

CHAPTER XI

GENERAL SUPERVISION AND CSSF INVOLVEMENT IN INTERNATIONAL GROUPS

1. General Supervision
2. Co-operation within European institutions
3. Multilateral co-operation



1. GENERAL SUPERVISION

1.1. Setting up of General Supervision: reasons and objective

Given the challenges of a complex regulatory environment, the development of more and more sophisticated risk management techniques and the continuous innovation in the structure of financial products, the support and assistance of the CSSF's agents that are directly in charge of the supervision of the professionals of the financial sector with respect to specific subjects is of utmost importance within a supervisory authority of a financial centre such as that of Luxembourg.

The CSSF has therefore created a transversal function "General Supervision" (SGE) as from 1 January 2005, which deals on a horizontal basis with prudential supervisory, accounting and auditing issues common to the CSSF's departments directly involved in the supervision of the professionals of the financial sector.

The objective of this "think tank", which proposes approaches and instruments for analysis and assessment, is thus to develop competence fields that require specific knowledge and experience, provide methodological support for the performance of prudential supervision on a daily basis, transmit and communicate the knowledge acquired at internal training sessions and accompany agents to on-site inspections that deal with more complex subjects, such as the validation of risk management models.

In particular, the SGE function is responsible for:

- all the files of the international groups in which the CSSF takes part, i.e. those established under the aegis of the EU Commission and EU Council, CEBS, CESR, CEIOPS, IOSCO, OECD, Basel Committee, European Central Bank and FATF;
- the development and the interpretation of the national and international regulations;
- general issues regarding the approach and methodology concerning prudential supervision, rules of conduct and professional obligations in the financial sector;
- dealing with issues relating to accounting, preparation of balance sheets, reporting, publication of financial information, and audit of global macro-prudential studies on professionals of the financial sector, as well as on financial markets and products;
- lending assistance in the field of risk management methods and risk modelling.

1.2. Activities in 2005

During its first year of existence, the SGE function, currently composed of nineteen agents, has sent 536 letters stating the CSSF's views as regards prudential supervisory, accounting and auditing issues.

In 2005, the agents of the SGE function took part in 42 meetings that were held with representatives of the banking industry at the CSSF's premises.

During the year under review, the CSSF participated in 219 meetings of international groups (among others CEBS, CESR, CEIOPS, Basel Committee, ECB, OECD, IOSCO, various groups at European level), including 170 which have been handled directly by the SGE function. In addition, eleven multilateral meetings, in which agents of the SGE function took part, were held with foreign supervisory authorities in the context of the implementation of the new capital adequacy provisions (Basel II) in certain cross-border banking groups with subsidiaries in Luxembourg.

The SGE function carried out nineteen on-site inspections at the premises of Luxembourg credit institutions in order to gather the necessary information for its meeting with the International Monetary Fund, as well as 52 other controls and on-site inspections. They mainly related to CSSF's monitoring of the future implementation of the new capital adequacy framework (Basel II) by Luxembourg banks and of the validation of market models.

1.3. Implementation of the new capital adequacy framework

In 2005, the SGE function continued its fact-finding missions concerning the implementation of the New Basel Accord and of the European Directive on capital requirements in close co-operation with the department in charge of the supervision of banks. The CSSF agents visited credit institutions more than twenty times in this context.

These specific fact-finding missions were either initiated by the credit institutions themselves or by the CSSF, or have been undertaken in the context of the coordination efforts made with foreign supervisory authorities within the scope of the home-host co-operation, as provided in the tenth consultative paper (CP10) of CEBS for the European framework, respectively by the co-operation principles drawn up by the Accord Implementation Group of the Basel Committee on banking supervision. They are also carried out in the context of case studies performed at European level as well as in the USA.

The main objectives of the fact-finding missions are:

- for the CSSF to learn about the progress of the credit institutions' implementation of the IRB approach (Internal Ratings Based Approach);
- the management of the project (budget, implementation and development plan, self-assessment analysis, including a gap analysis compared to regulatory requirements, etc.);

taking account notably of corporate governance (role of the authorised management, risk management and internal audit, development and validation process, stress testing, etc.) and concepts (philosophy of internal ratings, Masterscale, etc.), the methods chosen (expert, statistical, neural or causal models, etc.), as well as the use (use tests) and the operational and supervisory framework. The content and the intensity of the various elements of the control plan are adapted according to the role of the Luxembourg entity and its involvement in the development, maintenance, validation and use of the models considering the importance of the different activities and portfolios. The scope of these on-site missions is being extended to other areas, such as operational risk, and the first contacts in this respect have already been made.

In order to be able to prepare the on-site missions and to allow a structured dialogue, the CSSF invites banks to provide it with the documents relating to a standard agenda beforehand (kick-off meeting). Furthermore, other elements, such as the responses to specific letters or to different circular letters, the results and questionnaires relating to the Quantitative Impact Studies, the templates submitted in the context of informal files (pre-application packages), as well as the information gathered on the occasion of previous exchanges of opinion can be used for these missions.

In a proactive effort, the CSSF reserves the right to voice comments if it observes cases of non-compliance with specific points. However, it is important to note that considering the progress of regulatory texts, the CSSF's responses shall not be interpreted as a formal review and that the fact that some points have not been raised does not mean that there is compliance.

The CSSF's assessment is based to a large extent on the text of the future Directive, on the last version of CEBS CP10, as well as on numerous contributions of the Accord Implementation Group (AIG) and of the Sub-group on Validation (AIGV). All the important decisions likely to impact the CSSF's policy, the recommendations and questions are discussed within the Committee for Internal Validation (CoVa) of the CSSF, which gathers agents involved in the permanent supervision of banks, as well as agents dealing with risk management and prudential policy. The Committee for Internal Validation also adopts the standardised documents such as the control plans and the different documentation templates relating to applications for authorisation filed by credit institutions.

Qualitative impact study QIS 5

In March 2005, the Basel Committee decided to review the calibration of the revised framework in spring 2006. In order to evaluate the impact of the new proposals and to ensure that this study is based on the most recent and high-quality data, a fifth quantitative impact study (QIS 5) was launched in October 2005.

The CSSF had contacted the Luxembourg credit institutions and recommended them to perform this test computation on a voluntary basis. The interest of such an application for participating credit institutions is obvious as it will provide a realistic view of the means to be allocated for the implementation of the new rules and will allow to assess the consequences in terms of capital requirements. The protected workbooks integrating the various national parameters, as well as the relating documents have been sent by the CSSF to all institutions participating in this impact study.

The response of the Luxembourg credit institutions was absolutely satisfactory, as about twenty banks intended to perform the test computation. Several responses have been sent on an anonymous basis to the Basel Committee in order to take part in the overall evaluation which has not yet been completed.

2. CO-OPERATION WITHIN EUROPEAN INSTITUTIONS

Article 3 of the law of 23 December 1998 creating a *Commission de Surveillance du Secteur Financier* as amended appoints it, *inter alia*, to deal with and participate in the negotiations concerning problems relating to the financial sector, at both Community and international level. The CSSF therefore participates in the work of the following forums.

2.1. Groups attached to the European Commission

2.1.1. The Committee of European Banking Supervisors (CEBS)

The Committee of European Banking Supervisors (CEBS) was established by Commission Decision 2004/5/EC of 5 November 2003. Its duties encompass reflecting, discussing and giving advice to the European Commission in the fields of banking regulation and supervision. The Committee also co-operates with the other competent committees in banking matters, notably with the European Banking Committee established by Commission Decision 2004/10/EC. CEBS was chaired by Mr José-María Roldan (Banco de España, Spain) until January 2006. In February 2006, Mrs Danièle Nouy (Commission Bancaire, France), who was Vice-Chairman until that date, took the chair. She is assisted by Mr Helmut Bauer (Bundesanstalt für Finanzdienstleistungsaufsicht, Germany) as Vice-President. Mr Andrea Enria (Banca d'Italia, Italy) has been appointed General Secretary. The Chair is supported by a "Bureau", comprising Mr Andreas Ittner (Oesterreichische Nationalbank, Austria), Mrs Kerstin af Jochnick (Finansinspektionen, Sweden) and Mr Andrzej Reich (National Bank of Poland, Poland). CEBS' Secretariat is based in London.

CEBS took up its duties in January 2004 by holding its first meeting in Barcelona on 29 January 2004. Its objective is to fulfil the functions of a Level 3 committee for the banking sector in the application of the Lamfalussy process:

- advise the European Commission either at the Commission's request, within the time limit which the Commission may lay down according to the urgency of the matter, or on the Committee's own initiative, in particular as regards the preparation of draft implementing measures in the field of banking activities;
- contribute to the consistent application of European Directives and to the convergence of Member States' supervisory practices throughout the Community;
- enhance prudential supervisory co-operation, including the exchange of information.

During 2005, CEBS continued its work relating to the future Directive on capital adequacy, which will transpose the New Basel Accord into European law.

CEBS finalised three documents in this context. The first document relates to the common reporting framework to be used by credit institutions and investment firms when they report their solvency ratio to supervisory authorities under the Capital Requirements Directive (known as COREP). The second document relates to a standardised financial reporting framework based on IAS standards for credit institutions and investment firms operating within the European Union (known as FINREP). Finally, the third document relates to the information falling within the scope of the disclosure to be made by the supervisory authorities of the European Union in accordance with article 144 of the future Directive on capital adequacy.

