



**20<sup>th</sup> MEETING OF THE ASSOCIATES**

- Budapest, Hungary, 12 May 2005 -

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MINUTES

**ITEM 1 – OPENING AND WELCOME**

Mr Hein BLOCKS, chairman of the FBE Executive Committee, chaired the meeting and welcomed the participants of the meeting.

Mr. Rezso NYERS, Secretary General of the Hungarian Banking Association welcomed the participants of the meeting to the home of the Association.

A list of participants is attached (enclosure 1).

**ITEM 2 – MINUTES OF THE PREVIOUS MEETING**

The members approved the minutes of the 19<sup>th</sup> Meeting of the Associates, which was held in Brussels, Belgium, on 9 December 2004.

**ITEM 3 - BASEL II**

**a) SECOND PILLAR OF BASEL II: the Hungarian point of view.**

Mrs. Erika Marsi, General Director of the Hungarian Financial Supervision Authority presented the Hungarian Supervisory system and its main tasks and challenges with particular reference to banking supervision.

The Hungarian Financial Supervisory Authority (HFSA) is an integrated supervisory institution which covers all aspects of the financial industry – banks, investment firms, insurance companies, etc. As a result different approaches have to be used for different sectors. The institution employs around 540 staff.

The Hungarian FSA has a two-tier governing system with a Board, which is responsible for defining overall policy and strategy, and taking decisions on licensing, at the top of the decision-making hierarchy. The Board is composed of 5 independent persons, most of whom have a long professional experience in financial supervision.

Everyday operations of the HFSA are run by the Director General and two deputies, one per each wing of activities – Prudential supervision and Market Developments oversight blocks. Each of those two blocks has three directorates. Banking and capital market supervision, insurance and funds supervision and methodology directorates for the prudential supervision wing,

and Licensing, regulatory, analytical and international affairs as well as market oversight directorates for the market developments oversight wing.

The Hungarian FSA has various committees operating under its supervision such as the Committee of Cooperation on EU issues (BASEL II, Solvency II), Committee on Legal issues, Committee on Accounting, etc.

The Hungarian FSA is a member of the most important relevant EU committees such as the Committee of European Banking Supervisors (CEBS), Committee of European Security Regulators (CESR), etc.

One of the main current tasks of the HFSA is the implementation of new legislation, the new BASEL II accord and its EU version – the Capital Adequacy Directive in particular, as well as the Solvency II project.

The main challenges in this process lie with the internal preparation work of the supervisors, making sure that supervised financial entities are ready for the new requirements and challenges, and also the extensive coordination between home and host supervisors. Remaining uncertainties in several crucial practical fields regarding the implementation of the new BASEL II Accord make this task even more difficult.

The implementation of Pillar 2 in coordination between home and host supervisors was mentioned as a main area of uncertainty. Coordination of home and host countries supervisors itself is not expected to cause problems but rather the practical implementation and interpretation of pillars 2 and 3.

In most cases the Hungarian FSA will act as host supervisor as around 80% of the assets of the Hungarian banking sector are controlled by foreign banks, the vast majority of which are from other EU countries. This was mentioned as one of the reasons why the Hungarian FSA among others is not going to opt for national discretions.

The latest developments in financial supervision require substantial internal preparations by each institution involved – including the Hungarian FSA in this particular case.

To be able to meet the numerous challenges and to work in the new demanding environment each of the supervisors requires the highest possible level of training. Internal preparations for the validation process could be a “black hole” to all supervisors and market participants involved. This is another substantial reason why ongoing consultations with market players and ensuring the maximum transparency are considered of high priority.

During the discussions after the presentation various aspects of the future organization of European financial supervision were discussed. Mrs. Marsi shared her vision on the concept of consolidated supervision in Hungary stating that for the future only one real possibility exists – lead supervisor for the whole financial entity active cross-border, but everyday supervision and on-site checks carried out mainly by the local supervisor in close cooperation and coordination with the lead. However, the practical acceptance and implementation of such a concept could take some time.

As mentioned by one of the participants of the meeting – “it is not difficult to agree on the direction of European supervision, but once political bodies or issues are at stake, it may become far more difficult to progress...”

The necessity and possibility of creating a “roof” for CESR, CEBS, etc. – a kind of European FSA Committee was also discussed. Many participants agreed that in the long run this is the only way.

It was also mentioned by some participants that the decision of their national supervision authorities in the financial sector to merge proved to be the right one, although it may take a considerable time for them to adjust the sometimes different approaches they had before.

## **b) LATEST DEVELOPMENTS IN BASEL II AND CAPITAL REQUIREMENTS DIRECTIVE.**

Mr Elmars KRONBERGS, adviser at the European Banking Federation, made an introductory presentation on the subject.

The Basel project is a vast one which requires huge investment in technology and training, not just in Europe, but across the world. There are now over 100 countries which intend to implement the new Basel Framework in one form or another.

It took five years in total to get the new framework on the table. It was a remarkable achievement given the complexity and the differences between the members sitting in the Basel Committee.

It became apparent in 1999 that the simple 1988 framework was no longer adequate to cope with the growing complexity of the banking industry. The use of derivatives in risk management, the use of credit risk transfers, asset securitisation, etc really only gained ground in the 1990s.

The new framework includes a high level of optionality so that it can be applied to a wide range of institutions. The idea behind the optionality is to provide incentives for smaller less complex institutions to move to the more advanced approaches over time. This supports the notion of delivering financial stability on a global basis which is the objective of the Accord.

In the final two years of the project there were question marks over whether agreement would ever be reached. At one point, for example, it looked as if the treatment of credit cards would never be resolved. Major changes were made to the framework at a late stage.

