



## Munich Financial Centre Initiative Position Paper

for its visit to Brussels on June 11-12, 2008

### The Financial Market Crisis: Causes and Countermeasures

#### A. Core statements

##### I. On the financial market crisis

- Structured securitization: requisite to improving product accountability is a standardization of the disclosures made on the level of quality of the underlying asset, and as to the nature of the party upon whom the liability for the high-risk first loss tranches devolves. These tranches, in turn, should, as a rule, remain in the possession of the original providers of credit. The certification regulations comprised in Germany's True Sale Initiative (TSI) could serve as a template for these disclosures. Measures further restricting the securitization of risks would not, on the other hand, be efficacious.
- Basel II: An earlier introduction of Basel II in Europe and in the USA might have prevented the crisis, or at least substantially reduced its scope. We are pushing for a process of evaluation of some of these regulations. This process should employ the proposals advanced by the Financial Stability Forum on capital provision requirements for off-balance sheet items, and on risk and liquidity management.

The disclosure of risks stipulated in the third pillar of Basel II should be beefed up. A uniform and pan-European application of its provisions is requisite for the assuring of accountability and of comparison-enabling interpretability.

- Valuation: The application of fair value accountings' precepts to illiquid financial instruments has to be made more transparent. This is to be achieved by the publication of documents detailing valuation processes, and by the issuing of guidelines assuring the uniformity of the models applied and of the delimitations of the valuation levels employed. Financial authorities should lend their support to the development of an application of IFRS' provisions showing a high level of pan-European accountability and comparability.



- Rating agencies: The accountability, comprehensibility and integrity of the rating processes, with this statement particularly applying to those of structured products, have to be improved. The importance of this stems from the fact that ratings now play a quasi-regulatory role. The agencies therefore have to be subjected to processes ensuring their lack of affiliation with the parties whose products they are rating. These processes could use as templates those applied to official auditors (articles 22, 25, 29, 40 of the EU's directive on official auditors 2006/43/EG). The position accorded to third party ratings in banking supervision regulations has to be re-evaluated. A supervision of the rating process incorporating the EU's positions should be considered. The objective should be the promulgation of counter-measures assuring that investors' motivation to undertake proprietary due diligence measures will not be negatively affected by the legally-mandated incorporation of third party ratings into official processes of supervision.



## **II. On the future of the EU's supervisory structures of banks and insurers**

- The EU's structures of supervision for the banking and insurance sectors are currently under discussion. In this area, MFCI gives fundamental support to a further development of existing institutional structures that does not comprise far-reaching alterations of today's system of supervision.
- MFCI recommends a purposeful evolution of the structures comprising Europe's system of banking supervision. National-level banking supervisory authorities are to be further integrated into a continent-wide and effective network of cooperation.
- Supervisory practices need to be converged. This convergence will inculcate a culture of financial market supervision experienced all throughout Europe.
- The reporting requirements imposed by national-level supervisory regulations in the EU are dissimilar. Each of these regulations should be examined to determine its necessity. In our view, this scrutiny should foster a much-needed harmonization of the systems of reporting required by EU supervisory regulations.
- MFCI welcomes the cooperative group supervision approach foreseen in Solvency II. The approach takes into account diversification effects, and names a chief group supervisor who in turn is to serve as the EU-wide point of contact for all matters of concern to the individual insurance group in question. This set-up would greatly facilitate the pursuit of business by insurance groups operating in Europe.
- MFCI expressly supports ECOFIN's proposal to add a European dimension to the national-level supervisory bodies' scopes of responsibilities.

## **III. On CEBS consultation paper setting up a single, EU-wide set of regulations on the inclusion of hybrid own funds components in core capital**

- MFCI would welcome the promulgation of a single set of EU-wide regulations applied to the recognition of hybrid instruments as part of own funds.
- The formulation of in-depth stipulations should rely upon impact studies featuring an adequate amount of input from market players.