Furthermore, following calls for advice from the European Commission, CEBS presented its technical advice, within the allotted time, on the following topics:

- The review of article 16¹ of Directive 2000/12/EC of 20 March 2000 on the taking-up and pursuit of the business of credit institutions in order to make sure that prudential controls do not hamper cross-border mergers and acquisitions. This advice was provided on 31 May 2005.
- The review of article 8 of Directive 2000/46/EC of 18 September 2000 on the taking-up, pursuit of and prudential supervision of the business of electronic money institutions, relating to the waivers from the application of this Directive and of Directive 2000/12/EC for hybrid issuers. This advice was provided on 1 July 2005.
- The review of certain aspects of Directive 94/19/EC of 16 May 1994 on deposit guarantee schemes, such as the level of coverage, the division of the responsibilities between the home and host country authorities, information sharing between the local supervisory authority and the deposit guarantee system, as well as crisis management procedures. This advice was provided on 30 September 2005.

The above-mentioned topics were submitted to public consultation by CEBS and the European Commission.

Moreover, CEBS has published the following consultation papers:

CEBS consultation

The final document explaining the public consultation practices, as well as the timelines that CEBS is to follow in its consultation processes, was published on 11 March 2005.

Role and tasks of CEBS

On 5 July 2005, CEBS has published a consultation paper on its role and tasks. This document takes stock of the experience gained by CEBS over the first year of its existence. The paper explains CEBS' overall approach to meeting its main objectives, as well as the tools at its disposal. The consultation period closed on 28 November 2005.

Recognition of External Credit Assessment Institutions (ECAIs)

Based on the work achieved by its working group CEBS-EGCRD, CEBS published, on 29 June 2005, a consultation paper on the guidelines for a common approach to the recognition of external credit assessment institutions. The future Directive on capital adequacy provides for the use of these institutions to determine the risk weight of certain exposures of credit institutions and investment firms, under the condition that these institutions are recognised by the supervisory authorities concerned as eligible to perform this activity. The consultation closed on 30 September 2005.

On 1 November 2005, CEBS published a supplementary note to the above-mentioned consultation paper. This note sets out further details on the mapping of securitisation credit assessments and of credit assessments of undertakings for collective investment. The consultation closed on 30 November 2005.

The final document, published on 20 January 2006, takes to a large extent account of the industry's feedback on this subject (please refer to www.c-eps.org).

¹ Article 16 deals with the qualifying holding in a credit institution.

Co-operation between consolidating supervisors and host supervisors

On 8 July 2005, CEBS published a consultation paper on guidelines for establishing an enhanced co-operation between the supervisory authorities with respect to European banking groups and investment firms. These guidelines reflect the requirements of the future capital adequacy Directive. The consultation closed on 8 November 2005 and the final guidelines, which take account of the industry's feedback, were published on 25 January 2006.

Application of the Supervisory Review Process under Pillar 2

On 20 June 2005, CEBS published a second consultation paper on the Supervisory Review Process, which is a revised and expanded version of the first consultation paper of 2004. The Supervisory Review Process is an essential component of the future capital adequacy Directive. The objective of this process is that banks develop internal capital adequacy assessment processes and a strategy to maintain this adequacy. Furthermore, supervisory authorities should review and evaluate, in dialogue with the banks, the internal capital adequacy assessment and the strategies developed by the banks to require them to take corrective measures, where applicable.

This consultation closed on 21 October 2005 and the industry's feedback has been taken into account to a large extent in the final document published on 25 January 2006.

Joint Protocol between CEBS, CEIOPS and CESR

On 24 November 2005, CEBS, CESR (Committee of European Securities Regulators) and CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) signed a joint protocol to foster co-operation and coordination in the areas of regulation, information exchange and other tasks with a common interest to the three committees.

As the three committees are already closely co-operating on a regular basis, this joint protocol formalises this co-operation in a transparent manner.

Co-operation between CESR, CEBS and CEIOPS has become increasingly important with the sectoral market integration and cross-sector business activity within the European Union. The members of the three committees emphasise the importance of the consistency of the work done in the three sectors at Level 3 of the Lamfalussy procedure. With the joint protocol, the three committees will be able to align their work where necessary.

The practical objectives of the joint protocol are the following:

- share information in order to have compatible approaches;
- exchange experiences which can facilitate supervisors' ability to co-operate;
- produce work or reports that are common to the relevant EU committees and institutions;
- reduce supervisory burdens and streamline processes; and
- ensure that the basic functioning of the three committees develops along parallel lines.

Coordination and co-operation will be based on practical arrangements included in the joint protocol to support consistency in the works of these committees. The protocol defines the basic procedures for meetings and contacts to be made to gain access to information, and indicates the areas of joint work anticipated. Last but not least, the protocol defines the way in which the dialogue between the committees will take place to ensure that new developments are taken into consideration in a consistent manner by the three committees.

- **CEBS – Groupe de contact**

Created in 1972, the *Groupe de Contact* has been used from the outset as forum for informal co-operation between banking supervisory authorities on EU level. Following the enlargement of the European Union, it now also comprises the representatives of the authorities of the ten new Member States. The Groupe is chaired by Mr Fernand Naert of the Commission bancaire, financière et des assurances (Belgium) since the end of 2004.

Within the new European structure of banking supervision, the *Groupe* henceforth acts as main working group of the Committee of European Banking Supervisors. In that capacity, it assists CEBS with a view to achieve convergence of the prudential supervisory practices in the European Union. The *Groupe* also continues to be a body appreciated for informal co-operation concerning the situation of individual credit institutions, particularly in the event of problems. It follows the development of national regulations, discusses practical aspects of prudential supervision of credit institutions and conducts general comparative studies.

In 2005, the *Groupe* has welcomed two new observers within the context of the EU enlargement process, namely representatives of the supervisory authorities of Bulgaria and Romania.

The *Groupe* continued to focus on the implementation of the prudential supervisory review process, Pillar 2 of the new capital adequacy framework which is being adopted at Community level.

In this field, the *Groupe* notably continued to work on the different risk categories under Pillar 2. These works took shape with the publication of the document dealing with the relation between the internal capital adequacy assessment process of the credit institutions and the supervisory review process of the supervisory authorities. The works regarding the drawing up of best practice guidelines for internal governance of credit institutions and the relevant supervision to be carried out by the authorities, as well as the drawing up of approaches to solve issues relating to the distribution of responsibilities and duties between home and host authorities as regards banking groups operating across Europe, have also progressed.

Furthermore, the *Groupe* continues, following the public consultation that closed in July 2004, to polish up the high-level principles regarding outsourcing of banking functions. However, the outcome of these works depends on the implementation measures of MiFID (Directive concerning markets in financial instruments) that the European Commission intends to introduce (please refer to http://www.europa.eu.int/comm/internal_market/securities/isd/mifid2_en.htm). These measures, which also concern the provisions with respect to outsourcing, have been based on the work of the European Securities Committee.

Another important part of the *Groupe's* responsibilities concerns the exchange of information on particular problems encountered by one or several authorities and topical issues. This exchange of information between members, as well as between the *Groupe* and CEBS, continued during 2005.

- **CEBS – Joint EGCRD/Gdc Working group on Validation of the Advanced Approaches**

This joint EGCRD² and *Groupe de contact* working group, established in 2004, gathers experts of the banking supervisory authorities of CEBS member countries in the field of validation of advanced credit risk and operational risk approaches. The group's mandate is in line with the efforts of EGCRD to achieve convergence in the technical fields concerning validation of eligible models in the proposed amendment of Directives 2000/12/EC and 93/6/EEC.

The works of the group notably resulted in a first publication of the tenth CEBS consultative paper entitled “Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and International Ratings Based (IRB) Approaches” in July 2005 for a three-month consultation period, and a second publication in January 2006 with a consultation period closing on 15 February 2006. This document can be downloaded from http://www.c-ebs.org/Consultation_papers/consultationpapers.htm.

- ***CEBS – Working Group on Common Reporting (COREP)***

In order to meet the requirements of the industry and European institutions to reduce the administrative burden and harmonise the reporting requirements for credit institutions, CEBS mandated the Working Group on Common Reporting to develop a common reporting framework for the supervision of capital adequacy within the scope of the new regulatory framework, which is being endorsed.

This decision reflects CEBS’ conviction that the introduction of this new regulatory framework, as well as the adoption of the accounting standards IAS/IFRS (FINREP), present unique opportunities to achieve these objectives.

The proposed framework, which was subject to a public consultation launched in January 2005, was finalised in January 2006 (please refer to www.c-ebs.org). Following this consultation and in order to reduce the burden on banks and investment firms, CEBS divided the prudential reporting scheme into two parts, the first one representing “basic information” and the second one “detailed information”. Thus, the framework aims at achieving an enhanced convergence of basic information, while leaving enough flexibility for national authorities to fix the scope of the detailed information they request for prudential reporting needs.

It should also be stressed in this context that the final “product” does not only comprise a harmonised framework, but also an IT solution to support the framework, based on the XBRL protocol that each State is free to adopt.

- ***CEBS - Supervisory Disclosure Task Force (SDTF)***

The task force, established in 2004 by CEBS, is responsible for the definition of elements falling within the scope of the disclosure made by supervisory authorities of the European Union in accordance with article 144 of the re-cast Directive 2000/12/EC.

