Pan-European Regulatory Advisory Services - Contacts

Brussels Core team:

Charles Ilako
Tel: 00 32 2 710 71 21
e-mail: charles.ilako@pwc.be

Frederik Musch
Tel: 00 32 2 710 97 47
e-mail: frederik.musch@pwc.be

Richard Quinn
Tel: 00 32 2 710 71 11
e-mail: richard.quinn@uk.pwcglobal.com

Wendy Reed
Tel: 00 32 2 710 72 45
e-mail: wendy.reed@pwc.be

Roberto Setola
Tel: 00 32 2 710 71 13
e-mail: roberto.setola@pwc.be

Philip Warland
Tel: 00 44 207 212 63 45
e-mail: philip.warland@uk.pwcglobal.com

Central team:

Belgium

Josy Steenwinckel, Brussels
Tel: 00 32 2 710 72 20
e-mail: josy.steenwinckel@pwc.be

Marc Vandemeulebroeke, Brussels
Tel: 00 32 2 710 78 19
e-mail: marc.vandemeulebroeke@landwell.be

CEE

Jim Kernan, Warsaw
Tel: 00 48 22 523 43 26
e-mail: james.kernan@pl.pwcglobal.com

Petr Kriz, Prague
Tel: 00 420 5115 2045
e-mail: petr.kriz@cz.pwcglobal.com

France

Guy Flury, Paris
Tel: 00 33 1 56 57 10 67
e-mail: guy.flury@fr.pwcglobal.com

Germany

Rolf Friedhofen, Frankfurt
Tel: 00 49 69 95 85 21 60
e-mail: rolf.friedhofen@de.pwcglobal.com

Hiltrud Thelen-Pischke, Frankfurt
Tel: 00 49 69 95 85 21 41
e-mail: hiltrud.thelen-pischke@de.pwcglobal.com

Italy

Elisabetta Caldirola, Milan
Tel: 00 39 02 77 85 380
e-mail: elisabetta.caldirola@it.pwcglobal.com

Ireland

Alan Merriman, Dublin
Tel: 00 353 1 662 6599
e-mail: alan.merriman@ie.pwcglobal.com

Luxembourg

Thierry Blondeau
Tel: 00 352 49 48 48 61 13
e-mail: thierry.blondeau@lu.pwcglobal.com

Spain

José Luis López, Madrid
Tel: 00 34 91 590 44 45
e-mail: jose.luis.lopez.rodriguez@es.pwcglobal.com

Sweden

Göran Raspe, Stockholm
Tel: 00 46 8 690 330 59
e-mail: goran.raspe@se.pwcglobal.com

Switzerland

Pascal Portmann, Zurich
Tel: 00 41 1 630 2420
e-mail: pascal.portmann@ch.pwcglobal.com

The Netherlands

Wietse de Jong, Amsterdam
Tel: 00 31 20 568 7106
e-mail: wietse.de.jong@nl.landwellglobal.com

United Kingdom

John Tattersall, London
Tel: 00 44 20 72 12 46 89
e-mail: john.tattersall@uk.pwcglobal.com

Simon Chapman, London
Tel: 00 44 20 72 13 48 47
e-mail: simon.chapman@uk.pwcglobal.com

Paul Clarke, London
Tel: 00 44 20 78 04 44 69
e-mail: paul.e.clarke@uk.pwcglobal.com

Roger Turner, London
Tel: 00 44 20 78 04 32 49
e-mail: roger.turner@uk.pwcglobal.com

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FS Regulatory Focus

November 2002 Edition

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Regulatory Compliance: Adding Value

PricewaterhouseCoopers has just released a report - 'Regulatory Compliance: Adding value – a review of future trends[1]' - based on a pan-European survey looking at the development of the compliance function across Europe. Overall, the report shows progress but there is still a long way to go.

With the headline corporate failures of recent months, and the growing scrutiny on corporate governance, it is hardly surprising that the importance of the compliance function is increasingly recognised in Europe, as elsewhere. There are, however, some key aspects from a European perspective to be considered:

- The work of the Committee of European Securities Regulators (CESR) in this area clearly demonstrates how regulatory attitudes are converging
- Some leading international players, faced with different requirements across territories, are investing in a rigorous compliance regime across the group

- A broad scope for the compliance function is envisaged - and common structures and approaches are emerging - but the independence of the compliance function is a key challenge
- The ongoing development of the compliance function should remain a collaborative effort between the regulators and the regulated.

CESR's expectations

CESR has recently issued its standards harmonising conduct of business rules. According to these standards, firms are required to "*take all reasonable measures to ensure the firm and its members of the board, partners, employees and tied-agents at all times act in accordance with the best interests of its customers and the integrity of the market by establishing and implementing adequate compliance policies and procedures, including an independent compliance function and internal code of conduct*". This indeed seems a tall order, although relatively short on detail.

All CESR members – the securities regulators from the 15 EU Member States, plus Iceland and Norway – have signed up to these standards and have undertaken to implement them in their national territories. There are two clear messages: i) the compliance function needs to be independent, and ii) management needs to devise an internal code of conduct. However, with little detail provided by CESR, the risk is that significant differences could occur in implementation.

Leading international players

Some leading international players, faced with different requirements across territories, are already investing in a rigorous compliance regime across the group which, in no way, reflects a 'lowest common denominator' approach. Clearly, many recognise that, while compliance shortcomings can damage a firm's reputation (and serious ones can even threaten its survival), good compliance practice can bring competitive advantage.

Many of these players have experience of the US and UK compliance requirements, combined with a deep understanding of corporate governance issues and standards prevalent in Continental Europe. Compliance requirements in Europe, in effect, derive from two points of origin. In Continental Europe, compliance has grown out of the requirements for banks to have adequate administrative and accounting organisations and systems of internal control and out of specific requirements, such as anti-money laundering systems. In the UK, on the other hand, 'compliance' for a number of years was synonymous with 'conduct of business' relating primarily to market conduct. Economies of scale – or just pure common sense – are driving these viewpoints to converge. In Europe now, it is commonly accepted that the compliance function should support management in complying with all regulations relating to its firm's operations, as well as internal codes of conduct.

The independence challenge

Reflecting CESR's requirements, the most common model in Europe today is a stand-alone compliance function. Across the board, apparently, the endgame is that the compliance function will play an essential role in a holistic approach to risk management. However, it is clear that, while obviously moving in a similar direction, countries are at very different points along the path.

The biggest challenge is to ensure the independence of the compliance function. To operate effectively, the compliance function needs to stay much closer to the day-to-day operations than does, say, internal audit. Their role needs to be 'real-time' rather than historic: providing advice and guidance to business units. However, close links to front-line business units raises serious independence questions in terms of reporting lines and budgeting issues. Without clear compliance policies and procedures, matrix reporting structures can damage the independence of the compliance function, particularly if compliance officers report directly to business line heads and/or rely on the latter for resources. Matrix structures can also remove the necessary clarity in terms of compliance roles and responsibilities, particularly, with regards to other functions which have compliance-related responsibilities, such as internal audit and the legal department.

