

**International Capital Market Association
International Swaps and Derivatives Association
London Investment Banking Association
Securities Industry and Financial Markets Association
Swedish Securities Dealers Association
Finnish Association of Securities Dealers**

3L3 Medium Term Work Programme:

**Response to November 2007 consultation paper (CESR 07-775; CEBS 07 171;
CEIOPS-3L3-11-07)**

Response posted to: www.cesr.eu

18th January 2008

The Associations listed at the head of this response welcome the opportunity that the 3L3 Committees have given to comment on their medium-term work programme for 2008 to 2010.

Paragraph 6. We agree with 3L3's proposed arrangements for making progress reports both publicly and specifically to the FSC, ECON, and the Commission, and to ESC, EBC, and EIOPS.

Paragraph 7. We welcome 3L3's commitment to transparency and consultation with the industry.

Paragraph 9. We welcome 3L3's clarification of the basis on which it proposes to seek convergence on a cross-sector basis. It is indeed important to be proportionate, and to have regard to sector and market-specific requirements and political considerations. We attach a briefing paper on supervisory convergence which some of us prepared in the context of the review of the Lamfalussy process.

Paragraph 11. We do not think that the 3L3 work programme needs to be adapted in the light of the December 2006 Council Conclusions on the Lamfalussy review.

Paragraph 12. See our detailed comments below, in particular as regards item B(vi) – valuation of financial instruments – on 3L3's proposed allocation of priorities.

A. Common 3L3 framework for cooperation between national authorities

A.1. Home/Host delegations of tasks.

We agree that this is a key issue.

Paragraph 15. We agree that this is a priority area for 3L3 work in the future.

Paragraph 16. We welcome 3L3's agreement to work on home host cooperation within colleges, and between involved supervisors in the area of conduct of business (for example, as regards the supervision of branches, following up last year's CESR protocol).

Paragraph 17. We welcome 3L3's commitment to share lessons learned. We are not sure what 3L3 mean when they say that "the need to submit own-initiative recommendation to higher levels whenever inconsistencies arise in Level 1 or Level 2 legislation will be shared and jointly addressed where possible", but we agree that legislative inconsistencies need to be dealt with at Levels 1 and 2, and that Level 3 has an important role in advising legislators of their significance and impact.

Paragraph 18. We agree that it will be a key aspect of this work to examine, as a priority, the allocation of tasks and responsibilities between supervisors of a cross-border group. We welcome the fact that 3L3 recognises that various issues will be relevant. Indeed, we would argue that the range of important respects in which the activities of different groups vary, and their role in local markets and the local economy varies, means that the objective should be to work towards a methodology for determining the allocation of tasks and responsibilities, rather than to develop a single model of home-host cooperation. CESR's work on supervision of branches under MIFID, and CEBS work on colleges and operational networks point towards the complex issues that arise, and productive ways of resolving them.

Paragraph 19. We welcome 3L3's intention to report by 2009 on legal and practical issues which could help encourage delegation.

Paragraph 20. We agree that the work needs to consider not only Level 3, but also what is needed at Levels 1 and 2 to achieve effective and efficient use of delegation.

A.2 Developing tools to improve supervision on a cross-sector basis

A.2(i). Professional secrecy and limits on exchange of information

Paragraph 22. We welcome 3L3's proposal to identify practical barriers (including any legal barriers that remain) to information exchange.

Paragraph 23. We agree with 3L3's proposal to seek enhanced coordination of information exchange within 3L3's influence, to set out practical arrangements necessary for efficient and effective management of information in normal times and times of crisis, and to protect against intrusion into databases.

Paragraph 24. We agree with 3L3's proposal to look into the feasibility of easing joint access to sector databases. In doing so it is of course necessary to take into account confidentiality constraints that apply to the information.

A.2(ii) Powers and enforcement sanctioning

Paragraph 27. We agree with 3L3's proposal to carry out cross-sector analysis of supervisors' varying powers.

A.2(iii) Inspection practice consistency

Paragraph 29. We agree with 3L3's proposal to map inspection practices by 2008, explore possibilities for increased convergence, and develop any conclusions involving EU or national legislation by 2010. In this context we recommend the approach to convergence set out in the attached briefing paper. We also agree with 3L3's proposal to develop supporting IT tools, and we support 3L3's proposal to enhance the reporting framework for supervised financial institutions. In this last context, we stress the need to reduce unnecessary duplication of reporting. We also agree with the need to take into account cost and confidentiality considerations

B. Developing 3L3 convergence of regulatory and supervisory practices in key areas.

B.(i) Competing products

Paragraphs 32 to 34.