The split implementation dates of 2006 for the Standardised Approach and 2007 for the advanced approaches came as a surprise to industry. However, in May 2004 the new Basel framework was published.

Implementation of the Accord brings with it a whole new set of issues. The Accord is designed for application to international banks. In Europe, however, the decision was taken to apply the new framework to all banks and investment firms. This decision has been questioned, in particular by the European Parliament.

The FBE believes that this wider scope of application is in line with the EU's broader economic objectives and with the Single Market. That view is now shared by all

industry bodies. Deposits can only be protected in an environment where all banks subscribe to a minimum level of modern risk management practice.

In the EU the Accord will be implemented by a Directive. The Directive has changed names a number of times but it is now commonly known as the Capital Requirements Directive, or the CRD. The proposal for a Directive was published within weeks of the Basel framework's publication.

The Commission achieved a high level of parallelism with the Basel Accord taking account of specific characteristics of the European market. There was a great deal of concern before publication that this would not be the case and that the EU would not have a level playing field with the US. It is not clear yet to what extent US and EU implementation may result in different frameworks, but certainly industry is pleased that divergence from the Accord in the CRD is limited.

One of the problems with the European process is that changing legislation can take very long time. For that reason the Commission has split the Directive into Articles and Annexes.

The overarching principles are in the Articles and will be subject to review by the Member States and the European Parliament if they must be changed. All of the complex technical details and calculations are in the Annexes. The Annexes are subject to what is called the Lamfalussy procedure. That means that they can be changed quickly upon the advice of the Committee of European Banking Supervisors. The FBE welcomes the sensible split that the Commission has achieved between the articles and annexes.

However, there are a limited number of very serious problems which need to be tackled. The main three problem areas are:

1) Number of national discretions

The first and most pronounced problem in the Directive ironically partly results from its parallelism with the Basel framework. We have inherited all of the national discretions which found their way into the Accord during the negotiations. The result is that the current proposal includes 143 national discretions. Of these, supervisors have agreed to eliminate 20 before the Directive is even adopted. There are also a certain number which are necessary to cope with peculiarities in some Member States.

The FBE firmly believes that all national discretions must be removed over time. The existence of these options in the Directive is entirely inconsistent with the objective of achieving a Single Market. It should also be noted that not all the discretions relate to technical aspects of the Directive. Fundamental issues such as whether a group can calculate the rules at consolidated level within a Member State are subject to discretion. The risk weighting of Intra-Group Exposures is subject to discretion. The list goes on.

2) Implementation process

The objective during the legislative process, and going forward, must be to agree a flexible and high quality Directive that is consistent with the Basel framework and encourages convergent application across the EU.

Parallel treatment is essential to reflect the global nature of banking and investment business and ensure a level playing field for both industry and consumers.

The European Commission's approach of defining enduring principles and objectives in the Articles of the Directives and technical measures in the Annexes is an efficient way to deliver the necessary flexibility.

3) Efficient banking supervision and related consolidated supervision and host/home country issues

The FBE believes that consolidated supervision is the only mechanism which can deliver an efficient supervisory environment for banks active on a cross-border basis in the EU. The Commission's current proposal lays some of the necessary groundwork, but fails to deliver this principle. It is a paradox, that the EU, with a clear objective of a unified financial market, should choose a fragmented approach to banking supervision, burdening banks with multiple reporting requirements and additional capital constraints.

Some major issues in this area include:

- level of application of capital requirements (pillar 1) - discretionary waivers that could lock in an un-level playing field between Member States and competitive distortion not only between EU member States, but also with the rest of the world;
- level of Supervisory Review Process (Pillar 2) and Market Discipline (Pillar 3) – the need to extend the role of the consolidating supervisor to the Supervisory Review process under Pillar 2 and to Pillar 3 disclosures;
- intra-group exposures within banking groups applying risk management at the consolidated level – there is another discretionary waiver that could lead to competitive distortion. Namely, Credit institutions from Member States not applying the option are required to hold capital against IGEs whereas institutions from other Member States can apply 0% risk weighting.
- And finally the Advanced Measurement Approach for operational risk – it might be impossible for banks to apply the Advanced Measurement Approach at solo level. Operational risk is a new element of the framework and the data requirements necessary at solo level can simply not be fulfilled.

In the EU the deadline for amendment to Capital Requirements Directive in ECON is 13 May. The amendments are expected to be discussed in Committee on 26 May and the vote could take place in Committee on 15 June. Many of the MEPs are in line with the FBE's position and some are ready to push harder than we are pushing to achieve consolidated supervision now.

The US at the end of April announced that the results of their fourth quantitative impact study (QIS4) showed an unprecedented drop in capital requirements and large disparities between the banks applying the framework. On April 29, the US federal bank regulators issued a joint proclamation, announcing a delay for the major Basel II proposal that was due out by mid-year, pending further analysis. As a result, the regulators may need to rewrite the Notice of Proposed Rulemaking (NPR) and the implementation date of 1 January 2008 could slip as a result. This is not

good in terms of parallelism and global level playing field but has little concrete impact on European implementation.

#### **ITEM 4 - INTRODUCTION OF THE NEW FBE ASSOCIATES**

Mr. Michael LAUBER, CEO of the Liechtenstein Bankers Association gave a short presentation on the Liechtenstein banking sector and association.

Liechtenstein is a very small country of 160 square kilometres with only 34,000 inhabitants located in the centre of the Europe. Around 3,000 businesses are operating in the country.

The employment numbers in Liechtenstein are extraordinarily high. With a population of 34,000, there are 29,000 jobs. This is only possible because the number of cross-border commuters to Liechtenstein is many times higher than the number of cross-border commuters from Liechtenstein. About 13,000 people from the region (Austria, Switzerland and Germany) commute daily to their workplace in Liechtenstein. This is about 45% of the total employment.

