



**CEBS 2006 101**  
**9 June 2006**

## **Second Progress Report on Supervisory Convergence in the Field of Banking for the Financial Services Committee**

### **Executive summary**

This second progress report reviews the activities of CEBS over the past 12 months in promoting consistent implementation of the Capital Requirements Directive<sup>1</sup> (CRD) and enhancing convergence in day-to-day supervisory practices<sup>2</sup>. This review identifies priorities for work in three main areas:

#### **(i) *Fostering supervisory convergence***

The main priority of CEBS has been on **finalisation of common guidelines** related to implementation of the CRD. CEBS has published final guidelines on transparency and public disclosure of supervisory rules and guidance (Supervisory Disclosure), the Supervisory Review Process, the implementation, validation and assessment of the advanced approaches for credit and operational risk and, finally, on cooperation between home and host supervisors. CEBS has been actively involved in the work of the CRD Transposition Group as it is an important element for the consistent application of the CRD and for supervisory convergence.

The issuance of CEBS guidelines are followed up by initiatives to make sure that the guidelines are effectively used in day-to-day supervision. CEBS has already conducted a first internal assessment of the intention of its members to apply the guidelines at the national level and the initial results are predominantly positive. CEBS is developing self-assessment criteria and methodology to monitor the progress and implementation in the future.

#### **(ii) *Enhancing the cost-efficiency of the EU system***

CEBS' main contribution to improved cost-efficiency of EU supervisory systems comes from the **finalisation of common frameworks for reporting** that will allow institutions to use a common set of templates and data formats when transmitting financial and prudential data to supervisors. Moreover, CEBS guidelines on the **recognition of External Credit Assessment Institutions** (ECAIs) envisage criteria and procedures for reaching a joint assessment that is expected to streamline an otherwise fragmented recognition process.

---

<sup>1</sup> The Capital Requirements Directive (CRD), which recasts Directives 2000/12/EEC and 93/6/EEC (see MARKT/1050/04).

<sup>2</sup> A more comprehensive view of CEBS' work could be gathered by complementing this paper with the CEBS' Annual Report 2005.

(iii) ***Improving cross-border supervision***

The challenges of cross-border supervision are primarily addressed by the **guidelines on cooperation between consolidating and host supervisors**. These guidelines set the general framework within which cooperation and exchange of information between the authorities involved in the supervision of cross-border groups should be enhanced. CEBS has set in place a substructure to look at day-to-day **operational networking** between supervisors to highlight and address issues emerging in the supervision of cross-border groups. As a first stage, these arrangements for operational networking will be tested with reference to a rather narrow sample of cross-border groups.

Furthermore, common training of staff and short-term exchanges of experts between authorities will contribute to fostering a **common European supervisory culture**. The first training initiatives tests of staff exchanges have been started.

As requested by the FSC, the **report highlights some issues and trade-offs CEBS has met in fostering supervisory convergence**. As already mentioned in the 2005 report to the FSC, the main challenges are generally related to the different starting points in terms of traditions and approaches to banking supervision and to the divergence of solutions adopted through the political process and embodied in the Directives (e.g. national discretions in the CRD). However, CEBS members are encouraged with the results achieved in such a short space of time. Also the assessment by market participants is, in CEBS perception, fairly positive, although it is always accompanied by a legitimate caveat, that the **actual impact will be visible only when CEBS guidelines will be operationally put into practice** with the implementation of the CRD. In two areas – reporting and validation - the response from the industry has been less encouraging, due to the perception that convergence has been achieved by adopting overly detailed and burdensome approaches.

A description of work related to convergence of practices across financial sectors, prepared jointly with CESR and CEIOPS, has been attached separately to this report (Annex 1).

## **1. Fostering supervisory convergence**

1. The introduction of the CRD creates an opportunity for moving towards more consistent regulatory and supervisory approaches in the EU. In order to support consistent implementation of these regulations and convergence in the related supervisory practices, CEBS has approved guidelines on (i) public disclosure of supervisory rules and guidance (supervisory disclosure), (ii) the supervisory review process, and (iii) on implementation, validation and assessment of advanced approaches for credit and operational risk.