In 2005, the group published its proposals for the concrete setting-up of the publication infrastructure of these elements and the definition of CEBS’ role in this implementation. This future transparency obligation requires supervisory authorities to set up a permanent infrastructure allowing the European financial sector and the public to consult and compare the different legislative and regulatory environments of the banking supervisory authorities. These elements include laws, prudential regulations, national options and discretions exercised by national authorities, supervisory methodologies and statistical data relating to banks and investment firms.

The proposals of the task force were submitted to public consultation. As the response to the consultation had been overall positive, the task force has finalised the new disclosure framework, which has been published on the CEBS website on 1 November 2005. The information referred to under the new article 144 of the amended Directive 2000/12/EC should in principle be published for the first time as from 2007. The first statistical data should be published according to this framework in 2008.

- **CEBS - Expert Group on Accounting and Auditing (EGAA)**

The main activities of the working group established in 2004 are exposed hereinafter according to three sub-working groups.

CEBS - EGAA Sub-Working Group on Prudential and Accounting

At the end of 2004, CEBS had published “Guidelines on prudential filters for regulatory capital” to be made by the banks applying the IAS standards, in order to eliminate the potentially undesirable effects of the application of the IAS standards on the quality, level and stability of regulatory capital. In the course of 2005, the sub-group has conducted a survey on the implementation of these guidelines by Member States. The results of the survey revealed that CEBS’ recommendations were followed to a large extent, which had promoted a consistent application of prudential filters among the European States. However, a variety of prudential treatments has been noted in the fields where the CEBS recommendations provide for alternative approaches or none at all.

During 2005, the sub-working group has developed and carried out a quantitative survey to measure the impact of the application of the IAS/IFRS accounting standards on prudential own funds, as well as to assess the prudential filters’ efficiency. The main conclusions of the study show that the prudential filters recommended by CEBS, which are in line with the recommendations published by the Basel Committee on banking supervision, adequately address the undesired effects of the transition to the IAS/IFRS standards on regulatory capital of credit institutions.

CEBS - EGAA Sub-Working Group on Standards & Accounting

In March 2005, the sub-group submitted comments to the International Accounting Standards Committee Foundation (IASCF) concerning the consultation paper “Review of the Constitution, Proposals for change” in relation with the IASCF’s reorganisation. The documents are available on the IASCF’s website <http://www.iasb.org/current/iascf.asp>.

Moreover, at the beginning of 2005, the members have analysed the results of a survey on the provisions relating to macrohedging. This survey, which was conducted in October 2004, aimed at assessing how the carving-out of certain provisions relating to macrohedging by the European Commission will be implemented by the Member States. The survey reveals that the majority of the Member States will leave it at the regulated entities’ discretion to use the full IAS 39 standard of the IASB or the carved-out version of the standard as adopted by the European Commission.

CEBS - EGAA Sub-Working Group Financial Reporting (FINREP)

The sub-working group continued in 2005 to develop a consolidated financial reporting framework for the prudential supervision under the IAS/IFRS accounting framework. In April 2005, this framework was submitted to public consultation for a period of three months. A final amended version, which takes account of the feedback received, was adopted and published by CEBS in December 2005 (please refer to www.c-eps.org).

The common financial reporting framework, commonly referred to as FINREP, is designed for EU credit institutions that have to submit financial information using the accounting standards IAS/IFRS for prudential reporting to their supervisory authority. FINREP has been developed on the basis of the International Financial Reporting Standards, including the International Accounting Standards and Interpretations as at 1 January 2005 of the IASB, as endorsed by the European Commission. The framework also takes into account certain elements of the standard IFRS 7 “Financial Instruments: Disclosures”.

With the standardisation in terms of definition and content, FINREP will contribute at European level both to a better comparability of financial information submitted to the supervisory authorities and to reducing the reporting burden for banking groups that operate in several EU Member States. CEBS considers that the transfer format XBRL can be a helpful tool in constructing a harmonised European reporting system. In this context, CEBS will develop a XBRL FINREP taxonomy that will be made available to the supervisory authorities and the supervised credit institutions.

2.1.2. Committee of European Securities Regulators (CESR)

Established by the European Commission Decision of 6 June 2001, CESR (Committee of European Securities Regulators) took over from FESCO (Forum of European Securities Commissions) in September 2001. CESR is one of the two committees proposed in the Committee of Wise Men's report, which was endorsed by the Stockholm resolution of 23 March 2001. Composed of representatives of 27 supervisory authorities of securities markets in the European Economic Area (Member States of the European Union, Norway and Iceland), CESR is an independent body, which assists the European Commission in preparing technical measures relating to Community legislation on transferable securities, and is entrusted with ensuring harmonised and continued application of Community legislation in Member States. CESR also works towards strengthening co-operation between the supervisory authorities. CESR is chaired by Mr Arthur Docters van Leeuwen (Autoriteit Financiële Markten, Netherlands). He is assisted by Mr Kaarlo Jännäri (Financial Supervision Authority, Finland) as Vice-President.

CESR carried on with its work related to the initiatives concerning the Financial Services Action Plan (FSAP) by notably continuing its works on the mandates concerning the drafting of implementing measures within the scope of the Directive on the harmonisation of transparency requirements concerning the information on issuers whose securities are admitted to trading on a regulated market and Directives 2001/107/EC and 2001/108/EC (UCITS III Directives) that amend Directive 85/611/EEC (UCITS I Directive).

CESR closed its work on the mandates concerning the drafting of implementing measures within the scope of the Directive concerning markets in financial instruments and the Prospectus Directive.

In addition to the work carried out at Level 2 of the Lamfalussy process under the mandates received by the European Commission within the scope of the Directives, CESR continued Level 3 work by drawing up recommendations, standards, common interpretations and procedures to implement co-operation within different areas in order to strengthen regulatory convergence within the EU.

At its meeting on 28 and 29 January 2005, CESR decided to establish a Mediation Task Force intended to develop proposals on the introduction and the functioning of a CESR mediation mechanism. The decision to establish a mediation mechanism follows the request received by CESR of, among others, the Inter-Institutional Monitoring Group for securities markets, the European Securities Committee and the European Parliament, to consider establishing an internal mediation mechanism which goes beyond the requirements provided for the Market Abuse Directive. The consultation paper on the establishment of such a mechanism was published on 8 September 2005 and an open hearing was held on 21 November 2005.

The objective of the mechanism is to resolve disputes between supervisory authorities that are members of CESR and should promote convergence of supervisory practices at European level.

After four years of existence, CESR gradually begins to focus its work on the implementation of FSAP Directives. Its members have therefore decided in October 2005 to create a Task Force in order to define CESR's medium-term priorities as well as any adaptation of its functioning.

Considering the sectoral market integration and the interdependence of financial activities within the European Union, CESR signed, on 24 November 2005, a joint protocol with CEBS and CEIOPS to foster co-operation and coordination in the areas of regulation, information exchange and other tasks with a common interest to the three committees. More detailed information is available under point 2.1.1. above.

Moreover, owing to the growing interdependence of the European and American markets, CESR held discussions with the American regulatory authorities, i.e. the SEC (Securities and Exchange Commission) and CFTC (Commodities and Futures Trading Commission) in the various areas. A joint working programme between CESR and CFTC aiming at facilitating the performance and supervision of transatlantic activities as regards derivatives was published in June 2005.

The Market Participants Consultative Panel, a committee comprised of fifteen market participants appointed in a personal capacity, established in June 2002 following a suggestion of the European Parliament and the Committee of Wise Men, is charged with assisting CESR in carrying out its tasks. The three meetings in 2005 of this committee focused mainly on the major trends and evolutions in financial markets, on EU and US regulatory and supervisory issues, on the listing of EU companies on US exchanges, on the exercise of corporate rights in investment management, as well as on the supervisory convergence role of CESR.

Groups established within CESR

- ***Expert group related to the Directive concerning markets in financial instruments (MIFID)***

Under a **Steering Group** and assisted by a consultative group composed of 23 external experts (including a representative of a Luxembourg professional of the financial sector), three CESR expert groups cover the mandates for the Directive on markets in financial instruments (commonly referred to as ISD 2 or MIFID). It has to be noted that the transposition deadline of MIFID was extended to 1 February 2007. The Directive will be applicable as from 1 November 2007.

The mandates³ cover three major subjects handled by three working groups within CESR:

- the requirements for financial intermediaries and investor protection – the Group Intermediaries;
- the rules governing financial markets and market transparency – the Group Markets;
- the requirements for transaction reporting and co-operation – the Group Co-operation and Enforcement.

A first technical advice, submitted to the European Commission on 3 February 2005, covers organisational issues of the financial intermediaries and investor protection (compliance function, organisation regarding procedures, internal systems and resources, outsourcing, record keeping, safeguarding of clients' assets, management of conflicts of interest within an entity to which MIFID applies, rules of conduct for the provision of investment services in relation to the information to provide to customers and the relationships that should be established with customers on services provided by the investment firm, minimum content in the contract signed with the retail client), reporting requirement regarding transactions on financial instruments and co-operation and exchange of information between competent authorities.

