a.	-	-	-	-	-	-	-	-
Sweden	486	n.a.	15	n.a.	-	-	n.a.	-	-	-	-	-	-	-	-
United Kingdom	18,823	1,172	351	1,363	1,372	-	n.a.	38	75	-	459	-	30	124	-
MU12	**18,848**	**30,449**	**25,663**	**1,407**	**1,932**	**8,324**	**2,398**	**482**	**0**	**119**	**36**	**0**	**420**	**40**	**0**
EU25	**41,671**	**32,024**	**26,093**	**2,793**	**3,304**	**10,680**	**4,711**	**993**	**1,031**	**119**	**571**	**30**	**831**	**164**	**0**

Source: Thomson Financial SDC Platinum. ECB calculations.

ANNEX 2. FURTHER DETAILS ON AREAS OF WORK

I Liqudity

Background

1. The issue of liquidity risk management is a very complex one, since it can be analysed with respect to both normal and stressed market conditions.

2. Furthermore, the current EU framework has some quite peculiar characteristics, since it involves a number of authorities that operate according to differentiated features, both legally and geographically: (a) regulation is defined at EU-wide level; (b) national supervisors retain ongoing supervisory functions; (c) the ECB, together with National Central Banks (NCBs), is responsible for monetary policy; (d) the NCBs are in charge of lender of last resort decisions (although not independently free to act).

3. In this Annex we analyse liquidity risk from three different perspectives:

a) how firms manage their risk profile;

b) how supervisors assess firms' exposure to liquidity risk; and

c) how the European System of Central Banks (ESCB) implements monetary policy in the euro area.

4. In particular, we examine the current EU framework, identify possible issues that may prevent the creation of a single financial market and propose possible ways ahead to address those issues in the medium term.

5. This issue should also be considered in conjunction with Annexes 3 and 4 on crisis management and lender of last resort, and the separate paper (EBC/021/05) on deposit guarantee arrangements.

6. This document also benefits from additional work carried on the same issue by international bodies, in particular by the Joint Forum on Financial Conglomerates and its parent committees[14] as well as by the ECB.

The Current Situation

(a) Management of liquidity risk by banking groups

7. The majority of cross-border banking groups show a tendency towards centralisation of liquidity risk management at the parent company level, which provides services to all the components of the group. The introduction of the euro has also played an important role in this process, because the need to keep a fully-funding unit together with a separate risk management function has decreased significantly. Business are benefiting from this trend because of the following reasons:

a) increased transparency of liquidity policies and comparability of specific risks;

b) optimisation across the group of liquidity management via the creation of centres of expertise;

c) scale economies in liquidity management and funding resulting in the reduction of costs and related transaction costs;

d) more effective mitigation of operational risks;

e) development of effective internal reporting tools; and

[14] The Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO).

f) better control of strategic communication in case of crisis.

8. A variety of different structures for managing liquidity risk can be adopted depending on the degree of autonomy given at local level. A distinction should be made between liquidity risk management (i) on a daily basis, which may be conducted at a local level subject to overall policy defined at a group-wide level and (ii) under stressed market conditions, which is generally performed at a centralised level.

9. Even in the former case, the parent company always plays some role: one example would be setting limits on the amount of risk that the subsidiary could accept. This may limit the subsidiary's reliance on funding from the centre and reduce the likelihood of contagion from crisis elsewhere within the group. It could also give the subsidiary some autonomy in performing daily liquidity management if the parent company decides to keep some funds within the subsidiary itself.

10. In order to prepare themselves for potential liquidity crises, large banking groups have also developed some common forms of stress testing which are generally conducted at group-level. Even if this type of statistical exercises are not yet at the level of sophistication of those in respect of other traditional risk factors (e.g., market risk), they undoubtedly represent a useful tool for having an early warning system for the need for parent-level to intervene and mitigate contagion risks.

11. Stress testing can be based on different scenarios, driven either by firm-specific (e.g., downgrading) or general market events (e.g., tensions in the wholesale funding market). In both cases, as a further step in liquidity risk management, stress testing results are considered to develop contingency plans which aim at identifying potential additional sources of liquidity in case the pessimistic hypothesis would materialise.

12. In more general terms, banking groups seems to assume the possibility of (i) having access to secured funding and, consequently, having eligible collateral available; (ii) disposing of asset portfolios of sufficient liquidity; and (iii) having payment and clearing systems available. Furthermore, they seem not to estimate the impact on market liquidity of transactions made to cope with their liquidity crisis.