## B. Elucidations

### I. Financial market crisis

#### 1. Causes and drivers of the crisis

Phase 1: The financial market crisis was triggered by the irresponsible dispensing of real estate loans by the USA's banks in the subprime and other segments. This took the form of dispensing loans according to the prospective increases of value of customer properties, and not according to the consumers' ability to repay the loans. These practices resulted in the making of loans which were greater than the properties' fair values, which did not require initial repayment, which featured, in many cases, the levying of artificially-low rates of interest for the first couple of years of loan provision, and which were not preceded by the banks' conducting of thorough examinations of customer creditworthiness. Rather than doing that, the banks relied on the data submitted by the credit brokers, whose payment was commission-based. These practices helped cause an explosive rise in the number of cases of incorrect and even fraudulent reporting of usage (proprietary versus third party), of real estate valuation (by affiliated 'experts'), and of statement of property owner income. The extent of these risk-enhancing factors is what distinguishes the quality of loan-making in the current real estate crisis from that experienced in the past in the USA and Europe.

The resale of these credits - which were assigned into tranches according to their level of risk as 'equity' (not rated), 'mezzanine' (BB-CCC), 'junior' (BBB-A), and 'senior' (AA-AAA) - to international-level investors served to give this crisis a global dimension. The capability of selling primary risks associated with the credits in the equity and subordinated tranches to hedge funds and other risk-accepting investors was the prime driver of the moral hazard now afflicting the making of real estate loans. The past's practice was for the bank providing the loan to retain this highest risk tranche of securitization, so as to enable the bank to reap the greatest profit from a positive assessment of creditworthiness. The unjustified discrimination (vis-à-vis other kinds of instruments bearing comparable level of risks) against ABS imposed by Basel I's rules on own funds statement led to the ABS' often being maintained as off balance-sheet Special Purpose Vehicles. These SPVs generally secured refinancing through the issuing of short-term money market paper. To ensure their paper of receiving a top rating, the investments underlying the SPVs were nearly exclusively consigned to senior tranches (rated AA-AAA).

Phase 2: The withdrawal of the liquidity possessed by the SPVs invested in ABS gave rise to a drastic and market-wide shortage, as the banks associated with the vehicles were forced to provide proprietary liquid funds to them. The peril of the need to satisfy further obligations to supply liquidity and of a lack of refinancing options materializing on the interbank money market set in motion a downward spiral.



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To buck this trend and to thus restore stability to markets, the ECB and other central banks quickly began offering short-term tenders. It took the large-volume staging of three-month and six-month tenders to slightly ease the situation.

Phase 3: The banks' lack of liquidity gave rise to the bond market's experiencing a corresponding and record illiquidity. The kinds of bonds affected included everything from high yield and corporate bonds to mortgage, covered and - in March 2008 - even European state bonds (exceptions were Germany's federal bonds). The defensive conditions imposed by securities brokers caused the interest yield supplement to greatly increase, notwithstanding the fact that turnover remained extremely low. This situation, in turn, temporarily robbed the prices prevailing on markets of their import, as market players did not use them as pegs for either purchases or sales. The price declines necessitated writedowns and value adjustments on the part of banks. These in turn exacerbated the market's nervousness and led to further plunges. This downward spiral seems to have been ended by the undertaking of such actions as the rescuing from pending insolvency and illiquidity of Bear Stearns by the Fed and Northern Rock by the British government respectively.

## 2. MFCI's position

The above description indicates the underlying causes and outcomes of the turbulences roiling the world's financial markets.

- The situation was nurtured by the USA's long period of low interest rates and its accompanying large amount of investor liquidity, and was fostered by the lack of (adequate) supervision of the market for second-class mortgages. This situation gave rise to inadequate and inefficacious loan provision standards and to fraudulent practices.

The MFCI views a USA-style accumulation of lax credit dispensing practices as being precluded in the EU by national and European-level directives requiring the examination of the creditors' economic situations and the valuation of property, and protecting consumer interests. A further component of this effective system of protection is MiFID. No further regulations need to be enacted.