Due to the small domestic market, the above average success of the Liechtenstein economy is only possible if clients can be attracted from foreign markets. Accordingly, the integration objective of Liechtenstein's economic and foreign policy is very important. Liechtenstein joined EFTA in 1991, the European Economic Area (EEA) Agreement in 1995, and the World Trade Organization (WTO) and its subsidiary organizations also in 1995.

The gross domestic product (GDP) of Liechtenstein is 4.2 billion Swiss francs (2003). About 40% of GDP is covered by added value in industry and manufacturing and 30% in the financial services sector.

Liechtenstein has an independent and integrated Financial Services Authority; however their national Bank's functions are fulfilled by the Swiss Central Bank.

There are 16 banks operating in Liechtenstein with the total client assets under management of 104 billion CHF (68 billion Euro) and 1,600 employees. Banks are mainly focusing on private banking business. Three major banks control around 90% of all assets. Besides, Liechtenstein has 385 asset managers and trust companies and 17 fund management companies with 190 investment funds.

The Liechtenstein Banking Association was established in 1969. Nowadays the Association employs 6 staff members and has permanent committees and working groups under its supervision. All banks are members of the Association.

The Banking Association has a vital commitment to fight abuse by implementing strong Anti-Money Laundering and Financing of Terrorism measures, by cooperating with the respective government bodies and by developing innovative products.

Major discussions today are in relation to necessary innovations in funds, amendments in Trust/Foundation law and amendments in tax legislation; going "on-shore", mainly to Switzerland, Germany, Austria and South East Asia; the necessity to enhance reputation and enhance the institutional framework.

During the discussions after the presentation a question was raised on the state of play with the regards to "EU withholding tax" law. Mr. Lauber reported that the relevant law is expected to be in the Parliament on 21 May 2005, after which the referendum period of 30 days would start. In any case it is expected that despite the tight timeframe Liechtenstein would be ready to implement the requirements of the EU Savings Tax Directive by 1 July 2005.

Following the discussion, the Swiss representative, Mr. Roth informed the participants that Switzerland also is going to be ready to implement the requirements of the EU Savings Tax Directive by 1 July 2005. The test period of the relevant systems has been started already and results of the test run should be available by then.

## **ITEM 5 - LATEST DEVELOPMENTS IN THE EU FINANCIAL SERVICES AREA**

Mr Elmars KRONBERGS, adviser at the European Banking Federation, started with the presentation of a ninth report on the latest developments in the EU legislation concerning the financial sector.

Altogether 15 pieces of legislation and other community action are included in the presentation.

He outlined six recently adopted legislative actions - Regulation endorsing the International Accounting Standard (IAS) 39 on Financial Instruments, set of 3 regulations endorsing different IAS adopted in December 2004 and a regulation endorsing certain IAS adopted in February 2005, as well as the decision on new standard clauses for data transfers to non-EU countries, the Transparency Directive and the Fraud prevention Action Plan in payment fraud.

Mr. Kronbergs continued his report on the European Commission's proposal covering the update of the Anti-Money Laundering Directive (or 3<sup>rd</sup> Anti-Money Laundering Directive).

Among the most important European Commission consultations, highlighted in the presentation, were those regarding:

- call for technical advice on Article 16 of EU banking Directive;
- trading activities related issues (Capital Requirements);
- survey on obstacles to cross-border mergers and acquisitions;
- outcome of second consultation on clearing and settlement;
- feedback on consultation on how the Lamfalussy process is working;
- results of the consultation on 'Fostering an appropriate regime for shareholders' rights';
- addendum to the call for technical advice on possible implementing measures on the Markets in Financial Instruments Directive and
- expert report on boosting the cross-border mortgage market.



## **ITEM 6 - ENLARGEMENT OF THE EURO ZONE: the challenges ahead**

Mr Elmars KRONBERGS, adviser at the European Banking Federation, made an introductory presentation on the subject.

The Commission imparted major impetus towards the creation of a European financial area in May 1986: its "Programme for the liberalisation of capital movements in the Community" described in detail all the conditions to be met and the measures to be taken. It was against this background that a Directive, which required full liberalisation of all capital transactions directly necessary for the interconnection of the national financial markets, was adopted in November 1986. However, a very large number of operations still had not been liberalised.

The Single European Act, which placed the free movement of capital on the same footing as that of goods and services, was a decisive step forward, resulting in the adoption in June 1988 of a Directive, which was designed to give the single market its full financial dimension and preserved the principle of full liberalisation of capital movements with effect from 1 July 1990.

In accordance with the conclusions of the Madrid European Council on June 1989, the liberalisation of capital movements corresponds to the first stage of economic and monetary union.

Economic and monetary union (EMU) comprises various stages. The main objective of Stage One, which began in 1990, was the complete liberalization of capital movements.

In Stage Two, which began on 1 January 1994, the Member States implemented measures enabling them to achieve the convergence targets necessary in order to enter Stage Three of EMU and guaranteed the independence of their central banks. The process of coordinating economic policies and ensuring multilateral surveillance of progress with convergence began in the course of Stage Two. The Member States were called on to do all they could to avoid excessive public deficits.

Stage Three of EMU began on 1 January 1999 with the launch of the euro on financial markets. The start of Stage 3, on 1 January 1999, marks the effective beginning of economic and monetary union (EMU). It is from this date that the ECU ceased to be a basket of currencies and became a currency in its own right, in the form of the Euro. The Euro as the new 'single currency' of the European Monetary Union was adopted on January 1, 1999 by 11 Member States. The irrevocable conversion rates for the Euro were set against individual currencies of those countries. Greece became the 12th Member state to adopt the Euro on January 1, 2001.