### **1.1 Supervisory disclosure**

2. The CRD requires competent authorities to make public information about their supervisory and regulatory systems and to publish it in a common format in a single electronic location. Accordingly, CEBS has developed a common European supervisory disclosure framework, consisting of a series of information tables in standard formats to be published on the internet.
3. The framework will make supervisory practices more transparent and, consequently, promote convergence of supervisory practices. It enables meaningful comparison of which Member States exercise options and national discretions available to them in the CRD. In addition, the framework will enable institutions to compare the criteria and methodologies that supervisors use in evaluating and reviewing them. Finally, it will provide aggregate statistical data on key aspects of the implementation of the CRD.
4. Disclosures will be accessible as of end-2006 via the Internet, on both the CEBS website which will have links to members' national websites, and vice versa. The information on the CEBS website will be displayed in English and information on the national websites of non English-speaking countries will also be available in English, on a best-efforts basis.
5. Supervisors consider the disclosure framework a powerful tool for promoting convergence and are considering extending it to additional areas of work. For instance, the framework is presently being extended to also cover also reporting frameworks, in order to assess the progress made in the use of common reporting formats throughout the Single Market.

### **1.2. Supervisory Review Process**

6. The emphasis in the supervisory review process is on dialogue and interaction between an institution's own internal capital adequacy assessment process (ICAAP) and its supervisor's review and evaluation process (SREP). CEBS guidelines stress that an institution's management bears primary responsibility for developing and managing its risk management processes and ensuring that it holds sufficient capital to meet both regulatory and internal capital targets. The expectations of supervisors have been set out in detail in order to ensure transparency and promote convergence of supervisory practices.
7. In March 2006 CEBS issued a consultation paper for additional technical guidance on application of the supervisory review process under the CRD. The paper (CP11) complements CEBS guidelines on the supervisory review

process and sets out technical guidelines with regard to the management of the interest rate risk arising from non-trading activities and of concentration risk. CEBS proposes common guidance on how these risks could be measured and managed by institutions and assessed by supervisors in the context of the supervisory review process. In June 2006 a further consultative paper containing guidance on stress-testing has been submitted to public consultation.

8. The issuance of the guidelines on the supervisory review process has been followed up by the first of a series of internal seminars looking at implementation issues, held in April 2006, concentrating on issues raised by CEBS' ICAAP guidelines, including the prescriptiveness of guidance by supervisors, the scope of application, and issues of proportionality.

### **1.3. Implementation, validation, and assessment of the risk management and risk measurement systems**

9. The CRD allows institutions to use more risk-sensitive approaches to calculate their capital requirements for credit risk and operational risk. The most sophisticated approaches – the Internal Ratings Based (IRB) Approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk - permit institutions to use their own estimates of risk parameters for the calculation of capital requirements.
10. The CRD grants new responsibilities and powers to the 'consolidating supervisor,' including a role in considering applications from cross-border groups to use the IRB and AMA approaches. In particular, all competent authorities included in the supervision of a parent entity and its subsidiaries are directed to work together to decide whether to grant the permission sought and to determine the terms and conditions, if any, to which the permission should be subject.
11. CEBS guidelines reflect a common understanding of what supervisors should practically take into account when dealing with an application from an institution to use the IRB or AMA approaches for regulatory purposes. The guidelines aim at streamlining the approval process for cross-border groups and contributing to a level-playing field. They should also encourage the use of advanced risk management systems by institutions and provide a framework for convergence of practices.