Based on past standards drawn up by CESR relating to investor protection and having considered the informed comments of the industry and the participants in the open hearings, the **expert group Intermediaries** presented, on 29 April 2005, technical measures to the European Commission concerning the best practice rules by defining the criteria to be taken into account for the definition of the importance of the different elements of best practice (such as price, cost, swiftness, security and probability of execution and delivery), as well as the rules governing the handling of eligible counterparties. These technical measures also cover the definition of investment advice, the list of financial instruments, certain rules of conduct (requirement to act honestly, fairly and professionally in the best interest of the clients, suitability test, execution only), the conflicts of interest inherent in investment research, the agreement with the professional client and the handling of eligible counterparties.

Both advices have been discussed within the European Securities Committee and will be used by the European Commission to establish implementing measures complementing the MIFID framework.

CESR attaches increasingly attention to the involvement of private investors and consumers in its works and to their feedback. CESR had therefore organised a MIFID Consumer Day on 22 March 2005. Twelve representatives of national and European consumer organisations exchanged their views with CESR notably as regards the technical measures drawn up by the expert group Intermediaries. The importance of investor education and the need to have it high on the political agenda, as well as the need to organise such consumer days more often have been the essential conclusions that were drawn at the MIFID Consumer Day.

The **expert group Co-operation and Enforcement**, which submitted its technical advice to the European Commission on 31 January 2005, continued discussions on the technical aspects relating to the modalities for on and off stock exchange transaction reporting on financial instruments admitted on a regulated market. CESR-Pol (please refer to “CESR’s operational groups” hereunder) has been put in charge of drawing up the technical modalities regarding co-operation in this field.

Considering the complexity of the technical aspects and the implementation deadline of MIFID, CESR’s chairmen have decided to set up a **Technical Task Force** (TTF) comprising, among others, IT experts. The mandate given to TTF prioritised the establishment of common data formats and common file formats. At medium term, TTF will work on setting up common quality standards, determining the infrastructure and the setting up of the means to exchange information between competent authorities. TTF made concrete operational proposals for both categories of formats and stressed how important it is to create and maintain certain reference databases for adequate data identification (for example financial instruments). Furthermore, TTF prepared recommendations relating to qualitative subjects concerning the frequency and appropriateness of transaction reports on financial assets, as well as to safety and error correction. TTF considers that exchanges of financial assets transaction reports between competent authorities can be done (1) on a centralised basis, (2) on a decentralised basis, (3) on a mixed basis or (4) through a European database. The future work of TTF relating to the application and financing, as well as to the concrete modalities to implement with respect to transaction reports on financial instruments depends on the final technical measures adopted at Level 2 by the European Commission.

- ***Transparency expert group***

In the first half-year of 2005, the expert group continued its work under the mandate received in 2004 under the Directive on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market (Transparency Directive). These first mandates addressed certain issues related to the notification of reports of major stockholdings, the standards for the dissemination of regulated information and questions on semi-annual reports, the equivalence of transparency requirements provided by third countries and procedures whereby an issuer may elect its home Member State. CESR submitted its technical advice on these issues to the European Commission on 30 June 2005.

In March 2005, CESR took stock of the different options concerning the setting up of a future electronic network of central storage mechanisms for regulated information at European level. This report also addresses the issue of the electronic sending of regulated information by issuers to the competent authorities. Following this report, the European Commission requested CESR in July 2005 to provide:

- by June 2006, its opinion on possible implementing measures concerning the interoperability agreement necessary to allow the interconnection of national central storage mechanisms in a European network and the costs resulting from the creation of such network;
- by June 2006, technical advice on the minimum quality standards that should apply to central storage mechanisms. Moreover, CESR is invited to advise on the role of the competent authorities (notably with regard to their supervisory powers concerning central storage mechanisms), as well as on the minimum quality standards applicable to the transmission of regulated information to the competent authorities;
- by April 2006, an intermediary report on the impact in terms of costs related to the implementation and compliance with the above-mentioned standards by central storage mechanisms.

The working group is assisted by a consultative group gathering eleven external experts (including a representative of a Luxembourg professional of the financial sector) in its work under this new mandate. This work resulted in the publication of a first paper that is submitted to public consultation for a period of two months as from 31 January 2006. It covers the whole mandate, save for the cost-related aspect, which will be dealt with separately.

- ***Expert group Credit Rating Agencies***

The European Commission published a mandate on 27 July 2004 requesting CESR to draw up a technical advice in order for the Commission to assess the need for introducing European legislation concerning rating agencies. The deadline to submit technical advice was 1 April 2005.

On 30 March 2005, CESR presented to the European Commission its technical advice that included feedback of the professionals. CESR proposes not to regulate the credit rating agencies for the time being and to adopt a more pragmatic approach, which consists in keeping under review how credit rating agencies implement the standards set out in the IOSCO Code of Conduct. CESR intends to develop this strategy on the basis of voluntary co-operation of credit rating agencies. In addition, CESR will continue to monitor developments related to credit rating agencies, as well as issues impacting issuers and investors.

Within the context of the voluntary co-operation between CESR and credit rating agencies, every credit rating agency will send an annual letter to CESR outlining how it has complied with the IOSCO Code of Conduct standards and indicating any deviations from the Code. An annual meeting will be held between CESR and credit rating agencies in order to discuss any issues relating to the implementation of the IOSCO code. The credit rating agency will provide an explanation to the national CESR member where any substantial incident occurs with a particular issuer in its market.

CESR published its correspondence with credit rating agencies on 13 December 2005.

- ***Investment Management expert group***

In 2005, the expert group, chaired by the Chairman of the Italian Commissione Nazionale per le Società e la Borsa (Consob), has notably overseen three sub-working groups, two of them dealing with the clarification of definitions concerning eligible assets for UCITS and the third one with the guidelines for supervisory authorities regarding the notification procedure of UCITS.

The CSSF took part in the work of the expert group as well as in that of the three sub-working groups. Overall, these groups met sixteen times in 2005.

The expert group is assisted by a consultative group consisting of sixteen industry experts, including one representative of the Luxembourg investment fund sector. In 2005, three meetings were held between the expert group and the consultative group. The CSSF took part in all the meetings.

The two sub-working groups dealing with the clarification of the definitions concerning eligible assets for UCITS

The works of both sub-working groups led to the adoption, in January 2006, of the technical advice of CESR on the clarification of the definitions concerning eligible assets for investments of UCITS. This Lamfalussy Level 2 and 3 advice can be downloaded from CESR's website (www.cesr-eu.org), reference 06-005.

To prepare its technical advice, CESR had held two consultations and two open hearings in order to gather the comments of the persons and entities concerned. Around hundred persons and entities submitted their comments in writing within the scope of both consultation periods.

On the basis of CESR's technical advice, which aims at a common interpretation of the UCITS Directive, the European Commission will adopt, in spring/summer 2006, a Directive or a Regulation concerning the eligible assets for UCITS.

The following can be underlined in the context of CESR's technical advice:

- The technical advice lists the conditions to be fulfilled by securities under articles 19(1) and 19(2) of the UCITS Directive in order to constitute eligible assets.
- The technical advice specifies that the closed-end UCIs can constitute eligible assets under certain conditions. In this respect, the supervisory member authorities of CESR had developed divergent approaches. The approach adopted in the technical advice of CESR is more stringent than the current approach of the CSSF, but less restrictive than that of many other supervisory member authorities.

- As regards investment in financial derivative instruments on financial indices under the terms of article 19(1)g of the Directive, the technical advice sets down that hedge fund indices cannot be considered as financial indices. However, CESR added that it will reconsider its position by October 2006. It should be noted in this context that the CSSF had adopted a different approach and that it had authorised a small number of UCITS whose investment policy allows to invest in derivative instruments on a hedge fund index. Until that date, the CSSF and the other CESR members committed not to authorise UCITS anymore whose investment policy allows to invest in derivative instruments on a hedge fund index. The technical advice does not rule out investments in derivative instruments on financial indices based on non-eligible assets, such as commodities, and specifies that investments in derivative instruments on indices on commodities can be considered as eligible. The text specifies the conditions that financial indices must fulfil to be considered as eligible as underlying of derivative instruments.
- The technical advice also broaches the money market instruments, credit derivatives, securities and money market instruments that contain embedded derivatives, the other UCIs and UCITS tracking an index.

The sub-working group on guidelines for supervisory authorities as regards the notification procedure of UCITS

The sub-working group has finalised a consultation document on the notification procedure of UCITS which deals notably with the following subjects:

- the notification procedure: this point concerns the two-months period provided for by the Directive, the certification of documents, the translations and the issues concerning sub-funds of umbrella UCITS;
- the content of the notification file: CESR's guidelines contain a model attestation to be drawn up by the home Member State authority and a model notification letter to be submitted by the UCITS to the host supervisory authority;
- the arrangements concerning the marketing of units in the host Member State: the guidelines provide that the website of the supervisory authorities shall mention the marketing rules for units by UCITS.

Following a first three-month consultation period and an open hearing to gather the responses of the persons and entities concerned, a second consultation period of one month is currently envisaged. The final document on the notification procedure of UCITS will be at Level 3 of the Lamfalussy procedure.

- ***Joint CESR-ECB working group on compensation and securities settlement systems***

On 27 September 2001, the European Central Bank (ECB) and CESR drafted the framework for co-operation between the European System of Central Banks (ESCB) and CESR as regards compensation and securities settlement systems in order to study issues of common interest.

Until September 2005, the group worked on a methodology to assess compliance with the standards referred to in the report "Standards for clearing and settlement systems in the European Union" which had been approved in October 2004.

