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The future of EU financial regulation and supervision

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CONTENTS

NOTE:
(Q) refers to a question in oral evidence
(p) refers to a page of written evidence

The Report of the Committee is published in Volume I, HL Paper 106-I.
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SUMMARY

We conducted this inquiry as the implications of the financial crisis became clear. Supervisors in the UK, in the EU, and globally failed to identify the impending meltdown, and failed to take preventative action. Reform of regulation and supervision of the financial system has become an important political topic.

In response to the crisis the European Commission has so far published four regulatory proposals on Capital Requirements, Deposit Guarantee Schemes, Credit Rating Agencies and Alternative Investment Funds. The first two of these have been agreed and are largely sensible responses to the crisis. The proposals to regulate alternative investment funds and credit rating agencies came under some criticism from our witnesses. The desire for speedy action must not come at the expense of thorough consultation, impact assessment and risk analysis by the Commission in line with their own Better Regulations principles.

There is a consensus that further coordination of supervision of the EU financial institutions and markets is necessary. Financial services in the EU will benefit from strengthened macro- and micro-prudential supervision. This should provide a more effective early warning system for mitigating systemic risks and help improve the operation of the single market in financial services. Proposals and actions in the EU must be fully cognisant of the global context for financial services and the flow of capital.

We support the establishment of a new body at the EU level to assess and monitor macro-prudential systemic risks arising from financial markets and institutions. The Government differed from most other witnesses in its views on the role, powers and structure of such a body. The Government must clarify its thinking and its proposals speedily if it is to contribute most effectively to discussions and decisions on the establishment of a macro-prudential supervisor for the EU.

With regard to micro-prudential supervision of financial institutions in Member States, we agree with the de Larosière Report that the effectiveness of the existing Level 3 Committees would be strengthened by increased cooperation through colleges of supervisors for all significant cross-border institutions. Beyond that, further strengthening of the powers of any EU micro-prudential body is a matter of some controversy. The existing Treaty limits significantly the power of any EU micro-prudential supervisory body to issue rulings or decisions binding on national supervisors or governments of Member States, and it is Member States that bail out banks in a crisis. The Commission and the Government have suggested different ways forward in reconciling the need for reform with these limitations. Thorough and careful debate of the alternatives is more important than speed of decision on the outcome.

Finally, we believe that the Commission has applied state aid rules speedily and flexibly and has helped ensure that bail-outs of failing banks and mitigation of damage to the real economy do not jeopardise the single market. Such state aid must, however, be reviewed rigorously as the crisis unwinds.

The future of EU financial regulation and supervision

CHAPTER 1: THE FINANCIAL CRISIS

1. This report examines the structure, and current proposals for the revision, of financial supervision and regulation within the European Union. This has been brought to the forefront of debate by the financial crisis. Although the crisis began in financial markets in the United States, its effects have spread into the real economy around the world, not least in the EU. Measures have been implemented in response to the crisis globally, at EU and at national level.

The causes of the financial crisis

2. To understand how to prevent a repeat of the financial crisis, it is important to try to understand its causes. The consensus is that global macro-economic imbalances and financial innovation—which amplified the consequences of excessive credit and liquidity expansion—together with failures in regulation, supervision and corporate governance, combined to cause the financial crisis. The collapse of the subprime lending market in the United States triggered the crisis. Many commentators have argued that loose monetary policy did little to counter bubbles in asset prices.

3. In the belief that central banks had tamed inflation, interest rates were kept historically low. This led to plentiful availability of credit, but low returns on investments, fuelling the housing price bubble and contributing to the build-up of a large current account deficit in the USA and some other countries including the UK. Credit expansion in the US was financed by countries with sizable current account surpluses, notably China and oil exporting nations.

4. In an effort to achieve higher returns, financial institutions and their employees devised increasingly complex financial products, such as Asset-Backed Securities (ABS). This market expanded rapidly, and by 2007 ABS products were worth £2.5 trillion in the US alone.[1] For many the focus in financial institutions on short-term profit at the expense of long-term stability, and the incentive structure that encouraged bank employees to seek short-term profit, helped to lead to the greatest excesses of financial innovation.

5. The ability of banks to accrue fees and lower their capital requirements by selling assets in securitised bonds (see Appendix 8) led to increasingly higher leverage (capital to asset) ratios. The originate-to-distribute model and the transfer off-balance sheet of securitised assets removed much of the incentive for the lender to ensure the borrower could repay the loan. This left the institutions vulnerable to even the slightest changes in asset values and was exacerbated by high levels of leverage.

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[1] *The Turner Review: a regulatory response to the global banking crisis*, (Financial Services Authority, March 2009), p. 14 Exhibit 1.5

6. United Kingdom banks were amongst the most highly involved institutions globally in the trading of securitised financial instruments. The complexity and opacity of many instruments led institutions and investors to underestimate the riskiness of underlying assets. These problems were further exacerbated by the speed and volume at which the products were bought and sold. Lord Myners, Financial Services Secretary to the Treasury, described to us how securitisation led to the belief among many that "poor quality assets … assembled as a portfolio … could somehow by alchemy be converted into something stronger than they were" (Q 62).

7. Each securitised instrument was assigned a credit rating by a credit rating agency, which also rated the issuers of these instruments. The highest triple A rating, the standard rating for government bonds in developed countries, was increasingly given to complex, opaque and (as was later discovered) risky securitised products. Martin Power, Head of the Cabinet of Commissioner McCreevy, told us that around 64,000 securitised products received a triple A rating (Q 423). The major miscalculation of the risks inherent in these products occurred in part through flaws in the methodologies of rating agencies and was exacerbated by conflicts of interest caused by the originator, rather than the investor, purchasing the rating. This undervaluation of risk contributed greatly to the expansion of the securitised debt market and the "aggressive use of leverage by banks" described to us by the Minister (Q 62). The problems caused by complex securitised instruments were exacerbated further by what Marke Raines of Taylor Wessing LLP described as the "market frenzy" with many products purchased with little or no due diligence conducted by the investor (Q 24). Human behaviour and human frailties, in particular greed, played a role. Professor Goodhart told us "greed led them to take positions … which obtained relatively high short-term returns at the expense of excessive risks which were assumed … ultimately by the taxpayer and society" (Q 90).

8. Highly leveraged funds and the so-called shadow banking system flourished in an environment of easy money and contributed to the build-up of leverage in the system.

9. The financial crisis itself began when the subprime bubble burst in the summer of 2007, as it became increasingly clear that many borrowers in the USA were unable to meet their debt obligations. The lack of transparency in securitised products led to confusion over the size and location of credit losses, damaging market confidence. The recognition that markets had underestimated risk caused many financial institutions to sell off their assets. Concerns about liquidity helped to prompt banks to hoard cash.

10. The loss of trust and market confidence in financial products and institutions worsened, particularly following the failure of Northern Rock and Lehmann Brothers in September 2008, restricting the normal functioning of markets. Banks stopped lending to each other and some consumers withdrew their deposits, with panic spreading through both regulated and unregulated financial institutions. This reduced market liquidity further. As institutions struggled to find sources of funding, liquidity problems quickly turned into insolvency problems, with governments stepping in to provide guarantees and recapitalise financial institutions.

11. As the market value of financial institutions collapsed, pro-cyclical accounting and capital rules exacerbated the crisis (see Box 4). Basel rules stipulate the amount of capital an institution has to hold, in relation to credit

risk. They were first set out in 1988 by the Basel Committee on Banking Supervision. Rating agencies lowered the ratings of financial institutions as it became increasingly clear that credit risk was undervalued, which pushed required minimum capital ratios of institutions higher. This forced banks to sell off more assets, pushing their value still lower.

12. The financial crisis led to the bank run on Northern Rock and its subsequent nationalisation, the merger of the Lloyds TSB and the HBOS group, the recapitalisation of the RBS group, the break-up of Bradford & Bingley and many further Government actions in the financial market in the United Kingdom alone. Up to February 2009, the European Commission approved over 40 applications from Member States to recapitalise financial institutions.

13. The Global Stability Report of the International Monetary Fund estimates that to return to the bank leverage ratios of the mid-1990s would require capital injections of $500 billion for U.S. banks, about $725 billion for euro area banks and about $250 billion for U.K. banks.[2] This shows the crisis has had a particularly deep impact on the European banking system.

14. The scale of central bank and government intervention in the financial sector in recent months is unprecedented. The provision of emergency liquidity assistance, the use of conventional and non-conventional instruments of monetary policy (such as quantitative easing), the design of various forms of financial support, including bank recapitalisation and even nationalisation, and the reliance on expansionary fiscal policies have given the State a prominent role in the financial system and in the resolution to the crisis. These are, for the most part, national responses, albeit co-ordinated to some extent at the European and international level. While we recognise, in the words of Czech President Mr Klaus, that fighting the fire has been a priority for policy-makers in recent months, we must also address the issue of writing new fire regulations. In this report we address some important issues with regard to the reform of financial regulation and supervision in the EU, using our witnesses' version of events as the background for our analysis.

Our inquiry

15. Given the broad nature of financial regulation and supervision within the EU, our report comments on the following specific areas:

- The amendments to the Capital Requirements Directive, which create new minimum capital requirements for financial institutions, adopted on 7 April 2009;
- The regulation of credit rating agencies, adopted on 23 April 2009;
- Crisis managements procedures in the EU;
- The structure of financial supervision within the EU. This includes detailed analysis of the recommendations of the de Larosière group, the Turner review, the role of the European Central Bank and the powers of the home and host country supervisors over cross-border financial institutions;

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2 *Global Financial Stability Report: responding to the financial crisis and measuring systematic risk*, (International Monetary Fund, April 2009), p 37.

- The role of the EU in global supervisory and regulatory structures; and
- State aid measures in response to the financial crisis.

16. This report examines the proposed reform of each of these areas. Though the report focuses on EU responses to the financial crisis, we do not start from the assumption that the EU is the right arena for action. Rather, for each issue we have considered whether it is necessary to take any action and if so whether action is best taken at a national, EU or global level or combination thereof.

17. This report is intended to contribute to an in-depth review of the current regulatory and supervisory regime. Two previous reports, the Turner Review and the Report of the de Larosière Group, have already made detailed suggestions for the reform of supervision and regulation. The recommendations of these two reports, where they fall within the scope of the inquiry, are considered in our report, along with the suggestions for reform by other groups and individuals, particularly those of Her Majesty's Government, the Financial Services Authority and the European Commission.

18. The issues involved in any examination of regulation and supervision in the EU are diverse and we do not intend to cover them all in this report. In particular, we have not considered the impact of the crisis on the real economy, UK participation in the single European currency, regulation and supervision of insurance firms, remuneration of bankers and corporate governance issues or the divide between investment and commercial banking. The inquiry focuses mostly on the banking system, although we make reference, where relevant, to other parts of the financial system.

19. The House of Lords Economic Affairs Committee has conducted a concurrent inquiry into financial regulation and supervision within the United Kingdom.[3] The two reports together provide a broad overview of the supervisory and regulatory architecture in place in the United Kingdom. The House of Commons Treasury Select Committee has published three reports into different aspects of the banking crisis.[4]

20. The Membership of Sub-Committee A that undertook this inquiry is set out in Appendix 1. Lord Woolmer of Leeds chaired the deliberations on this report in place of Baroness Cohen of Pimlico. We are grateful to those who submitted written and oral evidence, who are listed in Appendix 3; all the evidence is printed with this report. There is also a glossary in Appendix 5. We also thank the Sub-Committee's specialist adviser to the inquiry, Rosa Maria Lastra, Professor in International Financial and Monetary Law at the Centre for Commercial Law Studies, Queen Mary University of London. **We make this report for debate.**

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3 Economic Affairs Committee, 2nd Report (2008–09): *Banking Supervision and Regulation* (HL 101).

4 Treasury Committee, 5th Report (2008–09): *Banking Crisis: the impact of failure of the Icelandic banks* (HC 402); Treasury Committee, 7th Report (2008–09): *Banking Crisis: dealing with the failure of UK banks* (HC 416); Treasury Committee, 9th Report (2008–09): *Banking Crisis: reforming corporate governance and pay in the City* (HC 519).

CHAPTER 2: REGULATION AND SUPERVISION IN THE EUROPEAN UNION

The definition of regulation and supervision

21. In taking evidence for this report, we observed an inconsistency among our witnesses in the use of the terms regulation and supervision, which were often used interchangeably. Supervision has to do with monitoring and enforcement, and regulation with rule making. Clive Maxwell, Director for Financial Stability at HM Treasury, described regulation as "actual hard rules that are written down" and supervision as "the application of those rules to a particular firm or group of firms and going in there and making sure that they are following those rules" (Q 67). An example of regulation is the EU's Capital Requirements Directive (CRD), which transposes the Basel II rules into EU law. These rules are applied by the UK national supervisor, the Financial Services Authority (FSA). The FSA ensures that financial institutions are adhering to the capital rules set out in the CRD.[5]

The purpose of regulation and supervision

22. The pursuit of financial stability is the common goal of both regulation and supervision. Regulation should aim to safeguard a stable financial system, whilst also offering protection to consumers. Rules should be as simple and clear as possible, to avoid both confusion and loopholes. However, more regulation is not necessarily better. Hastily applied regulation addressing a newsworthy problem can often cause more harm than good. The quality of regulation is therefore more crucial than the quantity.

23. Professor Goodhart told us that what makes sense for the institution individually frequently makes no sense at all for the system as a whole. For example, if an institution runs into difficulties, its normal response is to cut back on new loans. If every institution does this the whole system can implode (Q 89). Regulation must therefore work in the interests of the whole system rather than individual institutions.

24. Regulation within the EU must also support the development of the single market. Irregularity in the implementation of regulations across the 27 EU Member States can undermine the effectiveness of the single market in financial services.

25. Supervision should ensure that a bank or financial institution subject to regulation follows the rules correctly and uniformly, that they adequately manage their risks and that they adhere to certain minimum standards. It should also examine the system of banks and financial institutions as a whole to detect risks affecting the entire system. Supervisors can issue binding decisions and impose penalties on those institutions that do not adhere to the rules.

26. The work of a supervisory body usually consists of four separate roles:

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[5] Most EU banking and financial rules are adopted via Directives, though some are adopted via Regulations. A Regulation within the EU is a legislative act that is immediately enforceable without the need for transposition into Member States' national law. This is distinct from financial regulation, the rules which govern financial institutions.

- Licensing—the granting of permission for a financial institution to operate within its jurisdiction;
- Oversight—the monitoring of asset quality, capital adequacy, liquidity, internal controls and earnings;
- Enforcement—the application of monetary fines or other penalties to those institutions which do not adhere to the regulatory regime; and
- Crisis management—including the institution of deposit insurance schemes, lender of last resort assistance and insolvency proceedings.

27. A distinction is now made between macro- and micro-prudential supervision. Macro-prudential supervision is the analysis of trends and imbalances in the financial system and the detection of systemic risks that these trends may pose to financial institutions and the economy. The focus of macro-prudential supervision is the safety of the financial and economic system as a whole, the prevention of systemic risk.

28. Micro-prudential supervision is the day-to-day supervision of individual financial institutions. The focus of micro-prudential supervision is the safety and soundness of individual institutions as well as consumer protection. The same or a separate supervisor can carry out these two functions. If different supervisors carry out these functions they must work together to provide mechanisms to counteract macro-prudential risks at a micro-prudential level.

29. Because micro-prudential supervision monitors the degree to which the banks abide by the rules, there is a connection between regulation and supervision, since the very process of supervision is subject to regulation. For example, the adequacy of capital, a key element that supervisors assess to determine the health of the bank, is described in detailed rules.

30. Throughout the report, we refer back to the definitions of regulation and supervision and their functions to assess the value of proposals for reform.

Regulatory and supervisory organisation in the European Union

31. The EU system of supervision and regulation is organised on four separate levels, as shown in Appendix 6. This is known as the Lamfalussy framework after the report of a group chaired by Alexandre Lamfalussy, published and endorsed by the European Council in 2001.

32. The first two levels involve the creation of regulation, whilst the third and fourth involve consistent implementation of supervisory standards and enforcement of rules in Member States. While regulation is often devised at Community level (a single market needs a single set of rules) supervision remains essentially a matter for the Member State with community competence very limited. We further discuss the legal basis of supervision in Chapters 4, 5 and 6.

33. The first level involves the adoption of legislative acts under the co-decision procedure. These primary law rules apply to all financial institutions registered within the EU. Legislation often transposes global rules devised by international standard setting bodies. For example, the Capital Requirements Directive transposes the Basel II rules (see Box 4) into EU legislation.

34. Level 2 Committees, led by the Commission, provide the technical implementation process of the legislation, creating a set of rules, "a second tier of more detailed regulation" that can be changed quickly and refined

where necessary. These committees in effect fulfil a "quasi rule-making power" (Q 622). This system, known as comitology, is not unique to legislation implementing financial regulation.

35. Level 3 consists of three Committees: the Committee of European Banking Supervisors (CEBS); the Committee of European Securities Regulators (CESR); and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). The membership of the three committees is derived from national supervisors in the areas of banking, securities and insurance.

BOX 1

The role of the Level 3 Committees

Committee of European Banking Supervisors (CEBS), London:

- Advises the Commission on the preparation of draft implementing measures in the field of banking activities;
- Contributes to the consistent implementation of Community Directives and to the convergence of Member States' supervisory practices throughout the Community; and
- Enhances supervisory co-operation, including the exchange of information.

Committee of European Securities Regulators (CESR), Paris:

- Improves co-ordination among securities regulators: developing effective operational network mechanisms to enhance day to day consistent supervision and enforcement of the single market for financial services;
- Advises the Commission on the preparation of draft implementing measures of EU framework directives in the field of securities; and
- Works to ensure more consistent and timely day-to-day implementation of community legislation in the Member States.

Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS), Frankfurt:

- Advises the Commission on drafting of implementation measures for framework directives and regulations on insurance and occupational pensions;
- Issues supervisory standards, recommendations and guidelines to enhance convergent and effective application of the regulations and to facilitate cooperation between national supervisors; and
- The role also involves the participation of CEIOPS in the work of different European institutions with responsibilities for issues relating to insurance and occupational pensions, in particular the Economic and Financial Committee (EFC) and the Financial Services Committee (FSC).

Further information of the structure of the Committees can be found in Appendix 9.

36. The Level 3 Committees are not in charge of day-to-day micro-prudential supervision, which is a national competence; rather they bring together supervisors and act as a link between the Commission and national supervisory authorities. They also act as fora for information exchange

between supervisors, foster supervisory convergence and formulate best practice. Level 3 Committees can only issue non-binding guidance.

37. Level 4 refers to enforcement of regulations, a task firmly anchored at the national level and undertaken by national supervisory authorities.

38. Different Member States operate different formats of national supervision. In 1997, the UK split the roles of supervision and monetary policy between the FSA and the Bank of England respectively. Before 1997, the Bank of England was responsible for both. Some other Members States split these roles while several National Central Banks (NCBs) still hold a supervisory role, including Spain, Italy, Portugal, Greece, the Netherlands and the Czech Republic.

39. The European Central Bank (ECB) defines and implements the monetary policy of the eurozone. During the recent crisis, the ECB provided emergency liquidity assistance within the eurozone as did the Bank of England in the UK. At present, the ECB has no direct supervisory functions, an issue we discuss in detail in Chapters 4, 5 and 6.

CHAPTER 3: THE FUTURE OF FINANCIAL REGULATION IN THE EUROPEAN UNION

40. Although this is a global crisis, the EU has put forward legislative proposals in response to the crisis. This chapter examines these proposals and assesses the future options. The Commission has put forward four proposals on financial regulation since the summer of 2008:

- Amendments to the Directive on Deposit Guarantee Schemes;[6]
- Amendments to the Capital Requirements Directive;[7]
- Regulation of credit rating agencies;[8] and
- Regulation of alternative investment funds.[9]

We particularly focus on the regulation of credit rating agencies and the CRD in this chapter, as these proposals were under discussion during our inquiry. We do not discuss the proposals for the regulation of alternative investment funds in detail as these were published subsequent to our taking evidence. We expected to scrutinise these proposals in detail in due course.

The process of legislative action

TABLE 1

Speed of Legislation

Proposal	Consultation published	Proposal published	Final draft agreed
Regulation 2008/0217 on Credit Rating Agencies	31 July 2008	12 November 2008	23 April 2009
Amendments to Directive 2006/48/EC and 2006/49/EC, the Capital Requirements Directive	Initial consultation 15 April 2008 second consultation 30 June 2008.	1 October 2008	6 May 2009
Directive 1994/19/EC on Deposit Guarantee Schemes	none	7 October 2008	11 March 2009
Directive on Alternative Investment Funds	Green Paper 14 July 2005[10]	29 April 2009	Not yet agreed

41. Many general comments we heard from witnesses on EU proposals for regulation have followed certain common themes: in particular, whether the rapid speed of constructing legislation fits with the Commission's Better Regulation principles and whether it will have adverse affects in a global context. The Commission argued in its brochure "Better Regulation—simply

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6 OJ L68 (13 March 2009) p 5.