In effect, establishing the correct level of resource, skills and structure for the compliance function, and defining its role in the context of managing risk, is key to firms raising the profile of the compliance function within the organisation and enabling the compliance function to operate effectively and

efficiently. Many issues need to be addressed to ensure that the compliance function has sufficient – and appropriate - resources devoted to it and that the status of the compliance officer is such that he or she has significant influence within the organisation.

A collaborative effort

A number of regulators across Europe have issued guidelines to help firms establish independent compliance functions. In doing so, many have drawn upon firms' experience to date of good practice in this area. In all countries surveyed, collaboration between the regulators and industry was evident.

Nevertheless, a vital backdrop is an effective compliance industry infrastructure which provides ongoing support, education and training for compliance professionals. Regulators are keen to encourage and support the development of such an infrastructure but it needs to be largely an industry initiative. Compliance officer associations have been established in a number of territories and work to provide practical guidance and support to their members, both as individuals and as representatives of their firms.

Looking ahead

It is clear that progress is being made but there is still a long way to go. It is also evident that the way forward for the development of the compliance function across Europe lies in continued co-operation between the regulators and the senior management in regulated institutions to build the status and influence of the compliance officer so that he or she becomes an integral part of every organisation's risk management framework. There is still much to do if financial institutions are to meet the expectations of the CESR within a reasonable time-period.

Charles Ilako
EMEA Financial Services Regulatory Practice

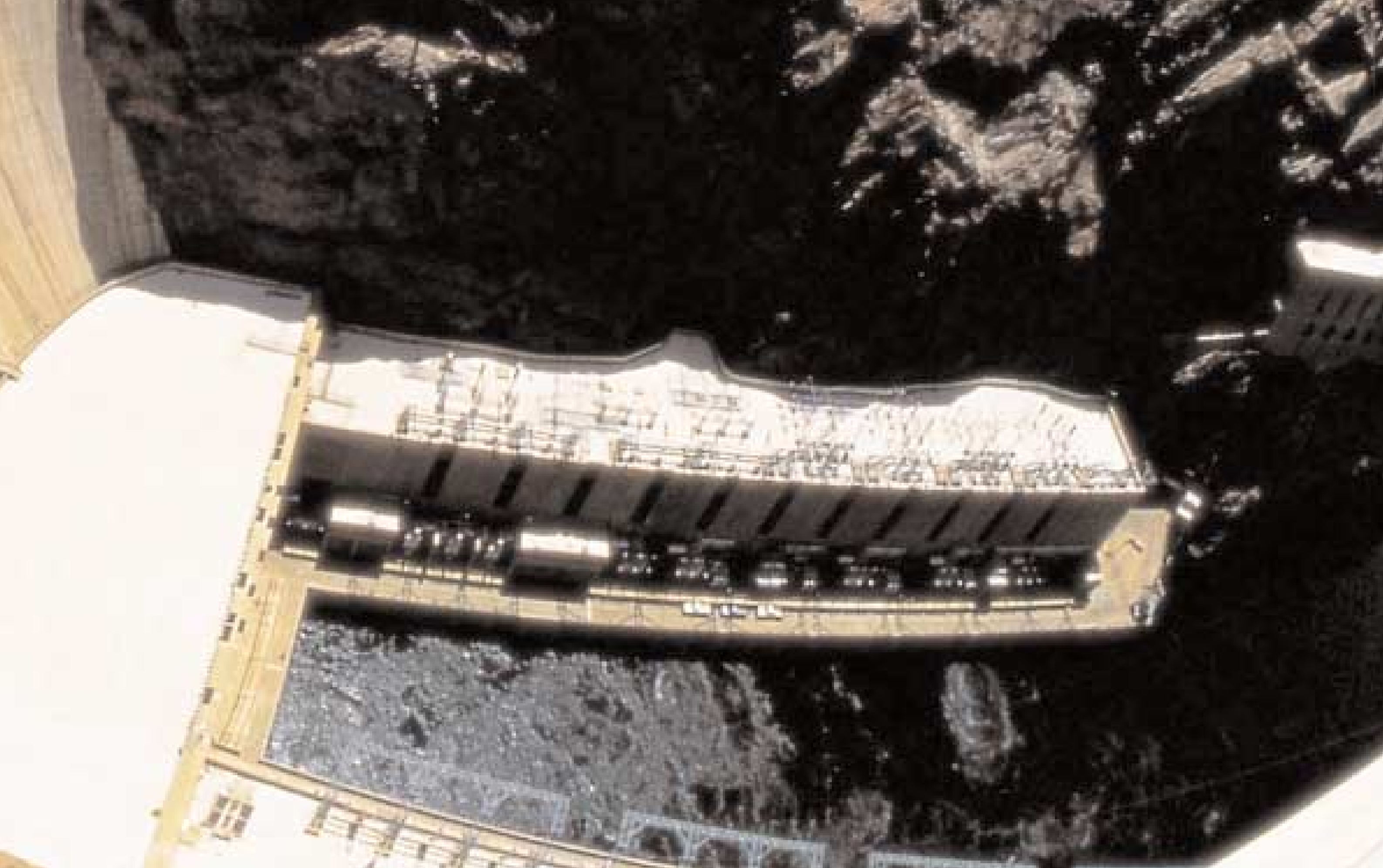
[1] Full report available on our website www.pwcglobal.com

UCITS III: Luxembourg ahead of the game

Two new Directives - together known commonly as "UCITS III" - came into force with their publication in the Official Journal of the European Communities on 13 February 2002. The Directives aim to (i) expand the scope of investment products available to co-ordinated UCITS (the "Product Directive") and (ii) widen the scope of activities which may be carried out by management companies of co-ordinated UCITS (the "Profession Directive"). The Profession Directive also foresees the granting of a European passport to Management Companies complying with the Directive's requirements. Both directives modify the original UCITS Directive (Directive 85/611/EEC).

Luxembourg is likely to be the first country to implement UCITS III in its legislation - a draft law (the "Draft Law") was published on 8 October 2002.

As required by the Product Directive, the Draft Law widens the scope of investments available to co-ordinated UCITS. In addition to shares and bonds, money market instruments, bank deposits, derivatives and shares of other investment funds will become eligible investments. The Draft Law also introduces a number of new requirements. In particular, it sets new investment restrictions, introduces the Group concept for the calculation of the said restrictions and stipulates that risk assessment systems be put in place by the UCITS.



The Profession Directive grants a European passport to management companies of UCITS, to the extent that they comply with new substance requirements detailed in the Directive. The Draft Law does not clarify what exactly these substance requirements mean in terms of personnel and control systems.

As regards delegation aspects, the Draft Law does not prevent Luxembourg SICAVs from being managed by foreign management companies which comply with UCITS III, even if these companies will have to “re-delegate” the central administration to Luxembourg service providers.

Transition Period

It now seems clear that, until 13 February 2004, Member States can refuse to accept on their territory UCITS of the new type (i.e. complying with the UCITS III requirements) originating from Member States that have already implemented the Directives (Luxembourg, for example). This may be the case even if they themselves have already adopted UCITS III in their national law!