We think that it is very important for there to be clarity with respect to the objectives and scope of this work. Whilst fact-finding by 3L3 may be appropriate, it is for the legislator or competition authorities to take a view on whether further action is needed. The Consultation Paper mentions customer protection in the preamble of paragraph 32, but the discussion in paragraph 33 refers to conduct of business and prudential regimes.

While clarity and robustness of consumer/customer protection is important, it is equally important that the 3L3 work takes account of, and does not confuse, the differing needs of retail/individual consumers and professional and sophisticated wholesale investors. In addition, the link between conduct of business/ prudential regulation and customer protection needs to be elaborated by the 3L3s given that prudential regulation in particular focuses on ensuring that a firm is protected adequately from the risks that it undertakes and thereby will be more likely to remain financially sound and able to meet its obligations to its depositors and investors.

In the context of prudential requirements, it is also important to remember that the extensive work that led to the CRD (which is still in the course of being implemented) had as a core objective the need to align risk to capital and ensure to the extent possible that similar economic risk was treated consistently. The CRD is the EU iteration of the global agreement on capital adequacy – the Basel Accord - but it is not aligned with the insurance sector's treatment of risks. This means that although there may be scope for aligning banking/investment and insurance sectors more closely, changes to the CRD may be at the expense of EU consistency with Basel. The efforts of regulators and of industry to ensure as few meaningful discrepancies as possible between the implementation of Basel in

different jurisdictions indicates that if changes to the CRD are contemplated that this needs to be discussed in conjunction with the Basel Committee and, as necessary, the Joint Forum.

As regards customer protection, it will be important to take account of the conclusions of the Commission's current Call for Evidence on substitute investment products – a process which we understand will require the rest of 2008 to complete –, and also take account of the new MIFID requirements relating to suitability and disclosure, and the extent to which they mitigate any perceived risks to consumers. In addition, we note the following.

- (a) It is in principle true that structured products are capable of being delivered in different legal forms (or 'wrappers'), each subject to different regulation. In practice, however, it is factors other than regulatory treatment that are the main drivers of the 'wrapper' used for delivery to a particular grouping of investors. Prominent among these factors is tax (though it is also true that new factors are emerging all the time, e.g. Islamic Finance provisions).
- (b) While the specifics may vary by individual structured product, in each case the returns are subject to precise parameters that are contractually fixed at the outset, net of any fees. Similarly, the level of risk is defined up front, taking into account the type of client for whom the product is designed. Moreover, the only sense in which a structured product can be described as 'complex' is in terms of the mechanics by which this risk-reward parameterisation is achieved. By contrast, the returns and risks associated with a ('simple') discretionary investment service depend on the good offices of the investment manager, on top of which fees will be levied. This distinction between approaches is a crucial one for policy purposes.
- (c) Differences in regulatory treatment of various 'wrappers' arise for good reason, suiting the way in which genuinely distinct products have been – and in the main continue to be – created and marketed. Traditional retail products (eg, life insurance) entail a strong nexus between provider and customer, with distributor acting as little more than agency introducer. Securities by contrast, appropriately place more emphasis on the role – whether transactional or informational – of the broker in the primary (and potentially secondary) market in a given product, including many structured products.
- (d) In practice, firms exercise the disciplines of 'know your distributor' and 'know your provider' as relevant. Related to this, industry-generated principles have been published for the management of the provider-distributor relationship^{1[1]}. In other words, commercial practice can accommodate and adapt to the use of various wrappers.

¹ Retail Structured Products: Principles for managing the provider-distributor relationship. July 2007
<http://www.isda.org/press/RSP-Principles071007.pdf>

- (e) We believe that, to the extent that any harmonisation or regulation is pursued, the proper emphasis should be on regulation of the distribution of products. A regime that focuses primarily on the nature of the product is more likely to run into issues of form over substance. For the same reason, any such distribution-focused regulation should take the form of principles. MiFID – which specifically addresses structured products and suitability – is a state-of-the-art piece of legislation that already satisfies these two conditions, being both principles-based and distribution-focused.

