

# **Strengthening the EU regulatory and supervisory framework: a practical approach**

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November 2007



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If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence and Enquiry Unit

HM Treasury

1 Horse Guards Road

London

SW1A 2HQ

Tel: 020 7270 4558

Fax: 020 7270 4861

E-mail: [public.enquiries@hm-treasury.gov.uk](mailto:public.enquiries@hm-treasury.gov.uk)

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# FOREWORD

Financial markets and institutions play a vital role in underpinning stability and growth in our economies. We welcome the integration of financial markets, both internationally and within the EU, and the contribution to economic growth and prosperity that it can bring. The challenge for Governments and supervisors is to put in place a regulatory and supervisory framework that is effective in terms of identifying and addressing risks and efficient in avoiding duplication and minimising costs. This is an ever-greater challenge as many financial groups operate on an increasingly cross-border basis.

Across the UK, 1.1m people are employed in financial services. London is host to the world's most international financial centre, acting as gateway to the EU for the world's capital markets and for EU to the rest of the world. As a result, we believe the UK has an important contribution to make to the ongoing debate on how our system of regulation and supervision develops both internationally and within the EU. The focus of this paper is the development of the EU's regulatory and supervisory framework – the so-called "Lamfalussy arrangements". At the same time, both the Treasury and the FSA are playing a full part in contributing to the international community's response to the recent turbulence affecting financial markets.

The Lamfalussy arrangements have made a major contribution to the regulation and supervision of the EU's financial markets. We believe these arrangements, including the roles and responsibilities of the EU and national institutions working within them, remain appropriate and effective. Based on experience to date, there are, of course, lessons we can learn to enhance the operation of the Lamfalussy arrangements without altering their basic structure. These include delivering cost-effective regulation, where regulation is necessary, through the use of better regulation techniques, and deepening cooperation and collaboration between national supervisory authorities in the supervision of markets and firms.

This paper represents a positive, constructive and ambitious contribution to the ongoing debate on the future of regulation and supervision of financial markets within the EU.

**Kitty Ussher MP**  
Economic Secretary to the Treasury

**Sir Callum McCarthy**  
Chairman, FSA



# EXECUTIVE SUMMARY

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Financial markets are highly dynamic. They are constantly changing and continually evolving in response to the demands of consumers, businesses and investors.

In response to globalisation and with the benefits of new technology, financial markets and institutions are increasingly integrating across borders and sectors, providing savers and investors with increased choice, greater access to capital and more sophisticated products. These developments can bring significant benefits and advantages for the global economy. Nevertheless, they also make the regulation and supervision of financial markets more complex.

Supervisors in all countries must respond to the challenges and opportunities posed by the evolution of markets. They need to ensure the effective supervision of financial markets and help underpin financial stability, without unduly restricting or harming the efficiency or competitive position of firms and markets.

In response to these challenges, many countries are modifying their national supervisory arrangements and developing and enhancing cooperation arrangements either within the EU through the so-called Lamfalussy arrangements, or internationally, where cooperation has intensified through a number of regulatory groupings.

This focus of this paper is an objective analysis of the operation of the Lamfalussy arrangements to date. Overall, the UK authorities believe the Lamfalussy arrangements:

- have made a major contribution to the regulatory and supervisory framework in EU; and
- provide an innovative, flexible, and effective solution to enhancing supervisory cooperation and convergence.

**The UK authorities believe the objectives and structures of the Lamfalussy arrangements are fundamentally sound. In particular, the respective roles and responsibilities of EU institutions and national authorities within the current framework, including the status of the level III committees, continues to provide the most appropriate and effective means of regulating and supervising the EU's markets for the foreseeable future.**

**Based on the experience to date, there are a number of areas where practical enhancements to the current framework might be made to deliver tangible benefits in terms of the efficiency of the supervisory process facing firms and the effectiveness in the way the Lamfalussy committees conduct their day-to-day business. These are set out below and represent an ambitious contribution to developing and enhancing the current framework.**

## CONVERGENCE

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The convergence of regulation and supervisory practices is desirable in terms of both the regulatory framework (i.e. the rules that apply to financial institutions) and the practices of supervisors.

Nevertheless, differences in national markets mean supervisors will often need to adopt different approaches and apply different tools in their daily work. For example, the

appropriate regulatory approach for international financial centres dominated by wholesale markets is clearly different to the appropriate approach for more retail focussed national markets in the EU.

Rather the UK authorities believe that consistent with a principles-based approach, **supervisory convergence is primarily about delivering equivalent regulatory outcomes.** Over time and through ongoing cooperation and sharing of best practice, it is likely and desirable that supervisory practices converge. However this needs to be part of an organic process, rather than one that is regulated into effect.

**The UK authorities recommend that the Level III committees operate in accordance with a principles-based-approach, which aims to achieve equivalent regulatory outcomes. In addition the UK authorities will continue to actively support further progress towards joint training and secondment initiatives, building on the recommendations in the 2006 FSC Report on Financial Supervision.**

## BETTER REGULATION

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The imposition of regulation, whilst potentially necessary to ensure financial stability, consumer protection, or market integrity, imposes costs and distorts competitive markets. Regulation is not an end in itself. It should only be used where non-legislative solutions are deemed inappropriate; be proportionate and justified by sound economic analysis in accordance with the principles of better regulation.

The European Commission is making good progress with more thorough use of impact analysis on EU legislative proposals. Such disciplines should now be extended to systematically cover advice and guidance produced by the Level III committees.

**The UK authorities recommend that robust economic analysis be undertaken systematically by the Level III committees when preparing advice to the European Commission for the formulation of implementing measures for EU directives and, in due course, non-binding guidance to assist with implementation, where such guidance would have a significant burden on industry.**

## ENSURING CONSISTENT IMPLEMENTATION

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The timely, consistent and proportionate implementation of EU financial services legislation is critical to ensuring the benefits of financial integration are realised. Nevertheless, Member States often have varying degrees of discretion in the way they implement EU legislation, which can result in inconsistent and sometimes disproportionate implementation.

Whilst such flexibility remains necessary given the specificities of national markets, it should be used to the minimum extent necessary.

In addition, the more comprehensive use of “comply or explain” and peer review mechanisms, each incorporating an element of public disclosure where necessary, can be powerful tools to promote consistent implementation.

**The UK authorities recommend all Member States should limit their use of national discretions to the minimum extent necessary and all Level III committees should introduce a “comply or explain” regime coupled with a comprehensive system of peer review.**

## STANDARD TIMESCALES AND GUIDELINES FOR IMPLEMENTATION

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When implementing EU legislation, it is crucial that supervisors and firms have sufficient time and guidance to comply. On occasion in the past too little time has been set aside for this important work.

**The UK authorities recommend that for substantial directives or legislative changes, it should become standard practice to provide a sufficient time period between adoption of relevant Level II measures and the implementation date for the piece of EU legislation.**

## ACCOUNTABILITY WITHIN THE LAMFALUSSY FRAMEWORK AND DECISION MAKING

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Accountability and transparency help to ensure good decision making and the UK authorities fully support appropriate measures to enhance both.

National supervisory authorities are, and should remain, accountable at Member State level. However, within the Lamfalussy framework, accountability might be improved with more regular and formalised reporting of the activities of the Level III committees to the Council and European Parliament.

On decision making, the key is to find a pragmatic way forward that enables the Level III committees to perform effectively without introducing an effective third layer of EU law making, or inhibiting the ability of national authorities to tailor implementation and supervision to the specificities of national markets where appropriate.

