



## **CHAPTER VII**

### ***International cooperation: the part played by the CSSF in international groups***

1. Cooperation within European Institutions
2. Multilateral cooperation



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The law of 23 December 1998 creating the *Commission de surveillance du secteur financier* (CSSF) appointed it to follow and participate in the negotiations concerning problems involving the financial sector, at both European community and international levels. In accordance therewith, the Commission participates in the work of the following bodies:

## **1. Cooperation within European Institutions**

### **1.1. Groups attached to the European Commission**

#### **A. The Banking Advisory Committee**

The Banking Advisory Committee was established by article 11 of the first banking coordination directive (Directive 77/780/EEC). It consists of decision makers of the highest level in the banking supervisory and regulatory authorities of each member state. The committee's mission is to assist the European Commission in the proper implementation of directives and in the preparation of new proposals for directives. In addition to this consultative function, the BAC assumes as part of the executive power of the Commission a regulatory role in the comitology procedure. The committee is not authorised to examine specific problems concerning individual credit institutions.

During 2000, the committee was consulted by the European Commission about a report on financial conglomerates issued by the mixed technical group. On the basis of this report the European Commission will submit a proposal for a directive concerning the supervision of financial conglomerates. During 2000 the committee did not find itself called upon to exercise its role as regulatory body in matters of comitology. As in the past, it was kept informed as to the evolution of supervisory systems and the legislative framework of countries in the process of becoming members of the European Union.

In the course of its general thinking on a review of the regulations concerning own funds, begun in 1998 parallel to the work in progress undertaken by the Basel Committee on Banking supervision, the committee looked closely at the question of choosing the most appropriate legislative approach with regard to capital adequacy, and also at the question of supervisory convergence. The European Commission submitted a second consultative document to the committee for discussion, bearing on a possible revision to the capital adequacy framework. The final document, based on the work of the Basel Committee on banking control and entitled "Second Consultative Document on Review of Regulatory Capital Requirements for Credit Institutions and Investment Firms in the European Union" has been open to public consultation since 5 February 2001. This document concentrates more on particular European Union concerns, specifically the inclu-

sion of investment firms in the field of application of the new regulatory capital framework, and the application of this new framework to all credit institutions and investment firms, irrespective of their size.

The Committee continued to follow the evolution of the banking sector's solvency and profitability in Member states, on the basis of annual reports prepared by the contact group. Additionally, the Committee examined the report developed by the same group on banking difficulties and risk provisioning. As in the past, the Committee closely followed the work in progress in other international groupings that was likely to have an effect on the European banking sector. The Committee was thus kept informed of the work on financial stability being conducted under the aegis of the Committee for Economic and Financial affairs.

## **B. High Level Securities Supervisors' Committee**

Created in 1985 and consisting of the most senior officials of securities supervisors, the Committee meets at regular intervals in its role as consultative committee to the European Commission's Economic and Financial Affairs Directorate General. In particular, the Committee examines the concrete problems encountered during the application of directives and assists the European Commission in defining the directions to be followed with a view to ensuring the optimum development of securities markets in the EU.

During 2000 the Committee examined specific questions concerning the supervision of financial conglomerates and the revision of liquidity ratios. In addition the committee held discussions on the opportunity for modernising the investment services directive and the drafting of a new directive on stock exchange offences other than insider trading.

## **C. The contact group**

The contact group created in 1972 is the source and origin of informal co-operation within the community. The group includes senior representatives of the banking supervisory authorities of the member states. A gathering appreciated for the informal exchanges concerning the situation of individual credit institutions, particularly in case of problems, the group follows the development of national regulations, discusses practical aspects of the prudential supervision of credit institutions and conducts comparative general studies.

During its three meetings in 2000, the contact group broached a considerable number of subjects of particular relevance to the prudential supervision of credit institutions. The group examined those areas in which supervisory convergence in the

practices of the relevant authorities would be particularly desirable. Those practices in connection with the supervisory review should be mentioned in this context.