7 0191/08, not yet published in Official Journal.

8 0217/08, not yet published in Official Journal.

9 0064/09

10 It is debatable whether this consultation is truly the basis of the current proposals

explained" that it has an obligation to consult widely from a broad section of society to ensure all interests are taken into account and that proposals are workable when devising legislation.[11]

42. Many witnesses argued that Better Regulation principles were being ignored by the Commission in its rush to produce legislation in response to the crisis. The London Investment Banking Association (LIBA) expressed concern over the drop in the quality of the Commission's legislative proposals with less consultation being conducted as dialogue with market participants has become "more perfunctory" (p 226). Standard & Poor's Rating Service concurred, telling us that "we are not clear that this consultation process [for the regulation of rating agencies] was conducted in a manner which fully respected the Commission's own Better Regulation Action Plan" (p 235). John Purvis MEP compared the rush to regulate credit rating agencies to the Dangerous Dogs Act 1992, with rushed legislation carrying unintended consequences (Q 291). We comment where appropriate on how individual proposals tally with the Better Regulation principles.

43. Several witnesses argued that there was no need to rush through new regulatory measures. Professor Goodhart of the London School of Economics explained that financial institutions are so risk averse in the wake of the crisis that there is currently no danger of institutions taking excessive risks (Q 98). Lee Buchheit, Partner, Cleary Gottlieb Steen & Hamilton LLP, explained that the current flurry of legislation on financial regulation is a case of "very much trying to shut the barn door after the horse has won the Kentucky derby". The attempt to close regulatory holes would have no positive effect on the current financial situation (QQ 10, 18).

44. In defence of the speed of legislation, DG Internal Market and Services (DG Markt) said that only rapid action by the Commission would restore confidence in the securitised products market and faith in credit rating agencies (Q 412). They argued that without restoring the confidence of the market, the EU financial sector would be unable to move toward recovery. The Minister echoed these sentiments. He argued that while the sequential approach of dealing with the current crisis before reforming regulatory instruments was attractive, in practice "reducing the risk of repetition is part of fixing the problem, because it is part of restoring confidence in our institutions". Therefore, "we need to do both at the same time" (Q 65).

45. Martin Power, head of the Cabinet of Commissioner for Internal Market and Services Charlie McCreevy, explained to us the great political pressure for action in the area of financial regulation (Q 450). The financial crisis has created a political imperative to do something about financial institutions.

46. Many witnesses also commented on the separate issue of how regulation will affect the business of EU institutions in the global market, with proposals coming under criticism for possible problems of extra-territoriality and spill-over effects. By introducing regulation that is out of touch or ahead of the global approach to an issue, the EU is at risk of disadvantaging its financial institutions compared to those situated elsewhere in the world. For example, the Council of Mortgage Lenders (CML) told us that having different regulatory regimes for credit rating agencies (CRAs) globally would increase confusion and decrease transparency of ratings (p 204). Without proper global coordination, regulation introduced at EU level will not have its desired effect.

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[11] This is available online at: www.ec.europa.eu/governance/better_regulation/brochure_en.htm

47. Where our witnesses have made relevant comments on either of these issues, we discuss these points in relation to the specific Directives below.

Regulation of credit rating agencies

BOX 2

Rules on credit rating agencies

The Commission published its initial proposals on the regulation of Credit Rating Agencies (CRAs) on 12 November 2008. There was no previous regime of regulation of CRAs in the EU. The key elements of the initial proposal were:

- CRAs must disclose key models, methodologies and assumptions on which their ratings are based;
- The removal of conflicts of interest from the ratings system through disclosure requirements;
- Introduction of a registration regime for CRAs; and
- EU financial institutions may only trade in instruments rated by an EU-registered rating agency.

48. DG Markt explained that the regulation of rating agencies is a necessary reaction to their "massive failures" revealed by the financial crisis. They described the conflicts of interest created when the issuer of a securitised bond pays for a rating, rather than the investor.[12] It is in the issuer's interest to get as high a rating as possible to raise the value of the product, encouraging the issuer to go "from one [rating agency] to another until they got the rating for the securitised product they wanted." DG Markt told us that these rules for rating agencies would subsequently increase the quality and accuracy of the ratings they produced (QQ 382–383).

49. The rating agencies Standard & Poor's Ratings Services (p 234) and Moody's Investor Service (p 230) both differentiated in their evidence between regulation of ratings and of rating agencies. Both agreed that the regulation of the methodologies and techniques used to calculate ratings would "be wholly inappropriate" (Moody's, p 230), compromising the fundamental independence of ratings. The FSA concurred, stating that they would not support a broadening of scope to include the regulation of methodologies used in ratings (p 211). We agree that there should be no attempt to regulate the quality of ratings, at EU level or otherwise. Both welcomed the regulation of agencies themselves, in particular to remove conflicts of interest and increase transparency, agreeing that this would help rebuild the reputation of the agencies.

50. There was some discussion from witnesses on these regulations and their possible unintended consequences. As described above, concerns were raised over the quality of consultation on the proposals and whether the Commission had stuck to its own Better Regulation principles. Professor Goodhart expressed concern that, by regulating rating agencies, the Commission "would actually become party to the blame when things go wrong in future." He went on to argue that "the credit rating agencies are being used primarily because both the institutions and the regulators [sic] have been lazy … it has meant that neither the regulators [sic] nor the institutions have actually had to do their own due diligence." He expressed

[12] See also evidence of Mr Power (Q 425).

concern that the proposals could increase reliance on ratings and reduce due diligence conducted by the purchaser of an instrument (Q 107).

51. The European Banking Federation (EBF) agreed that regulation would put agencies on a "special pedestal", whereas the Commission should instead aim to reduce the prominence given to ratings in the financial system (Q 331). The French Representation felt that there was a need to avoid clearing the rating agencies of responsibility for the quality of their ratings and giving them a "public endorsement" (Q 503). Sharon Bowles MEP and John Purvis MEP agreed (Q 277). Moody's accepted that there was a danger that "legislators could create the mistaken impression that because ratings are a closely regulated product they are fully endorsed by a national or EU authority" (p 231). The FSA told us that it was important for the Commission to monitor the use of ratings to ensure that regulation does not have this effect (p 212).

52. DG Markt, in response to these criticisms, highlighted the due diligence requirements on the part of financial institutions that form part of the amendments to the CRD. They argued that forcing financial institutions to conduct their own assessment of issuers and products will prevent the re-emergence of the over-reliance on ratings that helped to lead to the current financial situation (Q 384). The Regulation itself states "The user of credit ratings … should take utmost care to perform their own analysis and conduct appropriate due diligence" although the proposal includes no enforcement process.

53. **Despite the arguments of the Commission, it is unclear what effect the Regulation will have on the use of credit rating agencies by financial institutions. We recognise concerns that establishing a process for the regulation of ratings may provide the ratings with an unwarranted legitimacy. It would be desirable for financial supervisors closely to monitor the application of the Regulation to ensure that ratings are not used as a substitute for due diligence, although we recognise that this will be extremely difficult in practice. Ratings play an important role in providing a qualified opinion but due diligence is also required on the parts of the purchaser of any product. We also recognise the important role that rating agencies play in rating institutions, alongside their role in rating complex products which has been the subject of much of the criticism.**

54. Much evidence submitted to us expressed concern that the EU was in danger of losing touch with the global approach on rating agencies, with witnesses citing concerns that the Regulation may have adverse affects on competitiveness of EU businesses in the global economy.[13] Article 4 of the initial Commission proposal stated that financial institutions could only use "credit ratings which are issued by credit rating agencies established in the Community and registered in accordance with this Regulation." This would prevent financial institutions based in the EU from using ratings produced outside the EU. The City of London Corporation (CLC) described the resulting EU "debt ghetto" with EU-based institutions having no access to non-EU capital (p 198). This Article received strong criticism from many of our witnesses on the ground that it would unnecessarily restrict the ability of financial institutions to trade in the global financial instruments market.[14] The European Parliament and Council of Ministers have now amended this paragraph in an attempt to resolve this issue.

55. The initial text has been replaced with an endorsement requirement, whereby an EU-registered rating agency endorses non EU-ratings. However,

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[13] See evidence British Bankers' Association (p 35) and Council of Mortgage Lenders (p 204).

[14] See also evidence of Moody's (p 230), Standard & Poor's (p 234), Fitch Ratings (p 213), British Bankers' Association (p 36), Association of British Insurers (p 188) and City of London Corporation (p 198).

the new text requires that the rating be issued in a country with equivalent regulations on rating agencies. Moody's explain in their evidence that "neither the Council nor Parliamentary amendments have resolved the issue unless the rest of the world adopts regulations that are the same in their details to the EU Regulation" (p 230). The new text will therefore continue to inhibit the participation of EU financial institutions in the global market until there is an international consensus on the regulation of CRAs.

56. **Although we welcome attempts to remove conflicts of interest and improve transparency of rating agencies, we question whether rapid action on the regulation of credit rating agencies was necessary. The degree of uncertainty over the effects of this Regulation cast doubt over whether careful consideration was given to these proposals in line with the Better Regulation principles. Concerns over the initial Commission draft of the Regulation limiting the scope for EU-registered institutions to trade in overseas financial instruments were also justified. The Regulation must avoid stifling European participation in the global trade in financial products.**

57. Witnesses also commented on the incorporation of ratings into capital rules. At present, the rating of a financial institution determines the level of capital that the institution is required to hold. Mr Raines of Taylor-Wessing LLP explained that ratings had assumed excessive importance because of their incorporation into the Basel rules (Q 24). The rating agencies have argued that they never wanted ratings to be incorporated into legislation and that they would be happy for ratings not to be used in the calculation of capital requirements (Standard & Poor's, p 235). **We agree that as far as possible the Commission should remove the reliance on ratings for regulatory purposes, in conjunction with similar changes to the Basel rules.**

Amendments to the Capital Requirements Directive

BOX 3

Capital Requirements Directive

The Capital Requirements Directive (CRD), adopted in 2006, transposes the Basel II rules (see Box 4) into EU law. The Basel II accord consists of three pillars:

- Pillar one—Sets minimum capital requirements for credit, market and operational risk;
- Pillar two—Firms and supervisors must take a view on whether additional capital should be held against risks not covered in first pillar; and
- Pillar three—Firms required to publish details of capital, risks and risk management.

The Commission published its proposals for amendments to the CRD in October 2008. Final agreement was reached in May 2009. The key amendments initially proposed were:

- Limit banks' exposure to any one party;
- Colleges of supervisors established for all cross-border banking groups;
- Clear definitions of quality of capital and whether certain capital can count towards a bank's minimum requirement level; and
- Rules on securitised debt, including transparency and retention of risk requirements.

58. The proposal for the creation of colleges of supervisors received a great deal of attention from witnesses. We discuss this in detail in Chapter 6. We heard much concern from witnesses over the requirement for the retention of 5% of the risk by the originator in securitisation transactions. This would mean that the originator of a bond would have to retain part of that bond and in doing so retain part of the risk. This was designed to remove the inadequacies of the originate-to-distribute model, which is often seen as the lack of incentive for the originator to ensure the loans securitised as bonds were of a good quality. The Council of Ministers subsequently made changes to the Commission proposal, reducing its scope. These amendments stopped the retention requirement applying to less complex securitisation transactions and syndicated loans.[15]

59. The BBA argued that the original drafting of the retention requirement would not solve the problems with the originate-to-distribute model, instead having a detrimental affect on the securitisation market, the recovery of which was essential for economic recovery (p 36). The de Larosière report and witnesses argued that the securitisation was a useful economic model, despite its problems.[16] The City of London Corporation (CLC) concurred that the original drafting would "seriously harm the market function" of securitisation (p 198).

60. DG Markt disagreed, explaining that the Commission were not trying to end the practice of securitisation, but to regulate its most complex forms and hence reduce the risk inherent in these bonds (Q 384). They argued that rapid action in this was necessary to revive confidence in the securitised products market and help the EU out of the crisis (QQ 41–2). Requiring the originator to keep a share of the risk made it in the issuer's interest to construct bonds from sound loans (Q 418). The retention requirement also received support from the French Permanent Representation to the EU (Q 450) and the Association of British Insurers (p 187).

61. The Treasury welcomed the changes made to the requirement in Council, describing "particular improvements that have been made there around the way in which those requirements are calculated, around the scope and around the review arrangements" (Q 63). The BBA also welcomed the removal of simpler securitisation transactions from its scope (Q 114).

62. It is clear that many securitisation transactions were excessive and contributed to the financial crisis. These excesses notwithstanding we recognise the need to revive the confidence of the financial markets in securitised products. By removing simpler bonds from the scope of the retention requirement, the proposal will have a positive effect upon the confidence of the market, whilst creating a greater requirement for responsibility on the part of the originator. **The Commission's 5% retention requirement on complex securitised instruments is an effective compromise to limit the more excessive securitised transactions and we agree with it.**

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15 We acknowledge the transfer off-balance sheet of securitised assets has also been raised as a possible contributor to the crisis.

16 Report of *The High-Level Group on Financial Supervision in the EU*, chaired by Jacques de Larosière (25 February 2009), p8. See also evidence of David Wright (Q 412) and John Purvis MEP (Q 297).

The Basel rules and procyclicality

BOX 4

Basel rules

The Basel Committee on Banking Supervision includes representatives from the Group of 10 (eleven countries: Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the UK and the USA), plus Luxembourg and Spain. The Basel Accord of 1988 (now known as Basel I) set out rules for the minimum capital requirements of banks and was enshrined in law in all G10 countries by 1992. The accord included a universal requirement where all banks were required to cover 8% of risk-weighted assets with Tier 1 and 2 capital. Tier 1 capital had to account for at least 4% of a bank's risk-weighted assets.

The Basel II framework, agreed in June 2004, takes a more complex approach to capital requirements, with the intention of making them more sensitive to risk and to encourage a more sophisticated approach to risk management. These rules had only just come into effect at the time of the crisis. Basel II rules have not been fully implemented for any financial institutions in the USA.

63. The Basel rules provide an incentive for banks to take on bigger risks when the economy is booming, because they exacerbate the strength of the economic cycle. The rules treat favourably factors associated with credit growth including inflated collateral values, positive ratings by ratings agencies and limited loan loss provisions. Reliance on internal models and the calculation of off-balance sheet items for the measurement of capital can lead to banks underestimating risk. As a result, Basel capital requirements tend to fall in periods of credit growth as the economy expands, accentuating a boom.

64. In periods of economic contraction capital requirements rise, encouraging banks to sell assets and reduce lending to the real economy, damaging the business and retail sectors. In order to achieve a higher capital to risk adjusted assets ratio, an institution must either reduce its asset pool through selling of assets, or increase its capital levels by reducing lending, further aggravating the downturn. This process causes institutions to overestimate risk in bad times. This tendency of accentuating a boom and aggravating a downturn is known as pro-cyclicality.

65. Witnesses acknowledged that the current proposals for the amendment of the CRD would not by themselves prevent a future crisis, as they do not address the issues of excessive leverage, risk-taking without strong credit standards and pro-cyclicality. In this chapter, we focus on the issue of the pro-cyclical nature of Basel rules. Witnesses also emphasised the pro-cyclical tendency of accounting standards.[17] The importance of regulating liquidity, in addition to capital, was emphasised by some witnesses.[18]

66. The BBA told us that those who said Basel would be pro-cyclical "have *de facto* been proven to be correct". They acknowledged that the Basel Accord requires modification to remove this tendency. They used the example of Spain where banks are required to hold greater capital than under the Basel rules (Q 116). Spain also dissapplied accounting standards that have now been identified as pro-cyclical.

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17 See David Wright (Q 411) on accounting rules.

18 Professor Goodhart (Q 89) and the Bank of England (Q 604) on liquidity regulation.

67. So far, Spain's financial institutions have fared better during the crisis than their UK counterparts, which operate at Basel levels of capital requirements (QQ 120–2). There was general agreement amongst witnesses that Basel rules require modification to end their encouragement of pro-cyclicality.[19] The Commission indicated that they will publish a report on this issue in 2009, with the eventual intention of further revision of the CRD to include counter-cyclical rules devised by the Basel Committee (Q 420).

68. Several witnesses argued for the introduction of overt counter-cyclical capital rules, such as dynamic provisioning. This places a requirement on financial institutions to make extra provision for losses during times of economic expansion. It would then act as a buffer during periods of economic contraction, so that, when loans turn sour, their profits and capital fall by less, supporting continuation of lending to the real economy, so lessening the longevity of a recession.

69. M de Larosière, chair of the high-level group on EU supervision (see Box 8), argued that dynamic provisioning was the best method of creating counter-cyclical capital requirements (Q 559).[20] This method would lessen the economic cycle of bust and boom by preventing the excesses of risk taking and high leverage ratios in times of economic expansion. It would also increase the ability of banks to continue normal lending levels during a downturn. The European Banking Federation also supported this method (Q 336). The introduction of a leverage ratio as used in the USA or Switzerland can also help to ensure that banks are better capitalised.

70. The Bank of England described to us a formula-driven method of implementing counter-cyclical capital rules. They suggested that the minimum capital requirement of 8% should be shifted up or down during the course of a credit cycle. As growth accelerated, the requirement could be increased to 8.5%, or as conversely growth declined, it could be reduced to 7.5% and so on (Q 587).

71. The de Larosière report recommends that the ECB should play a role in counteracting the pro-cyclical nature of capital adequacy rules. The Bank of England argued that the ECB "as a central bank of one of the world's biggest currency areas" had a great role to play among other central banks in the assessment of risks and capital issues (Q 589). They explained that this role would not necessarily provide the ECB directly with the instruments for macro-prudential supervision (Q 588). This issue is discussed further in Chapter 5 on the ECB's role in financial supervision.

72. The pro-cyclicality of capital rules needs to be addressed, particularly in relation to the Basel rules and accounting rules that helped worsen the financial crisis. **We recommend that the Commission should work towards an overt counter-cyclical capital regime through further amendments to the Capital Requirements Directive. This should take place in conjunction with changes to the Basel rules to ensure international consistency.** We look forward to scrutinising the Commission's proposals in detail in due course.

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19 See evidence of Deutsche Bank (p 206), French Representation (Q 518), M de Larosière (Q 556) and Mr Bishop (QQ 181–182).

20 *The Turner Review*, p. 63 provides a detailed account of the Spanish method of dynamic provisioning.

Crisis Management Procedures

BOX 5

Crisis Management

Crisis management procedures involve an array of instruments available to the public authorities to confront troubled banks and financial institutions. These include the lender of last resort role of the central bank, deposit guarantee schemes, and bank insolvency proceedings. There are also policies of implicit or explicit protection of individuals (depositors, investors, and others) and institutions (via guarantees, recapitalisation, nationalisation). At the EU level, the provision of state aid (see Chapter 9) is also relevant.

Deposit Guarantee Schemes

The proposal to amend Directive 94/19/EC on Deposit Guarantee Schemes was adopted on 11 March 2009. The final text made the following key modifications to the Directive:

- Minimum deposit guarantee level of €50,000 to rise to €100,000 by 31 December 2011;
- The payout delay reduced to 20 days, with a further 10 days in exceptional circumstances, by December 2010;
- Compensation will cover 100% of eligible deposits.
- The Commission is tasked with reporting on effective payout procedures, cooperation arrangements and impacts of increasing the upper limit by December 2009.

The Committee examined Deposit Guarantee Schemes in its Report on EU legislative initiatives in response to the recent financial turmoil.[21]

73. DG Markt argued that rapid implementation of a minimum deposit level was important because it prevented varying guarantee levels creating distortions in the single market (Q 365). This was seen in September 2008 when the Irish government raised its guarantee level to €100,000 for Irish banks. This caused a flow of capital into Irish banks from non-Irish banks, as depositors moved their deposits into accounts to which the government guarantee applied. A unified deposit guarantee level across the EU, besides providing protection and reassurance for private depositors, prevents this distortion of the single market. In this case, rapid legislative action was required at an EU level to solve an immediate and pressing danger to the single market.

74. Graham Bishop, financial analyst at GrahamBishop.com, raised concerns over the Directive, arguing that governments guaranteeing deposits created moral hazard by reducing the risk of placing savings in a financial institution. He argued that guaranteeing all deposits across the EU removes the need for depositors to care about the riskiness of deposit-taking institutions (p 55). This could then lead to an increase in risk taking by both banks and consumers in the future. On the other hand, the UK consumer body Which? not only supported the proposals but felt the guarantee should apply per brand, rather than per institution, to avoid confusion for consumers (pp 236–7).

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[21] European Union Committee, 1st Report (2008–09): *EU legislative initiatives in response to the recent financial turmoil* (HL 3).