For the first three years, the currency was used on the financial markets in, for example, electronic commerce and transactions between banks.

However, on January 1, 2002, 12 Member Countries of the Euro zone officially introduced Euro banknotes and coins as legal tender. With few exceptions, the end of February 2002 was set as the last day for the individual currencies as legal tenders by the Member States involved. The 30<sup>th</sup> of June 2002 was the last day for changing old currency to Euro at any bank. Thereafter: old currency can continue to be exchanged at national central banks and some specially designated banks.



On 1 May 2004 the European Union (EU) welcomed ten new members: the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia. These ten countries did not adopt the euro as their new currency immediately because they first have to show that their economies have converged with the economy of the euro zone. However, once they have achieved economic and budgetary results which prove that their economies have converged, they all will join the single currency in accordance with the procedures laid down in the Treaty.

During the accession negotiations, which were wound up in Copenhagen in December 2002, none of the countries asked for a derogation and no opt-outs were granted along the lines of those secured by Denmark and the United Kingdom before. This means that the new Member States will be obliged to adopt the euro once they meet the convergence criteria.

When the Maastricht Treaty was signed in 1992, Denmark requested an exemption clause or "opt-out" from the third stage of Economic and Monetary Union (EMU) and the United Kingdom was granted an opt-out clause, meaning that those two countries would not be required to participate in the third stage of economic and monetary union (EMU). They have not, therefore, moved beyond the second stage.

Sweden has derogation but there is no provision to exempt it from participation in the third stage of EMU. Sweden is, therefore, required to adopt the euro sooner or later.

Under the accession treaty, the new Member States went straight into Stage Three of EMU on 1 May 2004. They have the status of "Member State with derogation" within the meaning of Article 122 EC.

This Article indicates the provisions of the Treaty which do not apply to the Member States with derogation: namely:

- the procedure for giving a Member State formal notice to reduce its budget deficit and the possibility for the Council to impose financial and other penalties on Member States which persistently fail to comply;
- certain monetary policy provisions, which remain the responsibility of Member States with a derogation;
- certain articles concerning the European System of Central Banks ( ESCB ) and the European Central Bank (ECB);
- rights and obligations under the ESCB as set out in its Statute (Article 43 ESCB)

However, relevant Articles which concern difficulties with a Member State's balance of payments, also apply to Member States with derogation.

With a view to achieving the necessary budgetary discipline to join the euro zone, the new Member States' budgetary policies are subject to supervision. They are required to develop multi-annual stability and convergence programmes which include objectives concerning their progress towards adopting the euro, particularly as regards price stability and healthy public finances. The Council evaluates these reports on the basis of an assessment carried out by the Commission.

In order to be able to adopt the euro, a Member State must have observed the normal fluctuation margins provided for by the European exchange-rate mechanism

(ERM-II) for at least two years without devaluing its currency. Three Member States (Estonia, Lithuania and Slovenia) joined ERM-II on 28 June 2004 and wish to adopt the euro as soon as possible. In practice, these Member States joining ERM-II in 2004 cannot meet the exchange-rate criterion until July 2006; this means that they cannot adopt the euro before that date. However, the earliest realistic date of entry of the first new Member State or states (maximum 3 – Estonia, Lithuania, Slovenia) to the Euro zone is January 2007.

Very recently these three countries were followed by three more countries as Cyprus, Latvia and Malta joined the euro waiting room of ERM-II on 2 May 2005. Theoretically these countries or some of them could adopt the euro already in January 2008.

The remaining four – the biggest new Member States, namely the Czech Republic, Hungary, Poland and Slovakia have to enter the ERM-II first, but in any case none of them would be able to adopt the euro before the year 2008. Most probably it could happen closer to year 2010 together with some countries which are already in the euro “waiting room”.

However, the real timing of the adoption of the euro in new Member States will mainly depend on how fast the new Member States reach a sufficient degree of sustainable nominal convergence. The sustainability of nominal convergence will be examined by means of the Maastricht convergence criteria.

### ***Maastricht convergence criteria.***

Convergence with the euro zone is required for all four criteria:

#### **1. price stability;**

According to the Maastricht criteria, the **inflation rate** of a given Member State must not exceed by more than 1.5 percentage points that of the three best-performing Member States in terms of price stability during the year preceding the examination of the situation in that Member State.

For the year 2004 the ceiling would be 2.2%.

Inflation in the new Member States is still generally higher than in most euro zone countries. This may be linked to an economic phenomenon known as the "Balassa-Samuelson" effect, whereby countries with higher growth generally have higher inflation. It is difficult to assess the scale of this effect. However, it has an undeniable impact on inflation during the catch-up process.

Another potential source of higher inflation in most of the New Member States lies in the eventual convergence of energy prices and some administratively regulated prices. Those prices nowadays are considerably lower in most of the New Member States than in the “old” ones, but they will catch up gradually.

For the year 2004 only Cyprus and Lithuania would fulfill the price stability criterion and estimates for the year 2005 show that also only two, if any, New Member States would be able to fulfill this requirement.

This is not a coincidence, but rather a very good example of one of the main challenges those new Member States which want to adopt the Euro as early as possible will face in coming years.

Many of the new Member States will face a dilemma soon – should we sacrifice a substantial part of the economic growth in a country and freeze administratively regulated prices for a while in order to push inflation down below the necessary threshold (also for a while) as the problem will not disappear, but rather it will be postponed or, should we allow the economy to develop naturally and more rapidly, which implies waiting for the introduction of euro a little longer than expected.

On the other hand, the advantages of adopting the euro include eliminating the transaction costs associated with keeping a national currency, cutting interest rates and reducing the exchange-rate risk for businesses. This should help to attract additional investment and stimulate real convergence of economies.

## 2. long-term interest rates;

In practice, the **nominal long-term interest rate** must not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability (that is to say, the same Member States as those in the case of the price stability criterion).

This is probably the criterion which would be most easy to fulfil, as financial markets in the New Member States in anticipation of eventual introduction of the euro there and driven by ever increasing competition among financial institutions have experienced a substantial drop in interest rates during the last several years.

## 3. government finances;

Government finances are another potentially problematic criterion, at least for some countries in the near future.

In practice, the Commission, when drawing up its annual recommendation to the Council of Finance Ministers, examines compliance with budgetary discipline on the basis of the following two criteria:

- **the annual government deficit:** the ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding financial year. If this is not the case, the ratio must have declined substantially and continuously and reached a level close to 3% or, alternatively, must remain close to 3% while representing only an exceptional and temporary excess;
- **government debt:** the ratio of gross government debt to GDP must not exceed 60% at the end of the preceding financial year. If this is not the case, the ratio must have sufficiently diminished and must be approaching the reference value at a satisfactory pace.

Last year 5 out of 10 new Member States had difficulties with the 3% government deficit ceiling and budgetary projections for this year do not promise many changes in this respect.

The difficulty of getting budgetary expenses under the defined 3% threshold could grow even further for some countries in coming years as many more funds will be necessary for co-financing the local projects financed partially by different EU funds.

Also the increasing need and pressures from certain state financed sectors like healthcare or education, for example, for additional financing will not be a great help to the situation in some countries.

And again some new Member States could face a similar dilemma to that in case of inflation – to allow things to develop naturally and to wait longer for euro adoption or, to sacrifice some economic growth and to implement some unpopular and “painful” measures, such as wage freeze in the public sector.

#### **4. stability in the exchange rate**

The Member State must have participated in the exchange-rate mechanism of the **European monetary system** without any break during the two years preceding the examination of the situation and without severe tensions.

In addition, it must not have devalued its currency (i.e. the bilateral central rate for its currency against any other Member State's currency) on its own initiative during the same period. Since the transition to stage three of EMU, the European Monetary System has been replaced by the new exchange-rate mechanism (ERM II).

A central exchange rate against the euro is defined for the currency of each Member State not participating in the euro area but participating in the exchange-rate mechanism if the country expresses a desire to participate in this system. There is one standard fluctuation band of 15% on either side of the central rate; however some National Banks have announced their intention to keep fluctuations in much narrower band of 1%.

In case of necessity, intervention is effected in euros and in the participating non-euro area currencies. Any foreign-exchange intervention must safeguard the cohesion of ERM II.

Intervention at the margin is, in principle, automatic and unlimited, with very short-term financing being available. However, the ECB and the national central banks (NCBs) of the other participants could suspend intervention if this were to conflict with their primary objective of price stability.

In principle this criterion should not be a major problem for new Member States in normal economic conditions.

#### ***Procedure after favourable assessment.***

In accordance with the EC Treaty, the Council, meeting at Head of State and Government level, reaches a decision after examining the convergence reports submitted by the Commission and the ECB and consulting the European Parliament. It decides, on a qualified-majority basis and on a proposal from the Commission, which Member States with a derogation meet the necessary conditions to adopt the single currency and terminates the derogation of the Member States in

question. It also fixes the date on which the country in question will join the euro area.

Once this decision has been taken, the Council sets the irrevocable conversion rate between the national currency in question and the euro. This decision is taken unanimously by those Member States which have adopted the euro and the Member State in question.

On the date of adoption of the euro, the conversion rate becomes effective, the national currency ceases to exist and responsibility for monetary policy is transferred to the European Central Bank (ECB).

The same procedure will apply to Denmark and the United Kingdom should they decide to waive their opt-out, and to Sweden once it meets all the criteria.

Specific measures then have to be taken to introduce the euro: minting of euro notes and coins, arrangements for the switchover and actions to introduce banks, businesses and the general public to the new currency.

Introduction of the euro requires careful practical preparation. The European Commission regularly reports on the state of preparations for introducing the euro. These reports are issued for information purposes only and have no legal value; they should not be confused with the convergence reports.

The introduction of the euro needs to be prepared well in advance. For practical and logistical reasons, the first wave of euro-area countries opted for a three-year transitional period between adopting the euro as a currency and putting euro banknotes and coins into circulation. But a "big bang" scenario in which entry into the euro area coincides with the introduction of euro notes and coins could also have its advantages, among other things because the new Member States are already familiar with the euro.

It is also possible, that a certain amount of time elapses between the Council decision and the actual introduction of euro notes and coins. However, as of the date set by the Council, the euro will be the official currency of the Member State concerned and will be used, for instance, in interbank transfers, as during the transitional period from 1 January 1999 to 31 December 2001.

The challenges for monetary policy are strongly influenced by a well-defined institutional framework for the monetary integration of new Member States. Two main principles have to be remembered. First, there is no single monetary and exchange rate policy strategy which can be considered appropriate for all new Member States. Second, the principle of equal treatment is a key in applying the institutional framework.

In the period before ERM II membership, monetary and exchange rate policy remains a responsibility and prerogative of the country concerned. However, the rules of the game are already different from the time before acceding to the EU, because a number of Treaty obligations apply already at this stage - price stability has to be the main objective of monetary policy. Moreover, exchange rate policy is to be treated as a matter of common interest. In general, the credibility of monetary policy could in this context be a key condition of success.

The orientation of other economic policies is crucial to establishing an overall economic environment conducive to stability. Sound fiscal policies play a key role in this respect. In addition, the implementation of structural reforms aimed at raising potential growth and enhancing the flexibility of labor and product markets will help to achieve higher growth. It is also vital that wages are set in line with labor productivity developments.