In accordance with the mandate given by the Banking Advisory Committee the contact group has drafted a document setting out the common principles allowing a uniform application of supervisory review practices at community level. This work has not yet been finished and discussions in this area will continue throughout 2001. Other areas examined by the contact group in the context of convergence in banking supervision bear on provisioning, liquidity risk and cross-border provision of banking services via the Internet.

During its meetings the group also discussed the situations of individual credit institutions, and practical problems bearing on the supervision of certain complex groups and contacts with the authorities of third countries. Various studies were undertaken: a comparative study of the methods used to supervise liquidity risk, another on the rules of conduct in the various member states, and the annual study on the solvency and profitability of credit institutions within the European Economic Area.

#### **D. The Working Group on the Interpretation and Application of the Banking Directives (GTIAD)**

The group can be consulted on technical matters by the Banking Advisory Committee and the European Commission; its mission is to examine such questions of interpretation that may arise in the course of the transposition of community directives or their implementation.

The group met three times during 2000. Views were exchanged in particular on questions related to the solvency ratio and own funds directives. The GTIAD discussed the applicability of the 10% preferential weighting allowed for mortgage bonds, by virtue of the transitional provisions of article 63 paragraph 2 of Directive 2000/12/EC. It also examined the question of the freedom to provide services, within the EU, by a branch established in a non-member country by a credit institution based in a member state.

Throughout the year the GTIAD followed the work carried out by a working group established after the first report by the European Commission concerning the application of Directive 89/299/EEC on the own funds of credit institutions. The working group's mission was to re-examine the own funds directive with a view to limiting competition distortions and strengthening the European banking system.

The study focussed on the admissibility of certain hybrid capital instruments in a specific category of capital. Early in 2001 an initial interim report was made to the Banking Advisory Committee.

### **E. The *ad hoc* group of bodies responsible for receiving consumer complaints about financial services**

During a meeting held on 31 January 2001 at the European Commission in Brussels, attended by the national out-of-court bodies for the settlement of disputes in the financial sector, a Cross-border Out-of-Court Network for the settlement of disputes between consumers and providers of financial services was launched (cf. Chapter VI - customer complaints).



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### **F. The *ad hoc* group concerned with the application of the directive on cross-border credit transfers and the directive on settlement finality in payment and securities settlement systems**

The *ad hoc* group met twice during 2000 and is closely following the progress made in the adoption of Directive 97/5/EC on cross-border credit transfers and Directive 98/26/EC on settlement finality in payment securities settlement systems under the national laws of member states. The group examined questions of interpretation that have arisen during the implementation of the said directives.

## **1.2. Groups operating at European Union Council level**

The CSSF is a participating member of groups working on proposals for directives concerning financial services. The groups of government experts meeting at Council level play an important role in the Community legislative process, since they put the text of the consensus into shape, forwarding only political difficulties to the Permanent Representatives Committee and the Council of Ministers of Finance.

The groups are presided over by a representative of the member state acting as president of the Council. The office of president was thus filled by Portugal during the first half of 2000 and by France during the second half. The list of directives under negotiation at Council level and a brief description thereof can be found in chapter VIII.

### **1.3. The Banking Supervision Committee of the European Central Bank**

The Banking Supervision Committee of the European Central Bank, which succeeded the subcommittee on banking supervision following the creation of the European Central Bank on 1 July 1998, is a committee composed of representatives of the banking supervisory authorities and the central banks of the member states. The missions concerning prudential supervision conferred by the Treaty and the statutes of the European Central Bank to the ECBS (European Central Banking System) are carried out by the Banking Supervision Committee on behalf of the ECBS.