75. **The introduction of a harmonised standard for deposit guarantee schemes provided a rapid solution to the dangerous distortions in the single market caused by different levels of deposit guarantees across the EU and the European Economic Area. Problems remain with the Directive and we ask the Commission to address these in its review of the Directive in December 2009**.

76. The Commission told us it plans to introduce a white paper to address insolvency law issues and the winding up of failed banks (p 118). This in particular affects cross-border banks that have subsidiaries in several different countries. Uniformity of winding-up procedures, including common early intervention mechanisms across the EU, will help the single market in financial services. The BBA also recognised the need to achieve consistency (p 38). **We agree that there is a case for further harmonisation of rules on the winding up and reorganisation of credit institutions.** We look forward to scrutinising in detail the Commission's white paper on insolvency proceedings.

Further regulation

77. On 2 April 2009, the G20 agreed that previously unregulated activities including alternative investment funds and credit derivatives should be regulated. The Commission published its proposals for the regulation of alternative investment funds subsequent to the evidence we took as part of this inquiry. We have not, therefore, been able to examine this subject in detail.

BOX 6

Commission proposal on alternative fund managers

The Commission published its proposal for the regulation of fund managers on 29 April 2009. The proposal focused on the following key areas:

- Authorisation—All fund managers within the scope of the proposal (those managing a portfolio of over €100m) will require authorisation and will be subject to harmonised standards;
- Enhance transparency of funds and fund managers;
- Ensure all funds have robust systems in place for management of risks, liquidity and conflicts of interest; and
- Grant access to the European market to third country funds after a transitional period of three years.

Alternative investment funds include:

- Hedge funds
- Private equity funds
- Real Estate Funds

The proposals do not affect all funds uniformly.

78. Witnesses have raised questions over whether rapid legislative action to regulation alternative investment funds is necessary. Sharon Bowles MEP commented to us that hedge funds had become a scapegoat for the current crisis (Q 282), whilst Professor Goodhart argued that they had a limited role in the crisis, reducing the urgent need for their regulation (Q 110).

79. The Minister pointed to the useful aspects of hedge funds, explaining they help smooth volatility in the markets (Q 69). On his second appearance before us, he criticised the proposal for leaping "at hedge funds and private equity as a source of instability in a way which is not as necessarily as well informed as it should be" (Q 651). He reiterated that hedge funds did not cause the financial crisis. Doubts were again raised over the adherence to Better Regulation principles as the Minister told us that "if anything, it [the proposal] has been too speedy" and that the proposal could have some "quite serious unintended consequences" for risk capital sources (Q 652).

80. The Minister reminded us on his first appearance that hedge funds and other alternative investment funds are already regulated in the UK, and said that the UK regulatory regime was considered amongst the most rigorous in the world, with fund mangers authorised and regulated by the FSA. He also explained that the FSA was consulting on the case for enhanced information gathering and macro-prudential oversight of hedge funds and other private equity funds (Q 66). The French Representation agreed that a system of registration and data collection needed to be instituted for hedge funds. They also suggested that there might be a place for centralised EU registration of hedge funds and hedge fund managers (Q 514). Mr Sáinz de Vicuña, however, emphasised the need for transparency and argued that hedge funds were systematically relevant (QQ 240–1). Professor Goodhart told us they "are systemic as a herd" not individually (Q 111).

81. Many witnesses doubted whether the EU was the correct forum for regulation of hedge funds. The FSA explained that it was important that any EU legislation complemented, rather than undermined, global arrangements (pp 209–10). Subsequent to the publication of the proposals, there have been many questions raised over the effect of the proposal on EU institutions in the global market. **It is imperative that the Commission properly consider the global effects of its proposals on alternative investment funds.**

82. Some alternative investment funds have received criticism in the wake of the financial crisis. Although the proposal was published after we finished taking evidence as part of this inquiry, **the consensus of our witnesses was that the influence of alternative investment funds in the financial crisis was limited and we recommend that the Government should work to prevent proposals for EU regulations from stifling these markets. There is currently no pressing requirement for rapid EU legislative action in this area.**

83. A Credit Default Swap (CDS) is a credit derivative contract between two counterparties. In a similar way to insurance, the buyer pays a premium to the seller and receives a pre-determined sum of money should a specific credit event occur. However, there is no obligation in a credit default swap for the buyer to own the paper on which the swap is based. In effect, this allows the buyer to speculate that the entity will go bankrupt.[22]

84. Professor Goodhart told us that a central counter-party clearing house for the CDS instruments market needs to be instituted (Q 110). Centrally cleared and transparent credit derivatives are needed to monitor and so reduce risks

22 Lee Buchheit described the system of CDS to us in some detail (Q 1).

they pose to the financial system. The setting-up of a clearing house in the EU has so far not advanced at the speed of such a system in the US.

85. HM Treasury told us there would be "significant potential benefits" from a central counter-party system (Q 658). They told us there was little point instituting several systems and that they expected to see the development of such a system within the EU. At present there are no EU proposals on this subject. We look forward to scrutinising in detail any further proposals.

General Conclusions on the proposals for financial regulation

86. While there are issues which need to be addressed through rapid EU action, it is important to create effective legislation that will not require early revision. In particular, the proposal for the regulation of credit rating agencies and for alternative investment funds came under significant criticism from our witnesses for being prepared and agreed at an unnecessary pace without adhering to the principles of Better Regulation. We recognise that the recent financial events have created an urgent impetus for regulatory reform of Deposit Guarantee Schemes and the Capital Requirements Directive. **Rapid action must not come at the expense of thorough consultation, impact assessment and risk analysis by the Commission in line with their own Better Regulation principles. Where necessary, the Commission should review the effectiveness of emergency legislation, to check that it is achieving its original objectives.**

87. Any EU legislation that is out of touch with a global approach has the potential to harm the competitiveness of EU financial institutions in a global market. This again has been a criticism we heard from our witnesses in relation to the regulation of alternative investment funds and rating agencies. Regulation that will prevent EU financial institutions participating in the global economy must be avoided. **We urge the Commission to ensure that proposals for new regulation of financial services in the EU are coordinated with global regulatory initiatives.**

CHAPTER 4: FINANCIAL SUPERVISION IN THE EU: AN INTRODUCTION

Why reform supervision in the EU?

88. The financial crisis has created political momentum to reform the structure of financial supervision in the European Union. DG Markt told us that one of the failures that led to the crisis was the lack of link up between the macro-prudential side and the micro-prudential side of supervision (Q 359). This highlights the two areas that reform of EU supervisory structures aims to address.

89. First, there was a failure to identify macro-prudential and systemic risks to the financial services industry at any level. As we discuss below, many have proposed the creation of a macro-prudential supervisory body within the EU, to link with similar structures at both global and national level to identify risks that affect the entire financial system within the EU single market. The problem is to agree upon the structure and powers of such a body, which remains a subject of much controversy.

90. Second, there was a failure of micro-prudential supervisors satisfactorily to identify and mitigate risks through the supervision of individual institutions. This applies both to institutions that have been heavily regulated in the past, such as banks, and to institutions that have been more lightly regulated or not regulated at all, such as credit rating agencies. The proposals for the restructuring of the EU system of financial supervision, currently based on the principles of national competence and co-operation, have significant implications for the future of the single market in financial services, in particular the supervision of cross-border financial institutions.

The ECB

91. The role of the European Central Bank in both macro and micro-prudential supervision has also come under discussion. The ECB has promoted the idea that it should play a stronger role in financial supervision. M Trichet, President of the ECB, declared that the ECB "stands ready" to take on supervision responsibilities.[23] The ECB has been cited by some as the best-placed organisation to hold macro-prudential supervisory responsibilities in the EU, because of its position as the largest central bank in the EU and the possibility of this happening without Treaty amendment (see below). However, there have been many objections to this role from several Member States including the UK Government. There is little realistic chance of the unanimity needed in the Council of Ministers being achieved to allow this to happen. We discuss these issues further in Chapters 5 and 6.

[23] Keynote address by Jean-Claude Trichet, President of the ECB, at the Committee of European Securities Regulators (CESR), Paris, 23 February 2009.

BOX 7

European Central Bank

Following the provisions of the EC Treaty, the ECB was established in 1998 as a specialised, independent organisation for conducting monetary policy in the euro-area and performing related functions. The ECB has its own legal personality with decision-making powers and a separate budget.

The ECB is the central bank for Europe's single currency, the euro. The eurosystem comprises the ECB and the 16 National Central Banks (NCBs) of Member States who have adopted the euro.[24] The European System of Central Banks (ESCB) comprises the ECB and the NCBs of all 27 EU Member States. The ESCB lacks legal personality.[25]

Organisation

The ECB has three decision-making bodies: the Governing Council, the Executive Board and the General Council. The first two decision-making bodies govern the eurozone. The third is a body that comprises the 27 Member States of the EU.

The Governing Council is the main decision-making body of the ECB and takes the most important and strategically significant decisions for the eurosystem. The Governing Council comprises the six members of the Executive Board and the governors of the NCBs of the Member States that have adopted the Euro.

The Executive Board is the operational decision-making body of the ECB and the eurosystem. It is responsible for all the decisions that have to be taken on a daily basis. The Executive Board has six members, the President, the Vice-President and four other members.

A third body, the General Council, includes the President and the Vice-President of the ECB and the governors of the NCBs of all EU Member States, both eurozone and non-eurozone. The General Council therefore provides representation for all EU Member States whether they have adopted the euro or not and will exist as long as some Member States have not adopted the euro. The Treaty, the Statute of the ESCB and the relevant Rules of Procedure dictate the functioning of these decision-making bodies.

Role

The primary objective of the ESCB is to maintain price stability in the eurozone as established in Article 105.1 of the Treaty.

Article 105.2 of the Treaty refers to the basic tasks to be carried out through the ESCB. In practice, these tasks apply only to the eurosystem and include:

- to define and implement the monetary policy of the euro area;
- to conduct foreign exchange operations consistent with the provisions of Article 111;
- to hold an manage the official foreign reserves of the Member States of the euro area; and
- to promote the smooth operation of the payment systems.

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24 Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

25 Chiara Zilioli and Martin Selmayr Eurediam, *The European Central Bank, its System and its Law* (1999); and Rosa Lastra, *Legal Foundations of International Monetary Stability* (2006), Chapter 7.

Other ECB tasks include:

- the authorisation to issue and the issuance of euro banknotes;
- the collection of the statistical information necessary for the tasks of the eurosystem (Article 5 of the Statute);
- advisory tasks (article 105.4 of the Treaty); and
- international cooperation (Article 6 of the Statute).

The Maastricht Treaty did not adopt a proposal for prescribing prudential supervision as one of the basic tasks of the ESCB. The references to supervision in the final version of the Treaty and in the ESCB Statute are limited (EC Treaty Article 105.4, 105.5 and 105.6 and ESCB Statute Articles 3.3. and 25) (See Appendix 10).

The ECB provides emergency liquidity assistance to the market (market liquidity assistance). Some argue it enjoys the status of Lender of Last Resort.[26]

Problems with supervisory powers at EU level

92. The EC Treaty and the national jurisdictional domain of the fiscal authority were both cited by witnesses as significant obstacles to any proposals to transfer supervisory responsibilities to an EU body. The problem for providing the ECB specifically with any supervisory responsibilities is further compounded by the differences between the eurozone, the EU single market in financial services, and the EEA, since the obligations of the single market affect all EU Member States as well as the EEA Member States.

The EC Treaty

93. At present, supervision is essentially a national competence, a matter for the Member State. It is important to understand what reform can be achieved within the existing EC Treaty, given the current political unwillingness for further Treaty amendment. DG Markt explained to us that there is no appetite for Treaty change amongst Member States, particularly given the stalled progress of the Lisbon Treaty (QQ 373–374).

94. The specific problem with regard to the EC Treaty lies in the powers which any EU supervisory body, macro or micro, would hold. Witnesses told us that giving binding powers to any EU body was not possible under the EC Treaty (Q 534 and Professor Jean-Victor Louis, pp 227–9), with the exception of Article 105 (see Appendix 10), which provides the possibility of transferring some supervisory powers to the European Central Bank. As supervision remains a national competence, no EU body is currently able to make binding decisions over national supervisors. This creates problems for the suggestions for reform of the EU's supervisory architecture. Proposals must work within the existing Treaty if they are to have any realistic political chance of implementation in the near future. For this reason, we examine the proposals for reform in financial supervision with the Treaty issues in mind.

95. However, Article 105.6 of the EC Treaty does provide the ability for Member States to confer upon the ECB specific tasks in the domain of financial supervision if they wish. The Treaty makes no distinction between

26 Hanspeter K. Scheller, *The European Central Bank: history, role and functions* (2004).

macro- and micro-prudential supervision. Article 105.6 states that the Council of Ministers may entrust the ECB with "specific tasks concerning policies relating to prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings." Mr Sáinz de Vicuña expressed his view that Article 105.6 could be applied through the General Council of the ESCB which encompasses the 27 National Central Banks of the European Union. Such a provision would therefore be applicable to all EU Member States, not only members of the eurozone (QQ 218–220).

96. The activation of Article 105.6 in order to entrust the ECB with new tasks in supervision would not require a Treaty change, but would need unanimity in the Council of Ministers and assent by the European Parliament to come into force. The UK Government has signalled to us its opposition to entrusting the ECB with powers through Article 105.6, which will reduce the chance of reaching a unanimous agreement in Council.

97. Mr Sáinz de Vicuña emphasised that Article 105.6 excludes insurance companies from the scope of supervisory tasks. Since financial institutions are active in both the banking and the insurance sectors this exclusion would raise the risk of supervisory fragmentation. Mr Bini Smaghi of the ECB has argued that the exclusion of insurance companies from Article 105.6 "would not prevent the ECB from being attributed with responsibilities related to the supervision of financial conglomerates as the related supervisory regime … does not regard the direct supervision of insurance undertakings."[27]

98. **We note that under the existing Treaty there is likely to be little opportunity to provide any EU supervisory body with the power to issue binding rulings or decisions on national supervisors. We also note the use of Article 105.6 requires unanimity and some Member States oppose its activation.**

Fiscal Authority

99. Several witnesses told us that the national jurisdictional domain of the fiscal authority provides significant problems for proposals to grant supervisory powers to any EU body, for example the ECB. The BBA told us that micro-prudential supervision will remain a national responsibility as long as the ultimate responsibility for bailing out a failed institution remained a national concern (p 39). This was a sentiment echoed by Lord Turner of Ecchinswell when he appeared before our Committee[28] and the Minister, who told us that governments would be unwilling to cede national micro-prudential supervisory powers to an EU body whilst they hold the responsibility for bailing out financial institutions (Q 53). Professor Goodhart told us that if crisis management was to be at the European level rather than at the national level, there needed to be a "federal source of money" (Q 88).

100. The FSA agreed asserting that: "until the EU has fiscal powers which permit it to raise the funds needed to rescue distressed banks, or until there is a

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27 Speech by Lorenzo Bini Smaghi, Member of the Executive Board of the ECB 2009 ECON meeting with national parliaments, *Financial crisis: Where does Europe stand?* Brussels, 12 February 2009. The exception of insurance undertakings was mentioned as an obstacle for the ECB having a supervision role by DG Markt (Q 410).

28 European Union Committee, 1st Report (2008–09): *EU legislative initiatives in response to the financial turmoil* (HL 3)

system of mandatory burden sharing between Member States for fiscal support, supervision will and should remain the responsibility of Member States" (p 208). DG Markt agreed that there is unlikely to be any transfer of supervisory powers to an EU body while banks are bailed out by Member States (Q 366). The Bank of England also told us that only the [national] fiscal authority had the ability to provide "capital of last resort" (Q 608).

101. Professor Willem Buiter, in his article *The fiscal hole at the heart of the eurosystem,* proposed three possible options to overcome the absence of ECB fiscal authority for the eurozone.[29] He explained the potential solutions "in decreasing order of desirability but increasing order of likelihood": a supranational eurozone-wide tax and borrowing authority, a eurozone wide fund, specifically dedicated to fiscal backing for the ECB/eurosystem and an ad-hoc, fiscal burden-sharing rule.

102. The political problem of the location of fiscal authority at Member State level reflects the parallel reality that further Treaty reform would be exceptionally difficult to achieve. **The establishment of any EU body with supervisory authority and far-reaching micro-prudential supervisory roles and powers to mobilise fiscal resources in the event of crisis, or passing such powers to the European Central Bank, is difficult if not impossible whilst national governments bail-out financial institutions.**

103. Witnesses also raised the related issue of the bail-out of eurozone Member States and whether this is possible under the EC Treaty. The no bail-out clause is an important basis for the functioning of the monetary union. This no bail-out clause contained in Article 103 prevents Member State and the Community from providing financial assistance to other Member States that are facing rising public debt. This is designed to prevent Member States in the eurozone from relying on the possibility of a bail-out from another Member State. The Minister and DG Markt discussed this in detail with us (QQ 440, 661).

The ECB, the UK and the eurozone

104. It has been suggested that the lack of a single currency within the single market would reduce the prospect of the ECB taking a strong role in supervision. Mr Green pointed out that any supervisory arrangements in which the ECB could be involved needed to consider the fact that "the largest centre for euro wholesale business is London, and that dozens of UK registered banks are counterparties of the ECB" (Q 76). Conversely, M de Larosière, discussing whether it would be viable for the City of London to be left out from the supervisory arrangements, said that the bulk of the assets of the banking system is in continental Europe, so rather than Europe losing out, it would be London (Q 552).

105. The EU single market in financial services suggests there is a strong argument for there to be a macro-prudential supervisory body at EU level (see Chapter 5), to monitor risks affecting the whole single market. However, the ECB itself does not have a mandate that covers the entire EU, rather its monetary policy responsibilities focus upon the eurozone. It does not determine the monetary or fiscal policy for the entire single market. This dichotomy, that the single market does not have a single currency, provides

[29] Professor Willem Buiter, *The fiscal hole at the heart of the eurosystem,* (Financial Times, 21 March 2009).

an argument against the ECB playing a sole or major role in an EU macro-prudential supervisory body.

Towards a single EU supervisory authority?

106. Some witnesses recommended the establishment of a single EU supervisory authority for cross-border banks, since the largest 43 cross-border banking groups in the EU account for 77% of total EU bank assets. This would take powers of supervision from national supervisors in regard to the cross-border banks and would represent a major reform of the EU financial supervisory structure. This would require a Treaty change given that supervision of institutions remains a national competence.

107. Mr Sáinz de Vicuña told us that for large cross-border banks it would be desirable to have a single reporting structure and an interlocutor for all supervisory arrangements of their multi-jurisdictional operations rather than having to deal with a plurality of national supervisors that co-operate "in a very soft and vague manner" (Q 218). However, he doubted whether the creation of such a system would be legally possible under the current EC Treaty.

108. Similarly, Deutsche Bank expressed strong views in favour of a central European banking supervisory authority to provide efficient and effective supervision of the largest pan-European banking groups. They argued that, "an integrated supervisor is much better placed to ensure the stability of the European financial system and to prevent and where necessary manage and resolve large scale crisis. As the financial centre of Europe, London has much to gain from overcoming the current fragmentation of the supervisory landscape in the EU … we expect immense benefits from a pan-European solution" (pp 205–6). Deutsche Bank said that the financial industry struggles with the complexity of 27 different national supervisory regimes. The duplication of internal systems and processes for cross-border banking groups created additional costs and risks. The integration of supervision "requires not only a lender of last resort but also swift access for fiscal resources if and when necessary to support, on a pan-European basis, individual financial groups in trouble" (p 205).

109. Following the collapse of the Icelandic banks, (see Chapter 7 on the home-host divide) Howard Davies wrote an article entitled *Europe's banks need a federal fix*. In his view, a supervisory authority, bearing in mind the model offered by the US federal approach "could sustain the single market, underpinned by institutions that match the integration of financial firms."[30] He also acknowledged the political difficulties that arise from this proposal as finance ministers from the EU Member States would need to reach a consensus to relinquish a national power to an EU authority.

110. Lord Myners told us that the UK has always rejected any proposal for a single EU supervisor, and that a crisis would be much more difficult to resolve if finance ministers were not accountable. He also raised the international dimension, stating that the largest banks are global, not simply European; a single EU supervisor would not by itself address the issue of cooperation with countries outside the EU. As a third reservation, he mentioned concerns related to the loss of regulatory diversity, as a single

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30 Howard Davies, *Europe's banks need a federal fix (*Financial Times, 13 January 2009).

European supervisory body eliminates the opportunity for national supervisors to learn from each other (Q 53).