#### ***Limits to convergence***

*The supervisory disclosure framework provides a powerful tool for convergence but does not, by itself, produce convergence: indeed, national differences will remain legally possible even if the application of national options and discretions is fully disclosed; but full disclosure will aid the identification of areas in which the differences are hampering cross-border banking, and are therefore of priority for further work.*

*The existence of the supervisory review guidelines has greatly helped supervisors in their discussions with their national industries to achieve early consensus, by setting out agreed processes and providing clear answers to common questions. However, the area of validation is a very new area and delivering convergence in the absence of benchmarks for*

*good supervisory and market practices is not easy. In order to do so, CEBS tried to cover as many aspects as possible, but faced some concern on the side of the industry that overly detailed guidance could block positive market developments in risk management practices. The final guidelines try to strike a difficult balance between the need for convergence and the request to avoid too much prescription. It is worthwhile noting that there are areas in which further convergence cannot be achieved because of legal constraints: for instance, in the definition of default, a more homogeneous and precise interpretation of the criteria of "unlikelihood to pay" and "material credit obligation" is hampered by the heterogeneity of the accounting and bankruptcy legislation in Member States.*

## **2. Enhancing the cost-efficiency of the supervisory system**

12. CEBS has responded to calls for more cost-efficient supervisory system by introducing common reporting frameworks and by streamlining the recognition process for External Credit Assessment Institutions (ECAIs).

### **2.1. Harmonisation of reporting frameworks**

13. CEBS has produced guidelines on a voluntary standardised framework for consolidated financial reporting for credit institutions (FINREP) enable institutions to use the same standardised data formats and definitions for IAS/IFRS-based prudential reporting. Concurrently with FINREP, CEBS developed guidelines on a flexible common framework to be used by credit institutions and investment firms when reporting their solvency ratio data to supervisory authorities under the CRD (COREP). Banking supervisors use these data to assess institutions' risks in relation to their capital adequacy.

14. These reporting frameworks contain common definitions and a common format, which should reduce the compliance burden on cross-border institutions and improve the exchange of information between supervisory authorities. Banking groups operating on a cross-border basis within the Single Market will no longer be required to prepare and submit their supervisory reports using different and incompatible national formats. However the volume of data required may vary from member state to member state, with the exception that a host authority of a banking group's subsidiary may not ask for more items to be reported to it at the group level, than that asked by the group's home authority.

15. CEBS also suggested that XBRL (Extensible Business Reporting Language) can be a helpful tool in constructing a harmonised European reporting system. CEBS is in the process of finalising XBRL taxonomies for both reporting frameworks, which will be available without cost to national authorities and supervised institutions.

16. CEBS will follow closely the adoption of the frameworks and will report on their effects on convergence of supervisory reporting in the EU.

### **2.2. Recognition of External Credit Assessment Institutions (ECAIs)**

17. The CRD allows institutions to use ratings generated by eligible External Credit Assessment Institutions (ECAIs) in assessing the credit risk of counterparties and in calculating capital requirements under the standardised approach. Competent authorities are to recognise an ECAI as eligible only if they are satisfied that the ECAI's assessment methodology complies with requirements relating to its objectivity, independence, and ongoing review and transparency; and that the resulting credit assessments meet requirements of credibility and transparency.

18. CEBS guidelines for a common approach to the recognition of ECAIs establish common procedures for recognising both local and cross-border ECAIs. These procedures include a 'joint assessment process' which will streamline the recognition of cross-border ECAIs: a facilitator is tasked with coordinating the process when recognition is sought in several Member States, so that all the involved authorities can come to a joint

determination, to be adopted via formally distinct administrative decisions. CEBS members have begun work on an informal basis on the first joint assessments of cross-border ECAI applications and so far the process seems to be working smoothly.

***Limits to convergence***

*Full convergence and harmonisation of reporting requirements, as requested by some market participants, cannot be achieved due to differences in the starting points and because of the direct connection of the reporting framework with the internal organisation of supervision (relative reliance on on-site versus off-site surveillance, use of early warning systems, recourse to peer group analysis, etc.). However, CEBS' flexible reporting frameworks constitute a useful tool for convergence: a survey conducted among CEBS members revealed that for COREP more than 80 percent of EU supervisors will rely on the core data put forward in the framework.*

*As regards ECAI recognition the common process will be accompanied by separate national decisions. As the assessment is developed in common, the likelihood of divergent decisions should be very low, but cannot be completely ruled out ex ante.*