**The UK authorities recommend more formalised reporting by the Level III committees to the Council and the European Parliament. In addition, whilst the Level III committees should make their decisions by consensus wherever possible, where appropriate and at the discretion of the Level III committees, forms of majority voting could be used to expedite business. Such decisions should be non-binding and accompanied by a “comply or explain” approach.**

## ENSURING GREATER EFFICIENCY FOR CROSS-BORDER GROUPS

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As markets continue to integrate globally and consolidate cross-border and cross-sectorally, so firms are increasingly demanding greater efficiency in their supervisory dealings.

Recent EU Directives, such as the current European Commission proposal in respect of Solvency II, are increasingly reflecting a shift towards more group supervision. In addition to making further progress towards supervisory cooperation in the ways outlined above, this will enhance the efficiency of supervision for cross-border groups and will help ensure better regulatory outcomes.

The UK authorities strongly support moves towards more group-based approaches to supervision, where tasks are delegated amongst supervisors and where one supervisor has overall responsibility for the group as a whole.

**To strengthen this approach, the UK authorities recommend a package of measures to further develop group-based approaches to supervision and the home-host**

framework for supervisory cooperation that underpins it. The UK authorities recommend this package of measures comprise:

- the more systematic and regular use of colleges of supervisors to promote supervisory cooperation and information sharing between supervisors of a cross-border group;
- further developing the home-host framework through the creation of principles governing a more extensive delegation of tasks between supervisors (where this is judged to be appropriate). This could be developed by the Level III committees; and
- further use of delegation of, or sharing of, supervisory tasks, within supervisory colleges to avoid duplication of supervisory effort.

The UK authorities believe that the package of measures set out in this paper are substantial, far reaching in nature and would significantly strengthen both the Lamfalussy arrangements and the formal day-to-day supervision of firms and markets in the EU.

As with all new initiatives, if adopted, such a package of measures would require time both to become operational and to demonstrate their effectiveness. **As a result, the UK authorities propose that such enhanced arrangements be subject to another review, after a further four years.**

# INTRODUCTION AND CONTEXT

## Why markets matter

**1.1** Efficient, stable and fair capital markets are key to promoting future growth in countries throughout the world. Many developed countries have seen benefits from financial globalisation, in the form of higher growth and lower inflation. However, the challenge remains to derive maximum benefit from this increased growth for the global economy, particularly for emerging markets and low-income countries.

**1.2** Open capital markets are also key to achieving wider policy objectives such as development, environment and climate change.

## Benefits of integration

**1.3** In the EU, there has been had a long-standing agenda to facilitate the integration of financial services' markets and the UK has strongly supported this. Greater integration of EU financial services markets is expected to yield considerable economic benefits, both for EU businesses and consumers in the wider economy. A more integrated financial services market is expected to:

- lower the **cost of capital** and improve the allocation of capital across the EU;
- give firms increased opportunities to **access markets** in other Member States and to carry out business effectively on a cross-border basis; and
- give **retail consumers** access to a wider range of products.

**1.4** Furthermore, several economic studies have estimated the economic benefits of EU financial market integration, and show that they range from 0.5 per cent to 1.1 per cent of GDP over time<sup>1</sup>.

## MARKET DEVELOPMENTS

## Markets are changing

**1.5** Such cross-border financial market integration, in recent years, increased substantially. In the past decade the global economy has undergone rapid economic change. Financial market liberalisation, coupled with rapid innovation in technology and trading platforms, has resulted in more integrated and interdependent global markets.

**1.6** Increasing integration and inter-connectedness can be seen in a number of key developments and trends, which are posing challenges for policy makers and supervisors:

- **increasingly global capital markets:** cross-border ownership has grown rapidly as investors have increasingly looked to invest capital abroad and issuers raise money in overseas markets. For example, the stock of financial assets held outside investors' home countries increased from 20 per cent of global GDP in the mid 1970s to 60 per cent in the early 1990s to around 140 per cent today. The external assets and liabilities of G7 industrial countries as a proportion of GDP have more than quadrupled between 1970 and 2004<sup>2</sup>. In addition, emerging financial centres are playing an increasingly

<sup>1</sup> The 1988 Cecchini Report estimated that the integration of financial markets in 8 Member States would result in a one-off increase in the value added of their financial services of 0.7 per cent of GDP, while a study by London Economics in 2002 concluded that fully integrated markets would lower the cost of capital by 0.5 per cent in absolute terms and increase the level of GDP (of the EU15) by 1.1 per cent over time.

<sup>2</sup> *The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970-2004*, G. Milesi-Ferretti and P. Lane, March 2006.

important role in financing development in their geographical regions and over time will integrate further into the global capital system;

- **increasingly sophisticated financial products and technology:** Alongside this increased integration, market participants are increasingly using more sophisticated new instruments and structured finance products to manage and spread risks. For example, between April 2001 and April 2007 average daily turnover on over-the-counter derivatives markets in Europe increased almost threefold to reach \$1,671 billion, whilst in the US it increased four fold over the same period to reach \$607 billion<sup>3</sup>. Moreover, the use of new structured finance products such as Collateralised Debt Obligations (CDOs) has grown rapidly: global issuance rose from \$157 billion in 2004 to \$549 billion in 2006<sup>4</sup>. The use of such products has enabled firms to manage risks better and their widespread trading has reduced concentration risks, spreading risks across the globe through a diverse range of investors. While this spreading of risk should be beneficial, the events of this summer demonstrate that issues arise over the proper management of that risk by firms, and transparency as to where the risk ultimately lies; and
- **globalisation of financial services firms:** In response to significant cross-border and cross-sector deregulation, and aided by new technology that allows firms to centralise major governance functions and key management systems, the past decade has seen an explosion in cross-border financial services mergers and acquisition (M&A) activity. Cross-border financial services M&A has risen from \$7 billion in 1999 to \$360 billion in 2006, and now makes up more than 40% of total financial services M&A<sup>5</sup>. As consolidation takes place, firms are restructuring themselves as financial groups rather than a collection of individual profit centres.

**1.7** This integration of financial markets can yield considerable benefits for the global economy in delivering deeper and more liquid markets, spreading risk, increasing choice and promoting competition. Nevertheless, as markets become more integrated, so the question of how to regulate and supervise them becomes more complex, which in turn poses challenges for policy makers.

## HOW POLICY MAKERS ARE RESPONDING

### Policy makers' response

**1.8** Policy makers are responding to these challenges in a variety of ways. The response has included developments both globally and at a European level, with the aim of enhancing understanding and surveillance of financial developments, and seeking common regulatory and supervisory approaches. Responses have included:

- developing a **regulatory and supervisory architecture** to enable effective cooperation and a common understanding of the sources of vulnerability and risk;
- developing **common regulatory approaches** to the rules governing financial markets and products; and

<sup>3</sup> *Financial market trends in Europe vs US*, International Financial Services London, October 2007.

<sup>4</sup> Securities Industry and Financial Markets Association.

<sup>5</sup> *Global Financial Stability Report*, IMF, April 2007.

- enhancing **supervisory cooperation** to effectively supervise cross-border institutions, including enhancing crisis management arrangements.

## The international context

### Role of the IMF and FSF

**1.9** A range of bodies exists at the global level to meet the regulatory challenges resulting from the developments outlined above. Key amongst them are the Financial Stability Forum (FSF) and the International Monetary Fund (IMF). The FSF – first established following the Asian financial crisis ten years ago – represents the principal international forum for addressing global vulnerabilities in financial markets and financial stability issues. The IMF supports and contributes to financial stability through its global economic and financial surveillance activities, which draw heavily on standards developed by international regulatory groupings.

### Global regulatory groupings

**1.10** These global regulatory groupings<sup>6</sup> set international standards for regulation; for example the Basel Committee on Banking Supervision (BCBS) for the prudential regulation of banks or the International Accounting Standards Board (IASB) in the field of accounting standards. In addition, the Financial Action Task Force (FATF) brings together the key agencies and authorities to ensure effective cooperation in tackling financial crime and fraud, which is increasingly cross-border in nature.

**1.11** Moreover, internationally and within Europe, national supervisors need to work together to gain an effective oversight of firms or financial groups. “Colleges” of supervisors are becoming an increasingly common approach.

**1.12** Regulatory dialogues between the major markets, such as the Financial Market Regulatory Dialogue (FMRD) between the EU and the United States, are also becoming increasingly important as a means of opening markets through mutual recognition and of sharing expertise on the regulation and supervision of financial markets. Such dialogue will become increasingly important with regard to key emerging markets such as India and China.

### Crisis management

**1.13** In addition to closer cooperation regarding ongoing regulation and supervision, supervisors need to develop arrangements for managing cross-border financial crises at the international level. The EU has made significant progress in this area including holding an EU wide crisis management exercise in 2006 and agreeing a continued programme of work to strengthen financial stability arrangements in the EU. The FSF has also recently focused on this area, including jointly hosting a best practice workshop on international cooperation in financial crises with the UK last year.

**1.14** Most immediately, the international community needs to consider the appropriate response to the summer’s market turbulence. The UK’s priorities for ongoing work are set out in Box 1.1.

<sup>6</sup> Such as the Basel Committee on Banking Supervision (BCBS), the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the Financial Action Task Force (FATF).

**Box 1.1 Recent turbulence on global financial markets**

The recent market turbulence, triggered initially by problems in the US sub-prime mortgage market has had a global impact. It is important that any response is international. The UK authorities believe that the FSF is best placed to assess the underlying causes of recent market developments and recommend the appropriate response.

In analysing how the international community should respond to these issues, international policymakers should be guided by some important principles. The primary responsibility for managing risk is, and must remain, with individual financial institutions and investors. This needs to be backed up by strong national regulatory frameworks. Regulatory authorities in different countries need to cooperate effectively across borders in the exchange of information and in the management of crises and contagion. Market solutions will also have a key role to play. In particular, work is needed in the following areas:

- appropriate **disclosure of information** on securitised debt and other structured financial products;
- assessment of **illiquid assets** and their significance for risk management, valuations of complex financial instruments, and financial institutions liquidity practices;
- possible weak points in the **risk management** of banks, special purpose entities and institutional investors;
- **transparency** surrounding banks' off-balance sheet risks;
- cross-border **cooperation and crisis management**; and
- the role of **rating agencies** in financial markets and the use of ratings by firms.

To strengthen the ability of the international system to understand the interaction of financial sector risks and economic growth, the IMF should support and complement the work of the FSF. This means that the IMF should enhance its surveillance role to ensure that the implications of developments in the financial sector for individual economies and cross-border linkages are fully understood. The UK believes that the IMF and FSF have the potential to provide global financial markets with:

- the **analytical and market knowledge** to understand the financial linkages between countries and the identification of risks which may impact across national boundaries;
- **practical recommendations** to mitigate threats to financial stability; and
- an **'early warning system'** in identifying economic risks from the financial system.

## The EU context

**The FSAP 1.15** In the EU, policy makers have adopted and implemented the Financial Services Action Plan (FSAP). The FSAP comprised 42 legislative and non-legislative proposals to further the integration of EU financial markets. With the near completion of the FSAP, HM Treasury, the Financial Services Authority and Bank of England published a strategy paper<sup>7</sup> setting out five priorities that should guide further financial services integration in the EU. These five priorities are set out in Box 1.2.

<sup>7</sup> After the EU Financial Services Action Plan, A new strategic approach, HM Treasury, Financial Services Authority and Bank of England, May 2004.

**Box 1.2: The UK's five priorities**

The UK authorities' five priorities for further financial services integration in the EU are:

- **better implementation and enforcement of EU measures affecting the financial sector.** Effective, proportionate and consistent implementation of EU legislation affecting the financial sector is key to delivering the potential benefits of economic integration from EU financial services legislation while avoiding costly burdens on business. This should take precedence over new legislative initiatives;
- **alternatives to EU regulation.** In general, EU legislation should be a last resort, and alternative approaches to policy making, such as more use of EU competition policy, market-based solutions and initiatives at national level, should be considered first;
- **better regulation.** In some specific cases, market failure analysis may demonstrate that further new EU legislation in financial services could be necessary. When new EU legislation on financial services is being considered, a proper assessment of the costs and benefits should be undertaken, and financial market participants should be fully consulted;
- **making the Lamfalussy arrangements work well.** These arrangements have been put in place to enhance the EU legislative process and improve supervisory cooperation. Policy makers need to ensure that these arrangements work well and deliver their full potential; and
- **recognising the global nature of financial services.** It is crucially important to remember that financial markets are global. A global perspective is needed when considering the impact of EU financial services regulation on the competitiveness of EU-based firms and financial centres. International action will often be needed to tackle global issues.

### The Lamfalussy arrangements

**1.16** Alongside the FSAP, new arrangements – known as the Lamfalussy arrangements – have been established to enhance the efficiency of the EU rule making process and enhance supervisory cooperation and convergence. These arrangements were first established for securities in 2001, and extended to banking and insurance in 2004.

**1.17** The design of the Lamfalussy arrangements followed a thorough debate on the appropriate institutional response to provide effective supervision of EU markets. It has resulted in the development of networks of national supervisors<sup>8</sup>, working together to enhance supervisory cooperation and the convergence of supervisory practice. These arrangements recognise the continuing need to tailor regulation and supervision to heterogeneous national markets, rather than establishing a single regulator at the European level as some have argued, or EU supervisory agencies. The UK continues to believe strongly that they represent the most appropriate means of delivering effective regulation and supervision in the EU.

**1.18** Making progress on enhancing supervisory cooperation and convergence lies at the forefront of the Lamfalussy arrangements. In January 2005, HM Treasury, Financial Services Authority and Bank of England published a discussion paper<sup>9</sup> setting out a

<sup>8</sup> Committee of European Banking Supervisors (CEBS), the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR).

<sup>9</sup> *Supervising financial services in an integrated European Single Market: A discussion paper*, HM Treasury, Financial Services Authority and Bank of England, January 2005.

number of wide ranging and ambitious proposals for enhancing supervisory cooperation and convergence in the EU. Since then, and as Chapter 2 will illustrate, much progress has been made. This paper brings that analysis up to date.

## PRINCIPLES FOR ANALYSING THE REGULATORY AND SUPERVISORY FRAMEWORK

**1.19** The UK authorities' primary objective is to put integrated markets at the service of the wider economy to maximise economic benefits. Regulation should never be an end in itself. Hence, in analysing the current arrangements, and how the future regulatory and supervisory framework for financial markets should be developed at the national, EU and international level, the UK authorities have been guided by a number of principles. These are that the regulatory or supervisory framework should:

- support **innovation, competition and efficiency** in the financial system;
- promote **financial stability, transparency and confidence** in the market and among its users; and
- recognise the need for regulators to be **accountable**, principally to **national governments and parliaments**.

**1.20** Further, any regulatory and supervisory framework should achieve this while:

- supporting effective **supervisory cooperation** to supervise an increasingly integrated market;
- being founded on a **principles-based approach** to regulation which is evidence based, outcomes-focused and which favours market or non-legislative solutions where appropriate;
- encouraging **convergence in regulatory approach** through the work of international standard setting bodies, and regulatory dialogues; and
- encouraging **convergence of supervisory practice** and philosophy through sharing best practice and forging joint approaches.

### The review of the Lamfalussy arrangements

**1.21** The Lamfalussy arrangements are due to be reviewed at the end of the year and this paper represents the UK authorities' contribution to this debate. It sets out the UK authorities' assessment of the operation of the Lamfalussy arrangements to date (Chapter 2), and a number of areas and recommendations where the operation of these arrangements could be further enhanced (Chapter 3).

**1.22** The UK authorities would welcome comments on the ideas expressed in this discussion paper from all interested parties. They can be sent to: [fsconsultation@hm-treasury.gov.uk](mailto:fsconsultation@hm-treasury.gov.uk).

# 2

## THE EU REGULATORY AND SUPERVISORY FRAMEWORK: OUR ASSESSMENT

### THE EU REGULATORY AND SUPERVISORY FRAMEWORK

**2.1** The current EU framework for the regulation and supervision of firms and markets is designed around two core elements:

- day-to-day collaboration among the supervisors in the EU is underpinned by the **division of legal responsibilities between home and host<sup>1</sup> supervisors**, enshrined in EU legislation. The division between home and host supervisors varies depending on the sector and function. Broadly speaking, most prudential supervision is undertaken by the supervisor in the country where the firm is authorised; conduct of business and liquidity regulation tend to be the responsibility of the Member State in which the firm is based<sup>2</sup>. Where business is undertaken cross-border, there are also a few responsibilities<sup>3</sup> which belong to the regulator in the Member State where the recipient of a service is based. The trend in recent years has been to transfer key responsibilities – for example, for aspects of capital adequacy – to the home or group supervisor. Within the framework of these formal responsibilities there is a need for supervisors to share information and to collaborate together in discharging their duties and agreeing an efficient allocation of supervisory tasks; and
- the **Lamfalussy arrangements** were established for securities markets in 2001 and subsequently extended to banking and insurance in 2004. These arrangements are designed to increase the efficiency of the EU legislative process and enhance cooperation and convergence of supervisory practice between the EU’s national supervisory authorities. They are set out in detail in Box 2.1.

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<sup>1</sup> For the purposes of this paper, the “home” supervisor is taken to be the supervisor of the jurisdiction in which the parent firm is licensed, authorised or incorporated. This is the definition enshrined in EU legislation to date. The “host” supervisor is taken to be the supervisor in the jurisdiction in which a branch or a local subsidiary is incorporated.

<sup>2</sup> Under the insurance directives liquidity is the responsibility of the home Member State.

<sup>3</sup> For example matters adopted for the public good and unfair terms in consumer contracts.

**Box 2.1: The Lamfalussy arrangements**

The four-level approach of the Lamfalussy arrangements is as follows:

- **Level I** consists of legislative acts, namely directives or regulations proposed by the Commission following consultation and adopted under the co-decision procedure by the Council of Ministers and the European Parliament. In adopting each directive or regulation, the Council and the Parliament agree on the nature and extent of detailed technical implementing legislation or technical adjustments to the Directive, both of which are to be decided at Level II;
- at **Level II** Commission-chaired comitology committees with Member States' finance ministries as members assist, on the basis of a Commission proposal in the adopting of relevant technical adjustments or implementing measures. Such measures will be used to ensure that technical provisions can be kept up-to-date with market developments;
- at **Level III** committees of national supervisors act as an advisory group to assist the European Commission in the preparation of implementing measures of European Directives or Regulations to be adopted at Level II; work to ensure more consistent and timely day-to-day implementation of Community legislation in Member States; improve coordination amongst national supervisory authorities; and enhance the convergence of supervisory practice; and
- **Level IV** is concerned with strengthening the enforcement of Community rules. Whilst Member States and national supervisory authorities do have an important role to play here, the majority responsibility lies with the European Commission, which has the legal duty to act as guardian of the European treaties.

**2.2** The EU framework for the regulation and supervision of firms and markets is designed to remove obstacles to the single market and to improve the efficient and effective supervision of the EU's heterogeneous national markets, albeit ones that are integrating both within the EU and globally. This framework has been developed to take into account a number of complex aspects of the financial landscape that more simplistic 'one-size-fits-all' solutions fail to address. These are:

- the need for supervision to respond to the quite different requirements of the **global wholesale market and diverse national retail and small business markets** (where barriers like language, culture and consumer preference cannot simply be legislated or regulated away);
- the fact that national finance ministries, central banks and supervisory authorities are **accountable to national parliaments** for ensuring efficient and well functioning financial markets and depositor protection;
- the importance of ensuring that regulation keeps pace with **market developments**, especially wholesale markets, and provides effective oversight of internationally active firms; and
- the importance of reducing **regulatory duplication**.

## ASSESSMENT OF THE CURRENT ARRANGEMENTS

**2.3** The UK authorities strongly believe that the Lamfalussy arrangements have made a significant positive contribution to the EU's regulatory and supervisory framework since their introduction for securities in 2001 and banking and insurance and pensions in 2004.

**2.4** Prior to the establishment of these arrangements for financial services, the EU's legislative processes had no formalised means of utilising the technical expertise of regulators or market participants. Legislation frequently lacked a sound evidence base and often failed to be consistently transposed and applied across the EU. Moreover, few established mechanisms were in place to assist supervisors to cooperate with each other. Since then the position has radically improved.

### Levels I and II

#### Key achievements

**2.5** In terms of their role in the EU legislative process (Levels I & II), we believe that the Lamfalussy arrangements have:

- delivered a considerable increase in the **transparency** of the rule making process;
- improved the technical **quality** of legislation by securing input from financial services supervisors;
- seen a marked increase in the extent to which the financial services industry is **consulted** during the EU rule making process; and
- created frameworks within which **regulation** can be introduced in a timely way, on the basis of sound evidence and, if appropriate, modified using flexible and speedy procedures.

#### Areas for refinement

**2.6** Nevertheless, despite these considerable improvements, there are some areas where further enhancements and refinements could be made. The main areas are:

- a better **demarkation between Level I and Level II**. It was envisaged that Level I would consist of framework legislation setting out high level principles, with detailed implementing measures being developed at Level II. In reality, Level I has often contained more detail than previous Community legislation, and Level II has contained more detail still. The Markets in Financial Instruments Directive (MiFID) is an example of a directive whose Level I provisions alone are far more detailed than those of the Investment Services Directive, which it replaced;
- striking a balance between the speed with which legislation is adopted and its **quality**. On the one hand, legislation needs to be produced in a timely and efficient manner. Equally, there is a need to ensure legislation is properly evidence based and justified according to thorough and rigorous economic analysis and full consultation with the industry. Getting this balance right has not always proved easy;
- providing industry with **sufficient time** to adapt its systems to new requirements. In the case of MiFID, additional time provided by extensions to the timetable were taken up largely at the legislative stage, leaving industry with a shortened time frame for implementation; and

- impact assessments of Level I proposals have often failed to analyse **market and regulatory failures** and have not been sufficiently granular to inform the policy debate on specific requirements. In addition no impact assessments have yet been undertaken on Level II implementing measures.

### Level III

#### Key achievements

**2.7** The UK authorities believe that, overall, the three Level III committees (CEBS, CESR and CEIOPS) have made a significant and positive contribution to both the development of financial services regulation in the EU and the convergence of supervisory practices. The work of these committees has been wide ranging, and spanned a number of areas. In summary, these committees:

- have submitted **extensive advice** to the European Commission on the development of key directives and subsequent implementing measures in their respective sectors, often based upon wide ranging consultation with market participants;
- have developed **guidance and tools** to assist with the consistent implementation of these EU directives. For example: CEBS has developed frameworks for the operation of colleges of supervisors; and CESR has looked at how supervisors have implemented CESR's guidelines on the UCITS Directive and has conducted a mapping exercise of the supervisory powers they possess under the Market Abuse and Prospectus Directives;
- are working to develop the **convergence of supervisory practices**. All three committees have developed joint training and staff secondment programmes, and have adopted mediation mechanisms to assist in the resolution of potential cross-border supervisory disputes. Work is also underway to establish frameworks and arrangements to assist in the delegation of supervisory tasks between supervisors to help enhance supervisory efficiency (i.e. work to implement the recommendations in the Financial Services Committee (FSC) Report on Financial Supervision<sup>4</sup>, as set out in Box 2.2); and
- are working together to develop **cross-sectoral approaches** to issues of common regulatory concern. Work undertaken through these cross-sectoral arrangements to date has included projects on outsourcing and on money laundering, in particular in relation to the roles of home and host supervisors.

<sup>4</sup> FSC Report on Financial Supervision, Report by the EU's Financial Services Committee, FSC 4159/06, 23 February 2006.

**Box 2.2: The 2006 FSC Report on Financial Supervision**

During the course of 2005 and 2006 the Financial Services Committee considered how the existing supervisory framework could be further enhanced and developed to meet the challenges of integrating markets. Its report contained a number of practical recommendations which finance ministers endorsed in May 2006. The report, among other things, called for:

- the fostering of a European supervisory culture through developing common supervisory training schemes, secondment schemes and joint inspection and supervisory visits;
- developing mediation mechanisms to help resolve supervisory disputes;
- developing arrangements and guidelines for the delegation of supervisory tasks, and where legally possible, responsibilities; and
- developing arrangements to streamline supervisory reporting and data-sharing arrangements.

Work on the implementation of these recommendations is currently under way and the timetable for their introduction varies between sectors. It is anticipated that all recommendations will be implemented in all sectors (banking, insurance and pensions and securities) by the end of 2008.

The UK authorities fully support these practical steps for enhancing the convergence of supervisory practices. We believe they represent the correct approach to delivering meaningful supervisory convergence designed to deliver equivalent regulatory **outcomes** to regulatory issues or problems.

**2.8** Annex A sets out in greater detail the work and output of each of the three Level III committees.

**Areas for refinement**

**2.9** Nevertheless, despite these considerable achievements, there are some areas where further enhancements and refinements could be made. The main areas are:

- the **meaning of ‘convergence’**. Although one of the roles of the Level 3 committees is to promote the convergence of supervisory practices, there is no common understanding on the meaning of convergence itself. This can lead to differences of view among supervisors about what outcomes the Level III committees should be seeking to achieve and the appropriate means by which to achieve them;
- **advice** produced by the committees can be excessively prescriptive. There is an element of learning through doing here, but over-prescription has, on occasion, been a problem;
- the absence of **standard timetables on implementation**. Much regulation imposes considerable transitional and other costs on firms. In the past there have been occasions where insufficient time has been available between the adoption of measures required to implement a directive, and the time when that directive comes into force. This has resulted in insufficient time being available to develop robust and comprehensive implementation guidance at Level III and for national supervisors and firms to prepare thoroughly for implementation;
- **implementation** can be inconsistent across EU Member States. There remains concern about the ability of the Level III committees to ensure

consistent implementation of EU directives (and Level III guidance) across the 27 Member States;

- supervisory cooperation at Level III needs to deliver greater tangible efficiencies for the supervision of **cross-border groups**. Cross-border groups often face multiple supervisory demands from multiple supervisors. More can, and needs to be done, to avoid duplication of supervisory tasks and increase efficiencies for cross-border groups;
- the **accountability** of the Level III committees within the Lamfalussy framework has been questioned. It has been suggested that the Level III committees should be more accountable to the EU institutions for the work they undertake to enhance the convergence of (national) supervisory practices. In addition some have argued that they should be able to reach non-binding decisions by majority voting as opposed to consensus as is often the case at present.

## Level IV

**2.10** Level IV concerns the enforcement of EU legislation. It requires verifying that EU legislation is both fully transposed into national law and that such measures are then properly applied in individual Member States.

**2.11** Most of the measures contained in the Financial Services Action Plan have now been implemented (or will be shortly). As a result, the regulatory emphasis is shifting towards ensuring these measures are properly enforced.

**2.12** To help mitigate enforcement issues that may inevitably arise, it is important that:

- supervisory authorities have the requisite **powers** to implement effectively the legislative commitments entered into by Member States in Level I and Level II legislation. The responsibility for ensuring supervisory authorities have such requisite powers rests with Member States; and
- the **Level III committees** have a vital role helping to ensure that implementation issues and inconsistencies do not give rise to subsequent enforcement problems. It is envisaged that the use of mediation mechanisms by CEBS, CEIOPS and CESR will act as a useful tool to assist in these efforts.

### Commission resources

**2.13** Overall, responsibility for the enforcement of Community legislation, however, rests with the European Commission, which has the legal duty to act as guardian of the European treaties. Along with the Inter-institutional Monitoring Group<sup>5</sup> the UK authorities urge the Commission to allocate additional resources to the transposition and enforcement of EU legislation and ensure sufficient staff are available to verify accurate transposition and bring enforcement action where necessary.

<sup>5</sup> *Final Report Monitoring the Lamfalussy Process*, Inter-institutional Monitoring Group, 15 October 2007.

## OVERALL ASSESSMENT

**2.14** The UK authorities believe the Lamfalussy arrangements have made a major contribution to development of the regulatory and supervisory framework for financial services in the EU.

**2.15** These arrangements have played an integral role in delivering many of the measures contained in the Financial Services Action Plan, the EU's flagship programme to create a Single Market in financial services. Had these arrangements not been in place, many of the measures might still be under negotiation. Moreover, without these arrangements, it would become increasingly difficult, when the time arises, to amend these directives in response to market developments without the directives themselves requiring time consuming renegotiation.

**2.16** As the legislative burden imposed by the negotiation and implementation of the Financial Services Action Plan begins to recede, so the Level III committees are increasingly focussing on enhancing supervisory cooperation and the convergence of supervisory practices. Already these committees have arguably begun to deliver greater cooperation between supervisors and more convergence of practices in the last three years than had been experienced in the previous three decades.

**2.17** Nevertheless, the Lamfalussy arrangements were never designed to be fixed in stone. Just as these arrangements are designed to allow regulation to respond and adapt to market developments, so the arrangements themselves should be flexible enough to adapt and evolve over time.

**2.18** The UK authorities believe that the operation of the Lamfalussy arrangements to date suggests:

- the **structures**, objectives and networks established are fundamentally sound. They provide an innovative and effective solution to enhancing supervisory convergence; but
- the **practical operation** of these arrangements could be further enhanced and developed by ensuring that the necessary tools are in place to facilitate the cooperation needed to optimise these working arrangements and deliver true regulatory and supervisory convergence.

**2.19** Chapter 3 proposes some practical tools to deliver these improvements. However, the success or otherwise of such tools depends crucially on supervisors themselves being prepared to adapt their behavioural approaches towards supervisory cooperation to ensure:

- there are high levels of **trust** and understanding between supervisors who are prepared to work collaboratively together;
- supervisors are prepared to **delegate** tasks and have confidence in, and accept, each other's standards of implementation; and
- supervisors are prepared to **challenge** their peers, and be willing, in return, to be challenged by them.



# 3

## PROPOSALS TO ENHANCE THE CURRENT FRAMEWORK

**3.1** As set out in Chapter 2, the UK authorities strongly believe that the Lamfalussy arrangements have made a major contribution to the EU's regulatory and supervisory framework since their introduction for securities in 2001 and banking and insurance and pensions in 2004. Nevertheless, the UK's assessment of the Lamfalussy arrangements, on the basis of the principles outlined in Chapter 1, suggests there are a number of areas where further enhancements and improvements can be made.

**3.2** This chapter sets out an agenda for further developing these arrangements, particularly the work of the Level III committees.

### CONVERGENCE

**3.3** The UK authorities strongly believe that convergence is desirable, in terms of both the regulatory framework (i.e. the rules that apply to financial institutions) and the practices of supervisors. However such convergence should be focussed on achieving equivalent regulatory outcomes in order that an integrated EU market can work efficiently and effectively.

**3.4** Considerable progress has been made to deliver a common body of EU rules, particularly through the adoption and implementation of the Financial Services Action Plan. Supervisory convergence – which concerns the ways in which national supervisors put rules and regulation into practice – poses greater challenges.

#### Different markets and approaches

**3.5** Despite considerable progress being made to integrate the EU's financial markets, retail markets will remain characterised by differences in national cultures or consumer preferences (often resulting in different market structures). Wholesale markets are often more uniform in structure, but even here, the most appropriate use of supervisory tools may depend on national or group-specific differences in areas such as systems and controls. Given these differences, which cannot simply be regulated or legislated away, supervisory convergence cannot be forced or imposed. As a result:

- a “**single rule book**”, would not be able to accommodate the individual specificities of national markets and is therefore inappropriate; and
- supervisors will often need to adopt **different approaches** and apply different tools in their daily work, even where the requirements on firms are the same. The process of convergence cannot therefore be expected to result in the same supervisory tool being used to the same intensity, even in similar supervisory situations. Rather supervisors should be free to use different supervisory tools to achieve similar goals and outcomes.

#### Convergence based on outcomes

**3.6** The UK authorities believe that supervisory convergence is primarily about delivering equivalent regulatory outcomes, not necessarily through identical means. This is consistent with our belief in a principles-based approach to regulation. Over time and through ongoing cooperation, the sharing of best practice, and the development of a common supervisory culture through joint supervisory training and secondment schemes, it is likely and desirable that supervisory practices will converge. Nevertheless, this should be an organic process and not one that is legislated into effect.

**Recommendation**

**The UK authorities propose that the Level III committees operate in accordance with a principles-based approach, which aims to achieve equivalent regulatory outcomes.**

**The UK authorities will continue actively to support further progress towards joint training and secondment initiatives, building on the recommendations in the 2006 FSC Report on Financial Supervision.**

**BETTER REGULATION**

**3.7** The imposition of regulation of any kind on financial markets imposes costs on firms and other market participants, which have the potential to impact adversely on Europe's international competitiveness. Regulation, therefore, should be used only where justified by sound economic analysis that shows:

- the presence of a demonstrable **market failure**. This means that a market imperfection exists which is a potential source of detriment to investors or consumers and the market itself is unable to correct this;
- the regulation can plausibly be expected to **resolve** the market failure; and
- the **cost** of regulation is likely to be smaller than the cost of allowing the market failure to continue.

**Economic analysis 3.8** Robust economic analysis must underpin any assessment as to whether or not regulation should be introduced. This should include an assessment of any market failures and the costs and benefits of all options (including non-legislative options) for correcting them, as well as thorough competitiveness testing of all options.

**3.9** The consistent and comprehensive use of such disciplines at the key stages of the legislative process is essential to the introduction of proportionate and effective EU regulation.

**3.10** As a result, the UK authorities strongly welcome the European Commission's commitment to undertake thorough impact assessments when considering EU regulatory action. However, to date there has been no requirement for the Lamfalussy committees to frame their advice on detailed implementing measures (at Level II) with reference to similarly robust and thorough economic impact analysis.

**3.11** The comprehensive and consistent use of robust economic analysis by the Lamfalussy committees when framing their advice to the European Commission would considerably improve the quality of that advice. This is why the FSA has been in the forefront of a collaborative effort to develop guidelines for the use of impact assessment at Level II. The use of these guidelines should help ensure that future EU action is properly evidence based, proportionate, and does not adversely affect international competitiveness.

**Recommendation**

The UK authorities propose that robust economic analysis be undertaken more systematically by the Level III committees when preparing:

- advice to the European Commission for the formulation of implementing measures for EU directives; and, in due course,
- non-binding guidance to assist with implementation, where it would have a significant burden on industry.

## ENSURING CONSISTENT IMPLEMENTATION

**3.12** The timely, consistent and proportionate implementation of EU financial services legislation is critical to securing the benefits of financial integration in the EU.

### Use of national discretions

**3.13** Responsibility for implementing EU legislation rests with Member States. Many EU Directives give Member States flexibility in preparing their markets for new legislation, setting only a deadline for implementation. Furthermore, individual EU directives may permit the Member State varying degrees of ‘national discretion’ in the way it then implements the piece of EU legislation. Such national discretions:

- allow a Member State **flexibility** to tailor an individual piece of EU legislation to its own diverse and heterogeneous national markets; but
- can also **adversely impact the overall functioning of the Single Market**, if such discretions restrict cross-border competition and particularly the entry of foreign firms into domestic markets.

### Level III guidance

**3.14** Compliance with Level III guidance is not compulsory. It is for supervisory authorities in each Member State to decide the extent to which they wish to incorporate guidance into national supervisory practices.

**3.15** The UK authorities believe such flexibility remains necessary given the nature of Level III guidance and the specificities of national markets to which it is applied. Nevertheless, Member States must be prepared publicly to justify divergences in their supervisory approaches to implementing directives or in their adoption and application of Level III guidance. The prospect of being held to account should help ensure that this flexibility is properly used and that inconsistencies are maintained only where they are clearly necessary.

**3.16** As a result the UK authorities propose the greater use of two tools to assist with ensuring consistent implementation. The UK authorities believe that the more comprehensive use of “comply or explain” and “peer review” mechanisms can be powerful tools to promote consistent implementation.

### Comply or explain

**3.17** In the case of Level III guidance, this is not, and should not become, legally binding. Nevertheless, supervisory authorities that do not accept, and choose not to apply such guidance, should be required to give a public account of their reasons for not doing so. This would enable them to explain the nature of their objections (for example, whether there are any legal barriers to doing so), providing clarity to the market on how the guidance was being treated.

**3.18** National supervisory authorities choosing to “explain” rather than “comply” should also explain why they believe their approach will be effective in achieving equivalent regulatory outcomes.

**Peer review 3.19** Such an approach should be reinforced with ongoing peer review – particularly in the implementation of directives. The key characteristics of peer review should be:

- **review panels** comprising national supervisory authorities would review in detail how each EU measure has been implemented. They would look at the application of rules, the use of supervisory tools, resources, and enforcement, to determine whether implementation is likely to have been sufficient to achieve the objectives of the measure;
- if the review panel concludes that implementation is deficient or unsatisfactory the national supervisory authority of the Member State will be required to **respond**, setting out and explaining its reasons for implementing the measure in the way it has; and
- the findings of the review are **published**. If the panel considers the national authority’s response unsatisfactory or is not convinced by the explanation provided, this will be made clear publicly, together with the national supervisory authority’s rationale for adopting a different approach.

**3.20** This peer review mechanism contains an element of the “comply or explain” approach outlined above, in that where there are judged to be deficiencies in national supervisory authorities’ implementation of measures, they would be called upon to explain their approach.

**3.21** In addition, the UK authorities believe that such a framework, which ultimately includes an element of public disclosure, would be a powerful tool for exerting both supervisory, and ultimately market pressure, where there are grounds for believing that the chosen method of implementation by a national authority is likely to be insufficient to achieve the objectives of the measure.

**3.22** It should be noted that such an approach would depend critically on national supervisory authorities being willing to offer and receive robust comment on their approaches to implementation. The UK authorities would be willing to engage fully in the spirit of such an approach.

#### **Recommendation**

**To improve the consistent implementation of EU financial services legislation and non-binding guidance, the UK authorities propose:**

- **all Member States should limit their use of national discretions to the minimum extent necessary; and**
- **all Level III committees should introduce a “comply or explain” regime, coupled with a comprehensive system of peer review.**

## STANDARD TIMESCALES AND GUIDELINES FOR IMPLEMENTATION

**3.23** When implementing EU legislation, it is crucial that firms and supervisors are given sufficient time and guidance to comply with new EU requirements. In the past there have been occasions when insufficient time has been available for the development of robust and comprehensive implementation guidance and for national supervisors and firms to prepare thoroughly for implementation.

**3.24** To ensure this does not occur in future, the UK authorities believe that, for substantive directives or legislative changes, a sufficient period of time be introduced between adoption and implementation of the relevant Level II measures. Such a period will ensure supervisory authorities and market participants are able properly to prepare and implement EU financial services legislation.

### Recommendation

**The UK authorities propose that, for substantial directives or legislative changes, it should become standard practice to provide a sufficient time period between adoption of relevant Level II measures and the implementation date for the piece of EU legislation.**

## ACCOUNTABILITY WITHIN THE LAMFALUSSY FRAMEWORK AND DECISION MAKING

**Accountability** **3.25** Accountability and transparency help to ensure good decision making. While the members of the Level III committees are, and should remain, answerable to their home governments or parliaments in the execution of their duties and responsibilities, the UK authorities support measures to enhance transparency and accountability within the Lamfalussy framework. That is why, during the UK's Presidency of the EU in 2005, the chairs of the Level III committees were invited to attend a meeting of ECOFIN to advise and update Finance Ministers on their activities.

**3.26** More regular reporting to the Council and the Parliament by the Level III committees will help to ensure more accountability within the Lamfalussy framework. We therefore believe that strengthening the **dialogue** between the Level III committees and the Council, and European Parliament, with more regular reporting of these committees to each institution, particularly the (ECOFIN) Council, would improve the accountability and transparency of the current framework.

**Decision making** **3.27** As a general rule the Level III committee charters provide for decisions to be taken by consensus. When providing technical advice to the European Commission, the charters also provide scope for these committees to reach decisions using forms of majority voting. The UK believes this should continue.

**3.28** Other decisions, such as those that relate to the adoption of Level III guidance and matters of general supervisory cooperation must remain non-binding. This is because:

- it would be neither desirable nor appropriate for the Level III committees to become a third institutional layer of EU law making; and

- differences in national markets, particularly in retail markets require supervisors to exercise a degree of flexibility in how they apply EU legislation and guidance in their own domestic markets.

**3.29** Given that decisions on such matters are non-binding in nature, the UK authorities believe it should be for the Level III committees to determine the most appropriate method by which decisions are reached. Nevertheless, where appropriate, and at the discretion of the Level III committees, majority voting could be used to expedite business. Such decisions should be non-binding and accompanied by a “comply or explain” approach.

#### Recommendation

**To enhance the accountability of the Level III committees within the Lamfalussy framework, the UK authorities propose more formalised reporting by the Level III committees to the Council and European Parliament, including a discussion of their annual work programmes.**

**On enhancing the process by which the Level III committees make their decisions, the UK authorities propose that:**

- the Level III committees should make their decisions by consensus wherever possible; and
- where appropriate, and at the discretion of the Level III committees, majority voting could be used to expedite business. Such decisions should be non-binding and accompanied by a “comply or explain” approach.

## ENSURING GREATER EFFICIENCY FOR CROSS-BORDER GROUPS<sup>1</sup>

**3.30** As markets integrate globally and increasingly consolidate cross-border and cross-sectorally, so firms are rightly demanding greater efficiency in their supervisory dealings.

**3.31** Increasing supervisory cooperation and interaction between relevant supervisors are essential pre-requisites for making the supervision of cross-border groups more efficient.

**3.32** Enhanced supervisory cooperation may result in the adoption of approaches to supervision that place greater importance on the group, where the home supervisor has responsibility for specific supervisory duties and tasks. Recent EU Directives are increasingly reflecting this shift towards more group supervision. For example:

- the **Capital Requirements Directive (CRD)** establishes a role for a college of supervisors in relation to the approval of the group’s risk model. It also provides the home supervisor with more responsibility for the coordination of consolidated supervision of subsidiaries and the ultimate decision as regards the group’s risk model; and

<sup>1</sup> The term “groups” is taken to mean internationally active firms. This definition includes firms with operations in other countries, where the services are provided remotely on a services-basis, through a branch, or through a subsidiary.

- the current European Commission proposal for a **Solvency II Directive** for insurance would, among other things, establish a clear role for the group supervisor and give a college of supervisors overall responsibility for the setting of the group-wide solvency capital requirement, with the group supervisor taking a final decision in the event that the college cannot reach agreement within a specified timeframe. See Box 3.1 for details.

#### Box 3.1: Solvency II: group supervision

The European Commission's proposal on the new prudential regime for insurers (Solvency II) includes an overhaul of the requirements for insurance and reinsurance groups that aim to streamline the supervision of these groups across the EU. The proposal includes the following key features:

- **diversification benefits at group level.** The proposal allows groups to take advantage of diversification on a group-wide basis. This allowance reflects the true economic benefits inherent in the group structure;
- **appointment of a group supervisor.** A single supervisory authority will be appointed with primary responsibility for key elements of supervision (such as the ability to approve the group-wide solvency capital requirement). This will streamline supervisory decision making;
- **group-wide capital requirement.** The proposal allows the use of a group-wide internal model to determine the capital requirements for the group as a whole. This is in line with the arrangements under the Capital Requirements Directive;
- **group support.** Groups can apply to use the financial resources of the group as a guarantee to partially meet capital requirements of particular subsidiaries. This is an innovative proposal which seeks to facilitate the transfer of resources to where they are needed in the group, thereby improving capital management; and
- **improved communication between supervisors.** The proposal requires robust coordination and communication arrangements to be put in place between the group supervisor and the local supervisors of the group's subsidiaries. This will reduce administrative burdens on groups having to report to multiple authorities.

The new approach in Solvency II represents a significant step forward in the supervision of insurance groups in the EU and is strongly supported by the UK. The Commission's proposal is being negotiated by the Council and the European Parliament, with implementation of the regime currently scheduled for 2012.

**3.33** The UK authorities strongly support the strengthening of day-to-day collaboration among supervisors.

**3.34** At the very least, each major cross-border group needs to have a clearly identified lead (or coordinating) supervisor. This will typically be the supervisor undertaking consolidated supervision in the Member State where the financial group is based<sup>2</sup>. In addition to undertaking the tasks associated with consolidated supervision, the coordinating or lead supervisor should also:

<sup>2</sup> See Article 126(3) of the Banking Consolidated Directive (BCD), Article 10(3) of the Financial Groups Directive (FGD) and Article 260 of the Solvency II proposal. These all allow for a different coordinating supervisor to be identified by mutual agreement.

- facilitate an appropriate level of **dialogue** among the supervisors of the group (who together comprise the members of the supervisory college);
- seek to ensure that **group-wide risks** are identified and the supervisory approaches of the other members of the college are aligned; and
- take the lead role in ensuring that **supervisory tasks** (and where appropriate responsibilities) are delegated efficiently among home and host supervisors. (The optimal allocation of such tasks will differ on a case-by-case and risk-based basis.)

**3.35** The Lamfalussy Level III committees have an important role to play in clarifying and underpinning the basis by which home-host cooperation and the delegation of tasks and responsibilities should, in general, operate.

**3.36** The Solvency II proposals outlined in Box 3.1 envisage a role for the lead supervisor which goes considerably beyond this coordinating role, giving the lead supervisor specific responsibilities in the determination of the group-wide solvency capital requirement. The precise responsibilities of the lead supervisor are not set in stone; they are likely to evolve over time and may differ according to the sector to which they are applied. The general principle, however, that lead supervisors have an essential role to play in improving information flows and making supervision of cross-border groups more joined up, is one that is common to all sectors.

#### **Recommendation**

**The UK authorities strongly support efforts to further develop group-based approaches to supervision, and the home-host framework for supervisory cooperation that underpins it. The UK authorities support:**

- **the more systematic and regular use of colleges of supervisors to promote supervisory cooperation and information sharing between supervisors of a cross-border group;**
- **further developing the home-host framework through the creation of principles governing a more extensive delegation of tasks between supervisors (where this is judged to be appropriate). This could be developed by the Level III committees; and**
- **further use of delegation of supervisory tasks, within supervisory colleges to avoid duplication of supervisory effort. In particular:**
  - **production of joint supervisory programmes and assessment – which involves assessment of common elements of group wide operations, such as trading models or IS security systems; and**
  - **reporting requirements – considerable work has already been undertaken to establish common frameworks for reporting. Further work now needs to be undertaken especially on agreeing common definitions of reportable events and creating consistency of reporting requirements between supervisory authorities for cross-border groups. All work in this area should be aimed at streamlining the reporting requirements and be supported by rigorous economic impact analysis.**

## CROSS-BORDER ARRANGEMENTS FOR FINANCIAL STABILITY

**3.37** The UK authorities welcome the work undertaken by Member States and the European Commission on cross-border financial crisis management over the past year. This work has served to strengthen national crisis management arrangements; establish common principles that act as the basis for cooperation between national authorities in the event of a cross-border financial crisis; and provide a common analytical framework to ensure the use of common terminology in assessing the systemic implications of a cross-border financial crisis. In the months ahead work will continue on common practical guidelines for crisis management to reflect a common understanding of the steps and procedures that need to be taken in a cross-border crisis situation. It is intended that these new arrangements will be reflected in a revised Memorandum of Understanding between the relevant national authorities in spring 2008.

**3.38** In parallel with this work, the UK authorities intend to work toward more tailored cooperation agreements with those Member States with whom we share responsibility in respect of specific or significant institutions or markets.



# A

## SUMMARY OF KEY WORK UNDERTAKEN BY CEBS, CESR AND CEIOPS

Committee of European Banking Supervisors (CEBS)	
Main area of regulatory focus	Issues dealt with
General	<ul style="list-style-type: none"> <li>• Advised the Commission on 31 issues (including joint advice with CEIOPS on cross-sectoral comparisons of capital instruments).</li> <li>• Issued standards and guidelines on 19 issues.</li> <li>• Conducted 15 major consultations.</li> </ul>
Work in relation to the Capital Requirements Directive	<ul style="list-style-type: none"> <li>• Model validation.</li> <li>• Colleges.</li> <li>• Home-host relations.</li> <li>• National discretions.</li> <li>• Own funds.</li> <li>• Large exposures.</li> <li>• Prudential treatment of commodities business and firms.</li> <li>• Equivalence of third country supervision.</li> <li>• Liquidity risk.</li> <li>• The application of the supervisory review process under Pillar II.</li> </ul>
Operational networking	<ul style="list-style-type: none"> <li>• Promoting practical supervisory convergence with a sample of 10 cross-border banking groups.</li> </ul>
CEBS Convergence Task Force	<ul style="list-style-type: none"> <li>• Established a framework for common training courses and for fostering secondments between supervisors.</li> <li>• Adapted and piloted impact assessment methodology to provide advice on Level II measures.</li> <li>• Developed peer review mechanism.</li> <li>• Developed mediation mechanism.</li> </ul>

<b>Committee of European Insurance and Occupations Pensions Supervisors (CEIOPS)</b>	
<b>Main area of regulatory focus</b>	<b>Issues dealt with</b>
General	<ul style="list-style-type: none"> <li>• Undertook 21 consultations.</li> <li>• Performed 7 analyses/surveys of insurance issues.</li> </ul>
Solvency II	<ul style="list-style-type: none"> <li>• Provided advice to the Commission on 23 separate subject areas.</li> <li>• Undertaken three quantitative impact studies.</li> </ul>
Home host	<ul style="list-style-type: none"> <li>• Revision of the current Sienna Protocol on home-host issues regarding insurance supervision.</li> <li>• Developed protocols facilitating supervisory cooperation, coordination and exchange of information on the supervision of occupational pensions and on insurance intermediaries.</li> <li>• Developed guidelines for Coordination Committees and the role of the lead supervisor for the supervision of insurance groups.</li> <li>• Developed mediation mechanisms.</li> <li>• Working on peer review mechanisms.</li> </ul>

<b>Committee of European Securities Regulators (CESR)</b>	
<b>Main area of regulatory focus</b>	<b>Issues dealt with</b>
General	<ul style="list-style-type: none"> <li>• Advised the Commission on 17 issues.</li> <li>• Issued standards, recommendations and guidelines on 21 issues.</li> <li>• Conducted 83 consultations.</li> </ul>
Advice	<ul style="list-style-type: none"> <li>• The Transparency Directive, the Market Abuse Directive, the Prospectus Directive, the Markets in Financial Instruments Directive, and the UCITS Directive.</li> <li>• Equivalence of the generally accepted accounting principles (GAAP) of third countries.</li> <li>• Definitions concerning the eligible assets for UCITS.</li> </ul>
CESR's Review Panel	<ul style="list-style-type: none"> <li>• Completed a survey on the implementation of the European Commission's Recommendation on UCITS.</li> <li>• Reviewed CESR Standard Number I on financial information.</li> <li>• Undertook a comprehensive mapping of members' supervisory powers under the Prospectus Directive and Market Abuse Directive.</li> </ul>
Operational groups (CESR-Fin and CESR-Pol)	<ul style="list-style-type: none"> <li>• CESR-Fin: CESR has been closely involved in the adoption of IFRS for all EU listed groups. CESR-Fin monitored the development and introduction of the EU standards and has made recommendations on the transition to IFRS.</li> <li>• CESR-Pol: On the Market Abuse Directive, developed draft guidance on what constitutes inside information; when it is legitimate to delay the disclosure of inside information; and on client orders, inside information and insider lists in multiple jurisdictions.</li> </ul>
Level III expert groups	<ul style="list-style-type: none"> <li>• CESR-Tech expert group is on track in developing a Transaction Reporting Mechanism under MiFID.</li> <li>• Econet expert group (CESR group of economists) has developed an impact assessment methodology and guidelines for use by all three committees in policy making.</li> <li>• Investment Management expert group has issued guidelines to facilitate cross-border notification of UCITS, on the classification of hedge fund indices as financial indices, and on eligible assets for investments in UCITS.</li> <li>• Mediation Task Force finalised a mediation mechanism to resolve disputes between members.</li> <li>• MiFID expert group has delivered Level III guidelines and advice on market data consolidation, record keeping, inducements, passporting, transaction reporting, and best execution.</li> </ul>



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