Apart from its consultative role concerning proposals for directives and the various draft laws by member states affecting matters within its competence, the Banking Supervision Committee has developed, jointly with the committee on payment and securities settlement systems, a multilateral Memorandum of Understanding (MoU), setting out the guidelines for cooperation between banking supervision authorities and the authorities responsible for the supervision of payment systems. Such an agreement is motivated in particular by concerns for financial stability within the new institutional context created by the euro. The practical aspects concerning the introduction of euro notes and coins in 2002 were, in addition, the subject of exchanges of views throughout the year.

The Banking Supervision Committee also examined the question of the role it should play in matters of supervisory convergence. It was thus agreed that its priorities should remain within the strict bounds of its competence, i.e. the study of convergence purely on the level of macro-prudential and structural changes in the financial sector.

## **2. Multilateral cooperation**

### **2.1. The Basel Committee on Banking Supervision**

During 2000 the Basel Committee concentrated its work on finalising a new capital adequacy framework, begun in June 1999. Taking account of the results of the initial consultative proposal, the Committee presented three general documents, “**Overview of the new Basel Capital Accord**”, “**The new Basel Capital**”, “**The new Basel Capital Accord: an explanatory note**” setting out more concrete proposals and inviting the interested parties to make known their comments by 31 May 2001. Seven supporting documents (“The standardised approach to credit risk”, “The internal ratings based approach”, “Asset securitisation”, “Operational risk”, “Pillar 2: Supervisory review process”, “Principles for the management and

supervision of interest rate risk”, “Pillar 3: Market discipline”, “Criteria in defining exceptional treatment of commercial real estate lending”) are also part of this second consultative package. The Committee envisages that the new agreement will be published in its final form around the end of 2001 and implemented in 2004.

Although the new framework is primarily focused on major international banks, its basic principles are intended to be suitable for application to banks of varying levels of complexity and sophistication. The provisions offer a range of options from simple to advanced methodologies for the measurement of both credit risk and operational risk in determining capital levels.

The new agreement provides a flexible structure in which banks, subject to supervisory review, will adopt approaches that best fit their level of sophistication and their risk profile. The framework also expressly builds in rewards for stronger and more accurate risk measurement.

In general terms, the framework intends to provide approaches that are both more comprehensive and more sensitive to risk than the 1988 Accord, while maintaining the overall level of regulatory capital. Capital requirements that are more in line with underlying risks will allow banks to manage their businesses more effectively. The Committee believes that the benefits of a regime in which capital is aligned more closely to risk significantly exceed the costs, since it should result in a safer, sounder and more efficient banking system.

The new Accord is based on the following three pillars:

***First pillar: minimum capital requirement***

The first pillar sets out minimum capital requirements. The new framework maintains the current definition of capital and the minimum requirement of 8% of capital to risk-weighted assets. To ensure that risks within the entire banking group are considered, the new Accord will be extended on a consolidated basis to holding companies of banking groups.

The revision of the 1988 Accord focuses primarily on improving the measurement of risk, that is to say the calculation of the denominator of the capital ratio. The credit risk measurement methods are more elaborate in the new Accord. The new framework proposes, for the first time, a measure for operational risk, while the market risk measure remains unchanged.

**a) Credit risk**

As regards credit risk, two major options are being proposed: the standardised approach, and the internal rating based (IRB) approach. There are two variants of the IRB approach, foundation and advanced. The use of the IRB approach will be



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subject to approval by the supervisor, based on the standards established by the Committee.

Conceptually, the standardised approach is identical to the approach in the 1988 Accord, but is more risk sensitive. The bank allocates a risk-weight to each of its assets and off-balance sheet positions, and produces a sum of risk-weighted values. At present the risk-weights are fixed according to the broad category of borrower (sovereigns, banks or corporates). The new Accord intends to refine these categories by reference to rating provided by an external credit assessment institution (such as a rating agency).

Under the internal rating based approach, banks will be able to use their internal estimates of borrowers creditworthiness to assess credit risk in their portfolios, subject to strict methodological and disclosure standards. Distinct analytical frameworks will be provided for different types of exposure, for example corporate and retail lending.