13. In particular, the general assumption seems to be that even if some problems arise during stressed market conditions, they would be solved by the public sector, thus raising the question of whether moral hazard reduces industry's willingness to keep liquidity buffers or to get ready to raise funds from the market.

(b) Regulatory framework and supervisory review of liquidity risk

14. The industry is increasing complaining that regulatory constraints in the banking sector, in particular across jurisdictions, represent obstacles to more efficient liquidity risk management practices. Constraints include (i) liquidity supervision home-host arrangements; (ii) the fragmentation of supervisory requirements across the EU; and (iii) the absence of a consolidated regime for the supervision of liquidity risks.

15. In February 2000, the Basel Committee on Banking Supervision issued guidance for managing liquidity risk; national supervisors keep however the discretion to implement such guidance. According to the EU legislation, the host supervisor is in charge of monitoring the liquidity risk for branches, which represents the only exception to the home-country control principle that have been in place for many years. This allocation of responsibilities was also based on the assumption that each country has its own currency; and it was also much easier for national central bank to monitor it and decide the relevant appropriate measures in relation to domestic money market conditions. Apart from that, no specific EU provision has been adopted over the years.

16. As a consequence, regulation and supervisory guidance with respect to liquidity risk vary significantly across jurisdictions; in particular, with respect to their quantitative/qualitative nature, the

degree of prescriptiveness, as well as their scope of application (i.e., either at group or subsidiary level).

17. Qualitative guidance includes direction to firms to maintain adequate policies and procedures, set limits on risk exposures, prepare a contingency plan, assure board oversight and, in more general terms, to maintain the group in a sound condition. Furthermore, it may either focus explicitly on liquidity risk or consider it as part of a wider analysis of internal controls. Qualitative requirements are more flexible and may fit more easily to different banking groups' structures; they may also be assessed with more flexibility by supervisors. Moreover, they require banks to have a broad understanding of the liquidity risk profile and to monitor it on a going concern basis by using effective risk management tools (e.g., sound corporate governance, contingency plans).

18. On the other hand, quantitative requirements are intended to assess the firm's ability to meet obligations over a specified timeframe by making general assumptions on the future development of some balance-sheet items. These requirements can take the form of a minimum level of liquid assets in relation to designated liabilities or the ratio of cash inflows in a near-time bucket to be no less than a minimum.

19. As regards the use for prudential purposes of collateral posted against banks' exposures, the recently approved Capital Requirement Directive (2000/12/EC and 93/6/EEC recast) (CRD) recognises a wider range of collateral than is currently the case. In particular, the list of eligible collateral varies depending on the degree of sophistication of firms and the type of approach for calculating capital requirements for credit risk (standardised, foundation IRB and advanced IRB).

20. Alternative methodologies are available for firms to choose between different levels of complexity (a simple method – based on an easy-to-use 'risk weight substitution' approach or a comprehensive approach – involving the application of volatility adjustments to the value of collateral received). To calculate volatility adjustments, more and less complex approaches are also made available (a simple 'supervisory' approach where the amounts of the benchmark volatility adjustments are set out or a more risk-sensitive 'own estimate' approach). More complex approaches which allow banks to use some types of internal models for estimating capital requirements are also made available for repo-style transactions.

21. CRD also updates the prudential treatment for unsettled and failed trades by creating incentives for "delivery versus payment" (DvP, and also PvP) transactions as compared to non-DvP. The settlement period - either agreed by counterparties or used according to market practices - together with the possible intermediation of central counterparties also represent important elements for determining the appropriate capital charge[15]. In cases of a system wide failure of a settlement or clearing system, national supervisors may also use their discretion to waive capital charges until the situation is rectified in case of market crisis.

(c) The implementation of monetary policy in the euro area

22. In order to achieve its objective the ESCB can use a range of monetary policy instruments, such as open market operations, standing facilities and mandatory requirement for banks to hold minimum reserves[16]. The ESCB has also defined some general eligibility criteria for counterparties that want to have access to the above monetary policy operations with the aim of ensuring participation of a broad range of counterparties. Some restrictions are however defined for certain type of transactions (e.g., foreign exchange swaps). A counterparty can participate through the national central bank of the Member State in which is established. If it has got many establishments in different member states, it

[15] It also shows some broad consistency with the increasing attention given to central counterparties by international bodies (see for example CPSS-IOSCO Recommendation for Central Counterparties, November 2004).
[16] 'The Implementation of Monetary policy in the Euro area'; The European Central Bank; February 2004.

has the option to choose which establishments may participate provided, however, that each national central bank receives one single application in each Member State.