- The mechanisms setting up incentives to maintain high standards as to the information provided on the quality of financial products and the assets providing their underlying security are inadequate, with this applying to each link in the chain of securitization. A further exacerbating factor is the incentive arising from Basel I for banks to found SPVs featuring low capital reserves.

A standardization of the reporting on the kind and quality of the underlying assets and on the natures of the parties upon whom the liabilities for the high-risk first loss tranches devolve would serve to increase accountability and comprehensibility and is thus to be striven for. These tranches, in turn, should, as a rule, remain in



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the possession of the original providers of credit. The regulations for certification laid down by Germany's True Sale Initiative (TSI) could serve as a template. So far, only a few originators have applied such policies. The high level of investor demand constituted a disincentive for originators to provide investors with easy-to-understand standard documents and data. Investors have now gained the upper hand. This will facilitate the introduction and adopting of effective standards. Measures further restricting the securitization of risks would not, on the other hand, be efficacious.

- Risk management systems maintained by financial institutions and by companies have proven to be deficient. They were not capable of recognizing and reporting quality and quantity-related risks specific to structured financial products.

Necessary is the further development of risk management systems and stress testing based on qualitative criteria. Risk management systems particularly have to pay greater attention to off-balance sheet items. The fact that these items are taken into account by capital requirements under Basel II is an important step forward. Also deserving support is Deutsche Bundesbank's proposal to examine those portions of Basel II involving risk weightings and conversion factors. The same applies to the more generally-formulated demands made by FSF as to risk and liquidity management. While taking these measures, care has to be exercised to avoid instituting distortions of competition in the EU and benefiting those international banks not (yet) falling within the scope of Basel II.

It is questionable whether or not stress tests availing themselves of quantitative models are capable of depicting such extreme liquidity crises as the current one, as they lack sufficient data which could serve as a basis for statistical forecasts. The current credit crisis constitutes a reason to further develop internal models' modes of operation. To be observed are the differences existing between the levels of development found in the internal models applied by banks and by insurers. The former are generally „modular“. As part of their Solvency II-related efforts, insurers are working to come up with a holistic approach (Enterprise Risk Management). Due to the „run on the bank“ risk, banks are subject to a strict supervision of their liquidity - insurers are not. MFCI and Germany's banking industry as a whole reject a regulation of liquidity-related risks which avails itself solely of formulas.

- Incomprehensible exposure of financial institutions to risks due to off-balance sheet SPVs and dissimilarities in the valuation of illiquid financial instruments

Constituting a great improvement in this field of regulation, Basel II did not take full and complete effect for all of the EU's institutions until 2008. The disclosure of risks mandated by Basel II's Pillar 3 has to be beefed-up fundamentally. To assure the transparency of regulations, a single, Europe-wide method of applicability has to be created. This will also ensure comparable interpretability. The IASB should also beef up the standards for the accounting of off-balance sheet activities.



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The uncertainties prevailing on markets are attributable to the past's limited and deficient reporting by banks of their exposure to SPVs, and to the great degree of divergence prevailing in the way individual banks and countries value their off-balance sheet investments. Rather than making such dealings easier for investors and financial analysts to understand and track, fair value accounting has not lived up to expectations. Requisite in fact are applications of fair value accounting which themselves offer a high degree of accountability and comprehensibility. This will be accomplished by publishing the methods of valuation employed, by instituting and maintaining best practices guidelines, by improving the quality of the models employed, and by unifying the delimitation of the levels of valuation applied. Financial supervisory authorities should lend their support to the development of methods of application of the IFRS that foster accountability and European-wide comparability.

- The deficiencies manifesting themselves in the rating process are ascribable to the models and methodologies employed by the rating agencies. The problems are also due to the ways in which the quality of the collateral securing the bonds was ascertained, to the lack of transparency of valuation procedures, and to conflicts of interest. Further causes: investors' inadequate methods of risk assessment. These often consisted of complete reliance on the evaluations supplied by the rating agencies. The investors thus failed to consider the limited, product-specific value of such evaluations. This reliance was implicitly strengthened by the importance which supervisory codes accord to such ratings.