Under the IRB approach, an institution estimates each borrower's creditworthiness and the results are translated into estimates of a potential future loss, which serves as the basis of minimum capital requirements. The framework allows for two methodologies, the foundation approach and the advanced approach, for corporate, sovereign and bank exposures. In the foundation approach, the financial institution estimates the probability of default associated with each borrower, and the supervisor supplies the other data. In the advanced approach, an institution with a sufficiently developed internal capital allocation process will be permitted to supply other data as well. Under both approaches, the range of risk weights will be far greater than those in the standardised approach, resulting in greater risk sensitivity.

The new framework introduces more risk sensitive approaches to the credit risk mitigation techniques, such as guarantees (real and personal), credit derivatives, netting and securitisation, under both the standardised and the IRB approach.

## **b) Operational risk**

The 1988 Accord set a capital requirement solely in terms of credit risk, even if the overall requirement (i.e. the 8% minimum ratio) was also intended to cover other risks too. In 1996, market risk exposures were removed and given separate capital charges. In its attempt to introduce greater credit risk sensitivity, the Committee consulted the industry regarding the implementation of a suitable capital charge for operational risk (for example, the risk of loss from computer failures, poor documentation or fraud). The major banks now allocate 20% or more of their internal capital to operational risk.

Work in this field is still in progress, but three approaches (in order of increasing sophistication: basic indicator, standardised and internal measurement) have been identified. The first approach uses one indicator of operational risk for all the activities of an institution. The second allocates different indicators to different business lines. In the third approach, the internal loss data are used in the estimation

of the required capital. On the basis of work completed to date, the Committee expects operational risk to constitute some 20% of the overall capital requirements under the new framework.

***Second pillar: supervisory review process***

The supervisory review process requires supervisors to ensure that each institution has sound internal procedures in place to assess its capital adequacy on the basis of a thorough evaluation of the risks to which it is exposed. The new framework stresses the importance of bank management developing an internal capital assessment process and setting targets for capital that are commensurate with the particular risk profile of their institution and its control environment. Supervisors will be responsible for judging whether banks are succeeding in correctly assessing their capital adequacy needs relative to their risks. They will subsequently subject this internal process to a supervisory review and could, where necessary, be led to impose modifications.

***Third pillar: market discipline***

Market discipline, the third pillar of the new framework, will be reinforced by enhanced disclosure by banks. Effective disclosure is essential to ensure that market participants better understand banks' risk profiles and the adequacy of their capital positions relative to these risks. The new framework sets out disclosure requirements and recommendations in several areas, in particular the calculation of capital adequacy and methods of risk assessment.



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### ***Other work undertaken by the Basel Committee***

The Basel Committee has in addition published a number of documents:

- the report “Banks’ Interactions with Highly Leveraged Institutions: implications of the Basel Committee’s Sound Practices paper” (January 2000) is based on a study into the response by banks to the recommendations formulated in January 1999 by the Committee in its paper, “Sound Practices for Banks’ Interactions with Highly Leveraged Institutions”; these recommendations were the consequence of the default of the LTCM hedge fund in September 1998; the report concludes that by and large banks seem to have considerably reduced their exposures to such institutions;
- the document “Sound Practices for Managing Liquidity in Banking Organisations” (February 2000) presents an array of sound practices for ensuring good liquidity management;
- the report “Basel Committee review of international accounting standards” (April 2000) presents the findings and conclusions of the Committee on its review of International Accounting Standards;
- the consultation document “Internal audit in banking organisations and the relationship of the supervisory authorities with internal and external auditors” (July 2000) underlines the importance of the internal audit function in credit institutions and relationship between the banks’ supervisors, internal auditors and external auditors; the audit function has an important role to play in a bank’s internal capital assessment process; effectively, the auditors’ work in this respect could provide additional support for the supervisory authorities in their prudential supervision of capital adequacy;
- the document “Principles for the Management of Credit Risk”, (September 2000) establishes the principles to be applied to all activities where credit risk is present, and which should be used by supervisors in assessing a bank’s credit risk management system;
- the document “Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions” (September 2000) provides the broad outlines for banking supervisors to follow in their control of procedures for managing settlement risk in foreign exchange transactions;
- the report entitled “EBG’s phase I report on risk management issues and cross-border supervisory considerations arising from e-banking developments”, published in October 2000 by the Electronic Banking Group (EBG), lists and assesses the major risks associated with e-banking and concludes that they fall into the following risk categories: legal, operational, cross-border, strategic, reputation, credit, market and liquidity;
- the document entitled “Customer due diligence for banks” (January 2001) is intended to guide banks and supervisory authorities in their rules of conduct regarding the identification and monitoring of their customers.

