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# 3L3 MEDIUM TERM WORK PROGRAMME

**Consultation paper**

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## Key consultation message

The Level 3 Committees have identified a comprehensive list of cross-sector areas for delivery in the period to the end of 2010 – the 'medium term'. In these areas they are committed to delivering maximum consistency across sectors. In doing so, the Committees will build on past work, and in other areas new inputs such as mapping exercises or exchanges of information. To ensure the most efficient and effective use of limited resources, six key areas have been identified within the three year term.

These areas concern:

- home-host/delegation of tasks;
- competing products ;
- credit rating agencies;
- internal governance;
- conglomerates (Interim Working Committee on Financial Conglomerates);
- valuation of financial instruments.

You are kindly invited to comment on these priorities, and on the work set out in these priorities and on other issues in this medium term work programme by 18 January 2008. Responses should be posted on the CESR web-site [www.cesr.eu](http://www.cesr.eu) under the folder “Consultations”. Links are also provided from the CEBS and CEIOPS webpages. In accordance with the consultation practices of the three level 3 Committees all responses will be made public, except where respondents specifically request that their comments remain confidential.

## Introduction

### *General*

- 1) The purpose of this Consultation Paper is to set out and explain the 3 Level 3 Committees' (the Committees) proposed **medium term** work plan for the period 2008 to 2010 inclusive. This follows a joint decision taken by the Committees to have a longer-term focused strategy allowing for market consultation, with a final outcome that clearly sets out agreed objectives. It should reflect the market's expectation of what the Committees' focus should be, as well as what they are able to commit to undertaking and achieving.
- 2) This initiative builds on the objectives set out in the three Committees' November 2005 Joint Protocol<sup>1</sup> and the two subsequent Joint 3L3 Work Programmes<sup>2</sup>, as well as the individual objectives set out in the Committees' respective charters. In addition the Committees have jointly established the Interim Working Committee on Financial Conglomerates (IWCFC) to focus on implementation of the FCD. All these elements influence the Medium Term Work Programme.
- 3) This work plan is intended to be read as a statement of high level and strategic objectives which will complement, reflect and sit alongside the annual, more detailed individual Committee and 3L3 Work Programmes. The prioritisation of certain pieces of work reflects the importance attached to achieving the desired outcome, rather than the immediacy with which that work will take place.
- 4) Some of the work streams identified below address the concerns listed by the EFC in its 4 October 2007 roadmap<sup>3</sup> further to the recent financial markets' developments.

### *Accountability*

- 5) This Consultation Paper also reflects the Committees' recognition that as they will be participating in, conducting and approving the medium term work carried out under this plan, the work will be subject to the Committees' normal established

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<sup>1</sup> See Joint Protocol set out as an annex to this paper

<sup>2</sup> For details of work agreed in the previous joint work programmes see the Joint 2006 3L3 Work programme, of 6 February 2006, and the Joint 2007 3L3 Work Programme, published on the 22 December 2006, both available on the Committees respective web-sites.

<sup>3</sup> See Financial markets situation – key issues and follow-up actions (EFC – 4 October 2007)

processes and their accountability, and intended to be included in the joint 3L3 sections of their Annual Reports.

- 6) The Committees therefore propose that going forward the work carried out under the medium term work plan will be included in their Reports to the Financial Services Committee for the Council, to ECON for the Parliament and to the Commission. In addition to the established close links with the Commission, which is represented at the Committees and many of their subgroups, progress reports will therefore be made on a yearly basis to the FSC, as well as by the 3L3 Chairs to ECON, and presented for discussion within the ESC, EBC, EIOPS and EFCC. Such progress reports will at the same time be copied to the Commission.
- 7) The Committees continue to attach major importance to transparency, consultation and accountability. They intend to consult the industry, end-users and other interested parties widely on a 3L3 basis when appropriate.