### **3. Improving cross-border supervision**

19. CEBS' objective is to promote cross-border supervisory cooperation by identifying sound international supervisory practices and encouraging its members to adopt them in a convergent and consistent manner. The growth of cross-border banking, consolidation, and the centralisation of key business functions create a misalignment between the legal and operational structures of cross-border groups, and present challenges to the smooth functioning of supervisory framework.
20. So far CEBS has responded to these challenges mainly by issuing its guidelines on supervisory cooperation between consolidating supervisors and host supervisors. These guidelines, together with operational networks of supervisors, will enhance cooperation and the exchange of information on the conduct of day-to-day supervisory tasks with reference to cross-border groups. Operational networks are expected to translate these commonly agreed guidelines into practice and promote delegation of tasks between authorities. This should help streamline the supervisory process and limit the compliance burden on financial groups.

#### **3.1. Co-operation between home and host authorities**

21. CEBS guidelines on supervisory cooperation between consolidating supervisors and host supervisors set out a practical framework designed to promote efficient, coherent, and cost- and resource-effective cross-border supervision for the benefit of both supervisory authorities and the supervised institutions. Increased cooperation between supervisors through operational networks cutting across consolidating supervisors and host supervisors will lead to a higher degree of commonality in supervisory standards, which should further improve supervisory efficiency. Cooperation should also promote convergence of supervisory practices, by fostering a better understanding of each others' methods and approaches.

#### **3.2. Operational networking**

22. According to its Charter CEBS "will develop effective operational network mechanisms to facilitate the exchange of information in normal times and at times of stress and to enhance day-to-day consistent supervision and enforcement in the Single banking Market". CEBS is supporting the development of operational networks for the cooperation between EU banking supervisors and the prompt identification of issues arising in the supervision of cross-border groups.
23. A specific structure has been established in order to intensify the dialogue between the supervisors involved – as consolidating and host authorities – in the supervision of a sample of cross-border groups and to highlight relevant issues to CEBS. In order to take stock of relevant issues, queries, seminars and other forms of informal contacts with representatives of the selected groups could be developed. The work could also encompass surveys and case-studies of evolving supervisory and market practices. Discussing practices being developed by banks and their supervisors will be fruitful for supervisory cooperation and convergence through time. Whenever possible, pragmatic solutions should be found by sharing and comparing relevant experience. In this context CEBS is also testing ways of delegating supervisory tasks from home to host and from host to home,

which in some cases could strengthen and streamline the prudential supervision of cross-border institutions.

***Limits to convergence***

*The success of the pragmatic approach devised by CEBS will have to be tested on empirical grounds. As home-host cooperation and operational networking is based on voluntary cooperation the success and achievements of convergence in practices will depend on the input and motivation of individual supervisors involved in the process.*

#### **4. Challenges to greater convergence**

24. The main challenges CEBS has faced are generally related to the different starting points in terms of traditions and approaches to banking supervision and to the diversity of solutions adopted through the political process and embodied in the Directives (e.g. national discretions in the CRD). The differences related to past traditions and approaches can be ironed out through time, but divergences included in the legislation are more complicated matter to be solved at supervisory level. Thus it is very important that supervisors are closely involved at an early stage in the process of drafting new directives, legislation and other regulation.
25. In general, CEBS considers Level 3 guidelines, standards and recommendations as good tools to drive convergence in supervisory practices. How far they are going in promoting effective convergence in day-to-day supervision remains to be ascertained at an empirical level. This will probably require some time to be fully assessed, as progress in this field is unavoidably gradual considering the very different starting points in national supervisory approaches.
26. CEBS has started a series of internal seminars on CRD implementation issues, with the aim of reviewing national preparations and identify specific implementation issues arising from CEBS' guidelines on supervisory review process, home-host, and validation. These initiatives aim at sharing experiences in developing supervisory systems and practical approaches. They should complement the guidelines, which by their nature are the result of a top-down approach (from the European level to national guidance), with a bottom-up feedback, which should allow assessing how the guidelines are working in practice.
27. The feedback received so far from market participants and end-users of financial services has been encouraging. In the dialogue with the industry there have been packages (in particular, the guidelines on common reporting and on validation) for which the complaint has been raised that CEBS guidance is overly detailed, rules-based instead of principles-based and burdensome. The comments received have been anyway taken seriously, with substantial changes to the draft guidelines and streamlining of the proposals. There is some remaining dissatisfaction with the solutions finally adopted, but supervisors feel that in these areas some degree of detail is needed to foster supervisory convergence.
28. CEBS is also developing a self-assessment methodology to measure its progress and contribution to financial integration and convergence of supervisory practices. The intention is to develop a set of quantitative and qualitative performance indicators. Market participants and end-users of financial services will be engaged in the process via dialogue with the CEBS Consultative Panel and possible public consultation. CEBS is also exploring the preconditions for the use of mediation mechanisms to solve possible disputes and diverging approaches amongst supervisors.