We would also make the general comment that though we welcome the 3L3 recognition that the EU-level approach to this issue should be a coherent one, we caution that citing competing products as a priority should not signify that, as a 'priority' issue there is a pre-determined case for legislative action. We believe that this is not the case, and the Commission will only seek to regulate in this area if a very clear case, justified by cost-benefit analysis and market failure analysis, has been made. This topic is discussed more fully in the response to the Call submitted to the Commission jointly by a number of associations and available at their web-sites².

B. (ii) Credit rating agencies

Paragraph 35. We agree with 3L3's proposal to continue ongoing work on the role of CRAs and their use in prudential regulations. Should, however, the L3 Committees consider that there is a case for proposing any changes in regulatory approach or content in Levels 1 or 2 of the prudential directives (i.e. the Capital Requirements Directive), there should be coordination and consultation with the Basel Committee as it would be unhelpful if there were to be a divergence between the EU and the global application of the Accord. While we understand that Credit rating agencies are an important issue for 3L3 given the attention that the rating agencies have received from the EU institutions, it is also important for 3L3 to follow any lead set by global bodies, in particular the Financial Stability Forum and IOSCO work in this area, in order to achieve maximum consistency of approach globally.

B. (iii) Anti Money laundering and counter terrorism financing

Paragraphs 36 – 38. We support 3L3's proposed work programme in this area. Supervisors should engage actively with the private sector when preparing "a catalogue of common pragmatic supervisory responses to specific issues identified". We see it as important that the supervisors ensure that they understand and take into account the industry's issues arising from implementing the Third Money Laundering Directive when undertaking the development of this catalogue. Some examples of industry issues are:

- a) beneficial ownership and the difficulties that can be encountered and overcome;

² Five associations are responding jointly on this topic: ESF, ICMA, ISDA, LIBA and SIFMA

- b) reliance on third parties, and the various interpretations of this leading to lack of consistency in its application – development of good practices may assist;
- c) the tensions arising as a result of data protection and privacy laws with the need for sharing information across groups and across borders as part of an effective AML/CTF regime;
- d) data availability from governments and other public sector agencies and the development of standards of good practices regarding the types of information that should be provided – this is not just about typologies which are often made available too late; and
- e) country evaluation good practices that would help firms and supervisors alike to evaluate the extent to which different countries have adequate AML/CTF practices, and to achieve consistency and transparency.

Supervisors need to understand these issues, and to appreciate the ways in which the industry overcomes them. This understanding then needs to be reflected in the 3L3 catalogue, which needs to take into account the risk based approach now being implemented by firms.

3L3 needs to give careful consideration to the differences between anti-money laundering practices and anti-terrorist financing when preparing the catalogue.

B. (iv) Commodity derivatives

Paragraph 39. We note CESR's and CEBS's continued work on the Commission mandate.

B. (v) Cross-border consolidation

Paragraph 40. Consistency of approach across sectors as well as across Member States would be desirable and we support the work of 3L3 in this field.

B (vi) Internal governance

Paragraphs 41 to 43. 3L3 observes that differences between sectors are slight in terms of objectives, but sometimes large in terms of drafting and detail. We agree that the implementation phase of CRD is not an opportune time to change internal governance requirements.

As regards 3L3's proposal to develop full cross-sector guidance for conglomerates, and to provide advice on how to harmonise legal texts at Levels 1 and 2, it is important to note that the industry has already struggled with the differences introduced by MIFID/CRD. The UK FSA sought to simplify matters by introducing a common "highest" standard in FSA rules, which UK firms supported. The following considerations would be important in assessing any 3L3 work in this area:

- a) Would the 3L3s propose to try to iron out all real or perceived differences between the different sectors?
- b) If so, would it necessarily be through proposed legislative change to the directive texts, or might it be through Level 3 Guidance?
- c) If Level 1 or 2 text were changed, presumably it is inevitable that implementation changes would follow, hence leading to further costs for firms. In this case, it would be important to consider whether the timing/sequencing of this work (notwithstanding the review of the FGD/Solvency 2 negotiation) is appropriate.
- d) If, instead, the 3L3s issued guidance, it would be essential for the status/usage of this guidance to be made clear in each jurisdiction, to avoid confusion as to which standards should apply. It would be important to avoid repeating the difficulties that arose when CEBS tried to “round up” various risk management standards and précis them for the industry – the industry effectively felt obliged to see the CEBS output as one additional standard to follow, and it did not necessarily reduce burdens as intended.