The group has also drawn up a new consultative report entitled "Standards for central counterparties in the European Union" which has not yet been published for consultation.

As regards the open issues identified in paragraph 27 of the October 2004 report, the group was confronted with more political issues, which led to many debates and opinions that diverge more frequently. Given this situation, CESR and the Governing Council of the ECB decided in October 2005 to suspend the work of the working group and to wait for the decision of the European Commission with respect to a proposal for a Directive on securities clearing and settlement. The European Commission announced a possible decision for the end of the first half-year of 2006.

- **Review Panel**

Established following the decision of CESR chairmen in December 2002, the Review Panel is responsible for assisting CESR in its task to ensure consistent and harmonised implementation of EU legislation in the Member States.

In April 2005, the Review Panel published a document describing the methodology to be used and the procedure to be followed for the assessment of the level of transposition and application of CESR measures.

The European Commission requested CESR to assess the transposition of two recommendations it had published on 30 April 2004 and which deal with the use of derivative instruments by UCIs and the simplified prospectuses of UCIs. Based on the assessment methodology, the Review Panel published its assessment report on 7 July 2005. Moreover, the Review Panel was mandated by the chairmen of CESR to assess the transposition of guidelines concerning the transitional provisions of the UCITS III Directive that have been published by CESR on 3 February 2005.

The Review Panel assessed the implementation of CESR standards on cold calling and published its review on 3 January 2006. It has also started to assess the implementation of CESR principles concerning financial information to be provided by issuers and the competences and powers of the authorities in this respect (Standard no. 1), as well as an impact study on Standard no. 1 of Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market.

These reports are available on the CESR website www.cesr-eu.org.

- **Prospectus expert group**

In 2005, the expert group continued its work on issues related to the complex historical financial information in order to determine common practice in this field. As a conclusion to the year under review, CESR noted that Regulation (EC) 809/2004 of 29 April 2004 implementing Directive 2003/71/EC (Prospectus Directive) did not allow anymore, in principle, to require the inclusion in a prospectus of certain historical financial information considered by the competent authorities as representing the information necessary for the proper assessment of the financial situation of a company issuing securities and which was previously required by the majority of competent authorities.

Following this observation, the European Commission considered that it would be preferable to rule out any uncertainty with respect to the information required in these events and to provide for a level of historical financial information that allows to ensure adequate investor protection. The European Commission published a formal mandate in this respect on 2 June 2005.

In its technical advice submitted to the European Commission at the end of October 2005, the expert group has:

- clarified the difference between the nature of the *pro forma* financial information and the complex historical financial information and the period covered;
- proposed to restrict the requests concerning complex historical financial information to the cases where the shares registration document applies;

- proposed a flexible approach allowing the competent authorities to take their decisions in this field in accordance with the situation, in light of the economic reality, the significance of the events and the costs related to the drawing-up of the requested information.

The expert group closely co-operated with a consultative group comprised of ten external experts, including one representative of the *Bourse de Luxembourg* (Luxembourg Stock Exchange) to draw up its technical advice.

Following the implementation of the Prospectus Directive in the different Member States, experts of the different competent authorities met twice in 2005 in order to ensure a coherent and consistent implementation of the European provisions relating to prospectuses for securities and to promote the proper operation of the European passport granted to issuers. Urgent practical questions concerning the co-operation and the procedures to apply in the context of this co-operation have been discussed. The experts have notably drawn up a contact list between authorities and a model notification certificate in order to simplify the procedures relating to the European passport for prospectuses. During these meetings, the experts started discussions concerning the practical implementation of the provisions of the Prospectus Directive and of the Regulation (EC) 809/2004 and were able to agree on a certain number of common positions.

Operational groups established within CESR

• *CESR-Fin*

The purpose of the permanent operational committee CESR-Fin is to coordinate CESR's works as regards financial information standards in Europe.

CESR-Fin allows CESR to play an effective role in the implementation and enforcement of the IAS/IFRS standards in the European Union within the context of the new compulsory accounting framework for all European listed companies since 2005. CESR-Fin also helps CESR to ensure a coordinated and effective application of the IAS/IFRS standards by EU listed companies by developing standards and guidelines as regards supervision and control of financial information in Europe.

Moreover, CESR-Fin has been put in charge of monitoring developments in Europe in the area of audit.

In 2005, CESR-Fin dedicated the majority of its activities to two main projects:

- the implementation of the coordination mechanism as envisaged by CESR's Standard no. 2 on the monitoring of the enforcement of financial information, with, among others, the organisation of the first meetings of the competent authorities in order to discuss practical cases linked to financial information and the creation of a CESR database of decisions in this field;
- the development and the finalisation of CESR's advice to the European Commission on the equivalence of accounting standards of certain third country GAAP and IAS/IFRS standards.

Moreover, CESR-Fin has continued to follow the endorsement process of IFRS standards in the European Union and prepared a consultation paper on the Alternative Performance Measures.

Enforcement of the IFRS standards

The Prospectus and Transparency Directives introduced considerable changes in the European institutional landscape of financial information by requiring the designation in each Member State of a competent administrative authority responsible for the supervision of financial information provided to the markets by means of prospectuses or on a periodic basis.

CESR anticipated the new institutional framework by developing Standard no. 1 whose implementation at national level is currently under review by the Review Panel.

The coordination mechanism developed by Standard no. 2 on the enforcement of financial information was further implemented by the European Enforcers Coordination Sessions (EECS). EECS started its activities in January 2005 and met seven times during the year. Its meetings have been entirely dedicated to discussing practical and technical issues that arose from the day-to-day supervisory practice of financial information in each jurisdiction and represent an efficient means for experts in accounting and financial information to exchange their views and experience.

Simultaneously, CESR completed its IT project by creating a database for decisions taken by the competent supervisory authorities, members of CESR. Operational since August 2005, the database is a useful source of information for EECS members that are required to look up the existing decisions before taking new ones.

CESR-Fin also took part in discussions led by the European Commission within the Accounting Regulatory Committee (ARC) in order to set up a temporary round table, supposed to act as informal forum of European accounting professionals and experts to rapidly identify the emerging accounting aspects and potential issues and requiring the intervention of the Regulator (IASB/IFRIC). CESR was invited to participate in the round table which supplements the existing European infrastructure.

Given the importance within the European context, the continuation of EECS meetings and the efficient use and development of the database has priority in the CESR-Fin agenda for the coming months and years.

Equivalence of accounting standards of certain third country GAAP and IFRS

On 29 June 2004, CESR received the mandate from the European Commission to provide technical advice on the equivalence of Canadian, Japanese and US GAAP and IFRS standards. The mandate also requested the description of the enforcement mechanisms of the financial information which are in place in the three countries concerned. The mandate related to the requirements laid down in the Prospectus and Transparency Directives concerning financial information issued by third country issuers.

The technical assessment of equivalence of accounting standards and the description of the enforcement mechanisms have been undertaken by the relevant CESR-Fin sub-committees assisted by a Consultative working group of high-level accounting and financial information experts.

In its final advice submitted to the European Commission on 30 June 2005, CESR confirms the premise of its initial technical assessment of equivalence and concludes, after having considered the needs of the investors in the EU financial markets, that the GAAP of the three countries, each of them taken as a whole, can be considered as equivalent to the IFRS standards subject to certain remedies (mainly relating to the publication of information; please refer to www.cesr-eu.org).

A key element of CESR's conclusion is the fact that issuers under the Canadian, Japanese or US GAAP are not at all required to provide full reconciliation to IFRS. The description of enforcement mechanisms of financial information is based on the information provided by Canada, Japan and the USA.

The European Commission has however pointed out that it would not take any decision on equivalence before 2009.

CESR's recommendation concerning Alternative Performance Measures and endorsement activities of CESR-Fin

The final recommendation on the use by the listed companies of the Alternative Performance Measures was published by CESR on 3 November 2005. Its purpose is to provide guidelines to the listed companies in order to make sure that the information they provide to investors is not misleading.

Moreover, CESR-Fin has continued to follow the developments as regards the new standards or adjusted financial information standards. In particular, the Committee analysed the project published by IASB proposing adjustments to the standards.

CESR-Fin voiced its concerns that IASB introduces major and much debated technical amendments without addressing some fundamental aspects that have been identified by CESR's advice on equivalence, such as the consolidation of special purpose entities (SPEs). According to CESR, it is important that the IASB (and IFRIC) first deals with the aspects identified by the regulators and other players as being of immediate practical importance, rather than with larger-scale ones.

CESR-Fin activities in the area of audit

CESR's audit activities focused on the developments regarding the 8th Directive and on the audit issues arising from the implementation of the new European Directives.

CESR-Fin has thus held discussions which resulted in the approval by the European Parliament of certain amendments to the 8th Directive (Audit Directive) on 28 September 2005. These amendments will introduce a system for the public oversight of the audit profession and for the co-operation between Member State authorities, require the application of international standards on auditing in the European audit and the rotation, every seven years, of the key audit partner / statutory auditor.

CESR-Fin also carried out a survey on the role of securities regulators in auditor oversight and on the relationship with auditors of public listed companies.

CESR-Pol

CESR-Pol's purpose is to enhance sharing of information, co-operation and coordination of supervision and enforcement activities between CESR members.

A major priority of CESR-Pol is to ensure the effective day-to-day implementation of the Market Abuse Directive at Level 3 of the Lamfalussy process. As a result of the mandate received by CESR's chairmen, CESR-Pol published, on 11 May 2005, a document containing detailed guidance on the following subjects:

- accepted market practices (procedure to abide by, format and accepted practices proposed by certain members);
- a description of certain types of price manipulation;
- indication of insider dealing and price manipulation;
- format for reporting suspicious transactions to the relevant authority.

In the same context, CESR-Pol started to work on the preparation of measures covering the following subjects:

- the definition of "inside information" and the moment as of which an information becomes an inside information;
- legitimate reasons to delay the publication of an inside information;

- questions on insider dealings relating to book-building and pre-marketing mechanisms;
- the moment as of which large customer orders may become an inside information;
- assessment criteria of a rather illiquid market;
- the establishment and keeping of insider lists, notably where financial instruments of an issuer are admitted to several regulated markets of different countries and where the registered office of the issuer is located in a country different from that of the person acting for the account of the issuer.

Similarly, in order to ensure harmonised implementation of the provisions concerning co-operation under MIFID, CESR's Chairmen requested CESR-Pol to draw up measures covering co-operation issues under this Directive. CESR-Pol will actively start its work once the European Commission has endorsed its implementing measures of MIFID.

In order to better achieve its goal to enhance co-operation, CESR-Pol had drawn up a paper describing the procedure to follow as regards requests to open an investigation by a competent authority to the authority of another CESR Member States, as well as requests for joint investigations between several authorities of Member States. Moreover, CESR-Pol has categorised the information that has to be exchanged between competent authorities (automatic information, information that has to be exchanged in consultation procedures and information to be exchanged on request).

One of the major decisions of CESR-Pol in 2005 was to establish a more operational structure. Thus, its members will deal, during plenary meetings, with subjects concerning political strategy and general principles of co-operation and will adopt proposals for more technical measures under the mandates received by CESR-Pol from CESR's Chairmen. A new permanent working group **Surveillance and Intelligence Group** (S & I Group) will focus on the exchange of practical experience in co-operation, daily supervision of investment firms and financial markets and unauthorised offers of financial services by persons and investment firms that do not hold adequate authorisation. CESR-Pol has also adopted the principle to establish an **Urgent Issues Group** every time that several authorities of different Member States are involved in an investigation and it is necessary to ensure swift co-operation and to take prompt measures in cases of threats to one or several securities markets.

Furthermore, CESR-Pol developed its network for the dissemination of warnings relating to illicit offers of financial services by investment firms or individuals that have not been granted the required authorisations thereto. Warnings are also transmitted to CEBS members.

CESR-Pol has also continued to enhance dialogue with IOSCO in order to improve co-operation and exchange of information with non-co-operative countries and to coordinate the measures to be taken in this respect. Moreover, CESR-Pol continued discussions with Liechtenstein and provided assistance for the transposition of the Market Abuse Directive.

2.1.3. Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS)

The Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) is comprised of high-level representatives from the insurance and occupational pensions supervisory authorities from EU Member States. The Committee's objectives are to advise the European Commission, either at the European Commission's request or on the Committee's own initiative, as regards the preparation of implementing measures in the fields of insurance, reinsurance and occupational pensions, to contribute to the consistent implementation of EU Directives and to the convergence of Member States' supervisory practices and to constitute a forum for supervisory co-operation, including the exchange of information on supervised institutions.

The CSSF participates in the works of CEIOPS concerning occupational pensions in its capacity as member.

CEIOPS has created several working groups among which the Occupational pensions committee. This permanent working group deals with all the aspects relating to the activities of institutions for occupational retirement provision under the terms of Directive 2003/41/EC concerning the activities and supervision of institutions for occupational retirement provision (IORP Directive).

Its tasks include:

- developing a common understanding of the IORP Directive;
- facilitating the co-operation, coordination and exchange of information between supervisory authorities on cross-border membership and related issues;
- carrying out the preparatory work for dealing with issues related to pension funds.

These functions notably comprise the following tasks:

- preparation of a protocol organising the co-operation, coordination and regular information exchange between occupational pensions supervisors in view of the implementation of the IORP Directive;
- analyses of the current status of the pension savings institutions from the EU legislation point of view;
- monitoring of the practices adopted by the Member States to calculate technical provisions;
- monitoring of the progress achieved in the adaptation of investment rules and the use of depositaries in the national supervisory systems.

On 22 February 2006, the plenary meeting of CEIOPS members adopted a protocol ("Budapest Protocol") relating to the collaboration of the relevant supervisory authorities in the application of the IORP Directive, which is available on the CEIOPS website (www.ceiops.org).

2.1.4. Capital Requirements Directive Transposition Group

Established in December 2005, the objective of the group is to provide all interested parties with responses as regards the implementation and interpretation of the recasted Directives 2000/12/EC and 93/6/EEC that transpose Basel II into European legislation, as the different linguistic versions of the final texts of these Directives will not be published before the end of the first half-year of 2006. To this end, the European Commission and its working group co-operate closely with CEBS. Further information on the operation of the process, which aims at ensuring a certain consistence in the transposition of both Directives, is available on CEBS' website at www.c-eps.org/crdtg.htm.

2.1.5. Contact committee on money laundering

The Contact committee on money laundering, established by Directive 91/308/EEC on the prevention of the use of the financial system for the purpose of money laundering, is entrusted with facilitating the harmonised implementation of the Directive through regular consultation on concrete issues regarding implementation. The committee also deals with questions discussed within the Financial Action Task Force on money laundering (FATF). Luxembourg is represented within this committee by representatives of the CSSF, the Ministry of Finance and the Ministry of Justice.

In 2005, the committee met on six occasions. Its works mainly concerned the implementing measures of the anti-money laundering Directive and FATF works.

2.1.6. Expert group on payment systems

The *ad hoc* group, which met twice in 2005, continued its work on the introduction of a new legal framework for payments within the internal market. The European Commission has published a proposal for a Directive in this context which is being discussed by the EU Council.

2.1.7. Accounting Regulatory Committee / Contact committee on accounting directives

The objective of the Accounting Regulatory Committee, established by the European Commission in accordance with Article 6 of the IAS Regulation, is to provide advice on the proposals of the European Commission in order to adopt one or several international accounting standards.

In 2005, the Accounting Regulatory Committee met five times jointly with the Contact committee on accounting directives, instituted under Article 52 of the fourth Company Law Directive (Directive 78/660/EEC). These meetings mainly concerned the adoption of the standards of the International Accounting Standards Board (IASB), the draft IASB standards in progress, the draft implementation of a Roundtable on consistent application, as well as the convergence and equivalence between the IFRS standards and third country GAAP, in particular US GAAP.

During the meeting of 8 July 2005, the Committee endorsed the international standard IAS 39 "Financial instruments: Recognition and measurement", introducing into this standard a new version of the fair value option, based on principles and allowing the use of this option solely in the cases that are listed in this standard. The adoption of this amendment entailed the elimination of the carve-out of November 2004, which excluded the use of the fair value option for liabilities. Consequently, only the carve-out of certain provisions on hedge accounting remains.⁴

The current situation of the approval process of the international accounting standards in the European Union, as well as the works of the Accounting Regulatory Committee are available on the website of the European Commission at http://europa.eu.int/comm/internal_market/accounting/ias_en.htm.

2.2. Groups operating at European Union Council level

The CSSF is a member of the 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 format the consensus texts, referring only political difficulties to the Permanent Representatives Committee and the Council of Finance Ministers. The groups are chaired by a representative of the Member State that presides over the Council. Luxembourg chaired in the first half of 2005 followed by the United Kingdom in the second half. The list of Directives under negotiation at Council level and a brief description thereof is available in Chapter XII.

⁴ Please also refer to the CSSF's Annual Report 2004.

2.3. Banking Supervision Committee of the European Central Bank

The Banking Supervision Committee (BSC) of the European Central Bank is a committee made up of high-level representatives of the banking supervisory authorities and the central banks of Member States. It is chaired by Mr Meister, member of the Board of Directors of Deutsche Bundesbank. The missions concerning prudential supervision conferred by the Treaty and the statutes of the European Central Bank on the ESCB (European System of Central Banks) are carried out by the Banking Supervision Committee on behalf of the ESCB. The Committee is a forum for the exchange of opinions on the supervisory policies and practices in Member States. It should also be consulted on proposals for Directives and bills tabled by Member States on matters within its competence.

Two working groups comprising members of the central banks and national supervisory authorities, i.e. the Working group on macro-prudential analysis and the Working group on developments in banking, mainly assisted the Banking Supervision Committee in carrying out its mandate in 2005.

In order to systematise the analysis of macro-economic data with a view to identifying, as far as possible in time, the factors likely to weaken the financial institutions as a whole and therefore the financial system, the Working group on macro-prudential analysis monitors the macro-economic environment and reports to the Committee on trends and facts likely to be relevant to the prudential supervision of the financial sector.

Every year, the working group draws up a report on the stability of the financial sector. This report is discussed by the Executive board of the European Central Bank. It has been published under the aegis of the Banking Supervision Committee for four years now (please refer to www.ecb.int). In 2005, the group has analysed in particular the potential risks for the stability of the banking sector resulting from direct positions, mainly investments and credit lines, and indirect exposure on the alternative fund sector. A specific study was dedicated to the changing relations between banks and large companies. The development of the price policy, as well as the diversification and impact of the condition of the corporate sector and of certain of its major players on the asset quality of banks have been studied.

As in the previous years, the Working group on developments in banking focused on the drawing up of its structural report during the first half of 2005. This annual report aims to identify and monitor the structural trends marking the European banking sector as a whole. The 2005 report focuses in particular on the market of syndicated lending, consumer credits, as well as the structure of large European banking groups. During the second half of the year, the group analysed the future of the European banking market by the end of the decade. This work consisted in particular in analysing the areas of financial intermediation and corporate governance.

The joint working group on crisis management established together with CEBS at the end of 2004 published a preliminary version of a document on the guidelines for prudential supervisory authorities and central banks to manage financial crises within the banking sector or the securities markets. An exemplifying list of information to exchange between authorities in case of a crisis has also been set up and transmitted to the founding committees.

3. MULTILATERAL CO-OPERATION

3.1. Basel Committee on banking supervision

The Basel Committee continued to follow the implementation of the new capital adequacy framework, commonly known as “New Basel Accord” or “Basel II”, in its different work groups.

Furthermore, the Basel Committee has revised the Core principles for effective banking supervision published in September 1997. These Core principles, along with the Core principles methodology, have been used by countries for assessing the quality of their supervisory systems and for identifying future work to be done to achieve a baseline level of sound supervisory practices. In conducting this review of the Core Principles and their Methodology, the Committee was motivated by a desire to ensure continuity and comparability with the 1997 framework, which has functioned well and is seen to have withstood the test of time.

Thus, the intention was not to radically rewrite the Core Principles, but rather to focus on those areas where adjustments to the existing framework were required to ensure their continued relevance. The publication of the document, which is currently under consultation with other international bodies, is planned for 2006.

The Committee also participated in the works of the Joint Forum established in 1996 under the aegis of the Basel Committee, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS), to deal with issues common to the banking, securities and insurance sectors. In 2005, the work of the Joint Forum resulted in the publication of the following documents, which are available on the website of the Basel Committee at www.bis.org/dcms/fl.jsp?aid=4&pmdid=3&smdid=14&tmdid=14&fmdid=0&dtid=1&y=now:

- the document “Outsourcing in Financial Services”, published in February 2005;
- the document “Credit Risk Transfer”, released in March 2005, which deals with the credit risk transfer in the context of transactions linked to credit derivatives. This market has developed rapidly over the last few years and the report includes a set of recommendations for market players and supervisory authorities in the areas of risk management, disclosure and supervisory approaches;
- the consultation document “High-level principles for business continuity”, published in December 2005.

3.1.1. Capital Task Force

The Capital Task Force (CTF) is the ultimate technical work group of the Basel Committee on banking supervision as regards regulatory aspects relating to the reforms of the capital adequacy framework. It met on a regular basis in 2005 and has notably adopted the technical part of the document “The Application of Basel II to Trading Activities and the Treatment of Double Default Effects”, published for consultation in April 2005 and finalised in July 2005.

This document, which has been drawn up jointly by the Basel Committee on banking supervision and IOSCO and which addresses explicitly credit institutions and investment firms, includes proposals on subjects whose works have already been announced in the preamble of the final text of the New Basel Accord in June 2004, namely:

- the treatment of counterparty risk for over-the-counter derivatives, repo-style and securities financing transactions;
- the treatment of cross-product netting arrangements;
- the treatment of double-default effects;
- the short-term maturity adjustment in the IRB approach;

- the new provisions relating to specific market risks for trading book positions;
- the review of the treatment for non-settled transactions.

The CTF has also been charged with consolidating this document with the documents “International Convergence of Capital Measurements and Capital Standards: A Revised Framework”, commonly known as New Basel Accord, and “Amendment to the Capital Accord to incorporate market risks” of 1996. The consolidated versions have been published on 15 November 2005 and are available at <http://www.bis.org/publ/bcbsca.htm>.

3.1.2. Accord Implementation Group

The Accord Implementation Group has been created to promote the consistent implementation of the new capital adequacy framework at international level. It operates as multilateral discussion forum that allows national supervisory authorities that are members of the Basel Committee, to share their experience in the field of validation of advanced approaches under Basel II. The group endeavours in particular to find a common solution to the concrete questions arising from the practical implementation of the Basel II standards. The Accord Implementation Group includes the Working Group on Capital of the Core Principles Liaison Group in this endeavour in order to extend the discussions to the States that are not members of the Basel Committee. In this context, the Basel Committee published a set of guidelines for the co-operation between home and host authorities under the title “Home-host information sharing for effective Basel II implementation” in November 2005.

During its three meetings in 2005, the Accord Implementation Group has closely followed the implementation works of the Basel II standards by the main banking groups that operate cross-border. It also endeavoured to consider the opinions of the different professional associations and their concrete questions concerning the practical implementation of Basel II. The specific subjects treated in 2005 concerned the elements left at national discretion, the estimation of LGD (Loss Given Default), risk concentration measure, simulations in crisis situations, as well as prudential supervisory process (pillar 2). The work on LGD led to a first publication “Guidance on the estimation of loss given default (Paragraph 468 of the Framework Document)” in July 2005.

3.1.3. Accord Implementation Group - Sub-group on Validation (AIGV)

The working group focused its efforts in 2005 on the methods that banks, whose low-default portfolio does not allow them to quantify their probability of default, should adopt. Other subjects included the criteria to fulfil for the adoption of vendor models, the requirements as regards governance and internal control and the use of internal ratings systems (use test).

In order to promote the exchange of knowledge between authorities, the AIGV proposes to regroup the documents produced by the group in relation with the validation of internal ratings systems in a compendium, which will be available to a larger community of banking supervisory authorities.

3.1.4. Risk Management and Modelling Group

In the introduction of the new Basel II framework, the Basel Committee stipulates that it “understands that the IRB approach represents a point on the continuum between purely regulatory measures of credit risk and an approach that builds more fully on internal credit risk models”. In order to achieve a prudential regulation that is more in line with internal models, the Basel Committee “seeks to continue to engage the banking industry”. To this end, it created the Risk Management and Modelling group, which met for the first time in 2005. The group’s objective is to interact with industry in order to propose in the long run and if necessary, a realignment of requirements regarding regulatory capital with internal risk measures.

3.1.5. Accounting Task Force

The Accounting Task Force is in charge of monitoring the works in the areas of accounting and audit and the development of the principles and guidelines in these areas.

In April 2005, the group finalised a document on “Compliance and the compliance function in banks” dealing in particular with best practice concerning compliance within credit institutions.

In the field of provisioning, which preoccupies the prudential supervisory authorities, the group has published a consultative document entitled “Sound credit risk assessment and valuation for loans” that replaces the paper “Sound practices for Loan Accounting and Disclosure” of July 1999. This document explains how common data and processes may be used for credit risk assessment, accounting and capital adequacy purposes. It also highlights the provisioning concepts that are intended to be consistent with prudential and accounting frameworks. The consultation period ended on 28 February 2006.

Another area of concern for the prudential authorities relates to the fair value option. It should be noted that the International Accounting Standards Board (IASB) published an amended version of the fair value option in June 2005, which limits its use to only those cases that are listed in the new provisions. The Accounting Task Force has been in contact with IASB representatives and submitted its view on IASB’s proposal in April 2005.

The consultative document “Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards” was published in July 2005. The first part of the document informs banks that use the fair value option on the appropriate and sound processes as regards risk management and control. The second part provides guidance for prudential supervisory authorities regarding the manner in which they should consider the level and the nature of the use of the fair value option when assessing the adequacy of risk management and regulatory capital of a credit institution. The CSSF will thus assess if banks utilise the fair value option appropriately and may take, where necessary, corrective measures as provided for in the document. The consultation period ended on 31 October 2005. The document will be revised soon in the light of the comments received during the public consultation. A final version will be published subsequently.

As regards audit, the group sent its comments on various exposure drafts of the International Federation of Accountants (IFAC) and of the International Auditing and Assurance Standards Board (IAASB), i.e. the “IFAC Exposure Draft on the Proposed Revised Code of Ethics”, the “IAASB Exposure Drafts on group audits, auditor communications, modified audit opinions and the use of emphasis of matter or other matter paragraphs in the independent auditor’s report”, the “IAASB Exposure Drafts on Materiality and Auditing Estimates” and the “IAASB Exposure Drafts on Clarity and Documentation”.

3.1.6. Working Group on corporate governance

Established in 2004 at the initiative of the Basel Committee on banking supervision, the group has updated the guidelines on corporate governance for banking organisations. Insofar as they apply to the banking sector, the group incorporated the revised principles on corporate governance as published by the OECD in 2004. The prudential lessons drawn from recent breakdowns in corporate governance also helped to enrich the text. Finally, the Know Your Structure issue has been dealt with more specifically to extract best practice principles as regards the use and implementation, for own account or on behalf of third parties, of legal means, as well as complex financing structures.

Representatives of the OECD and of the World Bank participated in these works. Discussions and dialogue took place with other international bodies, notably with the representatives of the International Association of Insurance Supervisors (IAIS), to share experience as regards the implementation of the “Insurance Core Principles on Corporate Governance” published in January 2004, as well as with regional associations of representatives of the financial sector.

The document “Enhancing Corporate Governance for Banking Organisations” was submitted to public consultation during the summer of 2005. The working group reviewed the comments collected during this consultation and incorporated them into the document insofar as they were useful for the implementation of certain principles and as they made the text clearer, more visible and coherent. The text was published on 13 February 2006 on the website www.bis.org.