The first changeover to the euro was a success, although there is room for improvement in several respects. Early, thorough preparation is therefore necessary in order to ensure a speedy changeover and public acceptance of the new currency. The transitional period of three years was too long and euro notes and coins would have to be introduced swiftly, for the benefit of all parties involved. It would be preferable for the period of dual circulation to be short.

The national authorities must take steps to avoid any impact on prices, for example as a result of incorrect conversion of prices by shopkeepers and retailers. Active involvement of consumer organizations would be preferable.

The enlargement of the euro area towards Eastern Europe will occur in several successive waves, but without the collective momentum of the first wave. The transition from the national currency to the euro could be much faster in the new Member States, not least because many countries are considering a "big bang" approach whereby the date of entry into the euro area coincides with the date of official introduction of euro cash.

In discussions following the initial presentation participants focused attention on several issues connected with the physical euro introduction in 12 euro zone countries such as the frontloading and uploading of euro coins and notes in advance, the effect of the introduction of the euro on prices and on the perception of prices of the population.

It was stressed that electronic payments should be promoted during the changeover period and the population should be encouraged to deposit cash savings in banks before the changeover. That would considerably decrease the use of cash during the first peak days.

It was also mentioned that in some countries interest rates decreased sharply after the introduction of the euro and that triggered the re-composition of choices of clients (investors).

Mrs. Katrin TALIHARM, Managing Director of the Estonian Banking Association briefed participants on the practical aspects of the preparation for the introduction of euro in Estonia. Estonia is aiming to introduce the euro both electronically and physically on 1 January 2007. The dual circulation period for the euro and national currency is planned for 2 weeks. A trial period of one month before the real introduction of the euro is foreseen in order to allow the population to exchange their cash savings into euro more efficiently. It was mentioned that bookkeeping is one of the main reasons in favour of adopting of the euro on 1<sup>st</sup> of January – on the first day of the new financial year.



## ITEM 7 - PAN-EUROPEAN PENSIONS DELIVERED THROUGH THE 26<sup>th</sup> REGIME

Mr Elmars KRONBERGS, adviser at the European Banking Federation, made an introductory presentation on the subject.

The 26th regime is the name for a proposal for a European set of optional laws aimed at creating separate, presumably non-complicated pan-European products. The proponents of such a system believe that creating a parallel system that operates alongside existing national legal systems would give undertakings and consumers of the EU a choice between, at the present moment, 25 national laws and the 26th regime.

Their aim is to define simple rules to enable banks to offer optional pan-European products accessible to multinational and local participants, which is currently impossible due to different national legislation (consumer law, contract law, etc.). Eventually this would foster creativity among providers and promote competition. It has been proposed as a way of integrating the market in those areas which have not been subjected to regulatory harmonisation (such as consumer credit, for example). Hence, it is targeted at those fields where “25 regimes” currently exist, whereas it is not seen as relevant for those other areas where one single EU regime has also replaced the existing national laws (such as capital markets regulation, for example).

According to its advocates, the main advantages of the 26<sup>th</sup> regime are the following:

- Such a system would promote the creation of a uniform European framework in those areas not yet integrated by the Financial Services Action Plan (FSAP);
- It would offer an alternative to a long and tedious process of full harmonisation;
- National rules would continue to exist alongside;
- Providers and consumers would have a choice between pan-European and local products;
- Providers would benefit from economies of scale; and
- Pan-European products would benefit from tax incentives.

According to its critics, the disadvantages of the 26<sup>th</sup> regime could be summarised as follows:

- Supplementing the national systems of the 25 Member States with a 26th regime would be complicated and generate additional, probably huge costs;
- We would be confronted with a multiplicity of legal systems;
- There would not be a level playing field between banks offering cross-border services and those offering their services in their national markets only; and
- The benefits of the current model used in many other areas covered by the FSAP – i.e., mutual recognition based on a single EU regime – would create a sounder environment whereby the key framework principles are harmonised and the day-to-day implementation of the EU rules ensures an optimal mix of convergence and flexibility.

The FBE's position on this issue, in the context of retail markets, has been to say that the 26<sup>th</sup> regime is one of the options that could be considered in order to achieve an integrated retail market, but there are other possibilities as well.

Due to the ageing of the population in Europe, even in the foreseeable future a diminishing group of active workers will have to support a growing group of pensioners. Therefore, it is more and more urgent to search sustainable solutions to address this potential problem already now.

Even though the European Commission has taken several steps to break down the barriers for cross-border pensions (e.g. FSAP, Institutions for Occupational Retirement Provision (IORP) Directive, etc.), it is widely accepted that further progress needs to be made in this area and needs to be made soon.

Whether the 26<sup>th</sup> regime can be useful in this context deserves further debate.

The European Financial Services Roundtable (EFR) "feels that the scale of the EU's ageing problem is so enormous that more radical alternatives to traditional approaches are necessary". According to the EFR, "finding a way to allow the same pension products to be sold anywhere in the EU, subject to a single regulatory regime, should be a top priority".

The EFR started the debate on the creation of a pan-European pension product in the autumn of 2004. Rather than embedding new pension rules and regulations in the national structures of all the Member States, the EFR proposed to create a pan-European pension regime that can exist alongside the existing structures, i.e. delivered via a so-called "26<sup>th</sup> regime".

The ultimate aim of the EFR in proposing a pan-European Pension Product (EPP) is to come to a clear standard for the outline of such plans which can be made available in every Member State and will be recognized by consumers all over the EU. The EFR sees its role as not to define the detailed features of pan-European pension products, but to describe the key features of a group of such products on a general level and trigger the debate on the way to move forward.