### ***Structure***

- 8) In contrast to the existing annual joint 3L3 work plans, the Committees have decided that it is better to structure this medium term work plan around themes which focus on broad 3L3 objectives and deliverables. These will complement and direct the more detailed annual work plans. In doing so, the Committees have identified the following categories of cooperation and convergence work for the proposals set out in this paper:
  - a) work to create a common 3L3 framework for cooperation between national authorities;
  - b) work to create 3L3 convergence of regulatory and supervisory practices in key areas; and
  - c) work to develop common 3L3 tools and working procedures.
- 9) The Committees recognise and consider it important to clarify that convergence on a cross sector basis does not mean achieving a joint position on all areas of their work. It will always be important to pursue a proportionate approach, having regard to sector and markets specific requirements and political considerations. That said, the Committees are resolved to working towards closing unnecessary gaps in the supervision of Europe's financial services.

- 10) This Consultation Paper discusses the areas of work in each of the above categories, that the Committees are committed to carrying out during the course of the next three years. As the proposed plan builds on existing work, some of the proposals are new, and some involve a renewed commitment to carry forward work, already begun in depth, over the next years.
- 11) The results of this consultation will be used for the 3L3 Work Programme for 2008, which will include a detailed timeline. Also, the ongoing Lamfalussy Review may result in changes in the working processes between the various levels and within level 3. If this occurs, this medium term work programme may need to be adapted, especially section C below.
- 12) The Committees consider that six key areas in particular should be considered as priorities during the next three years. Those are (i) home/host delegation of tasks; (ii) competing products; (iii) credit rating agencies; (iv) internal governance; (v) conglomerates; (vi) valuation of financial instruments. In these areas the 3L3 Committees are committed to an ambitious approach, aiming at maximum consistency across sectors where appropriate and beneficial. This will build on the past experience and in other areas the use of tools such as mapping exercises or exchanges of information. Also, where choices on resources need to be made, these areas will be allocated the available resource<sup>4</sup>.

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<sup>4</sup> The Committees are currently discussing issues regarding their tools, procedures, and roles in the delivery process. These may develop during the medium term work plan and in consequence of the Lamfalussy review.

## **A. Common 3L3 framework for cooperation between national authorities**

- 13) There are a number of work streams that the Committees have categorised as “improving the functioning of the three Committees’ supervisors”. This work aims to improve the way in which the national supervisory authorities of each of the three Committees respectively, carry out their day to day supervision and regulation of the firms and markets for which they are responsible.
- 14) To achieve this, the following two broad areas of work have been identified:
- a) developing tools for increasing cooperation amongst the national supervisors;  
and
  - b) developing tools to improve supervision on a cross sector basis.

### ***A.1 Developing tools for increasing cooperation amongst the national supervisors (Home/Host and Delegations of tasks (Key issue)***

- 15) The Committees recognise the importance of enlarging both the scope and method of supervisory cooperation between national supervisors. To this end, the Committees have identified home host issues and delegation between supervisors as a priority area for 3L3 work in the future.
- 16) The ability of home and host supervisors to cooperate efficiently and effectively with each other, is crucial in order to achieve the objective of contributing to the creation of an integrated financial market in Europe. For this reason, the three Committees have agreed to work on home host cooperation within colleges for prudential purposes and between involved supervisors in the area of conduct of business.
- 17) Lessons learned, and the need to submit own-initiative recommendations to higher levels whenever inconsistencies arise in Level 1 or Level 2 legislation will be shared and jointly addressed where possible.
- 18) A key aspect of this work will be the issue of delegation, on which the three Committees have agreed to work, looking at the transfer of both tasks and/or where legally possible, responsibilities between supervisors involved in the

supervision of an institution or a group of institutions, or in investigating market incidents. Various issues in this context are relevant across the sectors, such as differences in the availability of resources and payment for local supervision carried out in fulfilment of the tasks of and on behalf of another supervisor, mutual expectations on the acceptance of delegation, accountability, public expectations when the stability of the institution or system is endangered, as well as issues of liability and burden sharing.

19) The Committees are already working at a sector level in line with the recommendations of the Francq Report<sup>5</sup>. They have agreed to jointly look into these areas for the purpose of commonly addressing the obstacles found at Levels 1 and 2, as well as in domestic arrangements following from administrative law and funding issues. This will be done with a view to presenting a balanced report to the EU institutions at the latest by 2009 on the legal and practical issues which could help encourage delegation. This work will involve a mixture of commissioning legal analyses and investigating supervisory efficiency, experience and practicalities.

20) The report will provide recommendations for the period 2009-2011 for work at Level 3, building on the ongoing sector work as requested by the Francq report, but also identify what is needed at Level 1 and 2, in order to achieve the effective and efficient use of delegation in a home host context across both borders and sectors. Legal and practical obstacles to an extended use of delegation of responsibilities should also be considered.

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

21) The Committees recognise that in order to improve supervision on a cross sector basis, there are certain practical areas of work which might be undertaken:

- i) Professional secrecy and limits on exchange of information;
- ii) Powers and enforcement sanctioning;
- iii) Inspection rules.

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

22) The ability to share information between the members of the three Committees is crucial in order to enable a cross sector approach to supervision. The Committees

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<sup>5</sup> FSC Report on financial supervision, prepared by an FSC Subgroup chaired by Thierry Francq, FSC 4159/06.



will build on the work that CEBS and CESR have already done and some of which CEIOPS is currently forming, in the area of secrecy and data protection and the identification of practical barriers to information exchange that currently exist.

23) The Committees will develop proposals by 2010 in order to:

- a) seek enhanced harmonisation of the secrecy provisions and the obligations to share information across sectors and borders, where within the Committees' influence;
- b) provide legal clarity and, on a proportionate and risk-based basis, set out the practical arrangements necessary for efficient and effective management of information in both normal times and times of crisis; and
- c) protect against the intrusion into databases.

24) The Committees will also look into the feasibility of establishing joint access for Committees' members to sector databases. They will investigate the establishment of joint access databases of financial information on cross-border operating groups for all competent authorities involved in the supervision of the respective groups.

#### ***A.2 (ii) Powers and enforcement sanctioning***

25) In order to be able to supervise effectively on a cross sector basis, the nature and use that the Committee members make of their supervisory and enforcement sanctioning powers is paramount.

26) The Committees recognise that there are differences between the supervisory authorities at both a sector and cross sector level in terms of the nature of the powers that they have been given, how they use them, and to what end. The reasons for these differences are both legal and cultural in nature. Although at an individual level the Committees are addressing this issue, on a cross sector level these differences are even more acute. They become emphasised when conducting cross sector supervision on groups and conglomerates.

27) The Committees have agreed to carry out some cross sector analysis by 2010 of those powers that vary most prominently across sectors, with a view to identifying what, if any, recommendations bridging the existing gaps can be made.

### *A.2 (iii) Inspection practice consistency*

- 28) Supervisory inspections are presently conducted according to the requirements of the individual sectors and authorities. A small minority of sector-specific inspections are conducted jointly by relevant authorities. Those necessarily involve, as a minimum, a common requirement or concern, and a practical option for off-site surveillance to be combined with on-site cooperation. Approaches can differ between inspection practices for conduct of business and for prudential concerns. Common objectives, rules and their exercise, only coincide for a minority of inspections.
- 29) The Committees will jointly map inspection practices by 2008, explore possibilities for increasing convergence, and develop any 3L3 conclusions involving EU legislation or national mandates by 2010. This will be supported by proposals to develop – subject to available funding – IT supporting tools for exchanging information on institutions, on interpretations and application of regulation, as well as on precedents (e.g. in the context of IFRS) through e.g. Q&A databases. Continued 3L3 IT work on databases will also be undertaken with a view to, through facilitation and convergence, enhancing the reporting framework applicable to financial institutions under supervision within one or more of the sectors. In undertaking this work confidentiality requirements and cost efficiency aspects have to be taken into account .

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

30) The second broad category of work that the Committees have identified is those areas of work that aim at delivering a particular outcome for the markets or industry on a cross sector basis. These may involve any two or all three Committees.

31) This category covers both investor protection aspects and prudential aspects. Customer protection, the protection of investors, policy holders and deposit holders, is fundamental for the Committees. Prudential supervision is aimed both at the protection of these customers as well as at financial stability.

32) As such, the Committees have identified ten areas of work focussing in some degree on customer protection and on prudential supervision:

- i) Competing products (customer protection);
- ii) Credit rating agencies (market supervision, and extensively used in prudential supervision);
- iii) Anti money laundering and Counter terrorism financing (central to all financial supervision);
- iv) Commodity derivatives (both customer protection and financial stability);
- v) Cross border consolidation (central to all financial supervision);
- vi) Internal governance (central to all financial supervision);
- vii) Conglomerates supplementary supervision (prudential);
- viii) CRD and Solvency II (foremost prudential);
- ix) Own funds definition – definition of eligible capital elements. (prudential);
- x) Valuation of financial instruments (central to all financial supervision).

### **B. (i) *Competing products (Key issue)***

33) The Committees have agreed to take forward work on the issue of “competing products”. The term is used to describe financial products containing the same or similar risk features/exposure for the service provider (e.g. unit-linked insurance contracts and investment funds, structured products). These products often are marketed to investors under a variety of different names and classified as different types of product across the three sectors, but from an investor’s perspective achieve the same or similar economic returns. As to the service provider (e.g. insurance company and investment fund, or other financial institution) they can

be subject to different prudential and conduct of business rules. These can create problems with, for example, regulatory arbitrage, disclosure, the role of independent intermediaries and mis-selling. They necessitate a thorough and comprehensive analysis with respect to competition matters.

- 34) During the course of last year, the Committees undertook a fact finding exercise in order to ascertain how this issue has been dealt with by each of their members at a national level. The results of the exercise will be shared with the Commission to feed into the work on a level playing field between competing products that the Commission is undertaking. The Committees will bring the work on competing products forward as necessary, by reference to, and in coordination with, the Commission's work on the same subject.

**B (ii) Credit rating agencies (Key issue)**

- 35) Building on the existing and ongoing work of CESR and CEBS respectively, the role of rating agencies in the markets and the use of ratings in prudential regulations will be examined in light of the recent sub prime mortgages experience. If necessary, this will result in an advice from CESR on changes in the regulatory approach to rating agencies and from CEIOPS and CEBS on the use of ratings in prudential regulations at Levels 1 and 2. This work should be conducted in close connection with the project on valuation of financial instruments (see point B(x) below).

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

- 36) A joint 3L3 task force on anti money laundering and counter terrorism financing has already been established. As set out in the letter of 9 May 2006 to the Commission, the three Committees are working on the organisation and control issues relating to internal governance and “Know Your Customer”, as well as the cross sector aspects and new developments which need to be taken into account to ensure compliance with the provisions of the Third Directive and its implementing measures.
- 37) Based on surveys of practical issues facing supervisors, a catalogue of common pragmatic supervisory responses to the specific issues identified will be developed by 2008.

38) This phase of the work is practical. It focuses on finding common responses to issues emerging in the day to day application of the Directive, without attempting to elaborate Level 3 guidelines. The Anti Money Laundering Task force will provide a forum for discussion on the common responses during the implementation phase of the Directive and during the initial phase of its application.

#### ***B (iv) Commodity Derivatives***

39) Following the finalisation of the work of CEBS and of CESR on the mandates received from the Commission on the possibilities of prudential and market conduct supervision on these currently exempted market participants, continued work in relation to commodities derivatives in accordance with a joint mandate that CESR and CEBS have received from the European Commission and will be jointly undertaking, together with any other follow up work decided at Level 1.

