

***Hearing at the Economic and Monetary Affairs
Committee of the European Parliament***

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Madame la Présidente, Honorable Members,

I am pleased and honoured to be invited to address this Committee and thus to be able to continue the dialogue that you already established with my predecessors, Danièle Nouy and Josè Maria Roldàn. The decisions by this committee and your views are essential for CEBS' work, as they underpin the goal of integrating European financial markets and strengthening the Lamfalussy structure.

CEBS and its members are very mindful that effective accountability vis-à-vis European institutions are crucial to the status of our work and to its effectiveness in promoting supervisory cooperation and convergence in supervisory practices. In our contribution to the Lamfalussy review we pointed out that a reinforced mission statement for our committee, endorsed by all EU institutions, would provide a stronger basis for CEBS' work, with a formal extension of the accountability mechanisms towards the European Commission, Parliament and Council. Together with our sister committees CEIOPS and CESR we also welcomed the recommendation of the ECOFIN Council to transmit our draft work programmes to Commission, Parliament and Council, so as to allow them to express their views on the key priorities and to provide policy advice on supervisory convergence and cooperation. The draft work programmes of the three committees and the draft programme for joint cross-sector work were forwarded to Mme Berès in February this year. We look forward to receiving feedback and suggestions and stand ready to regularly report

back on the progress in achieving our targets – and on possible obstacles to meeting them.

In my remarks now, I will focus on two main areas of our work:

- (i) shaping a short-term supervisory response to the current international financial turmoil; and
- (ii) developing for the future the tools for cooperation and convergence in supervisory practices, building on the momentum of the review of the Lamfalussy Process.

1. Market turmoil

The financial turmoil triggered in the US market for subprime mortgages is still unfolding and our Committee is closely following the developments.

Since August last year we have held several ad hoc meetings and conference calls with a structured exchange of information and joint assessments of the situation in EU markets. Prudential supervision has been intensified in different ways: targeted interviews with banks' management; in-depth analysis of banks' internal management information; targeted on-site examinations; request for ad-hoc supervisory reporting or intensification of the regular reporting; frequent contact with external auditors.

Cross border cooperation between home and host authorities has been stepped up. There have been more frequent and in-depth bilateral discussions and the work within supervisory colleges for some cross-border groups has been intensified.

The results of this work have been brought to CEBS' table, to contribute to a common analysis of the main risks and the available supervisory responses. We also benefited from an analysis prepared by our Consultative Panel of the lessons learnt from the perspective of market participants.

Indeed, reality is providing for a real stress test also for CEBS and its ability to establish effective networking between banking supervisors. We are developing a framework for ranking risks from a supervisory perspective and identifying issues that require a common supervisory response. Initially, CEBS singled out three main areas of concern for supervisors, on which we are concentrating our efforts: (i) liquidity conditions and robustness of liquidity risk management; (ii) transparency of exposures to structured finance products and entities, and (iii) valuations of illiquid instruments.

Bank liquidity conditions and risk management continue to be subject to significant stress. The development in many markets, with disappearing liquidity and uncertain pricing, shows that steps have to be taken to reinforce both risk management and the supervisory framework.

A first CEBS stock take on the lessons from the crisis highlighted four areas in which improvements by firms are needed: (i) the internal governance mechanisms have to be strengthened, as our survey showed that banks in which the senior management was directly responsible for the design and implementation of the liquidity risk management framework performed better; (ii) stress testing needs to be reinforced, with more stressful scenarios and greater efforts to capture interactions between liquidity risk on the one hand and credit, market and operational risks on the other; (iii) the outcomes of stress tests have to be effectively used and acted upon, notably in terms of contingency planning; (iv) group-wide approaches to liquidity risk management could be further developed, as those firms with effective, group-wide approaches have been more successful, especially through an optimal use of collaterals.

As for the supervisory side, a first lesson concerns resources. Adequate supervisory resources must be dedicated to liquidity supervision, and attention should be paid both to the firms' liquidity risk profiles and the level of systemic risk they entail. Supervisors should systematically challenge the firms' assumptions on stress testing and make sure that

robust processes are in place to define the firms' strategy and risk appetite. It is also important that risk management procedures for a close follow up of actual risk positions are well developed and sufficiently sophisticated for the chosen risk profile.

With reference to the ***transparency of banks' exposures to structured finance instruments and vehicles***, CEBS has conducted a snapshot analysis of disclosures made by a sample of 20 large European banks. Our results are still preliminary and will be updated in the coming months, when the information disclosed in the 2007 audited financial statements and annual reports becomes available.

Our findings show differences in terms of the content of the disclosures as well as their presentation. To some extent, the differences in the level of detail can be explained by varying levels of involvement in these lines of business. However, we believe that there could be benefit in promoting more structured and organised disclosures to increase the comparability of the information. We are concerned that the lack of disclosure on banks' business models and on their role in structured finance activities could make it difficult for market participants to properly assess the banks' risk profile. While the coming into force of the Pillar 3 requirements of the CRD and of new accounting disclosure requirements (IFRS 7) should contribute to the quality, granularity and comparability in the disclosure of exposures, the disclosures seem in many cases to be aimed at banks' immediate stakeholders – i.e. at their shareholders – and not so much at market participants in the wider sense. It may be necessary for banks to reconsider their disclosure policies and the principle they build on, especially in times of stress.