Faced with this issue, Luxembourg’s approach is to pass the new legislation without cancelling the old one. The new law and the existing law of 30 March 1988 (“the 1988 Law”) will consequently “live in parallel” until 2007.

This will allow:

(i) UCITS existing before 13 February 2002 to retain the benefits of their European passport until 13 February 2007. If the UCITS is an umbrella fund, it can continue to launch new sub funds under the 1988 Law

(ii) New UCITS can continue to be created under the old rules and benefit from the EU Passport until 2004 (they will have to adapt to UCITS III by that date)

(iii) UCITS can be created according to the new provisions; however, they will need to wait until 2004 to benefit from the EU passport.

Conclusion

Because of the flexible approach adopted by the Luxembourg regulator in implementing UCITS III, fund promoters should be able to move smoothly into the UCITS III transition period.

However, considering the complexity of the issues, the fund promoters should not wait for too long before organizing their journey into these changing and challenging times.

Thierry Blondeau and Odile Renner
Luxembourg

Basel's QIS 3 - its importance cannot be overstressed

On 1 October the Basel Committee on Banking Supervision (Basel) launched its third quantitative impact study or QIS 3, a comprehensive field test for banks of its proposals for revising the 1988 Capital Accord. It represents a significant step in Basel's efforts to develop an improved capital adequacy framework. It aims to ensure the effectiveness of the Basel proposals and to gather information needed to assess whether further modifications to calibration are necessary before the next – and final - consultative paper is issued in spring 2003.

The documents released by Basel, including an Overview paper, are intended to provide some insight into the Committee's perspective on revising the Capital Accord, including major elements of the proposals which will be tested by the banking industry during the QIS 3.

QIS 3 focuses on the minimum capital requirements under pillar one of the New Basel Capital Accord. There are few surprises in the detail of the documents for those who have been following the debate on the reform of the Accord since the issue of CP 2 in January 2001. Those who have not focused so closely on these issues since CP2 will notice significant changes.

The three-pillar architecture is confirmed, as is the menu-driven approach to credit and operational risk – although there are many changes in the detail of the Internal Ratings Based Approach (including new credit curves for retail exposures) and some changes in the proposals on the standardised method (such as a new 75% weighting for non-mortgage retail exposures). No details have been released on Pillars 2 and 3 of the proposed Accord – although more details of the likely shape of these may emerge in mid November when the Commission issues its pre-consultative draft of its Directive to amend its regulatory capital framework (dubbed CAD 3).

There are three parts to the quantitative impact survey itself. There is a questionnaire in the form of an electronic workbook. There also is a set of instructions that specify how to complete the questionnaire in order to ensure consistency. Additionally, Basel has released a document of technical guidance that sets out the proposed minimum capital requirements in detail. It comprises all aspects of the pillar one proposals of the New Accord.

It is hard to overstress the importance of the QIS. It offers all banks – whether they are participating in the survey or not – an opportunity to assess both the impact of the Basel proposals on their own capital requirements and the effort involved in collecting the data that will be required to complete the new calculations from the entry into force of the new Accord. It is also an opportunity to revisit the firm's gap analysis and the effectiveness of its Basel programme.

The QIS also offers firms their last realistic chance to lobby regulators. While it is probably too late to change points of real substance, it may not be too late to influence the fine detail of how requirements are drafted with a view to easing the implementation task that lies ahead. The QIS will also offer firms (and regulators) an insight into how national discretion will be used by G10 and other supervisors in implementing the Accord, and to assess how level the playing field will turn out to be when the Accord is finally implemented. However, firms will need to be realistic in their lobbying objectives.

Banks participating in the QIS 3 are required to submit completed questionnaires to their national supervisors by 20 December 2002.

Richard Quinn
London

One size does not fit all:

international financial groups operating in the CEE need to pay particular attention to the local implications of Basel II

The implementation date for Basel II may be 2006 but preparations need to begin now for banks to be ready. PwC undertook a survey, earlier this year, of the state of preparedness in a number of territories in Central and Eastern Europe. There are good and bad signs.

The purpose of the survey was to describe and assess the current situation, awareness and plans of financial institutions in Central and Eastern Europe. Responses were received from over 60 banks operating in Bulgaria, Croatia, the Czech Republic, Hungary, Latvia, Lithuania and Poland. Based on these responses, it is clear that most of the national regulatory bodies plan to implement the Basel II rules in their territories in 2006. In EU Accession countries, regulators anticipate the same scope for the new capital adequacy regime as that adopted by the European Union.

It was evident from the survey that there are a number of similar issues facing banks across Central and Eastern Europe. There is some awareness of Basel II including its implementation schedule, particularly amongst banks in the pre-Accession countries, although the growing sense of urgency apparent in their Western counterparts is not as evident. In the south and eastern parts of the region, however, awareness appears low.

A number of issues result from the high level of foreign ownership of banks in the region. Subsidiaries of foreign financial institutions – for example, from the EU or the US – are likely to face significant challenges through inconsistency between national implementation measures and those adopted at the head office level. Participating in an ongoing dialogue with local regulators at this stage is essential as ideas and understanding are still being formulated. According to our survey, however, less than 25% of the respondents overall indicated that they are involved in any significant direct dialogue with their regulators. Over a third did not have any communication with the regulator at all either directly or through an industry association. Similarly, foreign parents may wish to introduce more sophisticated methods, such as the internal ratings based approach (IRB) for credit risk and the advanced measurement approaches for operational risk, across the geographic spread of their operations. Nearly two thirds of our respondents indicated that they expect to adopt IRB and nearly one third said that they plan to adopt an internal-measurement based approach to operational risk. Taking into account the complexities and tough implementation challenges of Basel II both for credit and operational risk, this is overly ambitious

and expectations need to be lowered. Historic data is lacking for both credit and operational risk purposes. In terms of operational risk, currently most banks in the region do not monitor operational risk by type of risk and by segment. Unless this situation is explored thoroughly, many banks may face the situation where, as the deadline comes closer, they need to shift their approach to a less sophisticated approach – with the consequent impact on capital requirements, regulators' and market expectations, project costs, and so forth.

Foreign parents may also find that they are requiring higher standards or more complex solutions than local regulators. As such, these foreign parents may need to invest additional time and resources to make sure that their solutions are fully understood and accepted by local regulators. In other cases where standards differ significantly between the local and foreign parent home market, the local branch may find itself in a situation where it will have to report different results to the parent bank and to its own local regulator. Certainly many banks had to live with this double reporting in regards to provisioning in the early years of operation in CEE.

In many cases, Basel appears to be seen now as a 'head office' problem without adequate thought being given to local implications. Having said that, a good number of respondents have Basel projects underway or are analysing the implications. Nevertheless, less than a third of the banks surveyed had financial or other resources budgeted for Basel compliance. The majority of respondents were unable to provide any indication of the anticipated cost of Basel. Where indications of expected expenditure were provided, they were polaric – from €0.3 million to €57 million.