3.2. International Organisation of Securities Commissions (IOSCO) and IOSCO groups

3.2.1. XXXth Annual Conference of IOSCO

The securities and futures regulators and other members of the international financial community met in Colombo, Sri Lanka, from 4 to 7 April 2005, on the occasion of the XXXth Annual Conference of IOSCO.

During this conference, IOSCO adopted a new strategic direction that will allow to fully play its role as international standard setter for securities regulation and to strengthen its effectiveness. The means that will be employed to reach these objectives include notably the improvement of enforcement related cross-border co-operation and the implementation of the IOSCO objectives and principles of securities regulation (IOSCO Principles). In addition, a new public consultation policy was endorsed.

Greater emphasis will be laid on the Multilateral Memorandum Concerning Consultation and Cooperation and the Exchange of Information (MMOU). IOSCO has also adopted a timetable by which all member regulators of IOSCO, which are not already signatories to the MMOU will be asked to meet this benchmark by 1 January 2010. By this date, all member regulators should have applied for and been accepted as signatories (under Appendix A) of the MMOU or have expressed a commitment to seek legal authority to enable them to become signatories (*via* Appendix B). In order to achieve these objectives, IOSCO will provide resources to members including technical assistance. Twenty-nine candidates have signed this MMOU and nine candidates have committed themselves to undertake the necessary reforms to become a full signatory. Similarly, IOSCO also endeavours to promote international co-operation by continuing to strengthen the ability of the members to obtain swift and effective co-operation with respect to aspects relating to cross-border investigations on potential infringements of the regulations on securities. Moreover, IOSCO tries to identify the countries that appear to be unable to co-operate or unwilling to co-operate and to enter into a dialogue with them in order to resolve related issues.

IOSCO continued its work as regards the fight against financial fraud and its collaboration with the Basel Committee on banking supervision and the International Association of Insurance Supervisors in order to coordinate actions in combating money laundering and terrorist financing.

IOSCO also continues its endeavours aiming to promote compliance with the IOSCO Principles by its members and the adoption of the principles of a Code of Conduct by credit rating agencies. Moreover, IOSCO reiterated its support for the work of the International Accounting Standards Board (IASB) and encouraged its members to accept financial statements prepared under the International Financial Reporting Standards (IFRS). IOSCO developed its work as regards boiler rooms, cold calling and the broad principles for undertakings for collective investment (UCITS) governance.

IOSCO also started an analysis of organised securities and derivatives markets and of their supervisory authorities, of market timing, hedge funds and the development of a model code of ethics for self-regulating organisations.

3.2.2. IOSCO groups

The CSSF is a member of two IOSCO groups, i.e. the Standing Committee n° 1, dealing with subjects concerning accounting, and the Standing Committee n° 5 concerning UCIs and collective management.

- ***Standing Committee n° 1 (SC1)***

The CSSF is member of the permanent committee SC1 and takes also part, as far as possible, in the meetings of the sub-committees on disclosure, accounting, auditing, as well as the implementation of the IAS/IFRS standards.

In 2005, the sub-committee Disclosure finished its work on the International Debt Disclosure Principles. This project, published on the IOSCO website (www.iosco.org), had been submitted to public consultation. The document will be completed at the beginning of 2006 and will take into account the comments received during the consultation period. The committee, in the meantime, resumed its work on the principles for periodic disclosure by issuers and believes being able to submit draft principles to the SC1 by the end of 2006.

Among the various projects initiated in 2005 by the SC1 is the survey on the internal control requirements for issuers. A questionnaire has been prepared which should provide an overview of the existing regulations and practices. The results of this survey will be included in a report that will probably be presented at the annual conference 2006.

Another SC1 project concerns the information disclosed by issuers where special purpose entities (SPEs) are used. In this context, SC1 takes stock of the current requirements applicable in the different jurisdictions as regards accounting and non-financial information and, where applicable, the level of assurance given by an auditor. SC1 will present a report to the Technical Committee that includes its recommendations, if, in its opinion, the use of SPEs by issuers justifies the disclosure of additional information.

As far as accounting is concerned, SC1 continued to follow the work of IASB and IFRIC concerning accounting regulation. Its sub-committee Accounting participates in the IASB working groups, including those on reporting of financial performance of issuers, accounting of financial instruments, insurance contracts and extraction of natural resources. In 2005, the SC1 sent several comment letters to the IASB, notably on the proposed amendment of the accounting for business combinations.

In the field of auditing, SC1 continued its analysis of the activities of IAASB, international standard-setter in auditing, and notably of the "Clarity" project, which aims at indicating how the International Standards on Auditing (ISAs) will be written in the future.

The results of the survey on the audit profession, performed by the sub-committee Auditing, were published on the IOSCO website in April 2005. It should be noted, among the consequences of the survey, the particular concentration of SC1 on the services other than auditing.

The sub-committee IFRS Regulatory Interpretation and Enforcement continued its work on the supervision of the implementation of financial information. Thus, the terms of the arrangements under which regulatory authorities may share their experience and decisions on the implementation of IFRS standards have been developed. The future work will mainly concern the development of a database, in close co-operation with CESR, in order to build an IOSCO database that is compatible with that of CESR.

- **Standing Committee n° 5 (SC5)**

In 2005, the Committee worked on the following topics: Examination of governance for CIS, Anti-money laundering guidance for CIS, Market timing and associated issues, Hedge funds and related issues, Distribution costs and fee structure, Soft commissions and Risk based approach of the future SC5 working program.

In October 2005, IOSCO published the documents "Final Report: Best practices standards on anti market timing and associated issues for CIS" and "Final Report: Anti-money laundering guidance for collective investment schemes". Both documents are available on the IOSCO website.

At the end of January 2006, the committee submitted to the Technical Committee of IOSCO the report prepared in 2005 on hedge funds offered to the public.

3.3. Informal groups

Extended contact group "Undertakings for collective investment"

The group is entrusted with establishing multinational dialogue on issues that arise within the scope of regulation and supervision of UCIs.

The CSSF participated in the annual meeting of the group, which was held from 28 to 30 September 2005 in Dublin. During this meeting, the following topics have been tackled: questions relating to prudential supervision, conflicts of interest / code of conduct, legal issues, financial issues, reporting, management and administration, UCITS and special UCIs.

3.4. Institut Francophone de la Régulation Financière (IFREFI)

The *Institut Francophone de la Régulation Financière* (IFREFI, Francophone institute for financial regulation), gathering the financial markets regulatory authorities of fourteen French-speaking countries (Algeria, Belgium, France, Guinea, Luxembourg, Quebec, Morocco, Switzerland, the West African Monetary Union, Monaco, Tunisia, the Economic and Monetary Community of Central Africa, Cameroon and Romania) was created in 2002 by a charter. IFREFI is a flexible structure of co-operation and dialogue and aims at furthering the exchange of knowledge and experience, drawing up studies and exchanging essential information relating to the financial markets between the Member States of the Institute. According to the charter, IFREFI also aims at promoting professional training by organising training seminars on specific topics.

During the annual meeting of chairmen that has been held in Brussels in June 2005, recent works of IOSCO relating to fraudulent bankruptcies, as well as rating agencies have been discussed. Following this meeting, a training seminar on the authorisation and supervision of investment service providers has been organised. The seminar dealt with the following subjects:

- minimum requirements for authorisation (material means, own funds, competence, professional repute and ethics of managers and main shareholders);
- supervisory means and techniques (documents, place and organisation);
- relief and administrative sanctions;
- rules of conduct (presentation of CESR's rules of conduct);
- irregular offer of investment services;
- close collaboration between supervisory authorities;
- compensation schemes.

As the participants showed a strong interest in the subject of administrative sanctions, it has been decided to look into this subject during one of the next meetings of IFREFI. In the context of this seminar, one CSSF agent gave an account of the Luxembourg professional experience as regards rules of conduct.

3.5. Groupe des superviseurs bancaires francophones

Following the kick-off meeting of the *Groupe des superviseurs bancaires francophones* (GSBF, Group of Francophone banking supervisors) within the context of the International Conference of Banking Supervisors in Madrid on 21 September 2004, a second meeting of the group took place in Morocco in March 2005 during which the GSBF charter has been signed. The GSBF gathers the banking supervisory authorities of the following French-speaking countries: Central Africa, Algeria, Canada, Congo, Belgium, Burundi, France, Guinea, Lebanon, Luxembourg, Madagascar, Morocco, Mauritania, Romania, Rwanda, Switzerland, Tunisia and the West African Monetary Union.

The objective of the GSBF is to develop a high-level co-operation between its members so that the exchange of experience and information promotes the generalisation of best practices and the convergence of the prudential approaches *vis-à-vis* common problems. Furthermore, it proposes to provide comments, following examination, on the work that has been circularised by the Basel Committee and to regularly inform the latter on the activities of the Group and on the specific work or research undertaken occasionally. Finally, the GSBF intends to strengthen the contacts and exchanges between regional supervisory groups and to rely on the Institute for Financial Stability (IFS) of the Bank for International Settlements to develop a set of appropriate training actions.



GENERAL SUPERVISION

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Absent: Guy HAAS, Ngoc Dinh LUU, Joëlle MARTINY, Romain STROCK, Claudine WANDERSCHIED