23. The liquidity-providing transactions are based on underlying assets that are provided by counterparties to the ESCB either in the form of ownership transfer or in the form of posted collateral. Eligible assets must comply with common operational requirements. In order to reflect some differences existing in financial markets across the EU, the ESCB has defined two different categories, namely tier 1 and tier 2 assets. The former group comprises marketable debt instruments which comply with eligibility criteria defined on a euro-area wide basis; the latter includes additional types of assets (both marketable and non-marketable) which may be of particular importance to national financial markets and comply with eligibility criteria defined by national central banks subject to the approval of the ECB. The ESCB has also plans to create a single list of eligible assets, by including the majority of current tier 2 assets and introducing euro-denominated debt instruments issued by entities established in G-10 countries. Furthermore, eligible assets are subject to some common risk measures and appropriate levels of haircuts defined by the ESCB in order to reduce potential financial loss in case they have to be sold on the market.

24. Counterparties to the ESCB may use eligible assets on a cross-border basis, i.e. they may obtain funds from their home national central bank by making use of assets located in another Member State. This may be achieved through two channels (i) the "corresponding central bank model" (CCBM); and (ii) the use of eligible links between Securities Settlement Systems (SSS).

25. In the former case, national central banks maintain securities accounts with each other for the purpose of the cross-border use of eligible assets. Through these securities accounts, national central banks act as custodian ("correspondent") for each other.

26. If a bank wants to provide its home central bank with eligible assets located in another Member State, the SSS where securities are located needs to transfer those securities to the corresponding national central bank for the account of the home central bank. The home central bank will hold the securities provided as collateral through the corresponding national central bank. In the latter case, the home central bank has a relation with its national SSS which in turn has a link, that is it has opened an omnibus account, with the SSS where securities are located. While in the CCBM the cross-border relationship is between NCBs, in this case, the cross-border relationship is between SSSs. In this respect, the ESCB has developed standards which must be met by all EU SSSs in order to be used for its credit operations. As a consequence, consistent with the attribution of the oversight function on payment systems, these standards may also be considered as "supervisory" guidance for the industry in respect of all kinds of operations.

Possible way forward

27. The current EU framework for liquidity risk management is the outcome of a process which followed some basic criteria to allocate responsibilities among national authorities. For example, as far as supervisory review of liquidity and the lender of last resort are concerned, it was basically due to the existence of different national currencies. In particular, in order to increase the effectiveness of the system as a whole, domestic supervisors should adequately monitor banks' risk profiles and risk management adequacy. On the other hand central banks should be able to provide the currency that the illiquid bank is using, without any restriction and the possible impact on national money markets. However, contrary to what has happened for other risk factors to which banking group are exposed to there is no EU specific regulation related to liquidity risk management that could be used to foster supervisory convergence across Member States.

28. As far as the implementation of monetary policy by the ESCB is concerned, a Eurozone wide common treatment has already been achieved in terms of type of transactions, counterparties and eligible assets as well as the cross-border use of collateral. Furthermore, the creation of a single list of

collateral can be positively considered since it may help banks to achieve smoother liquidity risk management. However, needless to say, the previous treatment does not apply to countries that do not use the euro yet. Furthermore, some differences may arise with new prudential provisions regarding the use of collateral.

29. The industry has not been able to provide data showing the negative impact of the current framework, owing to the difficulty of estimating reliable figures. Industry usually refers to opportunity costs incurred which seems to not be balanced by a better process of crisis management. Furthermore, legal obstacles to free movement of funds within the group, significant differences between supervisory quantitative approaches and internal liquidity risk management, together with the reporting requirement to the host supervisors even for local units have created a big gap between market practices and current (domestic) liquidity regulation.

30. It is quite clear however that liquidity risk management is a process that is being centralised within banking groups (not necessarily at the parent company level). The Commission services would propose to look at this issue in order to check whether it would be possible to promote regulatory and supervisory convergence at EU level by, for example, defining a limited set of qualitative requirements, which would include some type of quantitative analysis differentiated according to degree of sophistication. But further investigation, with interested stakeholders, is first necessary to establish the scale of any problems.

31. A further potential step would be to improve crisis management, by looking at the overall consistency of present arrangements regulating different aspects of the current framework, which play an important role in crisis resolution (e.g. use of collateral).

32. Even if the industry usually complains about the current regulatory burden, the Commission services believe that the timing is also appropriate: authorities should prepare for crisis in times of financial stability.