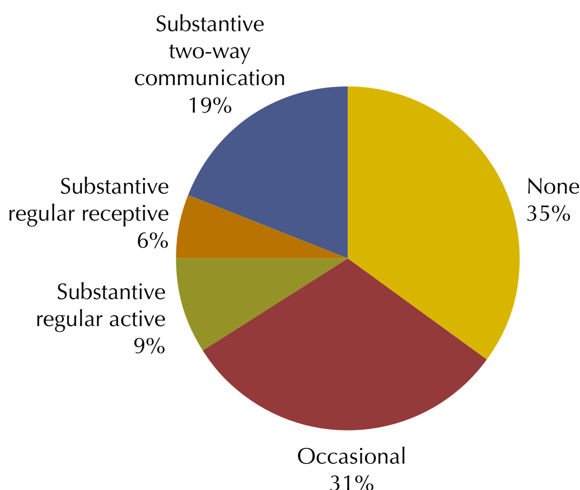
There are a number of key issues that need consideration for groups operating in the region. First, the good news. International accounting standards are widely used (75% of participating banks use IAS as their primary or secondary reporting framework) and these provide a consistent, robust and harmonised foundation for reliable and relevant disclosures across the region. Nevertheless, generally less sophisticated risk management systems, less experienced regulators, less developed markets and rating systems and extensive exposure to the retail sector and SMEs could seriously impact banks' capital requirements.

Based on the survey, we would highlight the following key areas for further consideration – (although these do not necessarily constitute an exhaustive list):

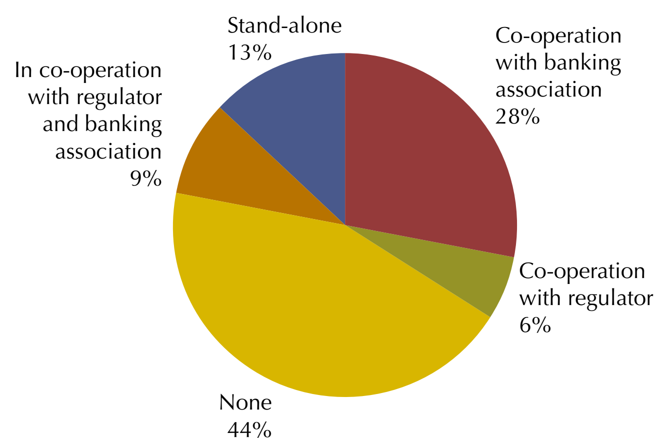
Overall:

- Impact on capital of EU accession – and the full application of EU capital adequacy requirements
- Cost/benefit analysis of adopting an IRB approach
- Appropriateness of current risk management systems

Communication with the regulator



Involvement in the commentary process



- Organisational, IT, financial and human resource issues
- Time to implement changes

Specifics:

- How the regulators will interpret the standards in the local environment
- Timing and scope of introduction locally
- Current availability of historical data (and databases)
- Data collection methods
- Current portfolio (particularly in terms of retail/SME exposures).

Conclusion

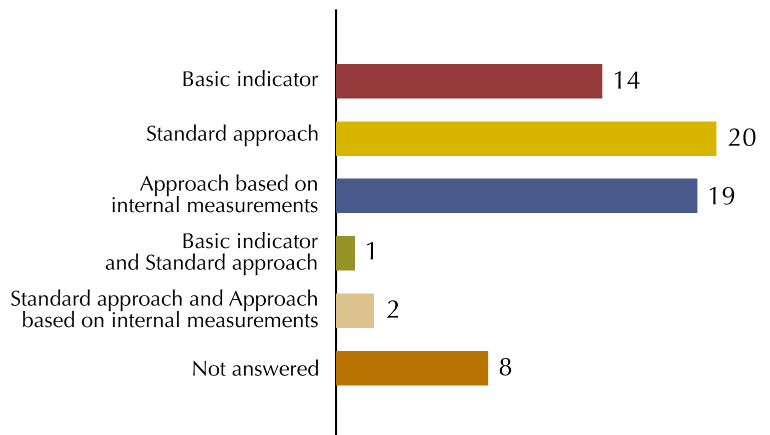
More than 40% of the banks surveyed have not taken any action whatsoever to comply with Basel II and complacency elsewhere may lead to significant compliance issues in the future. Competitive disadvantages - particularly in light of EU accession - could emerge if some of the region's leading banks fail to qualify for more sophisticated approaches to credit/operational risk and have to meet the full capital adequacy requirements.

Regulators may be inclined to provide certain flexibility to domestic champions. If this is well-managed from a regulatory perspective, then the national regulatory environment may prove attractive to further inward investment. If mismanaged, however, the credibility of the local financial markets could be at stake.

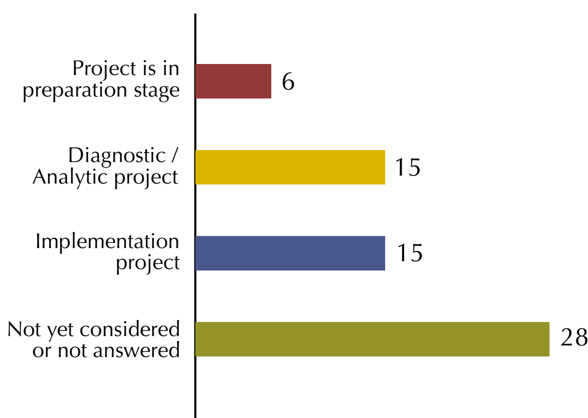
The whole question of stability of financial institutions – and Basel II – also raises the stakes in terms of further industry consolidation. Banks which manage Basel poorly could disappear. The go-ahead on Accession is likely to raise considerable interest in the region again. By 2006, some foreign banks may have larger operations in Central and Eastern Europe than in their home territories – or in the EU. These banks, in particular, will seek to meet Basel requirements fully in terms of credit and operational risk management standards. With enhanced disclosure, failure to do so could jeopardise their investment to date and leave them exposed to acquisition.

Antoni Reczek, Warsaw
Petr Kriz, Prague

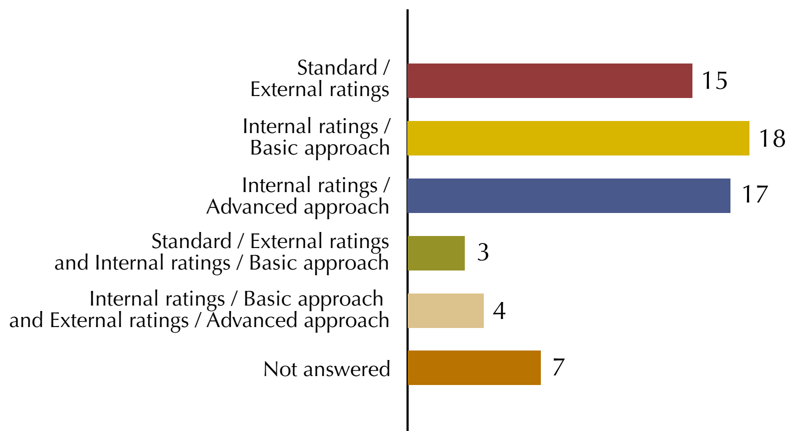
Expected approach to operational risk



Current stage of Basel II projects in the banks



Expected approach to credit risk



Germany's Response to the Principles for the Management of Credit Risk:

Mindestanforderungen an das Kreditgeschäft der Kreditinstitute (MaK)

On 22 February 2002 the German Financial Supervisory Authority (BAFin) issued draft guidance on the minimum requirements for the lending activities of credit institutions based on the Basel Committee's Principles for the Management of Credit Risk (PMCR). A final pronouncement is expected by the end of the year. The proposed rules have caused considerable consternation within the German banking community because of their apparent lack of flexibility and differentiation.