It is also important to take into account the linkage between internal governance and home-host relationships.

B (vii) Conglomerates

Paragraphs 44 to 45. We agree that the IWCFC should play a role in a range of activities mentioned in the medium term work programme. We note, though, that a key element of the IWCFC work on which the consultation focuses appears to be capital requirements, including the establishment of a common working definition of own funds. Read in conjunction with paragraphs 49 and 50, it is not entirely clear whether this describes the same work or a separate project.

On the assumption that it is the same project, there are a number of factors that need to be taken into consideration. One is that the definition of capital is another area where banking/investment prudential requirements are aligned with Basel, and it would be essential for any changes that are contemplated to be discussed first in fora such as the Basel Committee.

In general terms firms support moves to more principles based approaches, and we can welcome the statement that these avenues could be explored. In reality these discussions would have to address core issues such as the purpose of capital, and again it would be important for work to progress in parallel and in dialogue with wider international initiatives.

B (viii) Capital modelling

Paragraphs 46 to 48. This area of the 3L3 work programme is not clearly described, and it would be helpful if 3L3 could clarify which aspects of this workstream they plan to concentrate on. The proposal appears to be for a work stream that will assess potential challenges that arise in implementing both Solvency II and the CRD (Basel II) to the groups that are subject to both sets of

requirements. Firms would welcome attention being given to avoiding an outcome where they are subject to duplicative or conflicting requirements due to these regimes. If this is the intention, we agree that the work is worth undertaking. We also support the view that it will be important to take into account sector specificities and recognise that some differences may be legitimate or even necessary.

Given, however, that the title for this workstream is “capital modelling”, is there an intention for there to be work to assess either how firms create their own internal capital models (whether for Pillar 1 or Pillar 2 purposes) or for supervisors to undertake comparative work on how to assess such models where these models require supervisory approval (under Pillar 1) or assessment under Supervisory Evaluation (Pillar 2)?

We support this work 3L3 envisages on convergence of standards and approaches for reviewing capital models (eg VAR or IRB), and assessing firms’ internal capital allocation approaches (e.g. economic capital models), as a useful step towards an enhanced understanding of these practices.

B (ix) Own funds definition

Paragraphs 49 to 50. This workstream appears to refer to a project already mentioned in paragraph 44 (on Conglomerates).

B (x) Valuation of financial instruments

Paragraphs 51 to 52. It is important for work in this area to be coordinated with other global bodies who also have an interest. There is already considerable work being undertaken on a global basis with respect to Valuation – most of it feeding into the Financial Stability Forum, whether from the IASB, Basel Committee, IOSCO, the IAIS, or others. On 7th December the Commission, in the conclusions that it drew from its 5th December round table with industry on securitisation disclosure and transparency in securitisation, indicated that there is no need for specific EU work in this area. We therefore think that this should not be a key issue for 3L3. It is important that any work in the EU is effectively coordinated with existing global public and private sector efforts and does not cut across them, and also includes consultation with market experts given the technical and sensitive nature of valuation.

Also any work undertaken should have regard to the fact that different valuations may be equally valid for different purposes. For example, supervisory objectives may be different from those of other users of accounts – thus in the context of supervision prudent valuation may be more relevant than fair valuation and firms will not necessarily be required to submit prudential reports on an accounting basis.

We agree that supervisory action is appropriate to ensure that firms understand the risks they are running and the appropriate valuation processes that follow. We also agree that solutions may not be the same for all financial sectors.

The following considerations may also be relevant:

- a) IFRS requirements are relatively new; firms are still getting used to them, and practice still needs to evolve.
- b) The accounting profession is best placed to compare practice across firms and see where commonalities are emerging; the Global Public Policy Committee (representing six major firms) have recently issued a paper, following on from the one prepared by the US profession in September.
- c) Regulatory action on mark to model is unlikely to be helpful – apart from the difficulties of finding any generally applicable rules, as noted above different valuations may be valid for different purposes. It is also important to recall that there are already prudent valuation requirements in the trading book in the CRD which require firms to consider whether liquidity provisions are necessary.

C Developing common 3L3 tools and working procedures within the Committees

Paragraph 53. We think that 3L3's proposals are consistent with the December 2007 ECOFIN conclusions on the Lamfalussy review.