II Crisis management

33. Considerable effort has gone into improving the arrangements for crisis management in the EU since the publication of the Brouwer I and II reports. The work of the FSC, leading to the recently signed MoU between a wide range of stakeholders, has been pivotal. The work of the ECB (including the joint group set up between the ECB's BSC and CEBS) should also be noted

34. Nonetheless, it is important to optimise crisis management arrangements as part of the process of ensuring that systems are in place to deal adequately with cross-border spillover effects.

35. Some ideas for improving crisis management arrangements include:

a) ensuring that supervisors can, in some way, take into account cross-border factors such as financial stability in other Member States when carrying out their functions;

b) at the level of the financial institution, part of the crisis management arrangements should include having identified teams to deal with any crises that emerge for each institution which could pose large cross-border risks; and

c) practicing – there should be periodic crisis management exercises at national and at EU level;

d) developing cooperative arrangements with non-EU countries, given the global nature of financial markets.

36. The allocation of responsibilities between home and host authorities is especially important for firms that represent potential cross-border systemic risks.

<u>Some general considerations on crisis management</u>

It is well understood that the resolution of financial crises is more of an art than a mechanistic application of pre-determined rules. This holds true both in case of difficulties of an individual institution and in case of a system-wide crisis. In addition, it should be noted that crisis resolution does not only rest on (semi-)official institutional frameworks, such as deposit guarantee and lender of last resort. Private sector involvement has always been another important element for three reasons. First, it enlarges the pool of available resources. Second, it is often indispensable for the orderly wind-down of a failed institution in order to provide for the continuity of outstanding contracts in financial markets, so that chaos is prevented (LTCM is a case in hand). Third, it is assumed that private sector involvement has a positive impact in terms of market discipline and limits the costs of crisis resolution to the general taxpayer. While, therefore, a good case can be made for private sector involvement, its limits must also be acknowledged. For instance, private sector engagement can never fully substitute for the lender of last resort function: private actors cannot create ultimate liquidity on their own. There are obvious and acknowledged limits to private sector involvement, such as when doing so threatens to endanger the viability of the hitherto healthy part of a financial system.

Distinction must also be made between financial crises concerning only a small or a few smaller institutions and those of systemic dimensions affecting either one systemically important institution or entire financial systems. In the former, the orchestration of a private sector solution is usually sufficient and, hence, the instrument of choice. The take-over of an insolvent institution by one or several healthy ones is often complemented with the financial involvement of deposit guarantee funds in order to shield the acquirer(s) from assuming undue amounts of risk and losses. It must be noted though that these kinds of private sector solutions are possible only under restrictive conditions: First, the acquiring institution(s) must be sufficiently financially stable, so that the burden can be absorbed. Second, the acquiring institution(s) must feel a sufficient degree of self-interest in maintaining the stability of the market in question. As a consequence of the latter, private sector solutions are, at present, only realistic in a national context or in markets marked by a high degree of concentration (as was the case with LTCM). Whether EU banking markets are already interlinked to a degree that would provide sufficient incentive for a private sector solution in the case of the crisis of a systemically relevant institution is an open question.

It is an equally open question whether an exclusively private sector solution would in fact provide a sufficient amount of funds for the rescue or at least the orderly winding down of a systemically relevant institution, let alone in case of a large-scale banking crisis. Experience with banking crises in industrial countries over the last two decades suggest that the answer to this question is “no”. Consequently, in these cases some combination of official money (fiscal funds and central bank money), private funds and deposit guarantee funds will be necessary.

III Lender of last resort

37. It is important to note (see also Liquidity and Crisis Management) that lender of last resort arrangements can arise in the case of both liquidity and solvency crises, although traditionally the lender of last resort function focuses on liquidity, providing solvent, but illiquid, institutions with funds. Given its nature, this function usually resides with central banks. In contrast, deposit guarantees target solvency issues and are either self-regulatory regimes or publicly-funded/publicly-backed institutions.

38. The lender of last resort almost never operates in textbook fashion – not the least because in an actual crisis situation (as opposed to textbooks) it is almost impossible to assess with any precision whether an institution is merely illiquid or is insolvent.

39. In other words, the lender of last resort, in reality, does not work (only) to the benefit of the individual institution that faces problems, but rather and more importantly to the benefit of other

institutions and the financial system as a whole, which are thus shielded from the potential fall-out of the individual failure.