In line with the PMCR, the MaK aims at setting standards for managing and controlling credit risks which arise from both balance sheet and off-balance sheet transactions. The rules apply to all German credit institutions and their branches abroad.

General Requirements

The MaK requires that management should:

- define a credit risk strategy and assume responsibility for its implementation and its periodic - at least annual - review. This strategy should be embodied in a development plan for the lending business as a whole, broken down into loan type, geographic location, industry sector, the bank's business areas and distribution according to size and risk classification.
- set up documented organisational and operational guidelines establishing the clear allocation of duties, authorities and controls; guidelines for loan approval and administration; methodologies for the valuation of exposures; risk classification by borrower and country risk and an early warning system.
- define internal reporting processes and procedures and ensure the integration of the IT environment.
- ensure that the staff have the breadth and depth of knowledge necessary to enable them to effectively assess the risks associated with granting loans.

Organisation of the Lending Business

In line with PMCR's call for segregation of duties, BAFin stipulates that credit functions be divided into three divisions:

1. market/front-office ("Marktbereich")

The market division is in charge of initiating deals and has the first say in the loan approval process. This division must be organisationally segregated from the other two divisions up to the management board.

2. market support/back-office ("Marktfolge-Bereich")

The back-office division must be independent from the market division. It has the second say in the loan approval process. Generally - depending on size, nature, complexity and risk - both votes are needed to approve the granting of loans.

3. credit risk supervision ("Kreditrisikoüberwachung")

The objectives of the third division are monitoring credit risk at portfolio level and internal reporting.

The different processes for approving new loans, amendments, renewal or administration of existing loans, the monitoring of loan processing, the intensive maintenance of loans, the treatment of impaired loans and making provisions for bad debts have to be clearly set up at the outset in accordance with the MaK's requirements and subsequently co-ordinated. Credit commitments have to be assessed according to a risk classification procedure before approval or renewal, as well as when assessing an ongoing credit. Generally, there should be an impartial correlation between the terms and conditions of a contract and its risk classification. Internal controls have to ensure that the whole credit process, in particular loan approval, complies with the bank's organisational guidelines. All controls have to be documented.

Credit risk rating and management process

BAFin requires that all banks have solid risk classification procedures for assessing the risk of default and the specific risk of the project/property. Appropriate risk classification procedures for assessing industry and country risk should also be adopted. Management is responsible for establishing, reviewing and, where appropriate, modifying these procedures.

The bank has to design a system which permits the identification of potential risks at an early stage and facilitates credit risk management and monitoring in the lending business, bearing in mind the size and complexity of the bank's activities. This system should take into account the linkage between different types of risks (e.g. market price risk, liquidity risk and operational risk) and should be embedded in the bank's overall control system. All key credit risks should be covered by the system, appropriately quantified and presented on a single and on a portfolio basis. A consistent limit system should be established and all transactions need to be offset against these limits on a timely basis.

At least once every three months, the credit risk supervision division has to produce a risk report, presenting all the important structural characteristics of the lending business, for the management and the supervisory board. The report has to cover the development of the credit portfolio (differentiated according to industries, countries, size and rating classes), limits and exposures, country risk, maturity, significant overdrafts, new granted loans, provisions and important loan approvals.

Outsourcing and auditing

Outsourcing of any function or activity related to the bank's lending business will only be possible if the German Banking Act and BAFin's circular on outsourcing are fully complied with, in addition to the requirements laid down in the MaK. Compliance with the MaK will be monitored at appropriate intervals by the internal auditors. In addition, the external auditor needs to assess the lending activities generally, the organisation supporting these activities, the credit risks, and the internal controls and processes. The external auditor will also need to state in his audit report whether the lending activities comply with the MaK.

What happens next?

The banking sector has not welcomed the draft MaK. They feel that small banks may be hard hit. Even international universal banks believe that considerable effort – and cost - may be necessary to meet the rigid requirements in some areas. Generally, the banking sector is concerned that the MaK substantially increases the regulatory burden without taking the heterogeneous German banking industry sufficiently into account. They claim that regulations should adapt to the complexity of the business, the risk profile and the ability of the relevant bank to carry risk. If the MaK is not significantly amended to reflect these concerns, the banks are hoping for a reasonable transitional period so that they can make the necessary adjustments to meet BAFin's expectations.

As a result of this criticism, and following a hearing organised by the German Banking Associations, a new draft is expected which may offer some relief for smaller banks. It is expected that the MaK will come into effect in 2004 or soon thereafter.

Jürgen Breisch, Stuttgart
Clemens Koch, Frankfurt

IAIS takes first step towards a global approach to the supervision of reinsurers

The debate on the supervision of reinsurers has been resolved in favour of the development of some form of supervisory principles and practices. Both the International Association of Insurance Supervisors (IAIS) and the EU are developing frameworks. In October 2002, the IAIS released its Principles for the Supervision of Reinsurers: a small but significant step to the adoption of a global approach.

Recent years have seen increased debate about whether, and if so how, reinsurers should be supervised, as a result of growing recognition of the importance of reinsurance to the stability of the financial system as a whole. Reinsurance is a wholesale business but is critical to the solvency and stability of primary insurers. Failure of a reinsurer to meet its obligations, ultimately, can affect the security of individual policyholders.

A second strand of argument focuses on the international nature of reinsurance business. International recognition, based on international standards, is seen to have potential advantages in helping reinsurers to operate across borders and those in smaller and more fragmented markets to penetrate some of the larger markets.

Work of the IAIS

The IAIS, as part of its programme of developing regulatory principles, adopted a statement of 'Principles for Supervision of Reinsurers' at its Annual Meeting in Santiago de Chile in October 2002. The IAIS standard is directed at supervisors, not at firms. These high level principles are geared towards pure reinsurers but the IAIS also considers them applicable to insurers with a significant amount of reinsurance business in a mixed portfolio. IAIS also recognises that the risk posed by captives is less than that posed by some other forms of reinsurance and thus a different or modified regime might be appropriate. However, there is no detail of how this modified regime might look.

The IAIS paper recognises that the level and type of supervision of pure reinsurers varies significantly between jurisdictions. Direct supervision of the reinsurance entity varies from requiring compliance with basically the same set of requirements as apply to direct insurers to a far lighter touch regime. Some jurisdictions seek to evaluate those reinsurers writing business into their areas or to protect their own markets by requiring reinsurers to post collateral covering likely liabilities, or liabilities plus a margin. The paper, therefore, seeks to establish a set of minimum principles adaptable to different regimes but placing the onus for supervision on the home country. The IAIS's membership includes supervisors of both developed and developing countries, thus some sort of framework for accrediting supervisors is necessary in order that the supervisors in the country in which the reinsurer is writing business should be able to accept the supervision of the home state without the need for additional checks. This is recognised to be an evolutionary process – some supervisory regimes do not yet have the resources or expertise to supervise reinsurers and need to be supported by frameworks for exchanging information (subject to normal confidentiality provisions) and learning from best practice elsewhere.

The IAIS Statement of principles is divided into two. Using the supervision of direct insurers as a benchmark, IAIS Principle 1 describes where supervisory requirement and practices for reinsurance differ from those for direct insurers

because of the different characteristics of the business. These include prudential requirements (technical provisions, investments and capital), and corporate governance issues. The standard recognises that, while at base the issues facing insurers and reinsurers are the same, the problems faced by reinsurers are exacerbated by the nature of their business and the potential size and volatility of their exposures. The use of more sophisticated, dynamic financial analysis tools by reinsurers may facilitate mutual recognition of capital requirements.

Principle 2 covers legal issues (legal form, authorisation, fit and proper testing of individuals and controllers), the scope of supervision (extending to the entire business and to group relationships), supervisory methods, including on site inspections and sanctions to take remedial action, audit and accounting. Here the issues are deemed to be the same for insurers and reinsurers.

There is emphasis on exchanging information freely between supervisors. The IAIS has launched a database, accessible to its members, which will provide information on reinsurers active in their areas, including their legitimacy, supervisory and financial status, ownership and the extent of supervision, including whether there are restrictions on their activities.

Work in the EU

Work at EU level had a different starting point. Recognition that a fragmented European reinsurance market could be a barrier to writing reinsurance business in some parts of the world and that reinsurers did not benefit from a single passport within the EU led to industry pressure to develop some form of licence or passport for pure reinsurers. Although not part of the Financial Services Action Plan originally, the European Commission is now giving consideration to a harmonised framework for reinsurance supervision.

Early discussions focused on developing a 'fast track' system whereby EU legislation could be developed within a reasonably short period of time. This approach would, of necessity, be based on the existing approach for direct insurers. It is seen as being of benefit to the EU in negotiations with third countries to be in line with other initiatives (IAIS, World Bank, OECD, G7) and to be of benefit to EU reinsurers doing international business. This approach received strong support from Member States, but for it to be feasible, the EU institutions, the industry and Member States will need to be flexible in their approach.

One of the issues for debate was whether the systems should be a licence (i.e. available on request to those reinsurers wanting to operate across borders) or a passport (part of the authorisation process). The Commission favours a licence, although the reinsurance industry supported a passport. The Commission deems the licence route in line with the work of the IAIS: this is likely to be the model adopted. Despite opposition from some Member States, the Commission's view is that 'prudent man' rather than quantitative investment rules are more suited to reinsurance. A further key area is to determine the capital rules suitable to reinsurers.

A draft of the Directive may be available in 2003 but, as this is an area earmarked for an 'extended impact assessment'[2], progress may not be a fast as first hoped.

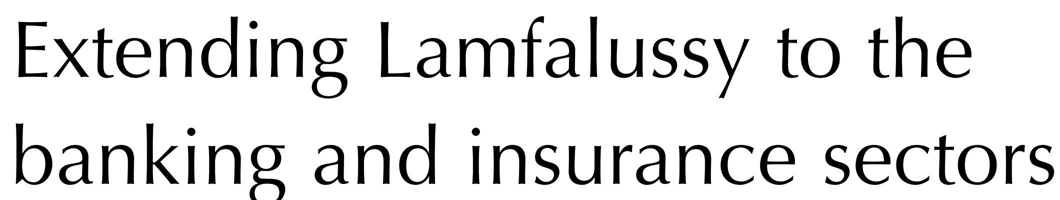
Conclusion

The IAIS has taken a seemingly small but significant step towards the adoption of a global approach to the supervision of reinsurers. In line with normal IAIS practice, we can expect the elaboration of standards to support the two principles. Supervisory authorities will pay increased attention to this issue going forward. For developed supervisory regimes, the IAIS supervisory principles will not be a significant hurdle.

In the EU, in parallel, a detailed consultation process will support the development of a directive. As this directive may help the European industry in writing European cross border and international business, it will be well worthwhile for reinsurers to participate actively in this consultation.

Cath Beech
London

[2] This assessment is part of an integrated procedure designed to 'improve the quality and coherence of the policy development process and assess the impact of action the Commission is proposing to take by making systematic examination of the principles of subsidiarity and proportionality in operational terms and by analysing the balance between the economic, social and environmental components of sustainable development'. This calls for in depth analysis of the potential impact and consultation with interested parties and relevant experts in line with the Commission's minimum standards for consultation.



Extending Lamfalussy to the banking and insurance sectors

The EcoFin Council at its meeting on 8 October 2002 endorsed a report prepared by the Economic and Financial Committee (EFC) on 'future EU financial regulation, supervision and stability'. The European Commission has launched a consultation on the EFC's report: the responses are due by 17 November. If the EFC's proposals are adopted, there will be significant changes in the EU legislative processes. Time will tell whether the proposed arrangements will effectively streamline them. The real test will only come with the adoption of CAD III or banks and Solvency II for insurers.

The Lamfalussy structure introduced for securities legislation is based on four levels:

Level 1: Framework legislation (directives or regulations) established using the co-decision procedure, whereby the European Council and Parliament jointly decide on a legislative proposal put forward by the Commission.

Level 2: Detailed technical legislative measures are prepared, within the context of the established Level 1 legislative framework, by the Commission with the support of Level 2 committee.

Level 3: The Level 3 committee, comprising representatives of EEA supervisory bodies, focuses on information exchange between supervisors, supervisory convergence, supervisory best practices and advice to the Commission.

Level 4: Enhanced enforcement of Community law by the Commission.

Source: EFC report

The EFC has proposed the adoption of similar arrangements for the banking and insurance sectors to the 4 level 'Lamfalussy' approach adopted for the securities industry last year, by modifying the remit and composition of existing committees, leveraging other relevant groups and, where appropriate, introducing new committees. This article takes a look at the proposed changes to committee structures.

Banking sector

The current Banking Advisory Committee (BAC)[3] comprises representatives of the supervisory bodies and central banks of the Member States, together with representatives of the Ministries of Finance. The reformed BAC will consist of one representative nominated by the relevant Ministry in each Member State (most often the Ministry of Finance). Technical experts nominated by each Member State (depending on the issues under discussion) and the chairman of the Level 3 banking committee, as well as representatives of the European Central Bank (ECB) and the non-EU EEA countries will be observers.

The banking supervisors will regroup in the Level 3 committee. The EFC has suggested that the members of the Level 3 banking committee should be 'high level' representatives of the relevant EU supervisory authorities, plus the ECB/non-supervisory central banks (full membership but without voting rights). Observers, again high-level, should include representatives from the Commission, the ESCB Banking Supervisory Committee, the Groupe de Contact and non-EU EEA countries.