111. We acknowledge that a single European supervisor and a single rulebook would improve functioning of the single market for financial services and would be beneficial for cross-border banks. Banking markets are much more interrelated than current supervisory arrangements. **While we recognise the benefits of further harmonisation, we believe that the establishment of a single supervisory authority can not happen unless there is a facility or burden-sharing arrangements on the bail-out of financial institutions at an EU level. In addition, the institution of any single EU supervisory authority would require substantial revision of the EC Treaty.**

The proposals of the de Larosière report, the UK Government and the FSA

112. The de Larosière report proposes a programme for the reform of financial supervision within the EU, whilst the UK Government and the Turner Review by the Financial Services Authority have suggested alternative reforms.

BOX 8

Supervisory recommendations of the de Larosière report

The report of 25 February 2009, *The high-level group on financial supervision in the EU* chaired by M de Larosière, outlines a reformed system of financial stability in the EU. The Group was set up to make recommendations to the Commission on strengthening European supervisory arrangements covering all financial sectors, with the objective of establishing a more efficient, integrated and sustainable European system of supervision and also of reinforcing cooperation between European supervisors and their international counterparts. The report recommends the creation of two bodies at EU level: a European Systemic Risk Council (ESRC) and a European System of Financial Supervision (ESFS).

The ESRC would act as a macro-prudential supervisory body under the auspices and chair of the ECB. It would be composed of the General Council of the ECB (representatives from the National Central Banks of all 27 Member States, including non-eurozone Member States), one representative from each of the Level 3 Committees (see Annex 8) and one representative from the European Commission. The representatives from NCBs could be replaced by representatives of national supervisory authorities where appropriate.

The ESRC would analyse information on the macro-prudential situation and monitor risk in all financial sectors. Risk warnings would be passed on to micro-economic supervisors to take action to ensure risks are mitigated. The ESRC would also have a responsibility to inform global organisations including the International Monetary Fund (IMF) and Financial Stability Forum (FSF) of identified risks.

In relation to micro-prudential supervision the de Larosière report outlines a two-stage process for the upgrading of the Level 3 Committees. The first stage would give them for a more active role in organising and guiding expanded colleges of supervisors (meetings of representatives of all national supervisors of a cross-border bank) and in reviewing the standards of national supervisors.

The second stage would turn the Committees into three new authorities (Banking, Insurance and Securities) which would constitute the ESFS. Day-to-day supervision of financial firms would remain at a national level, while the ESFS would play a largely coordinating role. However, the new authorities would have binding powers over national supervisors on supervisory standards. They would exercise legally binding mediation between national supervisors, adopt binding supervisory standards and technical decisions, coordinate colleges of supervisors, license EU-wide financial institutions and work in cooperation with the ESRC to ensure mitigation of macro-economic risks. Most of these powers would require Treaty Amendment.

113. The de Larosière report was published on 25 February 2009, after we began to take evidence for this inquiry. Therefore, some witnesses referred to supervisory bodies without using the terminology of the ESRC or ESFS that the de Larosière report introduced. To avoid confusion, we refer to the ESRC or ESFS only when witnesses specifically mentioned these bodies.

114. The three different sets of proposals of de Larosière, Lord Turner and the Government have three common themes: institution of macro-prudential supervision, expansion of colleges of supervisors and reform of the Level 3 Committees. We examine each of these areas in Chapters 5 and 6, commenting on the differences between the suggestions and concluding where appropriate. We also examine what role the ECB might play within these systems.

CHAPTER 5: THE REFORM OF MACRO-PRUDENTIAL SUPERVISION

115. Many witnesses argued that the financial crisis had shown the need for macro-prudential supervision,[31] which we define in paragraph 27. The de Larosière report recommends the institution of an EU-wide macro-prudential supervisor. This has opened the debate on the need for such a structure and at what level it should be based. The BBA summed up a consensus amongst witnesses: "One of the things we need to do is a much better job of assessing when something has the potential to become systemic and then do something about it" (Q 126). The Government has accepted that a new EU body was needed as part of the architecture of effective early warning systems (Q 610). However, the form, location and powers of a macro-prudential supervisory body remain the matter of some debate, as does the role, if any, the ECB should play in such an institution.

116. There are Treaty issues with the institution of a body to analyse macro-prudential risk at EU level, particularly if it held any powers. A structure as outlined by the FSA (see below) where national supervisors that consistently ignored risk warnings could be referred to the Council of Ministers would fit within the current Treaty as power would still lie at national level. Article 105.5 could also provide the ECB with a supervisory role for the eurozone.

117. On the issue of whether macro-prudential supervision should take place at an EU level, the BBA argued that a European macro-prudential supervisor would be able to take action to mitigate risk, whereas a global supervisor would not, because of the relative proximity of an EU body to national supervisors (Q 126). A European macro-prudential supervisor would be able to use its findings to inform national supervisors and global bodies of systemic problems and recommend actions to mitigate these risks. The de Larosière report proposes that the ESRC have a mandate to give advice on how to tackle risks to both the IMF (see Chapter 8 on global supervision and regulation) and national supervisors.[32] The single market in financial services within the European Union provides a strong case for a macro-prudential supervisory body to exist at an EU level, to monitor risks that apply to the single market. Proposals to establish such a body are to be welcomed. The institution of such a body could be possible under the EC Treaty, depending on the scope of powers and instruments entrusted to it.

Powers

118. Some of the powers suggested for an EU macro-prudential supervisory body run into significant Treaty issues. However, if such a body was to have a reporting structure to another group that did have power to act, this may be possible under the Treaty.

119. DG Markt argued the ESRC would play a crucial role "hooking up the micro-prudential side to the macro-prudential side" both from the ESRC to the ESFS and *vice versa* (Q 359). DG Markt explained this would work by creating a mandatory obligation for colleges of supervisors to act upon risks

[31] See evidence of BBA (QQ 126, 145, 153), EBF (Q 340), European Commission (QQ 348, 363, 439), Professor Goodhart (QQ 88, 89), French Representation (Q 494), CESR (Q 526), M de Larosière (Q 590) and Mr Sáinz de Vicuña (Q 228).

[32] *De Larosière report*, p. 45.

identified by the macro-prudential supervisor (Q 365). The BBA also recognised that a formalised reporting structure, from the Level 3 Committees to the macro-supervisory body and *vice versa*, must exist to allow effective risk mitigation (Q 126). M de Larosière highlighted the need for any macro-prudential supervisor to have close ties with global bodies, particularly the IMF (Q 552). This is a view reiterated by the Chancellor in his letter to the Czech Finance Minister.

120. Mr Sáinz de Vicuña, General Counsel of the ECB, argued that any macro-supervisory body has to be able to give direction on how to mitigate macro-prudential risks, to conduct stress tests and to give recommendations on changes needed to regulatory structures (Q 229). Mr Bini Smaghi said that the authority for macro-prudential supervision should be assigned with the necessary powers and instrument to act to prevent risk. This would to prevent a situation in which the relevant authorities failed to heed the risk warnings of a macro-prudential supervisor.

121. The BBA agreed there had to be mechanisms for action, warning that "it is very easy to set up very interesting, informative talking shops with all the right people which are not connected to what it is that is required in terms of the outcome" (Q 145).

122. The FSA agreed that macro-prudential supervision entails both risk analysis and the use of levers to offset emerging risks. But they argued that while the ESRC could play a role in analysis and identification of risk at a European level, offsetting these risks should take place at a national level, through "Bank of England / FSA decision-making and effected by the FSA" (p 208). The FSA also told us the role of the ESRC was not made sufficiently clear. The de Larosière report calls for "mandatory follow up"[33] on ESRC risk warnings and for appropriate action to be taken by relevant competent EU authorities. There is little detail provided on the instruments the ESRC would have at its disposal to address identified risks. In his evidence to us, M de Larosière explained that the system would be "relatively soft." Only when national supervisors consistently ignored ESRC recommendations would there be a facility to report the supervisor to the Council of Ministers (Q 552). It is uncertain what further action could then be taken.

123. The Bank of England told us how an EU-wide body could provide recommendations to national authorities to act upon risks, who would then have discretion to act as they saw fit (Q 589). They agreed that the creation of new institutional structures concerned with macro-prudential supervision had to be a priority. However, they warned that it would be "brave" to go ahead with institutional reform without providing greater clarity about the instruments these institutions would have available to deal with risks (Q 587).

124. The Minister argued that any macro-prudential supervisory body should be an "enabling and informing agency" that would independently analyse macro-economic risks, setting out the scope of responses and commenting on action taken to mitigate risks (QQ 612–3). It would therefore be in effect an advisory committee with no powers or instruments. When asked how the macro-supervisory body would advise governments they were following the wrong policy, Lord Myners argued that the independence and reputation of

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[33] *De Larosière report*, p. 46.

the group would play a strong part in leading to the mitigation of risk. He recognised that "there will no doubt be pressure to emasculate such a body from being too clear in its expressions of its conclusions" (Q 641). He argued that there was "merit" in the idea that any body should report to the ECOFIN council, as this forum would benefit from the advice of the agency (Q 614).

125. Mr Sáinz de Vicuña said the tasks of an ECB-led macro-prudential supervisory body should include assessment of monetary policy from a financial point of view (given that in the view of some loose monetary policy contributed to the crisis), assessment of global imbalances, financial shocks, new financial products and the impact of new accounting standards.[34] He added that the ECB should assess the impact of legislation on financial stability. He concluded that the ECB is independent so would avoid "an interested or biased assessment" (Q 229). However, providing instruments to the ECB to mitigate macro-economic risk would not be accepted by the UK Government as they are unwilling to cede the power from the FSA to the ECB to implement levers to mitigate risks to supra-national organisations, ECB or otherwise.

126. The recommendations of the de Larosière report for such a body have provided the impetus for the debate on what powers and reporting structures this body would have. As noted above, the institution of such a body could be possible under the EC Treaty, but providing it with powers and instruments will create difficulties.

127. **We conclude that a new body at the EU level to assess macro-prudential systemic risks, arising from financial institutions and markets, should be supported. There must be structures in place to strengthen the likelihood of macro-prudential risk warnings from any EU-wide body leading to mitigation of risk by national supervisory bodies.**

Structure and membership

128. The main arguments around the structure and membership of a macro-supervisory body for the single market in financial services revolve around the participation of supervisory authorities and the precise role the ECB, if any, should play. In analysing both of these questions we examine the advantages and disadvantages of each proposal for the structure and membership of such a body. As explained above, the de Larosière report recommends a European Systemic Risk Council (ESRC) whose membership could include all 27 Central Banks, to be run under the auspices of the ECB, without the automatic participation of national supervisory authorities. It recommends that the ECB should chair the proposed ESRC with the ESRC using the resources (staff and knowledge) of the ECB.

129. The BBA on the other hand recommended the establishment of a macro-prudential supervisor, membership of which would consist of central bankers, supervisors and finance ministers (Q 126).

130. The Government propose that national supervisory authorities should be present in any macro-prudential supervisory body where separate from NCBs and that the ECB should play no more than a participatory role. The

[34] de *Larosière report*, pp. 14–15.

Minister indicated that the Government supported a role for the FSA in a macro-prudential supervisory body, but explained that the membership of the body would be strongly influenced by the debate on its role, which has not yet been completed (Q 620). The Chancellor, in his letter to Miroslav Kalosek, the Czech Finance Minister during the Czech Presidency, argued that supervisory authorities must participate in any macro-prudential supervisory body.[35]

131. The FSA agreed that the EU's national supervisors should be represented in the ESRC or any other macro-prudential supervisory body where they are separate from the central bank (p 207–12). The Commission also recognised that a macro-prudential supervisor consisting only of central bankers would not provide a sufficient knowledge base. They said the membership they proposed would be broader than that recommended by de Larosière (Q 440).

132. M de Larosière told us the group "did not want to put 27 central bankers plus 27 supervisors together [in the ESRC]". He explained the ESRC should be "centred on the central bankers" because of their knowledge of macro-prudential issues (Q 552). The Committee of European Securities Regulators (CESR) argued that any macro-prudential supervisory body must be independent from politicians, with membership consisting only of NCBs and supervisors (QQ 527–528). We note the concerns of the FSA, BBA and the Commission that the membership of any EU macro-prudential supervision needs to be broader than that suggested by the de Larosière report.

133. Most witnesses agreed that the ECB should play a role in macro-prudential supervision, although there was much disagreement over its precise role. Mr Trichet, President of the ECB, argued that the ECB should play a strong role in EU macro-prudential supervision. He argued that macro-prudential supervision would be a "natural extension" of the ECB's mandate, given that the ECB already undertakes monitoring and analysis of financial stability. He went on to argue that central banks had the best access to supervisory information that is necessary for financial stability assessments. He concluded that the ECB "stands ready" to perform additional macro-prudential supervisory tasks.[36] Mr Green agreed, stating that the ECB could enforce the link between monetary policy and supervision through its Banking Supervision Committee, which brings together all the banking supervisors and all the central banks in the EU (QQ 74–75). This comparison does not take into account the multiple currencies used across the EU, with multiple central banks. Mr Sáinz de Vicuña explained that the ECB was staffed by 1,300 professionals, including an analytical division that would be able to undertake the work of the ESRC (Q 224).

134. We asked Mr Sáinz de Vicuña which specific macro-prudential supervisory tasks the ECB could be entrusted with. He said that to some extent the ECB is already performing a supervisory role through the publication of the financial stability report. However, he recognised the limitations of these reports, as they are "an ex-post analysis of banking trends and evolution and so on, so it not early warning, it does not provide for remedies" (Q 229).

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[35] Letter to the Minister of Finance of the Czech Republic, Miroslav Kalousek, from Rt Hon Alistair Darling MP, Chancellor of the Exchequer, 3 March 2009.

[36] Speech of M Trichet, 23 February 2009.

135. When the Minister first gave evidence to us, he argued that he was not convinced that the ECB had the necessary skills in place to become an overall supervisory body, but that "there is a very important role for the ECB to play in macro-prudential supervision … to look at the broader systemic risks" (Q 54). He continued that the ECB would need appropriate resources to perform such a role "as one of a number of agencies" (Q 58).

136. But when the Minister gave evidence to us the second time he clarified his position saying that he "would not for one minute be suggesting that the ECB do not have a lot of very competent analysts and economists" (Q 617). He explained that the Government's objection to the ECB playing a role in macro-prudential supervision was not one of competence but whether "the ECB could be the host of an agency which would be exercising some surveillance over the ECB" (Q 618). He argued that the Government still felt that the ECB had an important role to play, but it should only play a contributory rather than a leading role. He felt that any macro-prudential group should not "fall under the auspices of the ECB", as monitoring ECB actions would play an important part in the surveillance process, so the institution in charge of macro-prudential supervision should be independent of these actions (Q 611).

137. In his supplementary written evidence to us, the Minister told us that he believed that the ECB would "need to play a significant role" in a macro-prudential supervisory body, although only alongside other groups including the Bank of England and the FSA (p 186). While the Minister's view has somewhat differed in each set of evidence he provided to us, it is clear that the UK Government do not believe the ECB should be playing a leading role in any macro-prudential supervisory body.

138. The FSA argued that the ECB "will need to play a key role in the ESRC" and suggested that in the eurozone, the ECB could play a role in implementing offsetting actions to mitigate risks exposed by analysis of the macro-prudential situation (p 208). The French Representation agreed, observing that the ECB has a role to play in a revised supervisory framework, particularly in macro-prudential analysis. They explained that the ECB already exerts an informal role in this area as it provides analysis of financial markets in Europe that is shared with finance ministers and NCBs (Q 492).

139. Furthermore, the EBF told us that "for the macro-prudential side, getting the central banks involved makes a great deal of sense and is something we are promoting." They concluded that it would be appropriate to utilise the ESCB for this role as it includes non-eurozone countries (QQ 312–313). Similarly, Sharon Bowles MEP favoured a greater role for the ECB in supervision (Q 249).

140. A number of witnesses suggested that the General Council of the ESCB would be the appropriate forum for the ECB to participate in supervision, as it includes non-eurozone countries. Sharon Bowles, MEP, argued that "the network of ESCB which, of course, includes the ECB", should play a role as it covers all the EU Member States "you do not then run the risk that in some way the UK can be isolated out of it … I do not think anybody wants the UK not to be on it, but there are certainly moves in some quarters to try to make sure that there is a certain huddling around the eurozone to try and get institutions and regulation more centred on places other than London" (Q 250).

141. M de Larosière clarified that if the ESRC were to be established, "the ECB would not be the driver in the seat. The drivers in the seat would be the central bankers composing the General Council of the ESCB. That is a nuance … but it is a very important one and particularly important in this country" (Q 553). The role of the ECB would be one of providing resources and chairing, rather than making all decisions.

142. The Minister argued that the concept of the ECB being the macro-prudential supervisory body or that it should hold the chairmanship, does "raise issues" for those who are in the EU but not the eurozone (Q 634). He agreed that it should be the General Council that plays a role on macro-prudential supervision, but argued that the debate over membership should be wider than just over whether the General Council or Governing Council should play a role (p 185).

143. **We conclude that the Government differs from many witnesses, including M de Larosière, in its version of the role, powers and structure of a new EU-wide macro-prudential body. It appeared to us that the Government's thinking on those important issues was less than fully developed. We recommend the Government clarify its thinking and proposals speedily in order to contribute most effectively to the discussions on the development of a new macro-prudential supervisory structure.**

CHAPTER 6: THE REFORM OF MICRO-PRUDENTIAL SUPERVISION

144. The reform of micro-prudential supervisors within the EU has focused upon two issues: colleges of supervisors and a body acting in a role similar to the current Level 3 Committees—we discuss both of the issues in this chapter. We define micro-prudential supervision in paragraph 28.

Colleges of supervisors

145. The de Larosière report recommends establishing colleges of supervisors for every cross-border bank in the EU. Each college would consist of the national supervisor of each country in which the bank has a branch, as well as the representatives of the bank. As noted above, the revised CRD provides for this (see Chapter 3). Mr Sáinz de Vicuña told us there are currently 45 cross-border banks in the EU for which colleges would be instituted (Q 218). Colleges of supervisors have no powers of supervision. Rather, they provide a forum for discussion. This means that there are no Treaty issues with the institution of colleges of supervisors, informal or otherwise, neither does the problem of fiscal authority come into play.

146. The notion of colleges of supervisors predates the crisis. DG Markt explained that colleges bring together the supervisors for a banking group, allowing for information exchange and the development of common approaches. They also provide the opportunity for supervisors and the board to address issues and come to decisions on how supervision should be organised (QQ 358–60). The BBA noted the important role that colleges play in providing a consistent interpretation of rules applied to one bank across different Member States. This helps to tackle the inconsistencies and distortions in the single market created by a multitude of supervisors (p 40). The Commission explained that colleges provide the opportunity to develop approaches at the micro-economic level to tackle risks identified by the macro-prudential supervisor (QQ 358–9). Colleges act as vertical groups for enhancing cooperation in one specific institution. There are several proposals for a further horizontal group connecting the colleges, which we discuss below.

147. The EBF argued that colleges are the best way to get national supervisors to work together and develop a relationship of trust and confidence (Q 311). The Government agreed and recognised the good work already conducted by colleges in providing communication channels between supervisors (Q 59). The majority of witnesses shared the view that colleges play an important role in providing fora for exchanging information amongst supervisors and agreed that colleges should be expanded to all cross-border EU banks.[37]

148. Lord Myners' view was that colleges and in particular their role should not be formalised in legislation. The Government highlighted the importance of the flexibility of colleges to react to challenges posed by cross-border supervision and risks highlighted by a macro-supervisory body (Q 59). In his second appearance before us, the Minister explained there was considerable support for the concept of colleges amongst international institutions. Where

[37] See also evidence of the British Bankers' Association (p 40), Mr David Green (QQ 78–9) and Mr Sàinz de Vicuña (Q 217).

they had been established colleges were "working well" and where they were yet to be established, there were "clear plans" to do so (Q 633).

149. The ABI said that the Commission should provide guidance on the role of colleges, to promote consistency, although flexibility was required to take account of individual differences between institutions (p 192). They highlighted the guidance provided by the Level 3 Committees on the ten principles of colleges of supervisors as an example of how rules can exist and still provide flexibility. David Green, adviser on international affairs at the Financial Reporting Council, suggested that colleges should be formalised in a "softer sense" to ensure that the meetings happen, but without a rigid definition of their exact role (Q 79).

150. DG Markt described to us how the college of ABN Amro consisted of 76 people. They explained that meetings between the core supervisors (the host supervisor and those supervisors most important to the bank) are a necessity in order to prevent the large size of meetings leading to failure to get results. These smaller meetings between the core supervisors provide a more efficient forum for decision-making (QQ 359–60).

151. **Colleges of supervisors provide a useful forum of cooperation between supervisors and their existence is possible within the current Treaty. We welcome the move to expand colleges to all cross-border EU banks and agree provisions for meetings of core supervisors are necessary to maximise efficiency of supervisory cooperation. We recommend that while the Level 3 Committees exist (in their current form) they should provide guidance on the role of colleges. Such guidance should be provided on a flexible basis to ensure colleges are adaptable to differing and changing circumstances.** We discuss global colleges of supervisors in Chapter 8 on global supervisory arrangements since the essence of colleges is to bring supervisors from the relevant jurisdictions together, whether in the EU or in other parts of the world.