Paragraph 55. We support 3L3's development of a training platform for cross-border issues, and of other tools to explore overcoming existing practical barriers for staff exchanges.

Paragraph 56. We support the 3L3 Committees' focus on peer review mechanisms. It is important for peer reviews to focus on convergence of regulatory outcomes, and to take account of the fact that in this context differences in detailed practice may legitimately persist – see the attached briefing paper

Paragraph 57. We agree that 3L3 mediation mechanisms should be kept under review.

Paragraph 58. We agree that impact assessment methodology (including more use of cost-benefit analysis, and assessment of the impact on cross-border firms of super-equivalence in national implementation) should be built into all future policy work. The recent report by ESME on the practical issues relating to the implementation of the Transparency Obligations Directive has highlighted the importance of careful planning for implementation of major EU directives as well as the non-justified costs of superequivalence.

Paragraph 59. We agree with 3L3's proposal to create a method to compare across sectors decisions and experiences relating to assessing the equivalence of third country regimes. However, as regards 3L3's proposal to explore the possibility of greater cross-sector convergence of equivalence assessments, we stress the importance of assessing each area assessed on its own merits, and not seeking necessarily to apply the same methodology to everything,

Paragraph 61. We support 3L3's focus on as much information exchange as possible between the Committees, and its intention to develop common

approaches to issues of significance. In the latter context, it is again important to focus on regulatory outcomes, and to recognise that different approaches may be appropriate for specific reasons related to the sector concerned. In doing so it is of course important to respect the confidentiality of information provided by firms.

ANNEX

Lamfalussy Level 3: Different views of convergence, their implications and limits

A briefing paper by financial services industry firms and associations³

Executive Summary

Level 3 regulatory convergence has been the focus of some concerns that have been expressed about how the Lamfalussy process has evolved so far. Some commentators have asserted that there “has not been enough convergence”. But what is meant by “convergence” has never yet been clearly defined. In considering whether there is or is not “enough convergence”, it is first necessary to consider what nature and degree of “convergence” it is appropriate to aim for. This note, therefore, examines:

- o the **different ways in which the term “convergence” can be interpreted**,
- o our **minimum assumptions** for what convergence must deliver,
- o what the **implications and consequences** of each might be,
- o **what types and levels of convergence might therefore be most appropriate**.
- o whether **in some respects, or beyond certain limits, convergence would be unnecessary or harmful**: in these respects, we question whether convergence is needed or appropriate at all or whether there are suitable alternative options which merit consideration.

Industry recommendations

- o Any convergence process that is adopted must co-exist with and actively support principles based regulation. Emphasis needs to be on the validity of the regulatory outcome, not an insistence that there is only one legitimate method of achieving this outcome.
- o Alternative mechanisms to convergence, such as stronger reliance on formal delegation of powers and tasks and enhanced mutual recognition can be and should be used as complementary approaches to the convergence process.
- o The desire and pressure for convergence is clearly strong but different models and perceptions of convergence exist.
- o The consequences of convergence cannot be assumed to be positive or benign in all instances or for all market participants.
- o Hence it is essential to conduct a robust analysis of the costs and benefits of convergence, and alternative approaches which will take proper account of the different forms of convergence that could be considered.
- o Convergence of outlook is a necessary first step in order to pave the way for any convergence of practice, but it will also be a necessary first step for any other developments that might be adopted. We are ready to support any initiative promoting greater understanding in this field.

³ The Associations are: London Investment Banking Association (LIBA), British Bankers’ Association (BBA), Association of British Insurers (ABI), International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA)

- o It is important that continued movement towards convergence remains on a voluntary basis, as opposed to mandatory. Voluntary mechanisms, coupled with transparency, remain the best available proxy for ensuring that the national authorities are able to assess and balance the needs of different market participants as well as the range of institutional responsibilities.

Different ways in which “convergence” might be interpreted

“Convergence” might mean a range of different things, for example:

- o regulatory and supervisory arrangements that are broadly similar or cover the same ground;
- o regulatory arrangements and supervisory practices that differ in detail but deliver the same outcomes; or
- o regulatory requirements and supervisory practices that are the same in form and application.

“Convergence” might relate to a range of features of regulation, for example:

- o the **rules themselves**,
- o how they are **interpreted**,
- o how they are **enforced in practice**, or
- o how **regulated entities are expected to comply** with them.