In effect, the Level 3 banking committee will work in parallel with the ESCB Banking Supervisory Committee (BSC), established in 1998, which comprises representatives of the ECB and the central banks and the separate national banking supervisory authorities, where these exist. The BSC advises on policy issues of common interest to the EU banking supervisors and the ESCB, in relation to prudential supervision of credit institutions and the stability of the financial system. There may be possible areas of (unnecessary) overlap between the BSC and the Level 3 banking committee.

The EFC suggests that the current tasks of the BAC should be reallocated to the Level 2 and Level 3 committees, as appropriate. This reallocation may not be totally clear-cut. These are also areas of potential interest to the BSC.

Finally, the EFC's proposal will have the effect of 'institutionalising' the Groupe de Contact (GdC) as a working group for the new Level 3 banking committee. The GdC was set up in 1972, on an informal basis, to promote practical co-operation and exchange of information on banking regulatory/supervisory practices. It is made up of mid-level supervisors of the 18 EEA Member States and plays an important role in that it is the only established forum for information exchange on individual cases. The GdC currently sets its own agenda but, on occasion, examines/prepares reports for the BAC and the BSC, including regular overviews of the solvency and profitability of the EU banking system for the BAC. The EFC report indicates that the GdC, as a working group of the Level 3 banking committee, should continue to be used for regular exchange of supervisory information, alongside the Level 3 banking committee.

Insurance sector

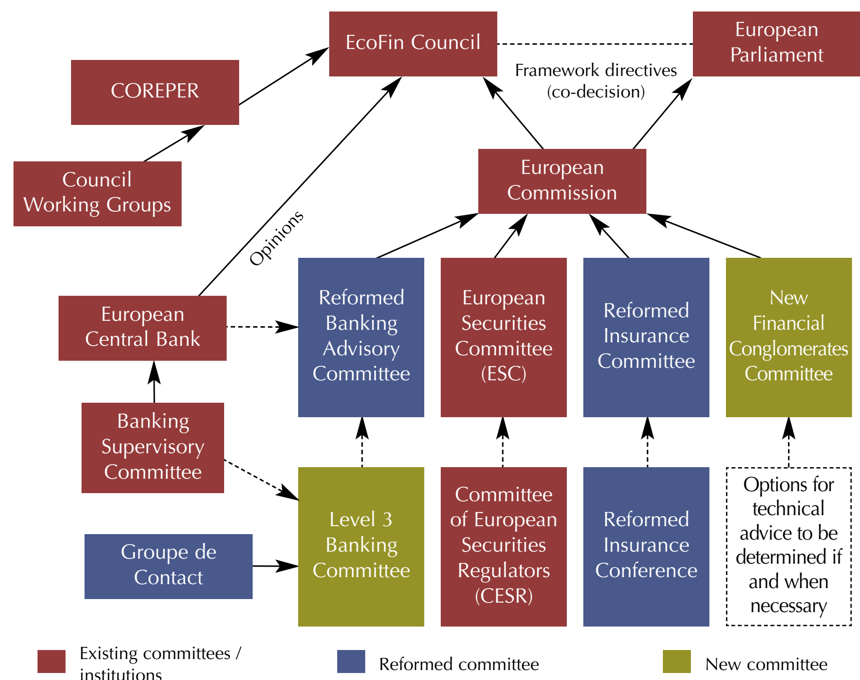
For the insurance sector, the EFC proposals indicate changes at both committee levels. The Level 2 and 3 committees would see their role formally extended beyond insurance to cover pensions.

The current Insurance Committee[4], established in 1992, has three objectives:

- Promote close co-operation between insurance supervisors and the Commission with regards to insurance directives aimed at creating the Single Market and prudential control
- Ensure equivalent representation for insurance supervisors as the banking supervisors at the Community level.
- Adopt, when necessary, rapid technical changes to insurance directives.

Each Member State has two appropriately high-level representatives on the committee, one each from the regulatory and supervisory bodies, where these are different (so generally, the insurance regulator and Ministry of Finance are represented). Representatives from non-EU EEA territories are observers.

Some members of the IC double as members of the Conference of European Insurance Supervisors. The Conference, like the GdC, has been independent of the EU institutions until now. Long before even the GdC was established[5], the Conference was designed to provide a forum for co-operation and information exchange between insurance supervisors.



Source: EFC report on financial regulation, supervision and stability revised to reflect the discussion at 8 October meeting of the EcoFin Council, Chart A.

BAC's current tasks[6]

1. Advise the Commission on need to adjust prudential regulations governing the supervisory system.
2. Establishing ratios for the solvency, liquidity and profitability of credit institutions.
3. Assisting the Commission with the proper implementation of EU banking directives.
4. Advise Commission on possible follow-up to the implementation of legislation.

[3] Set up under the First Banking Directive in 1978

[4] Set up in 1992, under a Council Directive (91/675/EEC) specifically setting up the Committee

[5] The Conference was officially established in 1958.

[6] Source: Institutional Arrangements for the Regulation and Supervision of the Financial Sector, January 2000

The reformed Insurance Committee would, like the European Securities Committee, comprise high-level Ministry representatives of each Member State, supported by a technical expert. The Commission would chair it and provide the secretariat. Each Member State representative would have one vote. Observers would include the ECB, non-EU EEA members and the chair of the Level 3 insurance committee.

The Level 3 insurance committee would leverage the Conference of European Insurance Supervisors but would also include national pensions supervisors, as appropriate. Some countries, therefore, would have two delegates but with only one voting right (depending on the issue to be decided).

Financial Conglomerates

Finally, a new committee at Level 2 would be established for financial conglomerates, under the financial conglomerates directive, with close links to the other three Level 2 committees. The composition would reflect those of the other Level 2 committees. There would be no Level 3 financial conglomerates committee: options for technical advice would be determined as and when necessary.

Some initial considerations

The changes discussed above are a major part but not all of the suggested changes included in the EFC report. There obviously is a risk of significantly increased complexity. Improved clarity of the different roles of the committees will improve efficiency of the process: more work needs to be done in this respect, perhaps as part of the consultation process. The EFC did mention that the ongoing manageability of the committees should be borne in mind, particularly in light of Accession. Based on its current proposals, Accession would lead to the Level 3 banking committee meetings having close to 60 high-level participants, 50 of which would be able to actively participate in debates.

The Lamfalussy structure has already brought enhanced transparency to securities legislation (although not as much as some would like) but it is worth noting that the final building block in Lamfalussy's overall picture of transparency – the Inter-Institutional Monitoring Group – has only recently been put into place. Concerns remain about the inter-institutional balance at the EU level.

There is another key issue to remember. A review of the Lamfalussy structure for securities has been fixed for 2004: the EFC's report indicates that this would also apply in the other sectors. Even if the committee structure, outlined above, were in place by early 2003, there will be very little history on which to base such a review for banking and insurance, particularly as the two significant legislative changes to impact these industries may not have gained sufficient momentum by that time.