Within the FBE there are three bodies with a specific interest in the topic of pensions. The Financial Markets Committee (FMC) is in the lead in terms of developing industry's response to the European Financial Services Roundtable's (EFR) proposal. The Fiscal Committee has expressed an interest in looking at potential tax obstacles to developing the product, while the Legal Committee is considering the wider concept of a 26<sup>th</sup> regime in terms of its usefulness and applicability as a legal concept.

The EFR has asked that industry provide it with input before the summer break on its proposals for the EPP. Therefore, the FBE will develop the FBE's response to the proposals, to be submitted by end of June 2005. Once the EFR has taken stock of the responses it will move onto the second stage of the proposal which is to develop a more detailed specification of a EPP.

It would then be up to the European Commission to develop the proposal further in whichever form that may take.

During the discussions following the initial presentation, some participants emphasized that it is very difficult to assess the feasibility of the 26<sup>th</sup> regime at the moment as this concept most probably will not be able to remove lot of existing obstacles like substantial differences civil law, different taxation regimes, etc. The EU Company is an example of the 26<sup>th</sup> regime: still many difficulties remain with this legal form of entrepreneurship as different tax regimes in different countries alongside with some administrative uncertainties prevent entrepreneurs from using this possibility.

It was widely agreed that targeted harmonization approach might be a better solution.

It was also mentioned that the European Commission is considering the 26<sup>th</sup> regime for mortgage products and that DG “Sanco” is trying to find a way of harmonizing the consumer protection rules through this regime.

## **ITEM 8 - BANKING SUPERVISION**

The main goal of banking supervision, which is to a certain extent also the political goal, is to maintain confidence in the financial system. The ideal supervision should be effective and efficient with no gaps, no overlaps and no contradictions. It should have consistent rules and coherent reporting, comply with economic reality and create a level playing field.

In fact, Supervision is triangle of entities:

- 1) Prudential supervision - Basel II or in the EU case the Capital Requirements Directive – which should focus on solvency and eventually should prevent bankruptcies;
- 2) Lender of last resort – tool to solve liquidity problems for sound banks; Theoretically the lender of last resort should be able to create unlimited liquidity in case of necessity;
- 3) Insurance – deposit insurance – a formal guarantee for depositors which should pay a bill in case of crisis.

The most important question is how to organize all these three entities into one, as efficient as possible, system. Inefficiencies often show up as overlaps in the system, but gaps are creating dangerous ineffectiveness. Fast reactivity would be essential for supervisors in order to be able to respond properly and in due time to economic realities. In theory it is easy and the key word here is to maintain the solvency of the system.

Eventually a supervisor should prevent bankruptcies. The lender of last resort should help banks in liquidity problems, but not in solvency problems. In reality all three factors are linked: a solvency problem may become a liquidity problem and vice versa.

There are conflicts of interest between different supervisory authorities (National banks, deposit insurance schemes, etc.). If those authorities are located in different countries, the problems do not simply increase, but rather multiply. One has to be able to react immediately and efficiently, on the spot once an incident happens.

In the EU there are 52 independent supervisory authorities at the moment. Some of them act as advisers, some negotiate, some even buy up banks in difficulties... there are many different independent supervisory authorities with different mandates. How can these different authorities solve a cross-border problem in a fast and efficient way once it arises?

Although there are signs of convergence in thinking in the EU regarding the supervision problem in the financial industry, a unified position has not been reached yet.

In Basel II the home and host country concept has been offered, but those two concepts are very often in opposition, sometimes even within the framework of one entity – e.g. the prudential supervision framework, the lender of the last resort or deposit protection frameworks...

For prudential supervision the basic principle is home country control for branches and host country control for subsidiaries. For banks active cross-border with subsidiaries that would mean local and to a certain extent also global supervision. That would result in inconsistencies and additional costs.

If we go further, to the second entity of supervision - the lender of last resort is always a host country. However, the liquidity problem normally arises within a financial group, often a pan-European entity.

In the area of deposit insurance a home country principle applies to branches, but a host country principle to subsidiaries.

And on top of everything that has been already said, there is always an ultimate question – tax payers of which country (host or home country) will pay the bill in case a bank active cross-border runs into problems!? Should the country “x” tax payer pay for the errors of the foreign supervisor? Conversely, should the foreign tax payer pay to bail out a bank in another country? At the moment it is not at all clear.

Nowadays, banking groups are managed in an integrated and centralised manner on the basis of business lines and central functions. Risks must be measured consistently and aggregated to be efficiently managed by a risk management system operated on a group-wide basis. The Basel Committee recognised this reality by applying the three pillars at a consolidated level. The Federation believes that consolidated supervision is the only mechanism which can deliver an efficient supervisory environment for banks active on a cross-border basis in the EU.

There is no doubt that in many respects also the Capital Requirements Directive (CRD) represents an important step forward. Most importantly it extends the responsibilities of the consolidated supervisor model. The consolidated supervisor, or home supervisor, is responsible under the Directive for taking the final decision on validation of the group-wide models.

However, the role of the consolidated supervisor is still extremely limited. The CRD merely provides the home supervisor with the power to take the final decision if the host supervisors cannot agree to validate the model within a six month period.

However banks need a single point of contact, not just for validation, but also for the Supervisory Review Process under Pillar 2 and for the reporting requirements under Pillar 3. In fact, ultimately the FBE would like to see full consolidated supervision for all three Pillars of the Accord.

Through putting the limited consolidated supervisor model in place, the Capital Requirements Directive (CRD) does lay some of the groundwork. However, it stops short of delivering any real consolidated supervision. Why is that?