## **Annex to the sector reports of CEBS, CEIOPS and CESR**

### ***Joint Level 3 work across financial sectors***

Key to supervisory convergence is the increasing cooperation and cross-sectoral work of the Level 3 Committees. The Level 3 cooperation ranges from information exchange on work under way in the individual sectors, to work undertaken together. According to the Joint Protocol signed in November 2005, the main responsibility for facilitating and ensuring good cooperation lies with the Chairs, assisted in this effort by the Secretariats.

The participation and results for cross-sector work of the three Committees may be summarised under the following subject headings:

#### Financial Conglomerates

CEBS together with CEIOPS have set up an 'Interim Working Committee on Financial Conglomerates' (IWCFC). The first aim of the IWCFC will be to assess the current status of the Financial Conglomerates Directive's (FCD) transposition and assist in the consistent application of the FCD. The IWCFC has prioritised its work in the first year: two Commission draft Mandates (on the equivalence of third country conglomerates supervision and capital requirements for conglomerates), a stocktake on national discretions under the FCD, and a mapping exercise of conglomerates together with work on the identification of conglomerates. It was also agreed that the committee will bring FCD implementation issues to the table.

#### Joint work

Besides the work on financial conglomerates, work aimed at providing common definitions of Level 3 measures (standards, guidelines and recommendations) is planned.

#### Consistency Projects

Under this heading, mapping and comparison of sectoral work projects are envisaged. They will aim to streamline processes and develop consistent approaches across sectors. This might lead to future joint initiatives. Work on the following aspects is currently planned:

##### *a. Outsourcing*

The objective of this work is to create consistency between CEBS' outsourcing standards and Level 1 and 2 requirements included in MiFID and its implementing measures. To avoid inconsistencies in these developments, CEIOPS is participating in the alignment in view of its work in the framework of the Solvency II project.

##### *b. Supervisory cooperation*

The Committees will compare their work on regulatory approaches and cooperative arrangements with regard to the relationship between home and host competent authorities in a group environment. The objective of this work is to research whether the individual sectoral work done by the

Committees might be extended to cooperation with supervisors or competent authorities in the other sectors, and to take on board their respective good practices. This should ensure greater cross-sector consistency of approaches. The comparison will be done during the course of 2006.

*c. Reporting requirements*

The Committees will take stock of potential inconsistencies and overlaps between sectors in reporting requirements, which originate in sectoral EU directives applying to European supervised entities and market participants. The Committees aim at presenting a first result of this inventory within the second half of 2006. Based on the inventory, future work may be proposed.

*d. Internal governance*

The work within the context of the CRD and the MIFID on internal governance of banks and investment firms will be further discussed. An analytical report will be prepared and shared with the market on any overlaps and areas of possible future work. For CEIOPS' purposes, this will take into account the current thinking on Solvency II.

Information exchange

The Committees ensure frequent exchange of information on all the topics of interest to each other in regular meetings of the Chairs and of the Secretariats, as well as through intensive contacts and discussions by phone and mail between the Secretariats and between the Members who have taken responsibility for drafting sector specific proposals. All meeting documents are distributed across sectors, as well as early drafts of discussion notes if relevant.