Finally, the Lamfalussy Committee stressed in their report that the efficiency of the process overall is jeopardised by lack of resources, recommending that both the Commission and Parliament to increase the resources dedicated to the financial services sector. The changes suggested now may increase the workload of the Commission still further. They may also exacerbate an already challenging situation for national supervisors, at a time when many of them are undergoing major structural changes and/or adopting new supervisory approaches.

Wendy Reed
Brussels

Belgium and the Netherlands revise their approach to supervision

On 1 September 2002, the Netherlands substantially changed its supervisory approach, splitting prudential and market supervision. In Belgium, the promulgation, on 2 August 2002[7], of the Act on the Supervision of the Financial Sector and the Financial Services (the "Act") also introduced a new supervisory regime. In both cases, there is a move towards greater integration of the supervisory regimes but progress may not be smooth.

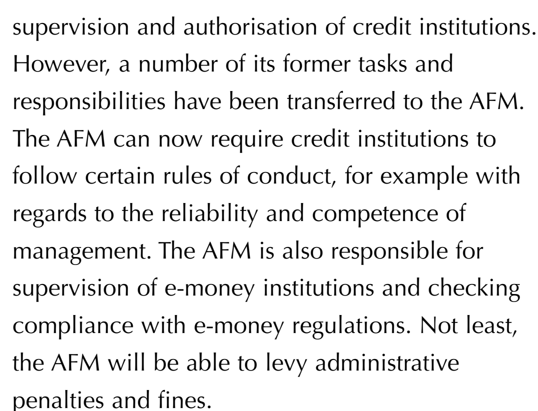
The Netherlands

In the Netherlands, 1 September 2002 saw the introduction of a new supervisory structure for Dutch financial institutions based on a division between prudential supervision and market conduct supervision. Within this new structure, prudential supervision aims at improving the financial soundness of financial institutions, while market conduct supervision aims at maintaining and improving an orderly and transparent market process.

The supervisory roles no longer operate on a sectoral basis but are now split between prudential supervision (the Dutch Central Bank, *De Nederlandsche Bank (DNB)* and the Pension- and Insurance Chamber, the *Pensioen- en Verzekeringskamer (PVK))* and market supervision (the Netherlands Authority for the Financial Markets, *Stichting Autoriteit Financiële Markten (AFM)*). This entails the following changes:

Credit institutions: The DNB will remain the competent authority with regards to prudential

[7] Published in the Belgian Official Gazette of 4 September 2002



supervision and authorisation of credit institutions. However, a number of its former tasks and responsibilities have been transferred to the AFM. The AFM can now require credit institutions to follow certain rules of conduct, for example with regards to the reliability and competence of management. The AFM is also responsible for supervision of e-money institutions and checking compliance with e-money regulations. Not least, the AFM will be able to levy administrative penalties and fines.

Securities firms: The AFM remains the primary supervisor of securities firms, with the authority to grant licences. Prudential supervision of securities firms, however, has shifted to the DNB. The DNB will determine whether the management fulfils all prudential requirements, including rules concerning capital and asset separation, as well as the administrative and accounting organisation and internal control.

Investment firms: The AFM has become the primary competent authority with the power to grant licences and responsibility for market conduct supervision. DNB will continue to carry out prudential supervision and AFM will consult DNB prior to granting a licence to ensure that all prudential requirements are met.

Insurance companies: The PVK remains the competent authority in terms of prudential supervision and authorisation of insurance companies. Its responsibilities in terms of the information which needs to be disclosed to the public by insurance companies, however, have been transferred to the AFM.

Belgium

As in the Netherlands, the Belgian financial supervisory system has traditionally been organised on a sectoral basis. The Act[7], however, creates the Financial Services Authority (FSA) with a view to enhancing co-operation between the existing supervisory bodies - the Banking and Finance Commission (BFC) and the Insurances Control Office (ICO). More notably perhaps, the Belgian National Bank (BNB), the central bank, will assume a co-ordinating role overall, reflecting Lamfalussy's recommendation of a close link between macro and micro prudential supervision.

The BFC will continue to supervise banks and financial institutions, while the ICO will supervise insurance companies, mortgage credit companies and pension funds. They will remain separate legal entities for the time being. The Act provides however that a merger of both the BFC and the ICO is possible by means of a Royal Decree. Recently, the Minister of Finance declared that this possibility will be chosen quite soon as the Act provides the "easy" way of a Royal Decree only until 30 June 2003. After that date, an Act will be necessary to merge both institutions.

However, the BFC's organisation structure will be adapted to reflect good corporate governance principles, with a management committee established and a president appointed. The management committee will define the general orientation and the general priorities of supervisory policy, drawing up each year a supervision action plan. It will be responsible for day-to-day management of the supervisory authority. In addition, a newly constituted supervisory board will be established to advise the management committee and carry out the general oversight of the supervisory authority. A Secretary General will assume responsibility over the administrative organisation. The ICO will adopt a similar structure.

In parallel, the Financial Services Authority (FSA) will create an umbrella under which the BFC, the ICO and the BNB will be brought together. The BNB's governor will preside over the FSA which

will comprise the members of the supervisory boards of the BFC and the ICO, as well as the members of the Council of Regents of the BNB. The FSA will advise on all issues related to the organisation, operations and co-ordination of the functioning of the financial sector.

In addition, the governor of the BNB will preside over the Committee for Financial Stability (CFS). Comprising the management committees of the BFC, the ICO and the BNB, the CFS will look into matters of "common interest", which includes financial system stability and the interaction between prudential supervision and the supervision of the financial system.

Not without controversy

One of the most controversial aspects of the Act is the fact that the BNB will occupy several seats on the management committees and the supervisory boards of both the BFC and the ICO. The initial intention was for BNB representatives to have a majority on both the management committees and supervisory boards of the BFC and the ICO. This idea met with severe criticism not least because the BNB is listed on Euronext in Brussels and, as a listed company, is supervised by the BFC. If the BNB had a majority, a clear conflict of interest would arise.

The Act as adopted, however, provides that representatives of the BNB will take their seats in their own names and not as representatives of the BNB. Also, the number of representatives of the BNB can be no more than half of the total number of seat holders. This compromise has not really convinced the Act's critics and some continue to hold conflict of interest concerns. Some even see the credibility of the Belgian supervisory system at stake. The critics also point out that the complexity of the new supervisory regimes could create confusion as a result of indistinct responsibilities of the BFC and ICO on the one hand, and the umbrella entities on the other.

Conclusion

Belgium and the Netherlands have not yet followed the lead of various other European supervisory authorities by moving to a totally integrated solution. However, recent developments in both countries show that they are moving in this general direction, adopting a solution that seems appropriate to the local environment. The effectiveness of these solutions will be demonstrated over time.

Jasper van der Poel
Landwell, Amsterdam

Dorien Fransens and David Vanparys
Landwell (Bogaert &Vandemeulebroeke), Brussels

[7] For the moment only a few provisions of the Act have already come into force following a recent Royal Decree: and these do not relate to the supervisory structure. Another Royal Decree will set the date at which the Act's provisions concerning the supervision structure will come into force.