The Level 3 Committees and alternatives

152. The de Larosière report recommends upgrading the Level 3 Committees into Authorities in a two-stage process to provide better coordination of micro-prudential supervision across the EU. The first stage would give the Committees a greater role in organising colleges of supervisors and in reviewing the standards of national supervisors. The second stage would turn the Committees into three new Authorities, which would constitute the ESFS. The new Authorities would have binding powers over national supervisors on supervisory standards. This is questionable under the Treaty, since granting binding powers requires a Treaty amendment.

153. M de Larosière outlined to us the main roles and powers the upgraded Level 3 Authorities should hold: mediation powers between supervisors in colleges; information exchange between colleges; interpretation of rules; and licensing and supervision of EU-wide institutions, for example rating agencies (Q 561). The European Banking Federation (EBF) described to us how the upgraded Committees would play a horizontal linking role (across all institutions) above the vertical colleges (one per institution), ensuring convergence in the operation of colleges. They would play a second role in ensuring convergence of interpretation of regulations by national supervisors (Q 311). This would reduce the fragmentation and divergence of rules, described to us by CESR and Deutsche Bank, which has prevented the

emergence of a true EU single market in financial services (Q 525, p 205). The Minister agreed that any standard setter would have a remit to focus on removing exceptions to the rules, undertake peer-review and undertake mediation (Q 621).

154. The de Larosière report recommends that the upgraded Authorities should provide the link between macro and micro-prudential supervision in the EU. The BBA outlined how they envisaged the Committees informing the macro-prudential supervisor of issues encountered by national supervisors which would be incorporated into stability reports (Q 126). The Committees would also ensure that the risks identified by the macro-prudential supervisor be tackled through actions by the national supervisors.

155. Mr Bini Smaghi argued that the ECB could act as an organising body, helping use its experience to coordinate national micro-prudential supervisors and the colleges of supervisors. The ECB could act in a similar way to the proposed upgraded Level 3 Committees, providing a forum for information exchange and best practice between national supervisory authorities. Mr Rene Smits suggested that the ECB should be involved in both micro and macro-prudential supervision (p 232).

156. Many witnesses commented that the powers and resources of the Level 3 Committees are currently insufficient to take on an upgraded role. Mr Sáinz de Vicuña described the Committees as "soft bodies, governed by soft instruments", who are unable to enforce their decisions (Q 231). CESR agreed, telling us how they cannot ensure national supervisors implement their rulings on supervisory standards. They argued for binding, or at least "sticky", powers to enable the Level 3 Committees to enforce decisions. They also suggested an alternative system where the Commission would formally endorse rulings to give them legal force (QQ 532–538).

157. While there was some consensus amongst witnesses that the Level 3 Committees should be strengthened, there was disagreement over whether their decisions should be binding. The BBA agreed that the Level 3 Committees needed "teeth" to ensure that colleges came to an agreement where there is a dispute between national supervisors (Q 123). They told us a mediation role for the Committees would be a positive step, enabling effective cooperation on the supervision of cross-border banks. The BBA did not however agree that the Level 3 Committees should have binding powers of standard setting over national supervisors, limiting their mediation role to colleges of supervisors. The City of London Corporation (pp 199–200), Ms Bowles MEP (Q 245) and Mr Purvis MEP (Q 250) all agreed that the powers of Level 3 Committees needed to be strengthened to provide a mediation role among colleges and a unified interpretation of rules.

158. DG Markt argued that upgraded Level 3 Authorities should "put forward standards for supervision … be able to mediate technical disputes … [and] be able to interpret technical rules" (Q 371). They agreed with the recommendations of the de Larosière report that the new authorities should have binding powers of mediation between supervisors and on rulings over supervisory standards (QQ 370–5).

159. The FSA told us they thought that the de Larosière report goes "too far in proposing that the EU level body should be able to overrule national supervisors" (p 209). The alternative solution proposed by the Turner Review (see below) argued that such a body should be able only to issue

"non-binding guidance" and it would have no power over national supervisors to prescribe supervisory practice or modify individual regulatory decisions.

160. The Minister agreed and told us that he was "extremely sceptical" over the prospect of any EU body being able to exercise binding powers over national supervisors. He explained "the Government do not see how we could have EU bodies overruling national authorities where national taxpayers can be asked to fund firms that have failed" (Q 621). He explained that the Government would not support any powers for a supervisor at an EU level. He felt that if the group commands respect for independence and its competence then its recommendations and conclusions would be taken seriously without the need for binding powers (Q 626). However, the Government's view on the exact powers of their suggested single EU rule-making body remains to be determined, with the Minister unable to provide precise detail on their proposals in his second evidence session with us.

161. The Minister told us that the Government recognised there was a clear need to ensure cross-border financial institutions are effectively supervised, as set out in the de Larosière report. He made a clear distinction between regulation and supervision and indicated that a body along the lines of, but replacing, the Level 3 Committees could contribute to a harmonisation of rules (QQ 609–22). He referred to this body as a "standard setter" which "should become a regulatory authority and a forum for reviewing national supervisors, but importantly should not have supervisory powers over firms or over supervisors". The Minister gave the example of short-selling of shares, which was tackled by supervisors in different ways across the EU. He explained that an EU-wide body could have helped coordinate national policies to the benefit of cross-border financial institutions.

162. The Government's proposals differ from M de Larosière's report in that instead of having three Authorities there would be one independent EU rule-making body. The letter from the Chancellor to Miroslav Kalousek, Czech Minister of Finance, explains that the EU should "bring together the three committees of national supervisors into a single body."[38] This body would devise technical financial rules and provide a forum for dialogue and cooperation between national supervisory authorities. It would not only replace the Level 3 Committees but would also "replace the Commission's role in making technical rules under Level 2", to facilitate the removal of certain national discretions (Q 621). It would be accountable to the Council of Ministers, separate from the Commission and from the European Central Bank. Crucially, the letter explains "it would not supervise individual banks, insurers or investment firms", nor would it have any powers over national supervisors.

163. When asked to define the role, composition and accountability of this body, the Minister told us that this was still under discussion so not definitive answer was available, though he emphasised that the "Government support regulatory and not supervisory powers at the EU level" (Q 621). The Government felt that you would expect such a body to be accountable to the institutions of the European Union "in some form or another" (Q 630).

[38] Chancellor's letter, p. 3

164. The Government and the de Larosière report agree that there needs to be greater coordination of supervision through an EU body or bodies. **Level 3 Committees, or a similar coordinating and standard-setting body, are well-placed to lend consistency to the work of colleges of supervisors and currently play an effective role in the supervisory structure of the EU. We welcome the Committees playing a linking role between any macro-prudential supervisory structure, national supervisors and colleges of supervisors as envisaged in the first stage of the de Larosière proposals. This role can in principle be accomplished under the current Treaty.**

165. Witnesses commented on whether the second stage of the de Larosière proposals, the upgrading of the Level 3 Committees into Authorities, is possible under the current EC Treaty. Mr Sáinz de Vicuña argued, "to create a new agency with new powers is in my view across the line of what is permissible under the internal market's legal basis" (Q 218). The Minister referred to Article 308, the so-called flexibility clause (p 184). This has been cited as a possible legal base for a new EU supervisory structure. However, Jean-Victor Louis told us that the European Court of Justice prohibits the attribution of discretionary powers to an entity that is not provided for in the Treaty, the so-called Meroni doctrine (p 229). As with the macro-supervisory body, the problem lies with the powers that the proposed body could exercise. While the Level 3 Committees can be given greater scope to recommend action and provide a forum for information exchange, without a Treaty change there is little chance of the Level Three Committees, upgraded Authorities or any other body holding binding and discretionary regulatory or supervisory powers. DG Markt hoped that the recommendations of the de Larosière report could be implemented under the current Treaty, although it is not clear that this is the case (QQ 373–374).

166. Giving the Level 3 Committees binding powers of interpretation of rules over national authorities could also raise significant issues over the location of fiscal authority. By moving supervisory powers to an EU level, fiscal management and supervisory authority would lie in different places. This is unacceptable to the UK Government and others. **The treaty and fiscal issues create significant problems for the proposal to upgrade Level 3 Committees into Authorities. However, the de Larosière report made a powerful case for reform when it identified weaknesses and failures of micro-prudential supervision of financial services in the single market (see paragraphs 165–166 of the de Larosière report). We agree that a debate on the powers of any new body is crucial for the reform of the structure and process of EU supervision. There is a need to reconcile the limitations of the EC Treaty and the location of fiscal authority with the need to improve upon micro-prudential supervision of the single market. We recommend the Government set out in further detail its own proposals for achieving this.**

167. CESR highlighted the importance of Qualified Majority Voting (QMV) that allows decision-making to be made in the Level 3 Committees without a unanimous vote. This has been in force in the CESR since September 2008 (Q 535). The importance of QMV in enabling the Level 3 Committees to work effectively was also stressed by DG Markt (Q 372). This issue is strongly affected by whether the powers of upgraded Authorities were to be binding on national supervisors. If so, there would be a case that voting

should be by unanimity to ensure a national supervisor is not forced into an action it is not prepared to accept.

Funding

168. Mr Sáinz de Vicuña noted that the Level 3 Committees could not currently undertake the new roles proposed. He referred to CEIOPS, which is underfunded and only employs a small number of junior staff (Q 231). CESR recognised this as correct (Q 533). They explained that to carry out a greater role in mediation and interpretation of rules the Committees must have an increased budget. However, they argued if this was to come from the Commission, it must be without strings attached in order to maintain independence. If the bodies were to be funded by the Commission this may provide the Commission with the possibility of influencing the work of the Authorities.

169. The FSA distinguished between the resources required at the first and second stages (see Box 8) of the upgrading process described by the de Larosière report. The role of the Level 3 Committees in the first stage would remain "broadly the same" and would require little additional resources. However, the second stage of upgrading the Committees to authorities would provide the new authorities with substantially more power and would require a great deal of extra resources (p 208).

Structure

170. We heard much debate from witnesses over the form the upgraded Level 3 Committees should take, or whether they should be replaced outright. The de Larosière report recommends upgrading the Committees directly into three new Authorities, which would cover the three financial sectors of insurance, banking and the securities market. The Turner Review suggests an alternative single body with no separation of supervision for the different sectors of the financial industry (in line with the FSA model of a single supervisor).[39] The FSA explained their view that a "sectoral approach … does not adequately capture the interlinkages" of the financial services industry, meaning a single body is preferable to three (p 208). The Government's case for one independent rule-making body, replacing current Level 2 and Level 3 arrangements, provides a streamlined solution for micro-supervision, although the proposal lacks detail.

171. The Turner review recommends that the Level 3 Committees should be replaced with one powerful body.[40] This body would not differ greatly from the role of the current Level 3 Committees, in that it would have the same role of overseeing colleges as well as acting as a forum for information exchange, as suggested by M de Larosière. It would act as a coordinating body for national supervisors within the EU. It differs significantly, however, in that it would have no binding powers over national supervisors. Such a body is therefore likely to fit within the current Treaty. Whether the structure of the independent rule making body suggested by the Government—replacing the three level 3 Committees and the Commission's role in Level 2—fits within the current Treaty depends upon the scope of powers and instruments that such a body would have.

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[39] *The Turner Review*, p. 103.

[40] *The Turner Review*, p. 103.

172. The Bank of England noted that as long as clear distinctions are maintained between the sectors within a single supervisor, or strong links maintained between three separate supervisory bodies, the specific details should not affect the quality of supervision. They argued, "however you organise the deckchairs, one needs to recognise the connections and one needs to recognise the differences" (Q 600).

173. **We agree that the question of whether the new Authorities should remain as three separate institutions or merged into two or one institution is not the relevant issue. It will be crucial to establish close working procedures in all proposals, but still have an understanding of particularities of the three areas of banking, securities and insurance. The proposal of the UK Government should begin an important debate over what structure any coordinating supervisory body at EU level should take.**

The role of the ECB in micro-prudential supervision

174. It should be noted that few witnesses recommended that the ECB should take on a micro-prudential supervisory role. The de Larosière report was clear in its lack of support for any role for the ECB in micro-prudential supervision. In his oral evidence, M de Larosière explained that conferring micro-prudential duties to the ECB would be difficult, as several NCBs in the General Council of the ESCB have no competence in supervision. Loose monetary policy has contributed to the crisis and thus conflicts of interest could emerge if the ECB was to play a role in the financial sector supervision. He explained a second reason was the lack of accountability of the ECB if it was to ask for taxpayers' money to rescue financial institutions in the event of a crisis. M de Larosière also mentioned the risk of creating a fragmented system of supervision as insurance companies are excluded from the scope of a potential ECB action in financial supervision by Article 105.6 (Q 550). The Minister reiterated that the ECB should not have powers over national supervisors, and again noted that the de Larosière report does not recommend a role in this respect (p 184).

175. In addition, the French Representation questioned whether the ECB should play a role in the supervision of banks that are by their nature national. They told us that "the ECB and the national banks consider there is a case for supervision at the most appropriate level, so in general at the regional or national level and not at the federal or pan-European level for most companies" (Q 492).

176. Professor Goodhart expressed concerns over assigning the ECB a supervisory role of large cross-border banks on the basis that the ECB can provide liquidity but not capital. He explained that central banks are not in a position to recapitalise a bank and that provision of capital is a state function as fiscal power remains at the national level even in the eurozone (Q 88). In the event of a crisis of major EU cross-border banks, if the ECB was to conduct micro-prudential supervision, it would have to turn to national taxpayers to bail-out the various cross-border parts of these large banks. Micro-prudential supervision would take place at EU level whilst crisis management would continue to take place at national level.[41] "I have never understood how you can separate crisis management from supervision … it goes back to, in a

[41] See also Mr Sáinz de Vicuña (Q 224).

sense, no taxation or no payment for recapitalisation without representation" (QQ 87, 104). The Bank of England stressed the national dimension of the "capital of last resort", explaining that supervisory authority will always lie with those who have fiscal authority (Q 608).

177. Similarly, basing their argument on the incapacity to provide capital, DG Markt were sceptical over the possibility of the ECB playing a role in micro-prudential supervision (Q 410). The Minister raised doubts over whether central banks should be involved in financial regulation or supervision. He pointed out the Bank of England plays no role in these areas in the UK (Q 635). He again argued that no European body should have supervisory power over firms when crisis management remains at a national level (p 228).

Overall conclusion on the proposals for reform of EU supervision

178. The first stage of the de Larosière proposals on micro-prudential supervisors involves an increase in the coordinating role of the Level 3 Committees without their upgrading to Authorities and instituting colleges of supervisors. **The creation of colleges of supervisors and the increase of the role of the Level 3 Committees in providing a forum for cooperation and information sharing between national supervisors are to be welcomed. They offer pragmatic steps to greater coordination of supervision within the EU that do not require Treaty amendment or provide difficulties over the location of supervisory authority.**

179. The second stage of the report recommends a system of micro-prudential supervision for the EU that keeps day-to-day supervision at a Member State level whilst increasing the powers held by the upgraded Level 3 Authorities. CESR explained, "by strengthening the [Level 3] committees you would arrive at something which is, on the one hand, not a European single regulator, a body written in the Treaty, you would have a more flexible thing which is based on the coordinating role of the committees and on the existence of the national supervisors" (Q 537). DG Markt described the de Larosière report as aiming to introduce "capacity at European level to ensure consistency of practice, high level standards, dispute settlement mechanisms, obligations to take into account major risks that are identified through the macro-prudential function" (Q 366). The Government and the FSA have also suggested viable alternatives to the de Larosière report particularly regarding the organisation of micro-prudential supervision.

180. We recognise that there remain uncertainties and some lack of clarity with the stage 2 recommendations of the de Larosière report, and those of the FSA and the Government particularly concerning the lack of detail on the powers those authorities would hold. The possibility of the ECB playing an organising role received little support from our witnesses. All these proposals for supervisory reform provide a useful basis for further discussions on the structure of financial supervision within the EU, leading to a more unified and effective macro- and micro- supervisory system. We look forward to scrutinising detailed proposals from the Commission in this regard as well as receiving further detail on the Governments proposals.

181. The Commission communication, European financial supervision, published on 27 May 2009, outlined the Commission's plans for the implementation of

the de Larosière recommendations.[42] It described more detailed plans for the institution of both the ESRC and the ESFS.[43] The ESRC would identify risks and issue recommendations for action. Its roles would be to:

- Collect and analyse information for monitoring potential threats to financial stability;
- Identify risks to financial stability;
- Issue risk warnings;
- Give recommendations on mitigation of risks;
- Monitor follow-up to risk warnings; and
- Liaise with IMF, FSB and other third party counterparts.

182. The ESRC would have no legally binding powers, but would be expected to exert major influence through its quality of analysis and expertise. It would report to the European Parliament and Council. The membership of the ESRC would include:

- The President of the ECB as a chairperson;
- Vice-chairperson elected by ESRC members, who will be from a non-eurozone Member State;
- Governors of 27 national central banks;
- Vice-president of the ECB;
- Chairpersons of the three upgraded Level 3 Authorities;
- Member of the European Commission; and
- Representatives of national supervisory authorities accompanying the governors of national central banks.

183. The ESRC will be based on Article 95 of the Treaty with no legal personality. The Communication proposes the ESFS would constitute the three upgraded Level 3 Authorities. Day-to-day supervision would remain primarily at a national level. The roles of the ESFS would include:

- Producing binding technical standards, to be approved by the Commission;
- Producing interpretative guidelines;
- Ensuring coherent application of Community legislation;
- Facilitating agreement between national supervisors;
- Investigating national supervisors manifestly diverging from Community law;
- Ensuring a common supervisory culture;
- Holding supervisory powers over pan-European entities, for example credit rating agencies;

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42 http://ec.europa.eu/internal_market/consultations/2009/fin_ supervision_may_en.htm.

43 This document was published at the very end of deliberations on this report, and so no evidence was taken with this in mind specifically. We will scrutinise any proposals in detail in due course.

- Playing a co-ordinating role in a crisis, with some powers to adopt emergency decisions; and
- Collating information from national supervisors.

184. The Commission envisages that the ESFS would be set up under Article 95 of the EC Treaty. The Commission proposes to have this system up and running by 2010. Detailed legislative proposals are due by the end of 2009, which we will scrutinise in detail once published.

CHAPTER 7: HOME-HOST COUNTRY SUPERVISION

185. The financial crisis has brought the division of powers between the home and host supervisor of cross-border banks into question. In the UK, the collapse of the Icelandic banking system and the subsequent requisition of their funds by the Government using powers in the Anti-Terrorism, Crime and Security Act 2001 to reimburse British customers has shown that the current model needs to be re-examined.

BOX 9

Home-Host Divide

The home-host divide refers to the division of the responsibility for supervision of a cross-border entities or firms. Branches are able to operate in a host country under the authority of a licence from the home supervisor. Subsidiaries are distinct from branches in that they are supervised by the country in which they operate. For example, Icesave's home country was Iceland (which is not in the EU, but in the European Economic Area), where it was registered with the supervisory authority, while the UK was a host country to Icesave's branches.

Currently banks from the European Economic Area (which includes Iceland, Norway and Liechtenstein) can operate in the UK under license from their home supervisor. The branch remains under the supervision of the home country supervisor, rather than the FSA.

When Icesave collapsed Iceland's deposit guarantee scheme applied to British savers rather than the UK scheme. In response to rumours that the Icelandic government would not cover their obligations to UK investors, the Government froze Icesave's funds to reimburse UK consumers.

The home-host divide also becomes an issue when economic contraction causes the withdrawal of funds and of lending by host country branches as the parent bank concentrates its lending and resources in its home country. In many central and Eastern EU Member States foreign banks make up the majority of financial institutions and such a withdrawal would cause major problems for the economies of these countries. As the home country supervisor has control, there is little the governments of these Member States are able to do to prevent this problem.

186. The Government believes the financial crisis has shown the home-host model needs revision. The Minister explained that the experience of the Icelandic banks has shown there are "very serious shortcomings" in the way deposit protection across borders works (Q 61). He argued that there should be a greater role for supervisory peer review to ensure high standards of supervision and better information sharing between supervisors. Most importantly, he argued that there should be an examination of the powers of the host supervisor, with the possible transfer of some power from the home to the host supervisor (Q 60). He explained that the Government is concerned branches should pose no greater risk to host country taxpayers than a subsidiary.

187. The consumer group Which? agreed that there needed to be a shift in power to the host supervisor because of the risk posed to UK consumers if the host supervisor does not do its job properly (p 236). When the Minister gave evidence to the Committee the second time, he argued there was a need for greater supervisory peer review and that deposit guarantee schemes need to have cooperation agreements between home and host country schemes. He

also argued supervisory colleges could play a role in ensuring even supervisory standards (Q 647).