Emergency Liquidity Assistance within the Eurosystem

"Co-ordination mechanisms are primarily called for within the Eurosystem. This is the case for emergency liquidity assistance (ELA), which embraces the support given by central banks in exceptional circumstances and on a case-by-case basis to temporarily illiquid institutions and markets. At the outset, it is necessary to stress that the importance of ELA should not be overemphasised. Central bank support should not be seen as a primary means for ensuring financial stability, since it bears the risk of moral hazard. Preventive measures aimed at fostering the adoption of sound risk management practices on the part of financial institutions, and the effectiveness of prudential regulation and supervision in achieving this goal, are the first line of defence against excessive risk-taking behaviour and financial distress. Furthermore, the provision of ELA has been a very rare event in industrial countries over the past few decades, while other elements of the safety net have gained importance in the management of crises. However, if and when appropriate, the necessary mechanisms to tackle a financial crisis are in place. The main guiding principle is that the competent national central bank takes the decision concerning the provision of ELA to an institution operating in its jurisdiction. This would take place under the responsibility and at the cost of the central bank in question. Mechanisms ensuring an adequate flow of information are in place in order that any potential liquidity impact can be managed in a manner consistent with the maintenance of the appropriate single monetary policy stance. The agreement on ELA is internal to the Eurosystem and therefore does not affect the existing arrangements between central banks and supervisors at the national level or bilateral and multilateral co-operation among supervisors and between the latter and the Eurosystem. However, their smooth functioning assumes an ability to implement, swiftly and efficiently, co-ordination mechanisms aimed at dealing with the cross-border implications of financial crises and at preventing contagion."

Source: ECB (2000). Annual Report 1999, p.98.

40. Arrangements relating to lender of last resort operations are applied in the Member State in which the institution experiences a liquidity shortage, irrespective of the nature of the establishment (e.g., headquarters, branches, subsidiaries). This means that for branches and subsidiaries of banking groups with cross-border operations, the host central bank would act as the lender of last resort. This function has been established in different ways in member states ranging from very explicit to very general rules. In the majority of cases, authorities have preferred to maintain considerable ambiguity as regards the lender of last resort function in order to reduce moral-hazard behaviour.

41. The oversight function on payment systems together with the definition of standards for Securities Settlement Systems has increased the preventive nature of some provisions, thus possibly reducing the importance of these arrangements. On the other hand, they represent necessary tools to adopt for trying to resolving crises of illiquid financial institutions.

42. It is possible, however, that the underlying logic no longer applies to banks and their subsidiaries/branches located in the Eurozone. In fact, Eurozone banks with branches and subsidiaries in other Eurozone Member States have generally centralised their liquidity management in headquarters. Thus, the notion that such a bank has a liquidity problem in one of its subsidiaries, but not in its home market (or vice versa) is less tenable. Within the Eurosystem, all participating national central banks decide, in principle, autonomously on whether or not to provide emergency liquidity assistance to an institution operating in its jurisdiction. However, given that the repercussions of providing liquidity in any one EMU member state extend beyond this member state, the Eurosystem has to be informed. In practice, it can probably be assumed that no national central bank that is a member of the Eurosystem would act in isolation.

43. Linked to the work on crisis management, clear arrangements need to be put in place for the LoLR function. The extent to which the existence, and even more the nature, of such arrangements is disclosed is another, and very difficult, question. Maintaining a policy of 'constructive ambiguity' on its issue may still be reasonable from the public perspective, to avoid creating incentives for private actors to act otherwise than they normally would, and to avoid exacerbating problems of moral hazard. But such a policy is not necessarily appropriate amongst the key actors who would need to be involved in crisis resolution (whether the crisis in question is one of liquidity or of solvency).

IV Deposit Guarantee Schemes

44. The separate paper EBC/021/05 gives an update on efforts in this area and sets out a number of further pieces of work that are required, so we will not repeat that in this paper. The Commission intends to come forward with a Communication on possible revisions to the legislation[17] in this area in June 2006.

V Bankruptcy and Winding-Up

45. Directive 2001/24/EC[18] put in place, for the first time, EU-wide rules specifically relating to the winding-up of credit institutions.

46. Although some Member States have still not transposed this Directive properly, it has already become clear that there are a number of ambiguities and potential gaps in the rules set out in the Directive.

47. To ensure that, if necessary, winding-up of a cross-border financial institution can be effected as smoothly as possible, it will be necessary to review the Directive with the aim of removing areas of ambiguity and filling any gaps that are identified.

[17] Directive 94/19/EC of the European Parliament and of the Council of 30 May 1994 on deposit-guarantee schemes.

[18] Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions.