

# **CURRENT DEVELOPMENTS IN THE REGULATORY FRAMEWORK OF THE EUROPEAN BANKING SYSTEM**

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## INTRODUCTORY REMARKS

### 1. Levels of regulatory intervention in the financial sector

**a. International level** (Basel Committee on Banking Supervision, International Organization of Securities Commissions (IOSCO), Financial Action Task Force (FATF), Organization of Economic Co-operation and Development (OECD))

### **b. Community level**

### **c. National level**

Currently, one of the principal sources of regulatory intervention in the financial sector are the legal acts adopted at Community level within the context of achieving the integration of the internal market in the European Community.

## INTRODUCTORY REMARKS

### 2. Reasons for regulatory intervention in the European financial sector

**a. Financial services trade liberalisation (necessary prerequisites – negative integration)**

**b. Ensuring that markets are fair, efficient and transparent (adequate prerequisites – positive integration)**

- Ensuring the stability of the banking system – capital markets – insurance markets
- Ensuring the effectiveness and transparency of capital markets
- Combating of financial crime
- Protection of consumers of financial services
- Creation of a single payments area

## A. THE EUROPEAN FINANCIAL REGULATORY FRAMEWORK

### 1. What rules are applied to credit institutions

- Operation and supervision of banks (under B)
- Corporate governance (under C)
- Operation, supervision and transparency of capital markets (under D)
- Consumer protection (under E)
- Operation of payments systems (under F)
- Combating of financial crime (under G)
- Regulatory compliance (under H)
- Insurance mediation
- Personal data
- Tax law and accounting law
- Commercial law
- Labour law
- Environmental liability

## A. THE EUROPEAN FINANCIAL REGULATORY FRAMEWORK

### 2. How the rules are produced

- **Legislative procedure**
  - Co-decision procedure
  - Lamfalussy procedure (under 3 below)
  
- **Self-regulation**
  - Codes of ethics
  - European Payments Council
  - Ombudsman

## A. THE EUROPEAN FINANCIAL REGULATORY FRAMEWORK

### 3. Lamfalussy procedure

The Lamfalussy procedure concerns the way of producing rules in European financial law and was adopted by the Community institutions in 2002, initially in the capital markets sector. Its extension to the banking and insurance sectors was then decided in 2004.

The Lamfalussy procedure consists in four levels:

#### **Level 1**

Aim: Adoption of a general regulatory framework and determination of the issues as to which implementing measures should be adopted by the European Commission.

Procedure: Adoption of Community acts by the classic procedure of co-decision of the Council and the European Parliament on a proposal of the European Commission

## A. THE EUROPEAN FINANCIAL REGULATORY FRAMEWORK

### 3. Lamfalussy procedure (cont.)

#### Level 2

Aim: Concretization of the framework principles of Level 1

Procedure: Adoption of implementing measures in the form of a Directive or Regulation by the European Commission. Provision of technical assistance by sectoral technical committees

#### Level 3

Aim: Joint interpretation and consistent implementation of the measures of Levels 1 and 2 at a national level

Procedure: Co-ordination of actions by the sectoral committees and issuing relevant guidelines

#### Level 4

Monitoring by the European Commission of the compliance of the Member States with the measures adopted



## **A. THE EUROPEAN FINANCIAL REGULATORY FRAMEWORK**

### **3. Lamfalussy procedure (cont.)**

#### **List of committees within the framework of the Lamfalussy procedure**

##### **Banking sector**

- European Banking Committee (EBC)
- Committee of European Banking Supervisors (CEBS)

##### **Capital markets sector**

- European Securities Committee (ESC)
- Committee of European Securities Regulators (CESR)

##### **Insurance sector**

- European Insurance and Pensions Committee (ECIP)
- Committee of European Insurance and Occupational Pension Supervisors (CEIOPS)

## A. THE EUROPEAN FINANCIAL REGULATORY FRAMEWORK

	Level 1	Level 2	Level 3
Category of legal act	Basic legal act	Implementing measures	Recommendations Guidelines
Legislator Standard Setter	European Parliament Council	European Commission	CEBS/ CESR/ CEIOPS
Supportive mechanism	EBS/ESC/ ECIP	EBS/ESC/ECIP and CEBS/ CESR/ CEIOPS	

## **A. THE EUROPEAN FINANCIAL REGULATORY FRAMEWORK**

### **4. What are the basic principles of the European financial regulatory framework**

- Principle of mutual recognition
- Principle of minimum harmonisation
- Principle of partial harmonisation
- Principle of the exercise of supervision at a national level (in contrast with monetary policy)
- Principle of national treatment on the basis of reciprocity in relation to financial intermediaries of third countries

### **5. How EU member states national law is affected**

- Regulations: immediate force
- Directives: obligation to implement
- Recommendations: possibility of implementation

## B. OPERATION AND SUPERVISION OF BANKS

### The new framework for the capital adequacy of credit institutions

1. **Directive 2006/48EC** relating to the taking up and pursuit of business of credit institutions (recast) and **Directive 2006/49/EC** on the capital adequacy of investment firms and credit institutions

## **B. OPERATION AND SUPERVISION OF BANKS**

### **The new framework for the capital adequacy of credit institutions (cont.)**

#### **2. Time schedule for implementation of the new framework**

- **2007:** Standardised and Internal Rating Based (IRB) Foundation method available
- **2008:** Advanced method also available
- Banks which opt for the adoption of the Advanced method will be free to remain during 2007 in the existing (present-day) framework

## B. OPERATION AND SUPERVISION OF BANKS

<b>METHODS OF CALCULATING CAPITAL REQUIREMENTS</b>		
<b>Degree of risk sensitivity</b>	<b>CREDIT RISK</b>	<b>OPERATIONAL RISK</b>
<b>low</b>	<b>Standardised</b>	<b>Basic Indicator</b>
<b>medium</b>	<b>IRB foundation</b>	<b>Standardised</b> <b>Alternative Standardised</b>
<b>high</b>	<b>IRB Advanced</b>	<b>Advanced Measurement approach</b>

## B. OPERATION AND SUPERVISION OF BANKS

<b>Methods of calculation of capital requirements for credit risk</b>	
<b>Method</b>	<b>Calculation of risk-weighted assets</b>
<b>STANDARDISED METHOD</b>	<p>Five (5) predetermined risk weights (0 –150) depending upon:</p> <ul style="list-style-type: none"> <li>• Counterparty credit rating, or</li> <li>• The type of transaction</li> </ul>
<b>IRB FOUNDATION METHOD</b>	<p>More weights with use of a special function for calculation of capital requirements by category of exposure</p>
<b>IRB ADVANCED METHOD</b>	<p>More weights with use of a special –more risk-sensitive- function for calculation of capital requirements by type of exposure</p>

## B. OPERATION AND SUPERVISION OF BANKS

<b>Parameters of Internal Rating Methods</b>	
<b>PD</b>	<b>Probability of Default - PD</b> <b>Statistical assessment of the probability of default</b>
<b>LGD</b>	<b>Loss Given Default - LGD</b> <b>Recovery rate in the event of default</b>
<b>EAD</b>	<b>Exposure At Default - EAD)</b>
<b>M</b>	<b>Maturity - M</b>



## **B. OPERATION AND SUPERVISION OF BANKS**

### **The new framework for the capital adequacy of credit institutions (cont.)**

#### **3. Amendments to the existing regulatory framework / Pillar I**

##### **What does not change**

- The portfolio for the calculation of capital requirements for credit risk
- The minimum capital requirements (8%)
- The definition of own funds (small change)
- The framework for the calculation of capital requirements for market risk (small change)

## **B. OPERATION AND SUPERVISION OF BANKS**

### **The new framework for the capital adequacy of credit institutions (cont.)**

#### **3. Amendments to the existing regulatory framework / Pillar I (cont.)**

##### **What changes**

- The framework for the calculation of capital requirements for credit risk
  - New methods
  - Risk mitigation techniques
  - Securitisation
- Introduction of capital requirements for operational risk
- Pillars II and III

## B. OPERATION AND SUPERVISION OF BANKS

**NO CHANGE**

**Regulatory Capital**

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**Value exposed to:**

**credit risk + market risk + operational risk**



**Level of capital requirement 8%**

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**NO CHANGE**

**CHANGE**

**NO CHANGE**

**NEW**

## **B. OPERATION AND SUPERVISION OF BANKS**

### **The new framework for the capital adequacy of credit institutions (cont.)**

#### **4. Amendments to the existing regulatory framework / Pillar II**

- Credit institutions should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels
- Supervisors should review and evaluate credit institutions' internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios.
- Supervisors should expect credit institutions to operate above the minimum regulatory capital ratios and have the ability to require credit institutions to hold capital in excess of the minimum (8%) ratio
- Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular credit institution

## **B. OPERATION AND SUPERVISION OF BANKS**

### **The new framework for the capital adequacy of credit institutions (cont.)**

#### **5. Amendments to the existing regulatory framework / Pillar III**

Disclosure of data of a qualitative and quantitative character:

- Incorporation into the price of a credit institution's securities of disclosed information
- Changes in the cost of raising capital (financing) and of risk premiums as the profile of the risk-exposure of the bank's portfolio alters

## C. CORPORATE GOVERNANCE

### 1. Developments at Community level

- Communication from the Commission in connection with the modernisation of company law and the reinforcement of corporate governance in the European Union. In the Communication in question, the approach which the Commission intends to follow in the field of company law and corporate governance is determined
- The main objectives of the initiatives of the European Commission in the field of corporate governance can be summed up as follows:
  - Reinforcement of shareholder rights
  - Improvement of the Board of Directors' operation
  - Co-ordination of Member States' efforts to reinforce corporate governance

## **D. OPERATION, SUPERVISION AND TRANSPARENCY OF CAPITAL MARKETS**

### **1. Undertakings for Collective Investment in Transferable Securities**

**Directive 2001/107/EC** amending Council Directive 85/611/EC with a view to regulating management companies and simplified prospectuses:

- Issuing of a single operating license valid throughout the EU
- Expansion of the activities which management companies are permitted to carry on (individual portfolio management, including the management of pensions funds, etc.)
- Introduction of a simplified prospectus which shall provide the investor with clear and easily understandable information

## **D. OPERATION, SUPERVISION AND TRANSPARENCY OF CAPITAL MARKETS**

### **1. Undertakings for Collective Investment in Transferable Securities (cont.)**

**Directive 2001/108/EEC** amending Council Directive 85/611/EEC with regard to investments of UCITS, which makes it possible for UCITS to invest in financial instruments other than transferable securities (deposits with credit institutions, financial derivative instruments, money market instruments etc.)

White Paper on the enhancement of the EU framework for investment funds



## D. OPERATION, SUPERVISION AND TRANSPARENCY OF CAPITAL MARKETS

### 2. Prospectuses

**Directive 2003/71/EC** on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC

Purpose: The harmonisation of the requirements for the drawing up, approval and distribution of the prospectus to be published when securities are offered to the public or admitted to trading on a regulated market situated or operating within a Member State

## D. OPERATION, SUPERVISION AND TRANSPARENCY OF CAPITAL MARKETS

### 3. Market manipulation

**Directive 2003/6/EC** on insider dealing and market manipulation (market abuse)

Objectives:

- The reinforcement of the integrity of the market
- Harmonisation of the rules on market abuse
- Reinforcement of transparency and equal treatment of market participants
- Reinforcement of co-operation and the exchange of information between the competent authorities

## **D. OPERATION, SUPERVISION AND TRANSPARENCY OF CAPITAL MARKETS**

### **4. Markets in financial instruments**

#### **Directive 2004/39/EC on markets in financial instruments**

Principal points of Directive 2004/39/EC:

- Introduction of a regulatory framework for the execution of transactions in financial instruments regardless of the trading methods used (regulated markets, multilateral trading facilities, systematic internalisation)
- Establishment of additional rules as to the operation and supervision of investment firms
- Addition to the (principal) investment services of investment advice and the operation of Multilateral Trading Facilities

## **D. OPERATION, SUPERVISION AND TRANSPARENCY OF CAPITAL MARKETS**

### **5. Protection of the investor and transparency**

**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 and amending Directive 2001/34/EC

Objective: The reinforcement:

- of transparency requirements
- the content of the information
- the frequency of the information which must be supplied by issuers whose securities are admitted on a regulated market

## **D. OPERATION, SUPERVISION AND TRANSPARENCY OF CAPITAL MARKETS**

### **6. Takeover bids**

#### **Directive 2004/25/EC on takeover bids**

This Directive lays down measures coordinating the laws, regulations, administrative provisions, codes of practice and other arrangements of the Member States relating to takeover bids for the securities of companies governed by the laws of Member States, where all or some of those securities are admitted to trading on a regulated market

## D. OPERATION, SUPERVISION AND TRANSPARENCY OF CAPITAL MARKETS

### 7. Clearing and settlement in the EU

Aim: The shaping of a single market at Community level for the clearing and settlement systems. For this purpose, the following initiatives are under way at Community level:

- Giovannini reports, in which 15 barriers (tax, legal and technical) that must be eliminated to render feasible the creation of a single clearing and settlement systems market are identified and a tentative timetable is drawn
- Compilation of 19 standards by a joint working group of ESCB and CESR which will be applied by CSDs and depositaries
- T2S Project: initiative of the ECB; securities and cash accounts in one platform; it concerns only the settlement function of CSDs (see also page 35)
- European Code of Conduct for Clearing and Settlement

## **E. CONSUMER PROTECTION**

### **1. Proposal for a Directive on credit agreements for consumers**

#### **1.1 Changes to the legislative framework on consumer credit currently in force:**

- Widening the scope of application of the Directive currently in force
- Increased obligations to provide information
- Introduction of new provisions on the way of calculating the Annual Percentage Rate of Charge
- Information on the borrowing rate

## **E. CONSUMER PROTECTION**

### **1. Proposal for a Directive on credit agreements for consumers**

#### **1.2 Provisions of major importance**

- The principle of responsible lending
- Duty to advice
- Right of withdrawal within 14 days
- Linked transactions

#### **1.3 Publication of the CIVIC consulting study on the proposal**



## E. CONSUMER PROTECTION

### 2. Directive 2005/29/EC on unfair commercial practices

- Prohibition of unfair commercial practices. A commercial practice shall be unfair if:
  - it is contrary to the requirements of professional diligence, and
  - it materially distorts or could materially distort the economic behavior of the average consumer to whom it is addressed
- In particular, commercial practices shall be unfair if they are:
  - misleading, or
  - aggressive
- Annex I of the Directive contains the list of those commercial practices which shall in all circumstances be regarded as unfair
- Principle of minimum harmonisation with regard to financial services

## F. OPERATION OF PAYMENTS SYSTEMS

### 1. Large value payment systems

**TARGET** (Trans-European Automated Real-time Gross settlement Express Transfer system) is the RTGS system for the euro, offered by the Eurosystem. It is used for the settlement of central bank operations, large-value euro interbank transfers as well as other euro payments. It provides real-time processing, settlement in central bank money and immediate finality

TARGET was created by interconnecting national euro real-time gross settlement (RTGS) systems and the ECB payment mechanism. It went live in January 1999. The launch of the single currency necessitated a real-time payment system for the euro area

- to provide the payment procedures necessary for implementing the ECB's single monetary policy, and
- to promote sound and efficient payment mechanisms in euro

## F. OPERATION OF PAYMENTS SYSTEMS

### 1. Large value payment systems (cont.)

In October 2002 the Governing Council of the ECB decided on the long-term strategy for TARGET (**TARGET2**).

TARGET2 is to become a system that

- provides extensively harmonised services via an integrated IT infrastructure,
- improves cost-efficiency,
- is prepared for swift adaptation to future developments, including the enlargement of the Eurosystem.

All Eurosystem central banks will participate in TARGET2. The Danmarks Nationalbank has confirmed its participation; while the Sveriges Riksbank and the Bank of England will not connect to TARGET2. Some new Member States central banks will only participate when they adopt the euro. TARGET2 is planned to go live in November 2007

## F. OPERATION OF PAYMENTS SYSTEMS

### 1. Large value payment systems (cont.)

**TARGET2S** – At its meeting on 6 July 2006, the Governing Council of the European Central Bank decided to further explore in cooperation with central securities depositories and other market participants, the setting up of a new service – which may be called TARGET2-Securities – for securities settlement in the euro area.

The objective of this project is to allow the harmonised settlement of securities transactions in euro which are settled in central bank money.

The benefits of the implementation of such a facility, which would be fully owned and operated by the Eurosystem, would allow large cost savings as a result of the high level of technical harmonisation that this facility would entail for all market participants and would represent a major step towards a single Eurosystem interface with the market.

On 8 March 2007 the Governing Council of the ECB concluded that it is feasible to implement TARGET2-Securities and therefore decided to go ahead with the next phase of the project.

## F. OPERATION OF PAYMENTS SYSTEMS

### 2. Low value payment systems

#### The implementation of the SEPA (Single Euro Payments Area)

- **SEPA is the area in which:** Citizens, businesses and other economic agencies will be able to make electronic payments in euro in the European Economic Area with the same conditions, rights and obligations, regardless of their country of establishment
- **The political dimension of SEPA and the self-regulatory initiatives**
- **Focusing of action on the Eurozone:** SEPA will be delivered to the countries of the Eurozone as a priority. The **states which do not belong to the Eurozone** will be able to participate in the pan-European systems of payments and will be able to adopt the relevant standards and practices to contribute to the single euro payments market

## F. OPERATION OF PAYMENTS SYSTEMS

### 2. Low value payment systems (cont.)

The European Payments Council (EPC) is a self-regulation decision-making organisation for the European Payment Industry

The development and delivery of competitive 'SEPA Payment Schemes' are a competence of the EPC

The adoption of the 'SEPA Payment Schemes' will be:

- a decision of the EPC and the national banking systems, so that they can develop the basic prerequisites (e.g., capability of delivery) in due time
- a decision of each bank so that it can provide its clientele with SEPA payment services

The adoption of 'SEPA Schemes' at a national level to supplement or replace existing 'infrastructures' at national level is a decision for the national banking communities

Within the framework of PE-ACH, the possibility of merging the national ACHs is a decision for the users and/or shareholders

## F. OPERATION OF PAYMENTS SYSTEMS

### 2. Low value payment systems (cont.)

#### Launch of the SEPA Payment Schemes

- **SEPA credit transfers payment scheme and services starting in January 2008.**
- Given that the Payment Systems Directive was approved by the European Parliament on 24 April 2007, **the roll-out SEPA direct debit services** is expected to take place from a date in first half of 2009. In the meantime technical preparation activities are occurring and will continue.

#### Launch of the SEPA Cards Framework (SCF)

- **Acquiring banks** will do their best to migrate POS and ATM networks to EMV by the end of 2007.
- **Issuing banks** shall offer to their customers at least one SCF compliant card by 2008 and complete their migration to EMV by the end of 2010.
- Commitment by any domestic payment card scheme to the SEPA Cards Framework provisions (e.g. participation rules, licensing, fraud prevention, interchange fees principles etc)

## F. OPERATION OF PAYMENTS SYSTEMS

### 2. Low value payment systems (cont.)

#### Time schedule for the realisation of the SEPA

- **2007:** Planning, pilot programmes, adoption and implementation of the pan-European schemes by banks, suppliers and managers of payments infrastructures and national banking associations
- **2008:** SEPA for citizens and businesses. Co-existence of national and pan-European instruments (SEPA CT, PRIEURO) and of national and PEACH-compliant infrastructures, but the use of the pan-European infrastructures should also be possible for domestic payments
- **2009:** Roll-out SEPA direct debit services and co-existence with national direct debit payment instruments
- **End of 2010:** A critical mass of transactions will migrate to these payment instruments by 2010 such that SEPA will be irreversible through the operation of market forces and network effects



## G. COMBATING FINANCIAL CRIME

### 1. Directive 2005/60/EC (3d AML Directive)

- The Third Anti-Money Laundering Directive incorporates into EU law the June 2003 revision of the Forty Recommendations of the Financial Action Task Force (FATF)
- The Directive is applicable to the financial sector as well as lawyers, notaries, accountants, real estate agents, casinos, trust and company service providers. Its scope also encompasses all providers of goods, when payments are made in cash in excess of €15.000.
- Those subject to the Directive need to:
  - identify and verify the identity of their customer and of its beneficial owner, and to monitor their business relationship with the customer;
  - report suspicions of money laundering or terrorist financing to the public authorities - usually, the national financial intelligence unit; and
  - take supporting measures, such as ensuring a proper training of the personnel and the establishment of appropriate internal preventive policies and procedures.
  - introduce additional requirements and safeguards for situations of higher risk (e.g. trading with correspondent banks situated outside the EU).
- Member States should implement the Directive until December 2007

## G. COMBATING FINANCIAL CRIME

### 2. Regulation (EC) 1781/2006

- Regulation (EC) No 1781/2006 on information on the payer accompanying transfers of funds lays down rules for payment service providers to send information on the payer throughout the payment chain. This is done for the purposes of prevention, investigation and detection of money laundering and terrorist financing.
- The Regulation transposes Special Recommendation VII (SRVII) of the Financial Action Task Force (FATF) into EU law and is part of the EU Plan of Action to Combat Terrorism.

## **G. COMBATING FINANCIAL CRIME**

### **3. Commission Directive 2006/70/EC**

Commission Directive lays down implementing measures for Directive 2005/60/EC of the European Parliament and of the Council as regards:

- the definition of politically exposed person
- the technical criteria for simplified customer due diligence procedures and
- for exemption on grounds of a financial activity conducted on an occasional or very limited basis

## H. REGULATORY COMPLIANCE

### 1. The role and significance of compliance

- a. The complexity of the regulatory framework which governs credit institutions:
  - renders compliance with it an increasingly composite process
  - increases the risk arising from non-compliance
- b. Compliance is an important parameter as concerns the exercise of sound corporate governance
- c. The risk from non-compliance with the regulatory framework in force consists in:
  - a risk of the imposition of legal sanctions
  - a risk of considerable financial losses
  - a risk of loss of reputation

## H. REGULATORY COMPLIANCE

### 1. The role and significance of compliance (cont.)

#### **Static function of compliance:**

The compliance function has as its objective:

- the identification, assessment and monitoring of the risk of a credit institution arising from non-compliance with the regulatory framework currently in force
- the ensuring of compliance of the credit institution with the regulatory framework currently in force

#### **Dynamic function of compliance:**

The compliance function has as its objective the timely provision of information to the Management in connection with forthcoming developments in the regulatory framework, with a view to:

- the planning of the appropriate strategy
- the assessment of the effects of the forthcoming changes on the operation of the credit institution

## H. REGULATORY COMPLIANCE

- 2. The role and responsibilities of the Management as concerns the monitoring of regulatory developments**
  - a. The Management of a credit institution bears the responsibility for the effective functioning of the credit institution
  - b. The exercise of sound corporate governance presupposes an understanding of the regulatory framework governing credit institutions and the ensuring of an effective dialogue with the supervisory authorities
  - c. The Management bears the responsibility for the effective management of the risk arising from incorrect application of the regulatory framework and for the implementation of the credit institution's compliance policy, for which it refers to the Board of Directors

## H. REGULATORY COMPLIANCE

### 3. The role of the HBA

- a. It monitors developments at all levels and stages of the regulatory intervention (international, community, national)
- b. It intervenes at the stage of elaborating the regulatory framework with a view to promoting the positions of the banking system
- c. It elaborates the forthcoming regulatory developments and informs its member-banks in due time
- d. It assesses the implications of the regulations being adopted on the criterion of the most effective compliance of the banking system