188. Professor Goodhart argued for a greater role for host country supervisors. He said that a cross-border bank is international in life, but national in death. The experience of Dexia, where the French and Belgian governments each saved their respective parts of the bank, showed that cross-border banks are saved on individual national bases rather than through collective cross-border action. He concluded that in the absence of a system of cross-border burden sharing for when a bank collapses, there must be a shift to greater host country control (QQ 102–104).

189. Financial analyst Graham Bishop agreed that newer Member States could be put in difficulties by the repatriation of lending and capital by a bank to its home Member State (QQ 192, 194). Whilst a bank is functioning correctly, home control simplifies its operation and increases its efficiency. However, when problems arise the home supervision model causes difficulties as host supervisors have no power to ensure that the customers of that bank in their own country do not lose out.

190. On the other hand, the EBF told us that giving greater power to the host supervisor would be an "unmitigated disaster" for the single market anchored as it was in the principles of home country supervision. The EBF were firmly in favour of keeping the current home country model of supervisory arrangements (Q 325). The BBA agreed, explaining, "anything which moves back from that will put a constraint on the single market because it will put a constraint on the cross-border flows of finance and capital" (Q 136). Mr Bishop also raised concerns that giving greater power to the host supervisor could cause a fragmentation of the single market (Q 192). The French government also felt there was no need to change the home-host country divide and argued that there was "no political support today within the EU" for a change to the current system (Q 496). Professor Goodhart acknowledged that greater host control would create "minor frictions" as cross-border banks would need to deal with more than one supervisory authority, but felt that the benefit of reducing risk made the loss of efficiency in the single market worthwhile (Q 106).

191. The BBA indicated to us that the rethinking of the home-host model was only just beginning. They said that colleges of supervisors could provide the opportunity for the home supervisor and the key host supervisors to work through issues and risks that come to the attention of a host supervisor of an institution. This allowed the host supervisors to play a role in the supervision of an institution with a presence in their Member State without a formal amendment of the model (Q 136).

192. The EBF argued that the colleges of supervisors and the Level 3 Committees (see Chapter 6) should be the fora in which plans for burden sharing in the event of a cross-border bank failure were constructed. Planning for the worst situation will help prevent the failure of a bank leading to national squabbles over who should take control of sections of a bank, as was seen with the collapses of both Dexia and Fortis (Q 321). Which? agreed that collaboration of national supervisors was essential to ensure host state supervisors are able to exert some influence over the supervision of a cross-border bank in their territory (p 236).

193. M de Larosière told us upgraded Level 3 Authorities would have a significant part to play in dispute resolution between home and host country supervisors. Giving the new authorities power to make binding decisions where there was a conflict would even the divide between the powers of home and host and ensure that the decision that was made was not only in the interests of the home country, as could be the case under the current model (Q 560). Giving Level 3 Authorities binding powers in home-host disputes would however raise the issues explained in Chapter 6 regarding the possibility of a single EU micro-prudential supervisor. The Government has indicated that decisions over micro-prudential supervision must remain with those who have fiscal authority, i.e. national authorities. Giving the upgraded Level 3 Authorities binding powers in home-host disputes would create problems over the separate location of fiscal and supervisory authority.

194. DG Markt argued that through an improved structure and links between macro and micro-prudential supervision, the home supervisor could address problems identified and flagged by host countries (Q 365). Mr Power, head of Commissioner McCreevy's Cabinet, confirmed that there had been discussions prior to the crisis concerning burden-sharing agreements, which had become "bogged down in details." He suggested that this would again be discussed with the intention of coming to some agreement on the issue (Q 444).

195. The case of the Icelandic banks and the banking system of central and Eastern Europe has shown that the current model of home country supervision has serious deficiencies where a bank faces a major crisis. We recognise the legitimate concerns of host Member States in respect of the presence of branches of cross-border banks in their countries. However, it is not clear that more power for the host supervisor is the right answer, as this has important implications for the single market. These issues need to be considered in further detail before a final decision is reached on the division of supervisory power and influence between home and host supervisors. **The call for increased powers for the host supervisor must not lead to a retreat from the single market and the emergence of protectionism. We recommend that there should be no shift of power to the host country supervisor. Colleges of supervisors must provide an effective forum in which legitimate concerns and responsibilities of home and host supervisors can be resolved within the clear framework of a single market in financial services. It is clear that there are difficulties in achieving this, and it remains a matter of real concern to us.**

CHAPTER 8: THE ROLE OF THE EU IN GLOBAL SUPERVISION AND REGULATION

Global supervisory colleges

196. In Chapter 6, we recommended the institution of colleges of supervisors for all cross-border EU financial institutions. Many witnesses commented to us that limiting colleges to EU supervisors only is artificial and they should include all relevant supervisors. Deutsche Bank told us that for banking groups that extend beyond EU borders, colleges should include all third country supervisors to ensure they fulfil their purpose of cooperation between all supervisory authorities (p 206). LIBA agreed, arguing that EU colleges must "dovetail" with global colleges, to prevent them becoming counter-productive (p 224). The Minister told us he supported global colleges (Q 56). The de Larosière report also supports the introduction of global colleges.[44]

197. All of the arguments for colleges of supervisors in the EU apply to colleges at global level. Without the inclusion of third country supervisors in the colleges of global financial institutions, these colleges cannot achieve their aim of cooperation of supervisors across borders to highlight any significant issues to the home supervisor and overcome risks identified at a macro-prudential level. Our concerns expressed in paragraph 194 apply equally at the global level.

The International Monetary Fund and the Financial Stability Forum

BOX 10

The functions of the International Monetary Fund and the Financial Stability Forum

The International Monetary Fund (IMF)

The IMF Articles of Agreement instituted the IMF in 1944. Its membership consists of 185 Member States. The IMF has gold holdings worth $83 billion (£50 billion) and its quotas for financial support to Members amount to $343 billion (£207 billion).

The goals of the IMF are to:

- Promote cooperation and collaboration on international monetary problems;
- Facilitate the expansion and balanced growth of international trade;
- Promote exchange rate stability;
- Assist in the establishment of multilateral system of payments; and
- Give confidence to members by making the Fund's resources available to them under adequate safeguards.

The IMF's functions are divided into three distinct areas:

- Surveillance: Oversee the economic and financial policies of the member

[44] *de Larosière report*, recommendation 26.

countries and the international monetary system;

- Financial Assistance: Provide support to Members experiencing temporary balance of payment problems; and
- Technical Assistance: Provide technical support and training on monetary issues to Member States upon request.

Financial Stability Forum (FSF)/Financial Stability Board (FSB)

The original FSF was instituted in 1999 by a decision of the G7. Its membership consists of representatives from the national authorities of Australia, Canada, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Singapore, Switzerland, the UK and the USA. Its membership included representatives from the Bank for International Settlements (BIS), the IMF, the Organisation for Economic Cooperation and Development (OECD), the World Bank, the ECB, the International Organisation of Securities Commissions (IOSCO), the Basel Committee and other standard setting bodies. In April 2009, the FSF was renamed the Financial Stability Board (FSB) and expanded to include all G20 Members as well as Spain and the European Commission.

The goals of the FSB are to:

- Promote international financial stability;
- Improve the functioning of financial markets; and
- Reduce the tendency for financial shocks to propagate from country to country, thus destabilizing the world economy.

The functions of the FSB include:

- Assessment of vulnerabilities affecting the international financial system through macro-prudential analysis;
- Identification and overseeing of action needed to address these vulnerabilities; and
- Improvement of co-ordination and information exchange among the various authorities responsible for financial stability.

198. There was a large degree of consensus amongst witnesses that the role of the IMF and the FSB should be expanded to develop a stable global economic system, in particular with regard to the need to develop effective early warning systems. The de Larosière Report argues "while many were observing the emergence of at least some developments and imbalances, only few rang alarm bells … The key failure in the past was not so much a lack of surveillance, although the messages from the surveillance could have been sharpened, but a lack of policy action."[45] DG Markt explained that "risks were not identified and action did not follow" (Q 359).

199. M de Larosière outlined to us the close relationship he believed the IMF should have with the proposed ESRC (see Box 8), with information exchanged between the two organisations (Q 552). The de Larosière report recommends that the FSB be tasked with promoting the convergence of international financial regulation and supports its enlargement. The report

[45] *de Larosière report*, p. 62

also recommends the linking between the FSB and IMF to provide an early warning system for financial risks.[46]

200. The BBA told us that the FSB and IMF have complementary roles to play in an early warning system, with the IMF reporting its findings on financial stability risks to the FSB. In its role in coordinating financial stability the FSB would then be well placed to identify "enhancements" to be made to regulatory frameworks to mitigate risks (p 37). The Commission agreed that the IMF should play a strong role in macro-prudential supervision, to be supplemented and supported by the FSB. In particular, these two bodies would need to work in conjunction to analyse global risks to financial systems (p 119).

201. The Government commented that the IMF "can bring a lot on the macro-economic side" (Q 57). In particular, they highlighted how the IMF has the capability to look at both macro-economic developments and financial market stability together on a global basis. The Government also agreed the IMF and FSB must work together to be effective. The Minister commented on the role of the FSB in financial market supervision and added that the Government would be supportive of expanded membership and powers to make it more effective (Q 57). He explained that the IMF and the new FSB would work together with increased resources and broader memberships to provide an early warning system, linking global monitoring bodies with those with the power to make policy decision (Q 644).

202. The French Representation agreed on this issue. They said the IMF and FSB should have a role "in analysing and giving solutions, proposals and recommendations, but without any binding powers" (Q 505). They went on to argue the FSB should engender greater links with the IMF and agreed with Lord Myners that FSB enlargement is an "important issue" (Q 508).

203. Witnesses agreed that the IMF and FSB had complementary roles to play in terms of avoiding systemic global risks to the financial system. **The IMF's surveillance role should be expanded, whilst a well-resourced FSF/FSB should continue to operate as an international standard setting body helping mitigate the risks outlined by the IMF.**

The role of the EU in the G20

BOX 11

G20 meeting 2 April 2009

The G20 meeting in London in April provided the platform for agreements on reform of the global system of financial supervision and regulation. The agreement included commitments to:

- Strengthen the IMF by tripling funding to €750 billion;
- Strengthen regulation to discourage excessive risk-taking and dampen economic cycles;
- Construct greater international supervisory links;
- Establish a Financial Stability Board (FSB) to replace FSF;
- Tackle tax havens; and
- Extend regulatory oversight of Credit Rating Agencies to ensure they meet international standards.

[46] *de Larosière report*, p. 65.

204. The G20 meetings of November 2008 and April 2009 have provided an outline of global reforms of supervision and regulation in response to the financial crisis. The Commission told us "you cannot deliver the global without the European" and argued that a strong EU consensus was needed at the G20 to lead global coordination on reform (QQ 406, 414). However, they warned that the G20 only provides the "titles" describing where reform should occur, rather than providing detailed proposals. Mr Bishop agreed that the G20 context was crucial in ensuring global coordination with the EU response (Q 176).

205. In Chapter 3, we urged the Commission and the Government to ensure all regulatory proposals are aligned with global proposals for action. We believe that the G20 is the right forum to achieve this global coordination, through an EU position on regulatory and supervisory reform. **We recommend the Government to work towards an EU statement at G20 meetings and the Commission to coordinate EU regulation with international responses. The EU can play a leading role in producing well-considered reforms that can provide a standard for global solutions, as long as it recognises that all regulation must be in coordination with global initiatives.**

CHAPTER 9: STATE AID IN THE FINANCIAL CRISIS

206. The state aid policy of the EC, founded in Articles 86–87 of the EC Treaty, is built upon the general premise that aid granted by a Member State that distorts competition or affects trade is incompatible with the common market, and is thus prohibited. The granting of illegal aid may confer an unfair economic advantage to the recipient, discriminating against those undertakings that do comply with the rules. State aid will only be compatible with the common market if it has been notified to and approved by the Commission.

207. The financial crisis has led some Member States to apply a series of emergency measures to prevent the collapse of their financial systems. Government intervention has included the nationalisation and recapitalisations of banks, deposit guarantees, guarantees, insurance or purchase of assets, extended liquidity facilities and other measures of financial support. DG Competition told us they have authorised €320 billion for recapitalisations, €2.1 trillion in guarantees and €400 billion for asset relief to help banks across Europe during the financial crisis as of the end of March 2009 (Q 564). Europe's industries have also received state aid support as a result of the crisis. The state aid scoreboard of spring 2009 gave the volume of guarantees at €2.285 trillion (see Appendix 11 for the full list of decisions).

208. The Commission has responded to the crisis by accelerating its decision-making process in assessing individual cases for the provision of state aid. Traditionally, the Commission has been reluctant to invoke Article 87(3)b that allows state aid "to remedy a serious disturbance in the economy of a Member State."[47] However, the Commission considered the financial crisis significant enough to justify state aid to credit institutions on the basis of this Article.

209. The EU Commission, in its approval of the rescue aid package for Northern Rock, concluded "that the emergency liquidity assistance provided by the Bank of England on 14th September 2007, which was secured by sufficient collateral and was interest-bearing, did not constitute state aid." They continued, "however, the guarantee on deposits granted by the Treasury on 17th September, as well as the measures granted on 9th October, which provided further liquidity and guarantees to Northern Rock and were secured by a Treasury indemnity, do constitute state aid."[48]

Commission guidelines

210. As a reaction to the growing number of government interventions designed to rescue financial institutions across the EU, the Commission published a Communication in October 2008 providing guidance on the application of state aid rules to ensure Member States apply measures that will not distort

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[47] In handling the very first cases at the beginning of the sub-prime crisis, the Commission used the legal framework of Article 87 (3) c EC Treaty and the Guidelines for Rescue and Restructuring aids. This was the case with Northern Rock.

[48] European Commission press release, *State aid: commission approves UK rescue aid package for Northern Rock*, 5 December 2007. On 17 March 2008, the UK authorities submitted to the Commission a restructuring plan which can be viewed online at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/08/489

competition.[49] The guidance deals with guarantee schemes, recapitalisation and the winding-up of financial institutions. It also requires that measures be time limited, granted in a non-discriminatory manner and receive contributions from the private sector where possible.

211. The Government, in their Explanatory Memorandum, expressed support for the Commission's guidelines and recognised that the state aid framework constituted a major instrument in minimising competitive distortions in the single market. They told us that their bank recapitalisation schemes were approved by the Commission on the basis of the principles outlined in the guidance.

212. To complement the broader guidance document, the Commission has issued an additional Communication in December 2008 providing guidance on bank recapitalisation to ensure Member States charge for state capital injections at market rates. This Guidance was prepared in consultation with Member States and in accordance with the recommendations of the ECB's Governing Council.[50] These guidelines distinguish between banks that are sound and receive temporary support to foster financial stability and those banks at risk of insolvency because of their mismanagement. Member States are required to provide an exit strategy for fundamentally sound banks and a restructuring plan for distressed banks, which could take the form of an orderly wind down.

213. The guidance also establishes the basis for appropriate safeguards to ensure that government funding will be used to sustain lending to the real economy and not to finance anti-competitive behaviour. The Communication states that safeguards will need to provide incentives for maintaining state intervention in the financial sector only until necessary. Banks at risk of insolvency will have to pay more for state support as well as complying with stricter safeguards. The Commission intends to review the recapitalisation and other measures implemented by Member States after six months.[51]

214. Witnesses were in general appreciative of the work undertaken by the European Commission. The EBF told us that the Commission had applied state aid rules and taken decisions on proposed state aid at very short notice, usually over the weekends (Q 352). They added that officials had been able to act in novel territory and complete assessments of individual state aid requests and proposals in a timely manner. The BBA highlighted the good work of DG Competition in striking the right balance between abuses of the bail-out measures and allowing for temporary measures to stabilise markets (p 40). Mr Bishop concluded that without the Commission "we would be in a protectionist mess already" (Q 160).

215. The Commission's prompt response to the crisis shows the importance of the application of state aid rules to avoid a complete disruption of the single market. Without the Commission's intervention, Member States could have entered a subsidies race across Europe and we are appreciative of the efforts made by DG Competition in co-ordinating national approaches to establish a level playing field across the EU. **We welcome the flexible, rapid and**

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49 OJ C270 (25 October 2008) p. 8

50 COM (2008) 8259

51 Further guidance by the Commission on the treatment of impaired assets in the EU banking sector was provided on 25 February 2009 (0322/09). Impaired assets correspond to categories of assets on which banks are likely to incur losses (e.g. sub-prime mortgage backed securities).

pragmatic approach demonstrated by the Commission in applying state aid rules.

State aid: a threat to the single market?

216. We were concerned whether state aid could distort the single market and nurture protectionism. Antony Whelan, Head of Cabinet for Neelie Kroes, Competition Commissioner, emphasised that the key starting point for DG Competition has been to determine an acceptable degree of distortion to achieve some other public good (Q 456). If a bank maintains a certain level of lending to the local economy it meant that aid was being deployed to serve a common good and not simply to preserve a "zombie bank which does not fulfil its social function" (Q 469). In addition, the Commission established a price corridor for capital injections by Member States, into which recapitalisations must fit to establish a level playing field across countries by setting values for the repayment of such injections (Q 461).

217. He described fears that banks would focus their activities in their home markets leading to a drying up of credit in other markets where subsidiaries and branches were established as a very "pessimistic prognosis". As an example, he explained that the Swedish government had encouraged their banks to maintain their normal levels of lending activity in the Baltic countries (QQ 455–457). DG Competition added that "one should be relatively heartened by the fact that all the official statements of the heads of state of European Union running up to the G20 and also in the European Council strongly back the need to fight protectionism and strongly back the need for the Commission to use its legal powers to step in" (Q 569).

218. There was a common perception among our witnesses that an appropriate exit strategy from reliance upon state aid is a fundamental requirement for all banks receiving state aid. Mr Sáinz de Vicuña argued that a major challenge for the single market is the development of exit policies from aid dependence (Q 228). The BBA told us that in the long term state guarantees should be dismantled carefully to ensure that financial institutions do not become dependent on state intervention and that normal market conditions resume (p 38).

219. We questioned DG Competition on the measures taken to ensure that government supported financial institutions would implement their restructuring plans or develop exit strategies. They emphasised that the presentation of a restructuring plan following any financial institution rescue is a legal requirement for Member States, and until they obtain authorisation for that plan, any aid which has been given is not approved (Q 565). Rescue aid must be temporary and reversible and must not be given for a duration exceeding six months, unless it is converted into restructuring aid through the submission of a restructuring plan (Q 564). They explained that the implementation of restructuring plans requires state aid to be necessary, proportionate and transitory (Q 568).

220. They went on to argue that restructuring plans are needed to ensure that banks return to "viability". This ensures the capacity of a bank to operate profitably on a sustainable basis without state aid in competitive market conditions. They explained that in some cases the viability of a bank could depend on some degree of retrenchment in certain areas to avoid risks and losses (Q 569).

221. Mr Lowe also said that the Commission was in the process of issuing further guidance on restructuring and return to viability (Q 573). We look forward to scrutinising the Commission's guidance on this issue in detail. Mr Whelan told us that "there are public policy problems if banks are too big to fail and nonetheless allowed to act as if they are not". He referred to three aspects of competition policy: state aid, anti-trust and merger control, and concluded that "the solution has to pass by the regulatory supervisory channel rather than the competition policy channel" (Q 484).

222. We are concerned that the provision of state aid seems likely to engender protectionism and lead to a distortion of the single market if exit strategies and restructuring plans are not appropriately designed and respected in the longer term. Exit strategies and restructuring plans should be established and respected in a way that will ensure the ability of banks to operate commercially. **We recommend the Commission to be vigilant in their assessment of restructuring plans in order to minimise the threat to the single market posed by state aid. The Commission must ensure that a viable time-based exit strategy is produced and followed for those institutions that receive state aid. State aid should be the exception and not the norm.**

CHAPTER 10: SUMMARY OF CONCLUSIONS

The future of financial regulation in the European Union

223. Although we welcome attempts to remove conflicts of interest and improve transparency of rating agencies, we question whether rapid action on the regulation of credit rating agencies was necessary. The degree of uncertainty over the effects of this Regulation cast doubt over whether careful consideration was given to these proposals in line with the Better Regulation principles. Concerns over the initial Commission draft of the Regulation limiting the scope for EU-registered institutions to trade in overseas financial instruments were also justified. The Regulation must avoid stifling European participation in the global trade in financial products (paragraph 56).

224. We agree that as far as possible the Commission should remove the reliance on ratings for regulatory purposes, in conjunction with similar changes to the Basel rules (paragraph 57).

225. The Commission's 5% retention requirement on complex securitised instruments is an effective compromise to limit the more excessive securitised transactions and we agree with it (paragraph 62).