## 2.2. The XXVth Annual Conference of the IOSCO

The regulatory authorities of the financial and futures markets met in Sydney from 14 to 19 May 2000 on the occasion of the XXVth annual conference of the International Organisation of Securities Commissions (IOSCO).

The theme of the conference was “Global Markets - Global Regulation” and the conference provided an opportunity for participants to discuss the regulatory challenges posed by today’s rapidly expanding markets; challenges characterised by changing market structures, market alliances, the new economy and technological advances. The implementation of the working programme of the IOSCO, in particular the objectives and principles of financial regulation, aimed at producing a concerted response to these challenges, thereby reinforcing the protection of investors, confidence in the markets and financial stability in the world.

The annual conference in Sydney was marked by the announcement of a specific result of particular importance to the international financial community. After nearly ten years’ work in conjunction with the International Accounting Standards Committee, the members of the IOSCO approved a resolution recommending the use of 30 IASC standards for cross-border offerings and listings. This decision makes an essential contribution to raising the quality of financial reporting worldwide. Effectively, the use of harmonised accounting standards will enable economic players to conduct their international strategies on the basis of a single set of accounts.

### IOSCO Task Forces

#### Task Force no. 1

The objective of Task Force no. 1 is to promulgate international norms for information, offering multinational issuers a reference framework for their prospectuses with a view to facilitating offerings and listings in several countries. Since the annual accounts are an integral part of any prospectus, it is clear that Task Force no. 1 can make a valuable contribution to internationally recognised accounting standards.

During the year IOSCO Task Force no. 1 finalised its analysis of accounting standards developed by the IASC. The final report is at the base of the IOSCO’s decision to recommend that its members permit the use of these standards by multinational issuers wishing to obtain a listing in several countries.

In addition, the Task Force has begun a comparable process with regard to a review of International Standards on Auditing. Subject to acceptance of the project by the IOSCO Technical Committee, the review as such will begin during the second half of 2001. Parallel to the examination of developments in the fields of international accounting and auditing, the Task Force has carried out a comparative study of the

state of implementation of the International Disclosure Standards developed by the IOSCO.

#### **Task Force no. 5**

In 2000, the task force finalised the three documents “Principles and Best Practice Standards on Infrastructure for Decision Making for CIS Operators”, “Delegation of functions” and “Conflicts of interests of CIS operators”. In addition, the Task Force developed a document entitled “The role of investor education in the regulation of CIS and CIS operators” and has continued its work on a study aimed at simplified prospectuses. Finally, the group has begun to consider thoughts on the setting up of common criteria in the area of investment fund risk assessment.

### **2.3. FESCO and FESCO Working groups**

Officially instituted by a charter that was adopted in December 1997, FESCO (“Forum of European Securities Commissions”) assembles seventeen Statutory Securities Commissions of the European Economic Area. The fundamental objective of cooperation of supervisors within FESCO is to work towards the construction of a single European market for financial services in support of the actions taken in this field by the European Community. In broader terms the objective is to assure investor protection, and the efficiency, integrity and transparency of markets, together with the global security of the financial system.