#### ***B (v) Cross border consolidation***

40) Following the introduction of the new Cross border consolidation Directive<sup>6</sup>, the three Committees will publish, by the end of 2008, guidelines aimed at assisting implementation of this directive in a consistent manner. This work will focus on the information requirements of the supervisors, the cooperation necessary to enable the work to be done within the timelines set for assessments of mergers and acquisitions, and on developing a common approach to the assessment criteria, including the approval of the relevant parties as fit and proper for subsidiaries and for groups/conglomerates.

#### ***B (vi) Internal governance (Key issue)***

41) For large cross-border operating groups and conglomerates, one of the main costs results from differing requirements relating to internal governance across sectors (either domestically or cross-border) and across borders within sectors. Internal governance has increasingly become the main linking pin on which risk based and principles based supervision is built. If the internal governance of an institution or group is lacking, the correct information and warning signs will not filter through to either its management nor to its supervisors. An analysis performed by the three Committees indicates that this increased importance has

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<sup>6</sup> Directive 2007/44/EC of the European Parliament and of the Council of 5 September 2007 amending Council directive 92/49/EEC and Directives 2002/83/EC, 2004/39/EC, 2005/68/EC and 2006/48/EC as regards procedural rules and evaluation criteria for the prudential assessment of acquisition and increase of shareholdings in the financial sector.

resulted in increased regulatory requirements. The differences in the securities, banking and (draft) insurance regulations are slight in terms of objectives, but sometimes large in terms of drafting/texts and level of detail. In other sectors (pensions and UCITS) the internal governance requirements are as of yet underdeveloped at the EU level, resulting in differences across borders. In the short term, the industry has pointed out that the implementation phase of the CRD is not an opportune time to change internal governance requirements.

- 42) The three Committees contemplate the development of full cross sector guidance for institutions and conglomerates operating in different financial sectors in the area of internal governance in the mid term, using the window of opportunity existing in the Solvency II developments and the review of the FCD. In this context, special consideration will be given to groups and the interaction of requirements on groups which perform activities in a variety of sectors. As the existing differences are currently due to the differences that exist in the sector specific Level 1 and level 2 texts of especially MiFID and CRD this work will include advice on how to harmonise the texts and the definitions that exist within them.
- 43) A side benefit of this work will be that the internal governance requirements on sectors will automatically be provided with a benchmark which can be taken into account when a regulatory initiative is undertaken.

***B (vii) Conglomerates (the work of the IWCFC) (Key issue)***

- 44) The three Committees have joined forces and formed the IWCFC specifically to concentrate on the convergent implementation of the FCD, with particular attention being paid to capital requirements and cooperation between supervisors. This work is developing well, but will need continued focus and resources over the next few years. The deliverables will be that in the review of the FCD, a common working definition of *own funds* will need to be established, in close liaison with the sector work in the context of the CRD and Solvency II and in recognition of conglomerate specific issues, to enable conglomerates to work well and to remove barriers to optimal market functioning.
- 45) The IWCFC will also be a key player or advisor in many other workstreams mentioned in this medium term work programme, including but not limited to cross-border consolidation, home host cooperation, internal governance, capital modelling, and own funds

### ***B (viii) Capital modelling CRD (Basel II) and Solvency II***

46) This area of work aims at meeting the challenges posed by the introduction of risk sensitive approaches to supervision in the banking and insurance sectors. Solvency II and the CRD (implementing Basel II in the EU) represent a unique opportunity to create convergence and enhance greater supervisory cooperation on a cross-sector basis. However, two main features of these two regimes must be taken into consideration:

- a) firstly, the two regimes are introducing new prudential risk-based regulatory frameworks in a bifurcated system relying on a standard approach and a more advanced, internal system based approach, depending on the degree of sophistication of institutions' risk management and actual risk experience; and
- b) secondly, the two regimes are also reshaping the supervisory dialogue, with the onus being on the institutions to assess their own capital needs in the light of all risks, while supervisors' focus would shift from compliance monitoring and capital, to evaluating institutions' risk profiles and the quality of their risk management.

47) Such complexity and tailor-made approaches to supervision pose a number of challenges to supervisors of groups that combine the two activities. Beyond the general commonalities of the two risk sensitive regimes, detailed aspects may lead to divergent requirements or loopholes that may impact on the supervision of sector or mixed activities groups.