226. We recommend that the Commission should work towards an overt counter-cyclical capital regime through further amendments to the Capital Requirements Directive. This should take place in conjunction with changes to the Basel rules to ensure international consistency (paragraph 72).

227. The introduction of a harmonised standard for deposit guarantee schemes provided a rapid solution to the dangerous distortions in the single market caused by different levels of deposit guarantees across the EU and the European Economic Area. Problems remain with the Directive and we ask the Commission to address these in its review of the Directive in December 2009 (paragraph 75).

228. We agree that there is a case for further harmonisation of rules on the winding up and reorganisation of credit institutions (paragraph 76).

229. It is imperative that the Commission properly consider the global effects of its proposals on alternative investment funds (paragraph 81).

230. The consensus of our witnesses was that the influence of alternative investment funds in the financial crisis was limited and we recommend that the Government should work to prevent proposals for EU regulations from stifling these markets. There is currently no pressing requirement for rapid EU legislative action in this area (paragraph 82).

231. Rapid action must not come at the expense of thorough consultation, impact assessment and risk analysis by the Commission in line with their own Better Regulation principles. Where necessary, the Commission should review the effectiveness of emergency legislation, to check that it is achieving its original objectives (paragraph 86).

232. We urge the Commission to ensure that proposals for new regulation of financial services in the EU are coordinated with global regulatory initiatives (paragraph 87).

Financial supervision in the EU: an introduction

233. We note that under the existing Treaty there is likely to be little opportunity to provide any EU supervisory body with the power to issue binding rulings or decisions on national supervisors. We also note the use of Article 105.6 requires unanimity and some Member States oppose its activation (paragraph 98).

234. The establishment of any EU body with supervisory authority and far-reaching micro-prudential supervisory roles and powers to mobilise fiscal resources in the event of crisis, or passing such powers to the European Central Bank, is difficult if not impossible whilst national governments bail-out financial institutions (paragraph 102).

235. While we recognise the benefits of further harmonisation, we believe that the establishment of a single supervisory authority can not happen unless there is a facility or burden-sharing arrangements on the bail-out of financial institutions at an EU level. In addition, the institution of any single EU supervisory authority would require substantial revision of the EC Treaty (paragraph 111).

The reform of macro-prudential supervision

236. We conclude that a new body at the EU level to assess macro-prudential systemic risks, arising from financial institutions and markets, should be supported. There must be structures in place to strengthen the likelihood of macro-prudential risk warnings from any EU-wide body leading to mitigation of risk by national supervisory bodies (paragraph 127).

237. We conclude that the Government differs from many witnesses, including M de Larosière, in its version of the role, powers and structure of a new EU-wide macro-prudential body. It appeared to us that the Government's thinking on those important issues was less than fully developed. We recommend the Government clarify its thinking and proposals speedily in order to contribute most effectively to the discussions on the development of a new macro-prudential supervisory structure (paragraph 143).

The reform of micro-prudential supervision

238. Colleges of supervisors provide a useful forum of cooperation between supervisors and their existence is possible within the current Treaty. We welcome the move to expand colleges to all cross-border EU banks and agree provisions for meetings of core supervisors are necessary to maximise efficiency of supervisory cooperation. We recommend that while the Level 3 Committees exist (in their current form) they should provide guidance on the role of colleges. Such guidance should be provided on a flexible basis to ensure colleges are adaptable to differing and changing circumstances (paragraph 151).

239. Level 3 Committees, or a similar coordinating and standard-setting body, are well-placed to lend consistency to the work of colleges of supervisors and currently play an effective role in the supervisory structure of the EU. We welcome the Committees playing a linking role between any macro-prudential supervisory structure, national supervisors and colleges of supervisors as envisaged in the first stage of the de Larosière proposals. This role can in principle be accomplished under the current Treaty (paragraph 164).

240. The treaty and fiscal issues create significant problems for the proposal to upgrade Level 3 Committees into Authorities. However, the de Larosière report made a powerful case for reform when it identified weaknesses and failures of micro-prudential supervision of financial services in the single market (see paragraphs 165–166 of the de Larosière report). We agree that a debate on the powers of any new body is crucial for the reform of the structure and process of EU supervision. There is a need to reconcile the limitations of the EC Treaty and the location of fiscal authority with the need to improve upon micro-prudential supervision of the single market. We recommend the Government set out in further detail its own proposals for achieving this (paragraph 166).

241. We agree that the question of whether the new Authorities should remain as three separate institutions or merged into two or one institution is not the relevant issue. It will be crucial to establish close working procedures in all proposals, but still have an understanding of particularities of the three areas of banking, securities and insurance. The proposal of the UK Government should begin an important debate over what structure any coordinating supervisory body at EU level should take (paragraph 173).

242. The creation of colleges of supervisors and the increase of the role of the Level 3 Committees in providing a forum for cooperation and information sharing between national supervisors are to be welcomed. They offer pragmatic steps to greater coordination of supervision within the EU that do not require Treaty amendment or provide difficulties over the location of supervisory authority (paragraph 178).

Home-host country supervision

243. The call for increased powers for the host supervisor must not lead to a retreat from the single market and the emergence of protectionism. We recommend that there should be no shift of power to the host country supervisor. Colleges of supervisors must provide an effective forum in which legitimate concerns and responsibilities of home and host supervisors can be resolved within the clear framework of a single market in financial services. It is clear that there are difficulties in achieving this, and it remains a matter of real concern to us (paragraph 195).

The role of the EU in global supervision and regulation

244. The IMF's surveillance role should be expanded, whilst a well-resourced FSF/FSB should continue to operate as an international standard setting body helping mitigate the risks outlined by the IMF (paragraph 203).

245. We recommend the Government to work towards an EU statement at G20 meetings and the Commission to coordinate EU regulation with international responses. The EU can play a leading role in producing well-considered reforms that can provide a standard for global solutions, as long as it recognises that all regulation must be in coordination with global initiatives (paragraph 205).

State aid in the financial crisis

246. We welcome the flexible, rapid and pragmatic approach demonstrated by the Commission in applying state aid rules (paragraph 215).

247. **We recommend the Commission to be vigilant in their assessment of restructuring plans in order to minimise the threat to the single market posed by state aid. The Commission must ensure that a viable time-based exit strategy is produced and followed for those institutions that receive state aid. State aid should be the exception and not the norm** (paragraph 222).

APPENDIX 1: EU SUB-COMMITTEE A (ECONOMIC AND FINANCIAL AFFAIRS, AND INTERNATIONAL TRADE)

Sub-Committee A

The members of the Sub-Committee which conducted this inquiry were:

Lord Browne of Madingley
Baroness Cohen of Pimlico (Chairman)
Lord Haskins
Baroness Hooper
Lord Jordan
Lord Moser
Baroness Northover
Lord Renton of Mount Harry
Lord Steinberg
Lord Trimble
Lord Watson of Richmond
Lord Woolmer of Leeds (Chairman for this inquiry)

Declaration of Interests

Lord Browne of Madingley
Member, Deutsche Bank Advisory Board for Climate Change
Member, Brevan Howard Advisory Board
Managing Partner and Managing Director, Riverstone LLP

Baroness Cohen of Pimlico
Non-executive Director of London Stock exchange plc.
Vice Chairman of Borsa Italiana SA
Non-executive Director of Management Consulting Group plc
Chairman, Trillium Partners Ltd

Lord Haskins
No relevant interests

Baroness Hooper
Chairman of the Advisory Committee of two Barclays European Infrastructure Funds

Lord Jordan
Chairman, Homes and Communities Agency Pension Scheme

Lord Moser
No relevant interests

Baroness Northover
No relevant interests

Lord Renton of Mount Harry
Ownership of agricultural land in Sussex with wife
Partnership with wife and son in Mount Harry Vines

Lord Steinberg
Life President of Genting Stanley Plc
Executive Chairman of E.G.M.I
Non-executive Director of Medgenics

Lord Trimble
No relevant interests

Lord Watson of Richmond

Chairman of CTN communications
Chairman of Havas Media
Chairman of The Cambridge Foundation
Director and Chairman of Stanleybet UK Investments

Lord Woolmer of Leeds

Member of the All Party Parliamentary Group on Wholesale Financial Markets

A full list of registered interests of Members of the House of Lords can be found at http://pubs1.tso.parliament.uk/pa/ld/ldreg/reg01.htm

APPENDIX 2: MINUTES OF PROCEEDINGS

2 June 2009

Present:

Lord Haskins
Lord Jordan
Lord Moser
Baroness Northover
Lord Renton of Mount Harry
Lord Steinberg
Lord Woolmer of Leeds (Chairman for inquiry into EU financial regulation)

The Committee considered the draft report.

Paragraphs 1 to 141 were agreed to, with amendments.

It was moved by Lord Renton of Mount Harry to replace paragraph 142 with:

> It is clear that the proposals for the role and structure of an EU macro-prudential supervisory body currently lack detail, which will emerge as discussion on these proposals progresses. **We recommend that there be a balance between including all relevant parties in such a body and the need to keep the membership relevant and efficient. The resources and position of the ECB offer a case for it having a leading role as the chair of this body.**

The Committee divided:

Contents	*Not-contents*
Lord Renton of Mount Harry	Baroness Northover
Lord Moser	Lord Woolmer of Leeds

In accordance with Standing Order 57(3) the amendments were disagreed to accordingly. [52]

Paragraphs 143–243 were agreed to, with amendments.

The following amendments were grouped with the amendment above:

Leave out paragraph 163 and replace 165 with the following:

> Witnesses have told us that the Level 3 Committees are "soft bodies, governed by soft powers." **We are not convinced that the Level 3 Committees are adequate bodies to either master or control supervisory co-ordination within the EU or help prevent a future financial crisis given the restrictions of the current EC Treaty and the reluctance of some Member States to give these new bodies any powers.**

Add paragraph below 176:

[52] Standing Order 57(3) states: "The Question … shall be decided in the negative unless there is a majority in its favour".

While we recognise that day-to-day supervision will remain the responsibility of national supervisory authorities, **the ECB should play a role in the coordination of national supervisors and should participate in colleges of supervisors. This will help provide an EU-wide consistency in supervisory standards that has yet to be achieved and will not be achieved under the de Larosière proposals.**

Replace paragraphs 177–179 with:

The de Larosière report does not recommend a completely satisfactory revision of EU financial supervisory architecture. While we agree that a macro-prudential supervisory body should be instituted at an EU level, we do not believe that the systems outlined for the mitigation of risks identified by this body or the upgrading of the Level 3 Committees address the problems shown by the financial crisis, in particular with regard to cross-border financial institutions.

The strengthening of the position of the ECB would be the most effective means of forestalling further a banking crisis for those Member States that have adopted the Euro. In the present crisis the ECB has followed the lead set by the Bank of England and the US Federal Reserve, reduced interest rates to a record low level and opted for quantitative easing. It proposes to make initial bond purchases worth around €60 billion to pump cash into the eurozone economy. It is lending unlimited sums to cash strapped eurozone banks and extending the duration of these loans to twelve months.

We recognise it is difficult for Member States not in the eurozone to accept an increase in the powers and responsibilities of the ECB. However, **at the present time and with the continuing financial crisis in Europe, the ECB must have a leading role in macro-prudential supervision and the co-ordination of national supervision.** Whether this would be possible under the current EC Treaty is a matter for continuing debate.

APPENDIX 3: LIST OF WITNESSES

The following witnesses gave evidence. Those marked ** gave both oral and written evidence; those marked * gave oral evidence only

	Association of British Insurers (ABI)
	Association of Chartered Certified Accountants (ACCA)
*	Bank of England
**	Mr Graham Bishop
*	Ms Sharon Bowles MEP, European Parliament
**	British Bankers' Association (BBA)
*	Mr Lee C. Buchheit, Cleary Gottlieb Steen & Hamilton LLP
	City of London Corporation
*	Committee of European Securities Regulators (CESR)
	Confederation of British Industry (CBI)
	Council of Mortgage Lenders (CML)
	Deutsche Bank
*	European Banking Federation
**	European Commission
*	Financial Reporting Council
	Financial Services Authority (FSA)
	Fitch Ratings
*	French Permanent Representation to the European Union
*	Professor Charles Goodhart, London School of Economics
	Professor Christos Gortsos, University of Athens
	Mr Will Hopper, former Member of the European Parliament
	Banking Commission, International Chamber of Commerce
*	M Jacques de Larosière, Chairman of the High-Level Group on Financial Supervision in the EU
	London Investment Banking Association (LIBA)
	Professor Jean-Victor Louis, Brussels University
	Moody's Investor Services
**	Lord Myners, Financial Services Secretary to HM Treasury, and Mr Clive Maxwell, Director of Financial Stability, HM Treasury
*	Mr John Purvis MEP, European Parliament
*	Mr Marke Raines, Taylor Wessing LLP
*	Mr Antonio Sáinz de Vicuña, European Central Bank
	Professor René Smits, University of Amsterdam
	Standard and Poor's
	Which?
	Wholesale Markets Brokers' Association and the London Energy Brokers' Association

APPENDIX 4: CALL FOR EVIDENCE

Changes to the regulation and supervision of financial markets, nationally and on a cross-border basis, have been proposed in response to the financial crisis. The European Commission has published three key proposals, updating capital requirements and deposit guarantee schemes and introducing rules on rating agencies. Sub-Committee A, under the Chairmanship of Baroness Cohen of Pimlico, has decided to commence an inquiry examining the role of European Union regulation in the financial sector, the effectiveness of these proposals and further responses at a European level.

The inquiry will seek to answer the following questions:

Current Commission Proposals: Will enforcing a prudential financial regime be an effective method of preventing a repeat of the financial turmoil? Will Commission proposals amending the Capital Requirements Directive and introducing rules on credit rating agencies prevent a future crisis? What dangers are presented by these amendments? Are changes needed to International Accounting Standards? How effective are current proposals to protect bank deposits?

Further Legislative Opportunities: How can we achieve a coherent set of rules on last resort assistance, deposit protection and bank insolvency proceedings? Should a revised directive on the reorganization and winding up of credit institutions include a system of prompt corrective action, with intervention triggers tied to a leverage or liquidity ratio? Do rules on state aid to the banking sector need to be clarified? What other rules are needed to ensure financial stability in Europe?

EU Supervisory Reform: Do we need a European System of Financial Supervisors or a central European authority to supervise pan-European financial institutions? What type of fiscal resources should such an authority have access to? How effective would group supervision be in creating a unified system of supervision across the single market? Would group supervision assert the primacy of large supervisors to the detriment of the supervising bodies of smaller Member States? Do we need a rethink of the home-host country divide with regard to supervision and crisis management in the EU?

Working Practices: Do EU institutions need to amend their working practices on financial services? How effective are current working practises in providing a rapid response to a crisis?

Global Supervisory Reform: Does the turmoil signal the need for a global supervisory system? If so, what role should the EU and existing financial institutions, such as the IMF, take in this system? Is a new Bretton Woods agreement necessary?

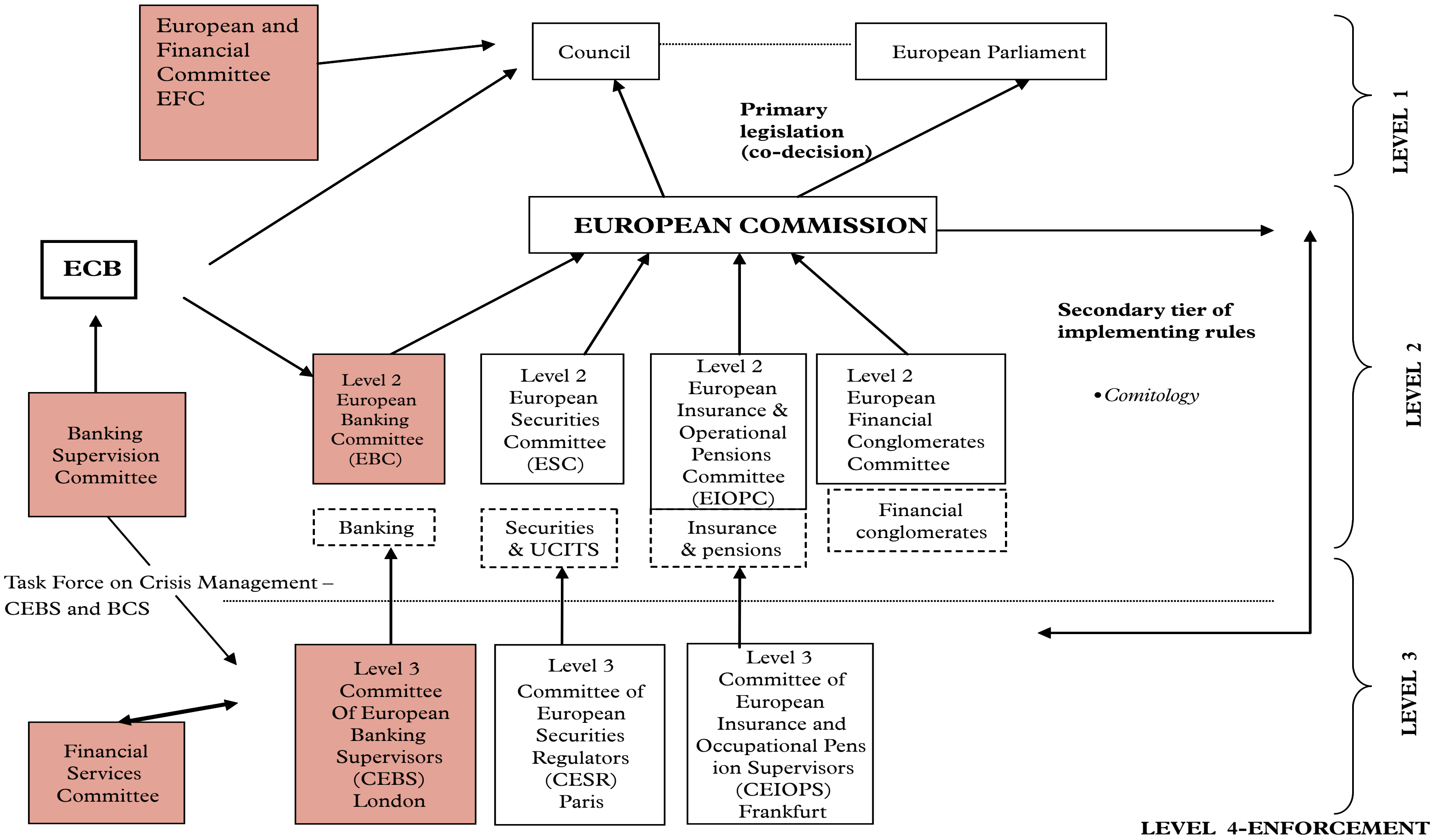
The aim of this inquiry is to provide an opinion on the effectiveness of the Commission responses, inform the debate surrounding these issues within EU institutions and examine possible opportunities for further reform. The inquiry does not intend to examine whether the United Kingdom should join the eurozone, nor the effectiveness of the national Government response to the crisis.