CEBS has also embarked on work in the area of ***valuation of illiquid assets***. As market liquidity disappeared and formerly observable market data became unobservable, some institutions started marking exposures to models while others continued to search for ways of marking to market. Explanations on how the valuations were carried out were not always

comprehensive. Lack of consistency in banks' valuations, uncertainty about their accuracy and inadequate transparency may have contributed to the lack of confidence of market participants and exacerbated the market turbulence. There is a perception that there might be a lack of guidance on valuations, as some European financial institutions referred to the US accounting standard for fair value measurements (SFAS 157). CEBS is closely liaising with the industry, as well as with accounting and auditing standard setters, to make sure that efforts are made to adopt robust and rigorous valuation standards that satisfy all involved parties. The efforts should not only cover valuations as such, but also the related internal controls and governance mechanisms and disclosures.

As the market turmoil is global in nature, CEBS is very much aware that the work it is undertaking needs to be closely linked with the initiatives taken in other international fora such as the Basel Committee on Banking Supervision. Close contacts are kept to ensure complete alignment between the European and the global dimension.

Finally, the current market turmoil underlines the importance of the preparation of the framework for cross-border financial crisis management. CEBS highly values the work of the Economic and Financial Committee on the revision and the extension of the 2005 Memorandum of Understanding (MoU) on the management of cross-border crises of a systemic nature. The MoU is intended to cover cooperation in normal times as well as resolution of a crisis, including burden-sharing, and to cover all financial sectors (not only banking) and financial market infrastructures. It also contains some provisions with regards to liquidity assistance to the cross-border banking group in crisis. We appreciate particularly that the latest draft acknowledges the role of colleges of supervisors in crisis management, an area in which CEBS is working quite hard. In our work on the general crisis management issues we are focusing on practical tools for information exchange and both internal and external communication.

2. Follow up work on the Lamfalussy review

The reports from the Inter-Institutional Monitoring Group and recommendations of EU institutions building on its findings identified a number of areas in which CEBS and its sister committees should work.

One of the identified areas where progress was requested was in the **supervision of cross-border groups**. This is not a new area of work for CEBS but an issue which has had high priority in our work with the implementation of the CRD. In early 2006 we published our guidelines for cooperation between home and host supervisors. As my predecessors reported in previous hearings, we have then put a lot of effort in addressing practical issues emerging from the application of the CRD and the related CEBS' Guidelines, for supervisors of cross border groups. Our pilot project on operational networking created an infrastructure to support enhanced exchanges of information and experiences between consolidating and host supervisors for a sample of ten banking groups with substantial cross-border business in the EU. The ten banks in the sample also established an industry platform which engaged in fruitful dialogue with supervisory experts. In December 2007 CEBS published two documents to assist supervisors involved in cross border banking groups: a *Template for a written agreements*, setting out a common framework for the working of supervisory colleges; and a note on *range of practices from existing supervisory colleges*, which allowed identifying useful references drawing on the experience of authorities that have been refining their cooperation arrangements during a fairly long period of time. The Template for written agreements is currently being tested with the banking groups included in our sample and will be subject to review in the light of practical experience.

We are aware that the Commission is considering a strengthening of the legal underpinning for the operation of supervisory colleges. While we keep up our efforts at Level 3, I believe that a tighter framework for

supervisory colleges in the Directive text could provide further impetus and support to CEBS work.

Besides the work on colleges, CEBS wishes to build on the momentum of the recent Review of the Lamfalussy Process, and accordingly

- (i) started its first peer review exercise and will explore further tools to further foster convergence and strengthen the national application of Level 3 guidelines, recommendations and standards;
- (ii) will look at the identification of possible obstacles stemming from differences in supervisory powers and objectives;
- (iii) together with CESR and CEIOPS, CEBS will also work at developing a common EU supervisory culture, including providing a common training platform for supervisors and facilitating staff exchanges.

CEBS supports the EU better regulation agenda and has recently finalised its 3L3 impact assessment methodology which it has started to apply in its work. Also we have set up a new mediation mechanism and stand ready to apply it when needed.

I have been focusing my remarks today mostly on our supervisory work, as I believe that both market developments and the debate on the Lamfalussy arrangements focused predominantly on the so-called Level 3 of the framework. However, before concluding let me note that increasing amounts of time and resources at CEBS have been devoted to support the European Commission's work to review and update the regulatory framework in some key areas. In particular, our contributions to the **review of the Capital Requirement Directive** (CRD) focused on two important topics: the definition of own funds and the regime for large exposures. The advice on own funds includes proposals for common criteria for the eligibility of hybrid capital instruments as regulatory capital and for ensuring an appropriate quality of banks' own funds. This is

essential to make sure that capital does effectively provide a buffer to absorb losses, especially under stress conditions. The advice on large exposures suggests sharpening the focus and seeing this as a limits-based “back-stop” regime to limit losses from event risk with a single counterparty or set of connected counterparties. It elaborates on the notion of connectedness, on the treatment of off-balance sheet exposures and on the controversial issues of the treatment of intra-group and interbank exposures. The timing is very opportune, as the recent turmoil shows the importance of avoiding excessive concentration of risks vis-à-vis single counterparties – also in the interbank market – and our advice tries to take these lessons into account.

Thank you for giving me the opportunity to speak and I stand ready to discuss any issues or comments that you may have.