It seems like a paradox that the EU, with its clear objective of a unified financial market, should choose a fragmented approach to banking supervision. It is the current fragmented legal framework in the EU which is the reason behind the approach taken. Consolidated supervision, which would reflect the business reality of European banking, is not possible at this point in time.

National supervisors in Europe are mandated to protect the deposits of banks active within their jurisdiction. A means must be found to allow host supervisors to carry out their tasks while at the same time providing a streamlined system for banks in the EU active on a cross-border basis. That will be no easy task.

The Commission intends to look at the impediments to consolidated supervision as part of its forward agenda over the next few years. The FBE is fully committed to working closely with the Commission to remove the existing impediments and to achieve a coherent framework in the EU.

Those impediments include deposit guarantee schemes, the role of the lender of last resort, liquidity risk management and the fragmented supervisory system. However, we also firmly believe that the Commission must be required by the Capital Requirements Directive to review the level of application of the rules within five years of the legislation being implemented. Otherwise we could be left in a situation where the legislation will not reflect a potentially more advantageous legal environment.

It is clear that there must be a significant role for the home supervisor but, outside the EU, there is no requirement for the host supervisors to cooperate with the home. There have been tentative talks between the EU and US about reaching some agreement on home supervision in the next few years.

Is not clear at this stage what the role of the host countries supervisor will be on Pillar 2 – i.e. the Pillar of the Basel II Accord dealing with the Supervisory Review Process. Within the EU the current proposal is for the institution to make its Pillar 2 analysis at a group level, but for the supervisor to do so at a solo entity level. This would obviously result in a mismatch. Under Basel on the other hand, the framework is applied at a group level and it is not clear what the involvement of the host supervisors will be in Pillar 2. This is also a level playing field issue.

The Committee of European Banking Supervisors has done outstanding work over the last year to increase trust and cooperation between its members. However, industry must look for solutions which allow banks to take a true global view of risks and which deliver financial stability in Europe, which is in the interest of society as a whole.

In discussions afterwards participants emphasized that in the future a good balance between home and host country supervisors will have to be established. This is not an approach of home versus host, but rather home plus host.

It was mentioned that the dialogue among supervisors has to be intensified and the deposit protection and lender of the last resort issues have to be tackled and solved as soon as possible. However, this is not going to be an easy task as National Parliaments most probably will not want to give away their authority over state public spending, because in case of a crisis in the national financial sector the public (tax payers') money of the concerned country will be involved.

Another existing trend is so-called supervisory arbitrage, which is practiced by banks more and more nowadays. It is caused by the fact that often the same rules are interpreted differently in different countries. Sometimes even the headquarters of the financial institution can be moved to a country with a less restrictive supervisory regime.

#### **ITEM 9 - ANY OTHER BUSINESS**

- a) Mr. Oleg PREKSIN, Vice President, Association of Russian Banks informed the participants of the meeting on the latest developments in the EU-Russia common economic space project. A question was raised on the best available means to facilitate the EU-Russia dialogue in the financial sector and to coordinate future policies under the framework of the common economic space project.

Mr. Guido RAVOET, Secretary General of the Federation has proposed to involve the FBE International Affairs Committee in monitoring the issue at the initial stage.

- b) Mr. Zoran BOHACEK, Managing Director of the Croatian Banking Association informed participants on a new project initiated in Croatia by the Croatian Banking Association: defining an index of regulatory burden. Once such a project is finalized and launched, the index of regulatory burden would be revised and published regularly – every 6 months.

#### **ITEM 10 - PREPARATION OF THE NEXT MEETING**

It was announced that the next – 21<sup>st</sup> Meeting of the FBE Associates will be held in Brussels on Thursday, 8 December 2005, a day before the FBE Executive Committee meeting.

The FBE Executive Committee members will be invited to participate in the meeting.

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Enclosure: 1





**20<sup>th</sup> MEETING OF THE ASSOCIATES**  
- Budapest, Hungary, 12 May 2005

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LIST OF PARTICIPANTS

<u>Chairman:</u>	Mr	Hein BLOCKS
<u>FBE Secretariat:</u>	Mr	Guido RAVOET
	Mr	Elmars KRONBERGS
<b>Associates:</b>		
<u>Albania</u>	Mr	Elvin MEKA
<u>Bulgaria</u>	Mrs	Irina MARTSEVA
<u>Croatia</u>	Mr	Zoran BOHACEK
<u>Liechtenstein</u>	Mr	Michael LAUBER
<u>Russia</u>	Mr	Oleg PREKSIN
<u>Turkey</u>	Mrs	Melike ALPARSLAN
<b>Executive Committee:</b>		
<u>Austria</u>	Mrs	Maria GEYER
<u>Belgium</u>	Mr	Michel VERMAERKE
<u>Czech Republic</u>	Mr	Petr SPACEK
<u>Cyprus</u>	Mr	Michael KAMMAS
<u>Estonia</u>	Mrs	Katrin TALIHARM
<u>Germany</u>	Mr	Bernd BRABANDER
<u>Hungary</u>	Mr	Rezso NYERS
	Mrs	Maria MORA
<u>Italy</u>	Mr	Enrico GRANATA
<u>Latvia</u>	Mr	Aivars GRAUDINS
<u>Netherlands</u>	Mr	Hein G. M. BLOCKS
<u>Norway</u>	Mr	Arne SKAUGE
<u>Poland</u>	Mr	Andrzej WOLSKI

	Mr	Pawel PNIEWSKI
<u>Spain</u>	Mr	Manuel TORRES ROJAS
<u>Sweden</u>	Mrs	Ulla LUNDQUIST
<u>Switzerland</u>	Mr	Urs ROTH

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Guest speakers:

Director General  
of the Hungarian Financial  
Supervisory Authority:

Mrs Erika MARSI

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