APPENDIX 5: GLOSSARY

ABI	Association of British Insurers
Asset Backed Securities (ABS)	Assets (such as mortgage loans) packaged together and sold on to investors in a process known as securitisation (see Annex 8)
BBA	British Bankers' Association
BIS	Bank for International Settlements
CDS	Credit Default Swap
CEBS	Committee of European Banking Supervisors
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
CESR	Committee of European Securities Regulators
CLC	City of London Corporation
CML	Council of Mortgage Lenders
CRA	Credit Rating Agency
CRD	Capital Requirements Directive
DG Competition	Directorate-General for Competition, European Commission
DG Markt	Directorate-General Internal Market and Services, European Commission
EBF	European Banking Federation
EC	European Community
ECB	European Central Bank
ECOFIN	Economic and Financial Affairs Council
EEA	European Economic Area
EFC	Economic and Financial Committee
Equity	Total assets minus total liabilities. Equivalent to economic capital; net worth
ESFS	European System of Financial Supervision
ESRC	European Systematic Risk Council
EU	European Union
FSA	Financial Services Authority
FSB	Financial Stability Board
FSC	Financial Services Committee
FSF	Financial Stability Forum
G20	Group of Twenty (G-20) Finance Ministers and Central Bank Governors
Home country	The country of residence of the head or parent office of the bank
Home supervisor	The supervisor in a bank's home country
Host country	The country where a bank's foreign affiliate is located
Host supervisor	The supervisor in a bank's host country
IMF	International Monetary Fund
Insolvency	The state of being unable to meet debt obligations. There are two tests of insolvency in commercial bankruptcy law: failure to pay obligations as they fall due (equitable insolvency) and

	the condition when liabilities exceed assets (balance sheet insolvency)
IOSCO	International Organisation of Securities Commissions
Lender of last resort	Central bank lending to illiquid but solvent institutions in the last instance, i.e., when other sources of funding are not available
Leverage ratio	Capital to total assets ratio
LIBA	London Investment Banking Association
Liquidity liquid asset	The ability to turn an asset readily into cash. Cash is the most
LOLR	Lender of Last Resort
Macro-prudential supervision	The analysis of wide economic trends and imbalances and the detection of risks that these trends may pose to the financial system
MEP	Member of the European Parliament
Micro-prudential supervision	The supervision of individual financial institutions
Moral Hazard	The incentives for those involved in financial institutions benefiting from actual or expected government protection or insurance to behave less carefully (e.g., undertaking risky investments) just because of the existence of the protection or insurance
NCBs	National Central Banks
OECD	Organisation for Economic Cooperation and Development
Originate-to-distribute	The process of a financial institution issuing loans and then distributing the underlying risk by selling the securitised assets (asset backed securities) for a fee to investors
QMV	Qualified Majority Voting
Risk weighted assets	For the purposes of calculating bank capital, banks assets are given a credit risk weighting of 0%, 10%, 20%, 50% or 100%, where riskier assets carry a higher risk, e.g. gilt is rated 0%, mortgages 50 % and loans to companies 100%. The total risk weighted asset value is calculated using these risk weightings. The minimum level of capital is 8% of the total risk-weighted asset value
RBS	Royal Bank of Scotland
Securitisation	The transformation of a loan into a security
Subprime mortgage lending	Lending to borrowers who do not meet prime underwriting expectations and are therefore less likely to repay a loan
Tier 1 Capital	Equity capital (core capital); the majority of Tier 1 capital is made of ordinary shares, preference shares and retained earnings
Tier 2 Capital	Secondary bank capital, formed mainly of undisclosed reserves, general loss reserves and subordinated debt. Together with tier 1 capital it should be at least 8% of the bank's risk adjusted assets
UCTIS	Units of Collective Investment in Transferable Securities

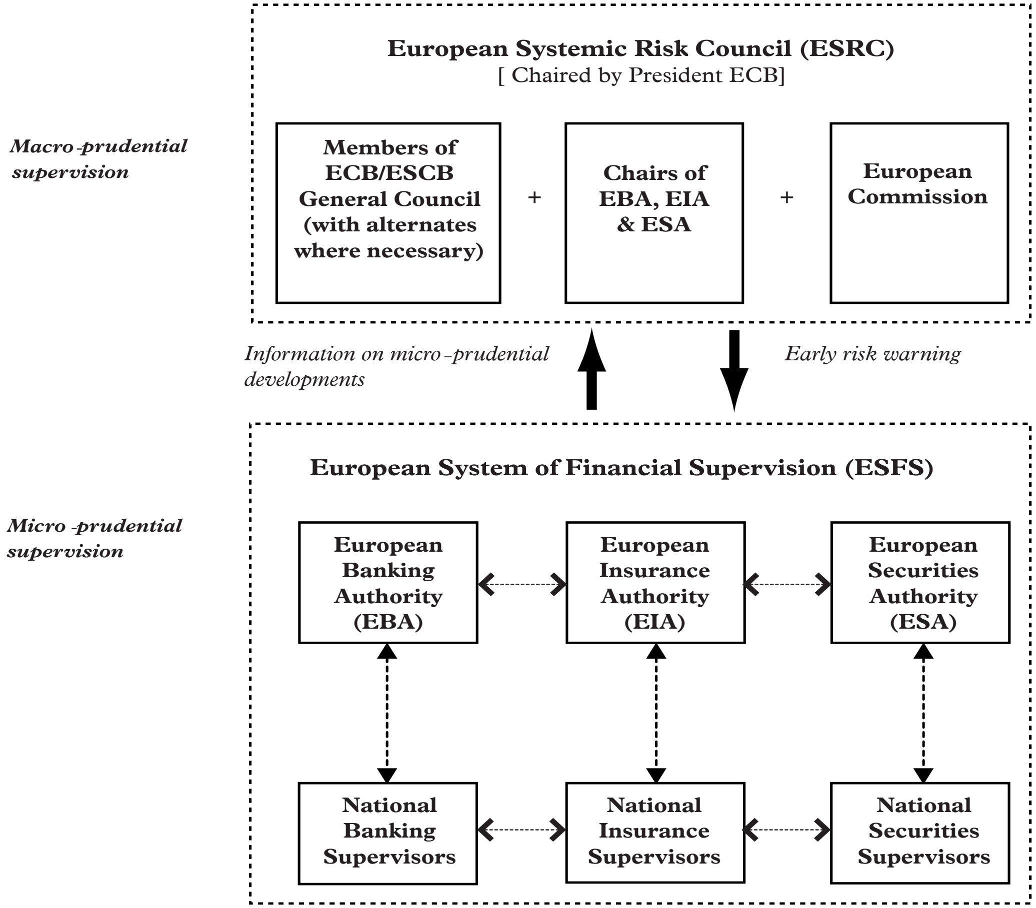
APPENDIX 6: EUROPEAN FINANCIAL ARCHITECTURE



Source: Professor Rosa Lastra, Queen Mary University of London, April 2009. Current design (Committees related to banking shaded in pink)

APPENDIX 7: SUPERVISORY ARCHITECTURE IN THE EU AS RECOMMENDED BY THE DE LAROSIÈRE GROUP

A new European Framework for Safeguarding Financial Stability



Main tasks of the European Systemic Risk Council: *decide on macro-prudential policy, provide early risk warning to EU supervisors, compare observations on macro-economic and prudential developments and give direction on these issues*

Main tasks of the Authorities: *in addition to the competences of the existing level 3 committees, the Authorities would have the following key-competences: (i) legally binding mediation between national supervisors, (ii) adoption of binding supervisory standards, (iii) adoption of binding technical decisions applicable to individual institutions, (iv) oversight and coordination of colleges of supervisors, (v) licensing and supervision of specific EU-wide institutions (e.g., Credit Rating Agencies and post-trading infrastructures), (vi) binding cooperation with the ESRC to ensure adequate macro-prudential supervision, and (vii) strong coordinating role in crisis situations.*

Main tasks of national supervisors: *continue to be fully responsible for day-to-day supervision of firms*

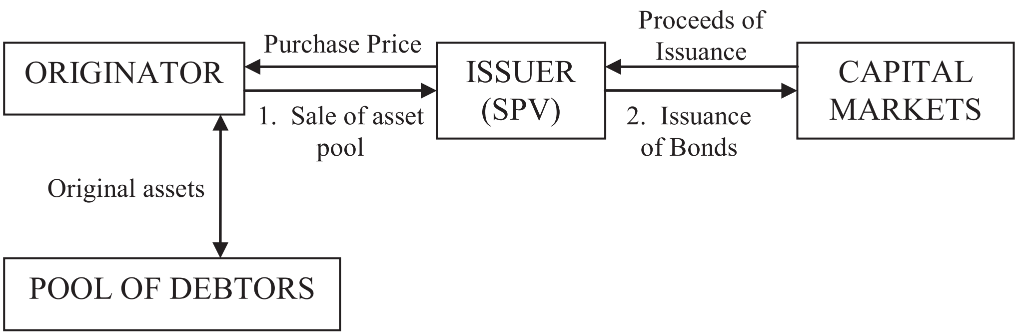
Source: The High-Level Group on Financial Supervision in the EU, chaired by Jacques de Larosière, 25 February 2009, page 57.

APPENDIX 8: SECURITISATION

Securitisation is in essence the issuance of bonds backed by assets, or asset-backed securities (ABS). The basic purpose of securitisation is to provide capital in the short-term from the issuance of bonds based on long-term investments.

Structure

The Bank for International Settlements describes the most basic form of securitisation as "the pooling of a group of homogenous loans, the sale of these assets to a special purpose company or trust [SPV], and the issue by that entity of marketable securities against the pooled assets."[53] This structure is shown in the following diagram:



Process:

- Originator[54] sells asset pool to Special Purpose Vehicle (SPV).
- SPV funds purchase by issuing bonds.
- Issuer charges its interest in these assets as security for its obligations under the bonds.
- Originator acts as collection agent for the issuer.

Regulation:

Under Basel I banking rules securitisation received very favourable treatment, with minimal regulation. Basel II has implemented improved regulatory measures, although securitised assets can still be regarding as receiving inadequate regulatory treatment.

53 BIS, Asset Transfers and Securitisation (September 1992), http://www.bis.org/publ/bcbs10a.htm.

54 An originator can be any entity that owns assets (e.g. a bank selling on its mortgage portfolio).

APPENDIX 9: LEVEL 3 COMMITTEES

Committee	Role	Structure
Committee of European Banking Supervisors (CEBS) London	Advise the Commission in particular as regards the preparation of draft implementing measures in the field of banking activities. Contribute to the consistent implementation of Community Directives and to the convergence of Member States' supervisory practices throughout the Community. Enhance supervisory co-operation, including the exchange of information.	**Members:** Each Member State of the European Union designates a senior representative from the national competent supervisory authority in the banking field to participate in the meetings of the Committee (the voting member), and a senior representative of the national central bank when the national central bank is not the competent authority (the non-voting member). **Observers:** Countries of the European Economic Area, which are not members of the European Union, designate senior representatives to participate in the meetings as observers. **Bureau:** Prepares and discusses matters of strategic importance. It gives advice and assists the Chair and the Committee in budgetary and administration matters. **Consultative Panel:** CEBS has established a Consultative Panel of representatives of market participants and end-users to assist in the performance of CEBS functions and to ensure that the consultation process functions effectively. The Panel acts also as a "Sounding Board" for CEBS in strategic issues.
Committee of European Securities Regulators (CESR) Paris	Improve co-ordination among securities regulators: developing effective operational network mechanisms to enhance day to day consistent supervision and enforcement of the single market for financial services. Act as an advisory group to assist the EU Commission: in particular in its preparation of	**Members:** Each Member State of the European Union designates a senior representative from the competent authorities in the securities field to participate in the meetings of the Committee. **Observers:** The competent authorities in the securities field from countries of the European Economic Area, who are not members of the European Union, designate a senior representative to participate fully in the meetings without, however, participating in decision making. **Committee:** The Committee meets at least four times a year, with expert and operational working groups of national experts meeting on a regular basis and working at a distance as necessary. CESR works with the support of a secretariat based in Paris conducted by a Secretary General.

	draft implementing measures of EU framework directives in the field of securities. Work to ensure more consistent and timely day-to-day implementation of community legislation in the Member States.	**Expert Groups:** The expert groups work on the basis of a clear mandate either supplied by the European Commission (commonly referred to as level 2 of the Lamfalussy process), or by CESR (level 3). Expert groups are chaired by the head of one of the CESR members. CESR Members send national experts to participate in each expert group. **Operational Groups:** The operational groups strengthen the network of regulators in a given area as agreed in a tailored set of terms of reference. An operational group is chaired by a senior representative of a CESR member. Much of the work of an operational group is therefore focused on producing work of a level 3 nature according to the Lamfalussy process. **Market Participants Consultative Panel:** Established to advice CESR on working priorities and assess developments in the single market in the field of Financial Services.
Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) Frankfurt	Provide advice to the European Commission on drafting of implementation measures for framework directives and regulations on insurance and occupational pensions (“Level 2 activities”). Issue supervisory standards, recommendations and guidelines to enhance convergent and effective application of the regulations and to facilitate cooperation between national supervisors (“Level 3 activities”). The role also involves the participation of CEIOPS in	**Members and Observers:** Members may be designated by (a) every national supervisory authority for insurance companies and/or occupational pension funds institutions of a Member State, or (b) a Member State, if the national supervisory authority is not organised as a legal entity, represented by the supervisory authority (or supervisory authorities insofar as the Member State has two or more separate supervisory bodies) for insurance and occupational pension funds. **Meeting:** CEIOPS’s main body which includes all CEIOPS’s Members and Observers, responsible for all tasks regarding CEIOPS, (which are not otherwise defined to be within the competence of the Managing Board). **Managing Board:** Responsible for progressing CEIOPS’s business by implementing the resolutions passed by the Members’ Meetings and fulfilling the administrative tasks of the Committee. **Secretariat:** Assists the Managing Board and the Committees in carrying out their tasks. Also acts as coordinator in the dialogue with market participants and maintains relations with the European Commission and other third parties. **Consultative Panel:** Composed of a limited number of high level experts committed to the objectives of the European Union, monitors CEIOPS’s work programme and results.

	the work of different European institutions with responsibilities for issues relating to insurance and occupational pensions, in particular the Economic and Financial Committee (EFC) and the Financial Services Committee (FSC).	It also acts as a "sounding board" to support CEIOPS's policy-making process. **Working Groups:** Consisting of experts from the national supervisory authorities, and to which other stakeholders contribute from their expertise and insight to prepare its statements and documents and carry out the technical work of the Association. **Review Panel:** Mandated to help monitoring the implementation of supervisory provisions set out in Community Legislation and in CEIOPS's measures, as well as to monitor convergence in supervisory practices.

APPENDIX 10: ARTICLE 105 OF THE EC TREATY

Article 105

The primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2. The ESCB shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 3a.

The basic tasks to be carried out through the ESCB shall be:

- to define and implement the monetary policy of the Community;
- to conduct foreign exchange operations consistent with the provisions of Article 109;
- to hold and manage the official foreign reserves of the Member States;
- to promote the smooth operation of payment systems.

The third indent of paragraph 2 shall be without prejudice to the holding and management by the governments of Member States of foreign exchange working balances.

The ECB shall be consulted:

- on any proposed Community act in its fields of competence;
- by national authorities regarding any draft legislative provision in its fields of competence, but within the limits and under the conditions set out by the Council in accordance with the procedure laid down in Article 106(6).

The ECB may submit opinions to the appropriate Community institutions or bodies or to national authorities on matters within its fields of competence.

The ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system.

The Council may, acting unanimously on a proposal from the Commission and after consulting the ECB and after receiving the assent of the European Parliament, confer upon the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings.

Article 105a

The ECB shall have the exclusive right to authorize the issue of bank notes within the Community. The ECB and the national central banks may issue such notes. The bank notes issued by the ECB and the national central banks shall be the only such notes to have the status of legal tender within the Community.

Member States may issue coins subject to approval by the ECB of the volume of the issue. The Council may, acting in accordance with the procedure referred to in Article 189c and after consulting the ECB, adopt measures to harmonize the denominations and technical specifications of all coins intended for circulation to the extent necessary to permit their smooth circulation within the Community.

APPENDIX 11: STATE AID SCOREBOARD

Cases of State aid for the financial sector—situation as of 17 March

Decisions adopted by the Commission in 2008/2009

	Member State	**Type of measure/beneficiary**	**Type of Decision**	**Date of adoption**
1	Austria	Aid scheme for the Austrian financial sector (guarantees, recapitalisation & other)	Decision not to raise objections	09 December 2008
2	Belgium/ France/ Luxembourg	Guarantee on liabilities of Dexia	Decision not to raise objections	19 November 2008
3	Belgium/ France/ Luxembourg	Guarantee in favour of Dexia on certain assets in FSA	Decision not to raise objections	13 March 2009
4	Belgium/ Luxembourg/ Netherlands	Measures in favour of Fortis	Decision not to raise objections	19 November 2008
5	Belgium/ Luxembourg/ Netherlands	Restructuring aid to Fortis Bank and Fortis Bank Luxembourg	Decision not to raise objections	03 December 2008
6	Belgium	Recapitalisation measure in favour of KBC	Decision not to raise objections	18 December 2008
7	Belgium	Capital injection for Ethias group	Decision not to raise objections	12 February 2009
8	Denmark	Rescue aid to Roskilde Bank	Decision not to raise objections)	31 July 2008
9	Denmark	Liquidation aid Roskilde Bank	Decision not to raise objections	5 November 2008
10	Denmark	Guarantee scheme for banks in Denmark	Decision not to raise objections	10 October 2008
11	Denmark	Recapitalisation scheme and amendment of the guarantee scheme	Decision not to raise objectives	3 February 2009
12	Finland	Finnish guarantee scheme	Decision not to raise objections	14 November 2008
13	Finland	Guarantee for Kaupthing Bank Finland	Decision not to raise objections	21 January 2008
14	France	Financial support measures to the banking industry in France (Refinancing)	Decision not to raise objections	30 October 2008
15	France	Financial support measures to the banking industry in France (Recapitalisation) Amendment to the Decision	Decision not to raise objections	08 December 2008 28 January 2009

16	Germany	Restructuring aid to Sachsen LB	Conditional decision (after formal investigation procedure	4 June 2008
17	Germany	Restructuring aid to IKB	Conditional decision (after formal investigation procedure)	21 October 2008
18	Germany	Rescue aid to Hypo Real Estate Holding	Decision not to raise objections	2 October 2008
19	Germany	Aid scheme for financial institutions in Germany (guarantees, recapitalisations & other) Amendment to the Decision	Decision not to raise objections	27 October 2008 12 December 2008
20	Germany	Guarantee and recapitalisation for Bayern LB	Decision not to raise objections	18 December 2008
21	Germany	Guarantee for NordLB	Decision not to raise objections	22 December 2008
22	Germany	Guarantee for IKB	Decision not to raise objections	22 December 2008
23	Germany	Guarantee for SdB—Sicherungseinrichtungsgesells chaft deutscher Banken mbH	Decision not to raise objections	22 January 2009
24	Greece	Aid scheme to the banking industry in Greece (guarantees, recapitalisation & other)	Decision not to raise objections	19 November 2008
25	Hungary	Support package for Hungarian financial institutions in form of recapitalisation and guarantee scheme	Decision not to raise objections	12 February 2009
26	Ireland	Guarantee scheme for banks in Ireland	Decision not to raise objections	13 October 2008
27	Ireland	Recapitalisation of Anglo Irish Bank	Decision not to raise objections	14 January 2009
28	Italy	Guarantee scheme for Italian banks	Decision not to raise objections	14 November 2008
29	Italy	Recapitalisation scheme Amendment to the Decision	Decision not to raise objections	23 December 2008 20 February 2009
30	Latvia	Public support measures to Parex Banka	Decision not to raise objections	24 November 2008

31	Latvia	Guarantee scheme for banks	Decision not to raise objections	22 December 2008
32	Netherlands	Guarantee scheme for Dutch financial institutions	Decision not to raise objections	30 October 2008
33	Netherlands	Measure in favour of ING	Decision not to raise objections	13 November 2008
34	Netherlands	Measure in favour of Aegon	Decision not to raise objections	27 November 2008
35	Netherlands	SNS Reaal/New capital injection by Dutch authorities	Decision not to raise objections	10 December 2008
36	Portugal	Guarantee scheme for credit institutions in Portugal	Decision not to raise objections	29 October 2008
37	Portugal	State guarantee for Banco Privado Português	Decision not to raise objections	13 March 2009
38	Slovenia	Guarantee scheme for credit institutions in Slovenia	Decision not to raise objections	12 December 2008
39	Spain	Fund for the Acquisition of Financial Assets in Spain	Decision not to raise objections	4 November 2008
40	Spain	Spanish guarantee scheme for credit institutions	Decision not to raise objections	22 December 2008
41	Sweden	Support measures for the banking industry in Sweden Amendment to the decision	Decision not to raise objections	29 October 2008 28 January 2009
42	Sweden	Emergency rescue measures regarding Carnegie Investment Bank	Decision not to raise objections	15 December 2008
43	Sweden	Swedish recapitalisation scheme	Decision not to raise objections	11 February 2009
44	United Kingdom	Rescue aid to Bradford and Bingley	Decision not to raise objections	1st October 2008
45	United Kingdom	Aid scheme to the banking industry in the UK (guarantees, recapitalisation & other) Amendment to the Decision	Decision not to raise objections	13 October 2008 22 December 2008

Source: www.ec.europa.eu/competition/state-aid/register.htm

APPENDIX 12: REPORTS

Recent reports from the Select Committee

Procedural rights in EU criminal proceedings-an update (9th Report session 2008–2009, HL Paper 84)

Priorities of the European Union: evidence from the Ambassador of the Czech Republic and the Minister for Europe (8th Report session 2008–2009, HL Paper 76)

The United Kingdom opt-in: problems with amendment and codification (7th Report session 2008–2009, HL Paper 55)

Civil Protection and Crisis Management in the European Union (6th Report session 2008–2009, HL Paper 43)

Mobile Phone Charges in the EU: Follow-up Report (5th Report session 2008–2009, HL Paper 42)

Reports prepared by Sub-Committee A

Session 2008–2009

EU Legislative Initiatives in response to the Financial Turmoil (1st Report, HL Paper 3)

Session 2007–2008

Developments in EU Trade Policy (35th Report, HL Paper 200)

The Future of EU Regional Policy (19th Report, HL Paper 141)

The 2009 EC Budget (18th Report, HL Paper 140)

The euro (13th Report, HL Paper 90)

Solvency II (6th Report, HL Paper 42)