48) The work will identify the challenges posed to industry and financial supervision, together with possible solutions where appropriate, by the introduction of the two new regimes. The discussion should carefully take into account sector specifics and recognise that due to different business models in the banking and insurance sector there might be limits to convergence in this context

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### ***B (ix) Own funds definition - Definition of eligible capital elements***

49) Introducing a risk sensitive regime addresses the ways financial institutions estimate and manage their risks. It also poses questions about the types of regulatory capital that institutions are using to cover those risks. The identification of a relevant set of capital instruments capable of absorbing losses

as they occur is critical to all institutions, whether banks or insurance undertakings.

50) The work is carried out by a Joint Task Force with a Mandate focussing on conglomerates, in satisfaction of a Call for Advice from the Commission. It could have a wider application, as it will aim to assess whether the definition of capital can rely on the same set of principles and eligibility criteria, or whether evidence based or well grounded differences in business activities should justify different capital.

***B (x) Valuation of financial instruments (Key issue)***

51) Fair valuation of securities is based either on market value or modelled value. As a consequence of the evolution of financial markets and financial products, market values are not always available or reliable, due in particular to insufficient liquidity and/or to the fact that some securities (e.g. bonds) are exchanged mostly outside regulated markets. Valuation standards for financial instruments, including structured products, have also significant implications for risk management practices by banks and other financial institutions, which need to be carefully analysed. The recent turbulences show the need to evaluate the market model approach, and the relevance of cross-sector assessment of this issue.

52) The work will aim to identify the challenges posed in this respect to all financial institutions and financial supervision, and possible solutions. It is recognised that these solutions may not be the same for all financial sectors, as sector specifics (e.g. as regards liquidity constraints) have to be taken into account.



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

53) The Committees have identified a number of areas of work aimed at improving the operation of the Committees, in order for them to be able to fulfil one of their basic objectives – fostering supervisory convergence. These tools are of course most susceptible to any changes following from the Lamfalussy review, which is currently the subject of debate at the political level. The further development of these tools may need to be amended as a result.

54) The following areas of work towards this have been identified:

- i) Common training and staff exchanges;
- ii) Conflict handling and peer pressure tools;
- iii) Impact assessment methodology;
- iv) Equivalence of 3<sup>rd</sup> country supervisory regimes;
- v) General policy and information exchanges between the Committees.

55) In addition to the sector specific training initiatives that each of the Committees is currently developing, the Committees are developing a 3L3 training platform that can deliver training on issues across the three sectors. In the other areas, the Committees are continuing to monitor and develop the various tools to explore overcoming existing practical barriers for staff exchanges following from for example tax issues, such as by forming a network of Committee Members' HR Departments to develop practical procedures towards this aim.

56) CESR has recently reviewed its peer review mechanism and CEIOPS and CEBS have approved and are in the process of implementing their own very similar mechanisms. The use of these mechanisms will, through transparency and peer pressure, result in greater convergence.

57) The issue of cross-sector access to the (identical, but currently sector-specific) mediation mechanisms will also be considered, as will the need to review the systems in the light of experience gained.

58) All three Committees have developed and adopted an Impact Assessment methodology which should be built into future policy work.

- 59) The Committees will create a method through which decisions and experiences in relation to assessing at a sector level the equivalence of 3<sup>rd</sup> countries supervisory regimes will be shared with each other, with a view to exploring the possibility of greater cross sector converge of equivalence assessments.
- 60) The Committees will jointly test and evaluate these tools during the course of 2008/2009, and will take this into consideration when reviewing the 3L3 Protocol.
- 61) In order to foster supervisory convergence on a cross sector basis, it is essential that common approaches on issues of significance across the Committees are developed. The Committees already seek to exchange as much information as possible. Committee documents will be mutually available via Committee websites' members' areas, and mechanisms have been put into place to develop 3L3 policy.
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