It is therefore necessary to try to analyse:

- o what **should be converged**,
- o what (in practice) **can be converged**,
- o what are the **likely consequences** (good and bad) of converging different aspects
- o whether in particular cases convergence is **needed**, and
- o whether the objectives convergence is supposed to deliver are in fact **better and more easily achievable by other means**.

For a full analysis, it would also be necessary to consider where the idea that convergence is perceived as a good thing emerged from, and to examine its history and intellectual credibility.

Like so many aspects of Level 3, **convergence needs to be considered from different points of view**, for example:

- o what type of convergence (e.g. of rules, interpretations, practices)?
- o what form of convergence (i.e. how and to what extent convergence is formalised)?
- o what extent of convergence (e.g. how much latitude is left for different approaches)?
- o what areas of convergence (e.g. prudential, conduct of business, reporting)?

It is important to recognise that in practice, different types, forms, or extents of convergence may be appropriate for different areas. A single approach, particularly one which emphasises “as much convergence as possible” may well be unhelpful, and could be harmful.

Minimum assumptions for what convergence must deliver

Whatever concept of convergence is adopted as a basis for policy, it must be compatible with and actively support the concept and reality of principles based regulation. It should focus on legitimate equality of opportunity and of outcome in a regulatory situation, since this is fundamental to both regulatory and prudential objectives, and is, we suggest, the objective against which the appropriate level of convergence necessary for the achievement of the Single Market must be measured.

This is why pressures towards convergence to enable the Single Market tend to run across the responsibilities of many authorities, in particular Ministries of Finance and Central Banks and the regulators (perhaps most notably in the context of the Lender of Last Resort). It is vital that the approach to convergence respects appropriate checks and balances of powers and decision-making responsibilities. It is important not to proceed on the simplistic assumption that 'as much convergence as possible' is the perfect answer, and that the only obstacle to it is the obduracy of national interests. Reality is more complicated than that.

The implications and consequences of different types of convergence

In respect of prudential regulation in particular (and maybe other areas too) there is a known and long standing tension between the equally valid objectives of the Single Market (like that of competitiveness generally) and that of prudential regulation. The appropriate balance needs to be struck. The Single Market aims at eliminating national borders or barriers. In a trade sense this is very desirable and may be achievable. In a prudential sense, however, there remain a number of dimensions - legal and administrative, including redress mechanisms, enforcement practices and court regimes - which remain separate and where full integration does not exist. There may therefore, in the prudential context, be issues about: whether if a crisis emerges capital and liquidity can be relied on to flow to where it is needed; whether firms themselves actually want to be able to cut loose problem subsidiaries or branches; whether national supervisors will be faced with balancing the needs of the national economy and national investors against the wider good of the Single Market working smoothly; and whether liquidation, winding up, and insolvency laws all fit with each other smoothly. These are all part of the many and complex aspects of what to do in a crisis situation and who has to pay and whether those who are forced to pay have been included in or cut out of the chain of decision making. Those who have powers to make decisions may lack responsibility and accountability. Ensuring that all the checks and balances are effectively worked out is hard. Trying to force 'as much convergence as possible' against this background, without considering and taking into account a range of factors and constraints, is likely to be not only impractical, but also actively harmful.

What are the different forms of convergence and what are the implications?

Many discussions on convergence are made more complex because of different concepts of convergence. Therefore this section seeks to examine alternative interpretations and the potential consequences of these differences.

Convergence of rules

Does "convergence" mean **convergence of rules**? This definition appears to be viable, but if this is what we intend by convergence, it prompts the question of why do we not regard the Directives as having achieved this? In Treaty terms (Article 249)

Directives are addressed to Member States in order to bring about a desired outcome. It is for Member State discretion to determine how to achieve these outcomes. Hence the spirit of the Directive itself is a focus upon outcome. In more granular terms, the reason that a Directive does not deliver automatic convergence lies in two areas (a) the interpretative process that each Member State/Competent Authority must undertake in order to express the directive in terms that the regulated entities can comply with and (b) the processes, practices and behaviours that the competent authority must adopt in order to enact its obligations and which must be in conformity with national law. Yet even setting aside any debate on how Directives should be implemented, it is worth noting that even if there were "a single rule book for Europe", there would still be a lot of variation in what supervisors understand those rules to mean and how they think they should be put into operation.

There is also, in fact a third area, which is that of national options that are left open to Member States. These options are incorporated in the EU legislation as a result of the EU political process. Over time, and with evolution of practices and skills, then the need for such options may die away. However, in the interim, there is the possibility that Member States (and their competent authorities) may opt for a consistent set of choices in these options. In the early days following the adoption of a directive, this behaviour would appear unlikely, or else the political process would not have ensured that the options were enshrined in the first place. However, it is worth noting that even if directives were to be expunged of all scope for national discretion, there would still be scope for differences of interpretation and practice as defined in (a) and (b) in the paragraph above.

Convergence of interpretation

Taking the issue of interpretative process, does "convergence" mean **convergence of interpretation of directive requirements** in practice? The way the directives are drafted, even when they are very detailed, does not, given its nature (as noted above) tell Member States precisely how to go about doing something, merely what is to be done and/or what the outcome is expected to be. There are many different ways in which directives require many underpinning national decisions and practices – for example, even something as simple as saying sovereign risk attracts a 100% risk weight means that there are a lot of interpretative decisions to be made on what is a sovereign risk and what is not.

Where a Member State's interpretation or application represents a breach in the implementation of Directives by Member States, the matter should be dealt with by infraction or other enforcement proceedings, and is not a convergence issue.

With respect to the elements of interpretation and of operational, supervisory practice, there is a limit to how far Directive implementation can be converged without a radical change in the Directives themselves. In other words, there could be uniformity of practice and application only if the Directives were damagingly granular and prescriptive.

Convergence of implementation and supervisory practice

The fact that the Directives do not operate as a single rule book for all of the EU takes us to the recognition that it is not so much the content or drafting of the rules that matters in practice as their application on the ground – itself a function of interpretation of what the rule is saying in the context of the national tradition of supervision and supervisory practices. So does "convergence" mean **convergence of**

implementation and supervisory behaviour? Convergence of this sort would mean that we would expect supervisors to behave in the same way as each other.

With a landscape of disparate supervisory histories and practices born out of different national experiences, then it is easy to recognise that convergence of supervisory practice (if this is the goal) could not be achieved overnight. It would require one or more of a number of factors to be in place, including:

- o absence of any legal (even constitutional) barrier to tasks being performed in a certain way;
- o clear analysis and agreement on the detailed objectives of supervision (at a high level, these objectives are probably easy to agree upon);
- o clear understanding of the priority placed by the different Member States on different aspects of supervision, or risks which require particular attention;
- o committed agreement on the structure, timing, and manner in which supervisory action and surveillance is delivered; and
- o comparable resources.

An example of issues that would need to be addressed in this context is what practices and process would apply when implementing the Directive requirement that there should be a higher than 8% minimum capital requirement for firms (ie credit institutions and investment firms), for example determining whether an individual Member State had constitutional issues, what processes could be agreed upon for determining when greater than 8% capital was necessary and how much the incremental capital should be. Another example is methods of approval for internal models (whether Value at Risk (VAR) models in the trading book, or Internal Ratings Based Models in the non-trading book). Other variations of supervisory practice that would come under consideration would include choices such as use of “on site inspections” or use of external auditors in the supervisory process. Again it is worth noting that these matters are not prescribed in the Directive – and as matters of supervisory practice would not actually be included in any version of “a single rule book.”

Assessing and evaluating the implications of convergence: what types and levels of convergence might be most appropriate?

Regardless of the form and degree of convergence that is agreed upon as a goal, it is also necessary to examine the convergence debate from the perspective of the benefits and costs that would be imposed on firms, on consumers (whether investors or depositors etc) and on the supervisory authorities and Member States themselves. That is to say an analytical framework needs to be devised to assess the appropriateness of the convergence project. Would there actually be a benefit to anyone? Would there be costs to anyone? Are there valid operational alternatives to achieving the same outcome? In simple terms, is convergence actually appropriate, and if so of what character (eg identical form and application, identical outcome, or just broadly similar or covering the same ground) and then to what extent should it be pursued? It would be necessary to answer these questions if a policy of convergence on this basis were to be justified in an evidence-based way on identified need.

Source of pressure for convergence

If the pressure for convergence arises from frictional costs that crop up in cross border groups' supervision, robust application of mutual recognition, and targeted convergence through joint supervisory work, or agreement between regulators to use the same reporting formats, may be equally or more effective ways of tackling the

frustration and inefficiencies often experienced by the international groups. It is not acceptable for a system of supervision to impose requirements upon a firm to replicate work performed for different supervisors. Arguably different supervisors within a group may have different priorities and concerns that they wish to satisfy when assessing whether a firm meets a particular standard. This could lead to a situation where a firm is subject to different tests by different supervisor in order to meet the same legal requirement/standard. It is understandable and indeed inevitable that firms will resist such an overlay of regulatory tasks being imposed. Convergence of supervisory practice, predicated on convergence of supervisory priorities and risk assessment can easily be seen as an attractive remedy to this sub-optimal supervisory arrangement.

An examination of the different needs of international groups and domestic firms can, however, demonstrate that the benefits and potential costs or disadvantages of a push to convergence are not evenly distributed across the industry.

While duplication and overlay of regulatory tasks creates costs for firms who operate across borders, for domestic firms, the pressure for convergence described above may not exist at all as they will not be subject to multiple national interpretations. As convergence would generate changes to supervisory practice, it is probable that the domestic firms would experience increased costs on either a transitional or a continued basis. Hence, given that convergence means change, the question is whether the costs would be shared proportionately according to expected benefit, or by some other means. The big international firms are likely to be best placed to absorb costs, but what would be the impact on small, domestic or regional players? Can the needs of these two broadly defined groups be reconciled, or alternatively, can the needs be satisfied using different means? It is also important to be aware that not only industry but the national authorities would face costs, and this would be most likely to fall on the public purse. If the needs of the different groups cannot be reconciled there will remain a significant obstacle to convergence from a structural and potentially political level.

Delegation of powers, decision making, or even a form of mutual recognition *could* arguably avoid an overlay of regulatory tasks being imposed on an international group. This solution could deliver all or most of the benefits of convergence of supervisory practice as it would act to remove the frictional costs for international groups and would not imply any need for change for domestic groups.

It has also been argued that this dichotomy could be resolved by two-tier supervision, with converged supervision for large international firms, but not for smaller domestic ones. But two tier supervision would raise a number of problems that might well be insurmountable:

- o How to define which firms went into which category. Where would the boundary be drawn? Would the decision be at regulators' discretion, or would firms volunteer? Voluntary allocation would meet the test of equality of opportunity, but regulators might have strong views about which firms they would or would not want to be included in which regime.
- o Would the distinction be purely one of regulatory practice, or would it involve rules as well; where would the boundary be drawn?
- o How would the training of regulators in converged practices be resourced and funded?

- o How would the costs involved in adjusting to converged supervision avoid becoming a barrier to competition and effectively limit access to the Single Market?
- o How would the differential in costs between converged supervision and local practice avoid becoming a barrier to competition in each domestic market?
- o How would supervisory practices for local and international firms evolve over time? How could regulatory practice in each keep up with market developments while avoiding getting out of step with each other?

In what ways, or beyond what limits, could convergence be unnecessary or harmful?

Not least in view of the competing needs and pressures from the industry and regulatory sector, it is necessary to pose the primary question of whether convergence is an appropriate or correct goal? And if so, on what terms should convergence be delivered?

We consider that it is the outcomes that matter. There may be more than one way legitimately to achieve the right outcomes, and the costs and benefits of the alternative approaches, including that of convergence, need to be assessed. The principle that there may be more than one legitimate method of achieving an equitable and appropriate outcome, and that these methods can validly co-exist is the basis on which Principles Based Regulation is founded. The concept is as true for the way supervisors carry out their activities as it is for the way that firms fulfil their obligations under the Directives. For this reason, the debate on convergence is intimately related to the debate on Principles Based Regulation. The ultimate objective is for the same regulatory situation to produce the same response in each country, even if the answer was arrived at by a different means.

It follows that it is vital that convergence is not interpreted in a way that cuts EU regulation off from the concept that there is more than one way to reach principle-based objectives. Pressure to use only one way could have very damaging consequences. It would be quite wrong to force convergence in a way that introduced systemic weakness across all firms and supervisors. As an example, a few years ago, there was considerable debate with respect to whether regulators were restricting model recognition to an overly limited range of Value At Risk (VAR) Models. There were serious concerns that a single prescriptive model applied to all firms would cause systemic weakness, because the lack of diversity would tend to exacerbate any crisis. It is clear that such concerns could persist today in a variety of areas.