At the beginning of 2000, FESCO opened a public web site at [www.eurofefesco.org](http://www.eurofefesco.org) where the documents referred to below are available.

Under the European Commission’s action plan for financial services, FESCO has developed concrete proposals for European directives in various priority areas, in particular cross-border public offerings. The goal aimed at by the document “**A European Passport for Issuers**” is to provide an issuer with a European passport that will enable it to make a public offering or apply for listing on a regulated market in all the member states of the European Economic Area by simple notification and based on a single prospectus approved by the authorities of the issuer’s member state of origin. To this end, the prospectus could be separated into two documents: a Registration Document registered with the authority of the member state of origin and valid for one year, containing the information about the issuer, and an operational memorandum Securities Note describing the securities involved and the terms and conditions of the offer.

Similarly in response to the call from the European Commission, the **Market Abuse** group published a document setting out proposals for the creation of a harmonised European regulatory framework to fight against market abuses. This innovative document, itself entitled “**Market Abuse**”, initially establishes the notion of market abuse and proceeds to advocate greater convergence of administrative powers to investigate and sanction.

In close collaboration with this group, continuing the work that resulted in the establishment in 1999 of common rules of conduct for participants in an offering, the **Primary Markets Practices** group published a consultative document in September 2000, entitled “**Stabilisation and Allotment – A European Supervisory Approach**”. This document sets out a harmonised regulatory treatment of price stabilisation practices in the context of an offering of transferable securities, and a European code on the allotment of equity issues during a public share offering.

After establishing standards for regulated markets, FESCO continued its work on market controls by studying the effects of the emergence of **alternative trading systems (ATS)**. A report has been published identifying the risks and advantages associated with alternative trading systems and listing their legislative treatment. The group will concentrate its future work on developing common standards for alternative trading systems operated by investment firms.

At the beginning of the year the **Investor Protection** group reached agreement on the document “**Categorisation of Investors for the Purpose of Conduct of Business Rules**” which provides criteria and procedures to implement appropriate differentiation between categories of investors. This categorisation procedure allows account to be taken of the principle established by the Investment Services Directive concerning, i.e. that the different categories of investor have different needs with regard to their protection and the application of rules of conduct.

The consultative paper “**Standards and Rules for Harmonising Core Conduct of Business Rules for Investor Protection**” (December 2000) established common standards for rules of conduct governing relations between an investment company and a client with the aim of ensuring adequate and complete protection for the investor throughout the investment cycle.

Finally, the FESCO work plan led to the creation of a new group entitled “**Expert Group on Accounting**” and responsible for harmonising the implementation of the International Accounting Standards at European level for the accounts of listed companies with the aim of promoting high disclosure standards and reinforcing co-ordination in this matter between the various market supervisory authorities.

## **FESCOPEL**

FESCO has set up a network of senior officials of each Authority. Named FESCOPEL, this network is responsible for facilitating exchanges of information and co-ordinating the organisation of investigations into breaches of stock exchange rules.

FESCOPEL met three times during 2000 and has continued to draft and standardise of requests for information in such a way as to satisfy both the requesting authority in its need for information and the responding authority in its deployment of resources for gathering the necessary information. Furthermore, since FESCO's member regulators are not always the competent authority for launching investigations into breaches of stock exchange rules, FESCOPEL is looking into whether it can accept these regulators as members of FESCOPEL.

## **2.4. Informal groups**

### **The enlarged informal contact group "Undertakings for Collective Investment"**

The CSSF took part in the annual meeting of the enlarged informal contact group "Undertakings for Collective Investment" that was held from 4 to 6 October 2000 in Amsterdam. The aim of this contact group is to institute regular, multinational focus on problems arising with regard to the regulation and supervision of undertakings for collective investment. The group brings together the Supervisors of 26 different jurisdictions.