The accountability, comprehensibility and integrity of rating processes have to be improved. This especially applies to structured products. The risks specific to products have to be made more apparent. The ratings' findings have to be imparted a scope and reliability transcending individual products. The employment of a range of rating scales to structured products (ABS, CDO etc.) does not solve a key problem. Such products bear risks differing from those of covered or corporate bonds. Rather than solving problems, rating scales impair the ratings' multi-product comparability. Is a corporate bond bearing a BBB ratings as 'safe' as a BBB-rated ABS based on residential real estate in the Netherlands? This approach also complicates the formulation of those in-house and supervisory codes of procedure lending accountability to the process.

Also needed are measures precluding rating agencies' being exposed to conflicts of interest through their primarily being paid by issuers or originators and not by investors. Rating agencies should also not be put into the position of jeopardizing their independence of action by offering consulting services to issuers requiring payment and going considerably beyond the scope of their core activities. Worthy of being considered is a regulation supplying the requisite accountability by using the rules and regulations applying to official auditors as a template (articles 22, 25, 29, 40 of the EU's official auditors directive). Investors have to be assured of being provided with easy-to-follow elucidations of the models and assumptions employed by the agencies, and with data enabling the investors to perform their own evaluations of risks.



The role assigned to third party ratings in the codes of supervision applied to banks has to be reexamined, so as to determine whether or not this role entails the examination of the rating procedures by the supervisory authorities, and whether or not this role is compatible with the objective of fostering investors' conducting of their own due diligence. The same thrust is evinced by the proposals being advanced on the regulations governing the supervisory of the insurance industry and forming part of Solvency II.

## **MFCI's summary:**

As detailed above, the best way to get a grip on the causes of the financial market crisis is to make rating and valuation procedures and risks arising from structured securities easier to understand, track and analyse.

## **II. The future of the EU's structures of banking and insurance supervision**

### **1. Background**

The turbulences on the world's financial markets have also raised the question as to which structures of supervision would best serve the banking and insurance sectors. The implementation at the EU-level of Basel II's new own funds provisions and progress on the Solvency II framework directive have triggered a EU-wide discussion on the scope of responsibility borne by national-level supervisory bodies and on the need for fundamental changes in the supervisory structures for Europe's financial industry.

The political and legal conditions forming the industry's playing field led MFCI to call for solutions based on the further development of today's institutions, as this would not be accompanied by far-reaching upheavals of the supervisory scene. At the same time, it will be important to serve the interests of both those financial institutions which operate regionally, and of those whose scope of activity is Europe and the world as a whole. The development will also have to pay due heed to the ever-stronger internationalisation of the financial world.



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## 2. MFCI's position

### a) Closer and stronger working relationships among national-level supervisory authorities

The primary goal has to be a strengthening of the ties existing among national-level supervisory bodies, so as to foster an EU-wide convergence of supervisory procedures. This in turn will lead to the creation and inculcation of a single European culture of financial market supervision, one precluding any form of competition among the EU's national-level bodies. To realize this, MFCI supports the recommendations recently issued by ECOFIN's council to the member countries and calling for a greater awareness of the Europe-wide impact of their national-level financial supervision.

Playing a central role in this area are CEBS (Committee of European Banking Supervisors) and CEIOPS (Committee of European Insurance and Occupational Pensions Supervisors) in the banking and insurance sectors. Situated at level three of the Lamfalussy legislative process, these committees are responsible for ensuring the consistent and uniform application of the EU's harmonized bodies of regulations by the continent's supervisors. Key to this task is the development of uniform supervisory processes.

A primary thrust has to be the fostering of efficient and transnational working relationships between home and host authorities supervising financial institutions active on a EU-wide scale. Also of great benefit would be CEBS' formulation of clearly-delineated minimum standards for the supervision of banks. Further and highly useful impetus to this process could also come from the provision of practical solutions promoting a mandatory exchanging of information among national-level supervisory bodies.

We view CEBS' moves to set up „colleges of supervisors“ charged with monitoring transnational groups of institutions as being a step in the right direction. This process of setting up individual-group colleges whose members are equally-empowered representatives of their responsible national-level supervisory authorities should be pursued, and, should it prove its mettle in daily operation, be further developed.

### b) Discussion on CEIOPS' role in the years to come

The supervision of insurance groups foreseen in Solvency II makes CEIOPS' involvement in several areas of day-to-day supervisory operations foreseeable. This involvement could take the form of establishing CEIOPS to be an appellate authority handling disputes arising from certain kinds of decisions reached by group supervisors. In cases in which a supervisory authority does not accept a supervisor's decision, the authority would lodge an application with CEIOPS



for a resumption of the decision-making process. This form of legal recourse would not, however, postpone the promulgation of a group supervisor's decision, which would take effect despite CEIOPS' having been called upon. Should the insurance group being supervised not accept a group supervisor's decision, it would be entitled to present their case to CEIOPS as well. Legal principles would in such cases preclude the group supervisor's decision from taking effect. In cases in which plaintiffs wished to appeal CEIOPS' decisions, they would seek legal recourse via the European Court of First Instance and, in the next step, the European Court of Justice.

MFCI maintains that this transformation of CEIOPS into an organ of ongoing supervision of insurance groups would augment the popularity of the proposals comprised in the Solvency II framework guidelines on the group operations approach.

## **c) Harmonization of reporting requirements**

The divergences displayed by the reporting requirements imposed by the national level supervisory bodies within the EU seriously impair the pursuit of business by transnationally operating institutions. As these divergences also give rise to administrative costs and bureaucracy, remedial measures are urgently needed.

The MFCI believes that the first step to be undertaken is an examination of the efficaciousness of the large quantity of data gathered in meeting the needs of supervisory authorities. This step would ensure the declarations made by the financial institutions of not being consigned to half-forgotten and rarely-used files. The second step would be to harmonize the reporting requirements.

The MFCI therefore expressly hails every push to reduce the encumbrances arising from the divergences displayed in the reporting required by supervisory authorities in the EU. Methods of reduction would be the deployment of a single set of reporting forms and the use of a single technical basis of reporting (common reporting). Further details are needed to properly evaluate the proposals currently being considered on the establishing of a concrete schedule for the Europe-wide introduction of a single set of reporting forms and deadlines.

## **d) The cooperative group supervision approach (Solvency II)**

MFCI expressly welcomes the cooperative group supervision approach delineated in Solvency II. It therefore also supports the augmenting of group-wide supervision foreseen in the corresponding EU framework directive and recently confirmed by ECOFIN's council. Needed to be clarified in this regard is how the information-procurement and decision-making processes undertaken by the bodies presiding over group supervision will be configured (for further information please see section B II. 2. b above).



The system currently used to supervise the operations of groups of insurers is based upon an encompassing of the activities of individual group units. This focus arose from the tradition of supervisory codes' showing a considerable time lag in responding to economic developments. It took several decades for the EU's solo (single-company) supervision to be joined by a complementary system of group-wide supervision. The constituting of groups comprised of both banks and insurers caused the supervision of insurance groups to be supplemented by that of financial conglomerates. As a risk-based system of supervision, Solvency II should exploit the opportunities arising from a fresh start and set a new standard of group-wide supervision.

This group-wide supervision should manifest, to an extent greater than today, business realities. This entails the basic attitude towards group-wide supervision's going from being a purely „supplementary supervision“ to being a „consolidated one“. The former views the supervision of groups as being a complement to the single-company supervision, a viewpoint expressed in the term „solo-plus“ supervision. Consolidated supervision, on the other hand, views the group as an entity and not as the sum of its parts.

A decisive advantage of the shift would be the setting up of a central point of contact for financial institutions on all issues of supervision. The thrust of this proposal is an adaptation of the structures of supervision to those manifested in the management of corporate operations. Subsidiaries and offices form intrinsic components of insurers' group-wide business processes (planning, management, distribution and risk management). These economic realities of group operations are not taken into account by an approach focusing exclusively on legal divisions.

The group-wide supervisory approach foreseen in Solvency II would establish for each insurance group, be it nationally or internationally-active, a group supervisor who would be the central point of contact for all group concerns. The supervisor would organize processes of deliberation involving the supervisors monitoring the group companies, including those responsible for other countries, and would facilitate the transmission of information. Further proposals are for the establishing of a uniform system of reporting, for a harmonization of supervision requirements, and, most important of all, for the certification of internal models for use at the group-wide level, with this being the responsibility of the group supervisor. The group supervisor would have the capability of assessing and tracking the group's total exposure to risk in cooperation with supervisors operating on local levels in other countries.

The powers foreseen in the draft Solvency II framework guideline for group supervisors have given rise to concerns that solo supervisors could lose influence and independence of operation. These concerns have to be taken seriously. A closer glance at the situation reveals, however, them to be unfounded, as these powers would be confined to three items: the authorization of the in-house risk model; the closely-related determination of any capital add-ons; and the decision on the making within the group („group support“) of capital transfers.



The introduction of the approach proposed for group-wide supervision would greatly reduce the incidence of multiple reporting and the fulfilment of other purely local stipulations experienced by all insurance groups operating in Europe. The introduction would also permit insurance groups to reap the benefits of clearly demonstrable diversification effects. This, in turn, would increase the efficiency of capital employment, thus boosting the companies' viability- and benefiting policyholders.

To ensure an adequately high quality of group-wide supervision and to satisfy the stipulations of Solvency II, MFCI views the adherence to the following principles as being of central importance:

1. Full recognition of group diversification effects
2. Enabling of the optimal allocation of capital
3. Clear delineation of the powers charged to the group and solo supervisors respectively
4. Avoidance of subgroup supervision
5. Recognition of in-house and partial models on the group level
6. Solving third country-related problems
7. Effective harmonization of group-wide supervision (Pillar II)
8. Coordination of group-level and solo reporting obligations (Pillar III)

The overall objective should be to set up a system of group-wide supervision which improves the operating efficiency of insurance markets. This improvement will strengthen markets and competition, and will thus be in the interest of the insurers, their policyholders, their investors and their supervisory bodies. The supervision of insurance groups should be further developed to encompass those groups comprised of both insurers and other financial services companies (financial conglomerates).

### **Summary of MFCI's position:**

The MFCI is calling for a setting forth of the development of Europe's structures of supervision. The achieving of this objective requires the joining of national-level supervisory authorities. This will yield a continent-wide system of cooperation, and is predicated upon the convergence of supervisory practices.



## **III. CEBS' consultation paper on the enactment of a single set of Europe-wide regulations governing the inclusion of hybrid own funds components in core capital**

### **1. The EU Commission's activities: a briefing**

In mid-April 2008, the Internal Markets and Services Directorate General of the EU Commission launched a process of consultation on alterations in 2006/48/EG (Banking Directive) and in 2006/49/EG (Capital Adequacy Directive) which will come to an end on June 16, 2008. This process of alteration of directives has a sweeping scope. One thrust is the incorporation of regulations on „hybrid own funds instruments“. MFCI views an adaptation of own funds statements as being highly sensitive in nature. The alterations announced therefore have to be scrutinized carefully and critically.

The regulations resolved upon by the Basel Committee for Banking Supervision on October 27, 1998 (referred to as the „Sydney Press Release“) form the basis for the recognition of hybrid own funds instruments. These regulations only apply, on a binding basis, to the group constituted by those institutions which have voluntarily pledged – in a gentleman's agreement – to respect them.

The EU Commission has criticized both this lack of compulsive compliance and the divergences displayed in the sets of criteria developed by the supervisory bodies in the EU's member countries for the recognition of hybrid own funds instruments. These divergences have given rise to a heterogeneity of practices of application causing substantial distortions of competition. Thus, the requirements for an integrated domestic market for financial services are no longer being fully met.

These highly-evident dissimilarities caused the EU Commission to commission the Committee of European Banking Supervisors (CEBS) with the formulation of proposals on the European-wide revamping of the definition of own funds. In fulfilling this commission, CEBS published a consultation paper on December 2007 and used its results as the basis for proposals on prospective stipulations published on April 3, 2008. The impact of these could well manifest itself in alterations of the CRD.

### **2. MFCI's position**

We welcome the EU Commission's setting of the objective of creating EU-wide regulations applying to the recognition of hybrid own funds instruments. This would improve the legal security of operation in the EU. The objective's attainment would also eliminate distortions of competition, thus facilitating the creating of a level playing field in European banking.



The EU Commission's proposals innately impinge upon problems of a fundamental nature. These, in turn, could give rise to far-reaching encumbrances upon Europe's banks.

## **a) CEBS proposals: highly detailed**

The proposals advanced by the Committee of European Banking Supervisors foresee the establishment of a wide-ranging and highly detailed code of application to hybrid capital. This code would take the place of regulations which are based on principles that have proven their mettle in daily application. This statement also applies to the proposals advanced by the Committee of European Insurance and Occupation Pensions Supervisors (CEIOPS) for insurers, in conjunction with Solvency II.

This highly detailed code of regulations might well be capable of achieving a high degree of harmonization. It would, however, restrict national-level supervisory authorities' ability to configure the implementation to their countries' conditions.

The EU Commission should issue directives containing a great depth of detailed regulation only in those cases in which the regulations' impacts are predetermined. This precondition does not seem to have been fulfilled in the case of hybrid capital. The dissimilarities existing in the legal and tax codes existing among the member states would give rise to distortions of competition. These in turn would contravene the objective of establishing a level playing field.

## **b) Limitations placed upon hybrid capital in core capital**

CEBS' proposes to limit the share accounted for by hybrid capital instruments in core capital. One limit is that of 15%. It is to be placed upon the share of so-called „innovative instruments“ in core capital. A further limitation is the range of 30% to 50% imposed upon the recognition of hybrid capital in core capital. The formulation of these measures was obviously undertaken to substantially bolster the financial institutions' capital reserves.

The banking community has voiced their concerns about these limitations, and their contention that the 15% limit imposed in the Sydney Press Release fails to reflect today's realities and should therefore be rescinded. A further consideration is the problems which seem likely to arise from the practical implementation of the „continuum of recognition“ of 30% to 50% foreseen in the CEBS proposals, which would also cause difficulties on the part of banks carrying out the management of capital. A final point of criticism: the changes would not preclude the peril of crisis-reinforcing effects.



The prevailing consensus is that a thorough reconsideration of the CEBS proposals would be widely welcomed as a way of facilitating the compilation of findings on the possible ramifications of such regulations.

## **c) Regulations on the protection of capital deposited**

The ramifications of the proposed regulations upon the banks' protection of their deposits of capital cannot be assessed with an adequate degree of certainty. CEBS has proposed the step-by-step diminishing of hybrid capital instruments over a thirty-year period. This would seem appropriately large. A hard-and-fast evaluation of the proposal requires, however, the conducting of comprehensive-scope investigations of ramifications.

### **Summary of MFCI's position**

For the banking industry, the regulations initiated by the EU Commission give rise to uncertainties and questions of considerable scope. The same holds true for the proposals formulated for the insurance industry in conjunction with Solvency II.

It also seems questionable whether this revamping, which is comprised of a wealth of highly-detailed regulations, will in fact effectively solve the problems facing banks and arising from the financial markets' crises. A hard-and-fast assessment of this revamping requires the conducting of comprehensive-scope investigations of ramifications.

Any alterations of directives should not – in any case and in any way – trigger the launching of a „Basel III“ wave of regulation. This would be unnecessary, as Basel II's framework regulations have proven their efficacy. This includes those areas of the subprime crises to which the regulations have already been applied.