

BRIEF SUMMARY OF THE DE LAROSIERE REPORT

1. MANDATE

The de Larosi re Group's mandate primarily covered the issues of how to organize the supervision of financial institutions and markets in the EU; how to strengthen European cooperation on financial stability oversight, early warning and crisis mechanisms; and how EU supervisors should cooperate globally. With the agreement of the President, the Group has also analysed and brought forward recommendations on regulation of financial markets.

2. THE REPORT

The report is structured into 4 chapters:

- I. Causes of the financial crisis.**
- II. Policy and regulatory repair.**
- III. EU supervisory repair.**
- IV. Global repair.**

The Group's 31 recommendations are in Annex.

I. CAUSES OF THE FINANCIAL CRISIS

The report analyses in some detail the main causes of the financial crisis. What is striking is the complexity and interconnectedness of a number of major factors that amplified the crisis. The main failures are:

• Macroeconomic causes	Example: ample liquidity, low interest rates – and too loose monetary policy – the US in particular; accumulation of large global imbalances; mispricing of risk and large increases in leverage.
• Risk management	By firms, supervisors, regulators and a lack of transparency – leading to the build up of the shadow banking system, the originate to distribute model and extreme complexity which few understood.
• Credit rating agencies	Dramatic failures in the ratings of structured products, major conflicts of interests.
• Corporate governance	Weak shareholders and management of firms; remuneration schemes providing the wrong incentives...
• Regulatory/supervisory	Wrong incentives – procyclicality e.g. Basle process; mark to market accounting; lack of regulation of derivatives markets; insufficient examination of macroprudential risk.
• Global institutional weakness	IMF, FSF, G20... and lack of coordination.

II. POLICY AND REGULATORY REPAIR

This chapter sets out the Group's views on the priority areas that need regulatory change. They are:

<ul style="list-style-type: none"> • Stronger macroeconomic policy and macroprudential analysis 	Avoiding too loose monetary policy and excess liquidity; assessment of asset bubbles... tightening monetary policy when money or credit grow in an unsustainable way.
<ul style="list-style-type: none"> • Reforming expeditiously the Basle 2 capital requirement process for bank capital 	> capital for banks and higher quality of capital; counter-cyclical approaches – capital buffers; higher capital for trading books; measuring and limiting liquidity risk; stricter rules for off-balance sheet vehicles; common definition of own funds.
<ul style="list-style-type: none"> • Credit rating agencies (CRA's) 	To be supervised by new European Securities Authority; fundamental review of role of CRA's in the financial system; distinct new approach to rating of securitized products.
<ul style="list-style-type: none"> • Accounting 	Strengthened governance of the IASB; wide reflection of the role of mark to market accounting necessary; improved valuation techniques.
<ul style="list-style-type: none"> • Insurance 	Essential to deliver Solvency II before May this year. Appropriate safeguards to be defined to ensure an effective group support regime.
<ul style="list-style-type: none"> • Sanctions/supervisory powers 	To be strengthened throughout the EU – so sanctions bite and are deterrent.
<ul style="list-style-type: none"> • Parallel banking system (HP's, private equity...) 	All parts of the financial system where they have a potentially systemic nature should be appropriately regulated and supervised; for hedge funds information requirements on hedge funds should become mandatory – through regulation of hedge fund managers.
<ul style="list-style-type: none"> • Securitized products/derivative markets 	Derivative products should be standardized and simplified; at least one well-capitalized clearing house for credit default swaps should be created in the EU.
<ul style="list-style-type: none"> • Investment funds 	Common EU rules should be strengthened – including tighter control over depositories and custodians...

The Group strongly supports the view that there should be a single set of core regulatory rules and supervisory standards in the EU – and lists examples where this is not the case with the current rulebook. On corporate governance and remuneration strong recommendations are made. Concerning crisis management and resolution, the Group considers that the current arrangements are not satisfactory. It recommends that a clear and transparent framework must be immediately established to manage a crisis – and that all Member States must have the same set of tools and procedures. Legal obstacles must be removed. Deposit Guarantee Schemes should be harmonized and pre-funded by the private sector; And further work must be carried out on burden sharing in the context of a cross border crisis – with the establishment of more detailed criteria in the EU MOU.

III. EU SUPERVISORY REPAIR

This chapter sets some ambitious reforms that the Group considers the European Union should adopt in the supervisory sphere. In essence, there are 2 main blocks:

<ul style="list-style-type: none"> • Macroprudential supervision A NEW EU FUNCTION called the European Systemic Risk Council [ESRC] should be set up 	<p>The Group considers the new body should be set up under the auspices of the ECB, and chaired by the President of the ECB. It will be composed of the members of the General Council of the ECB, the Commission plus the Chairs of CEBS, CEIOPS and CESR. Insurance and securities supervisors will be brought in where necessary. Its role will be to gather information on all macroprudential risks in the EU. It shall have access to all necessary macro and micro information and issue risk warnings on which there would be mandatory follow-up and monitoring by EU supervisors. If the risks were very serious they should be taken up by the EFC, working with the Commission, to address the risks. The ESRC will work closely with the IMF, FSF, G20 at global level.</p>
<ul style="list-style-type: none"> • A NEW European System of Financial Supervision (ESFS) – transforming the L3 Committees into EU Authorities 	<p>This covers microprudential supervision (the supervision of firms). The 3L3 Committees (CEBS, CEIOPS, CESR) will be each transformed into 3 new European Authorities (the European Banking Authority; the European Securities Authority; and the European Insurance Authority). These Authorities will have a considerably expanded role compared to the current L3 Committees including some legal powers.</p> <p>The main additional tasks of the Authorities on top of the competences of the existing level 3 committees, will be the following: (i) legally</p>

	binding mediation between national supervisors; (ii) adoption of binding supervisory standards; (iii) adoption of binding technical decisions applicable to individual institutions; (iv) oversight and coordination of colleges of supervisors; (v) licensing and supervision of specific EU-wide institutions (e.g. Credit Rating Agencies and post-trading infrastructures); (vi) binding cooperation with the ESRC to ensure adequate prudential supervision; and (vii) strong coordinating role in crisis situations.
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The ESFS should be set up in a 2 stage procedure: Stage 1 – Preparation (2009-2010) and Stage 2 – The establishment of the ESFS legal system (2011-2012).

Thus for the first time – the EU's supervisory system would be joined up from the macro to the micro end of supervision – with clear and defined responsibilities for each level. The Group does not recommend transferring the responsibility for supervision of financial firms (large cross border, or more) to the European level.

The Group recommends that after 3 years of the ESFS functioning - a full review is undertaken to determine whether further development may be necessary (e.g. merging the banking and insurance Authorities together to have one Authority responsible for financial stability – and the other for market/conduct of business issues for all 3 sectors; plus extending the horizontal rule making powers etc).

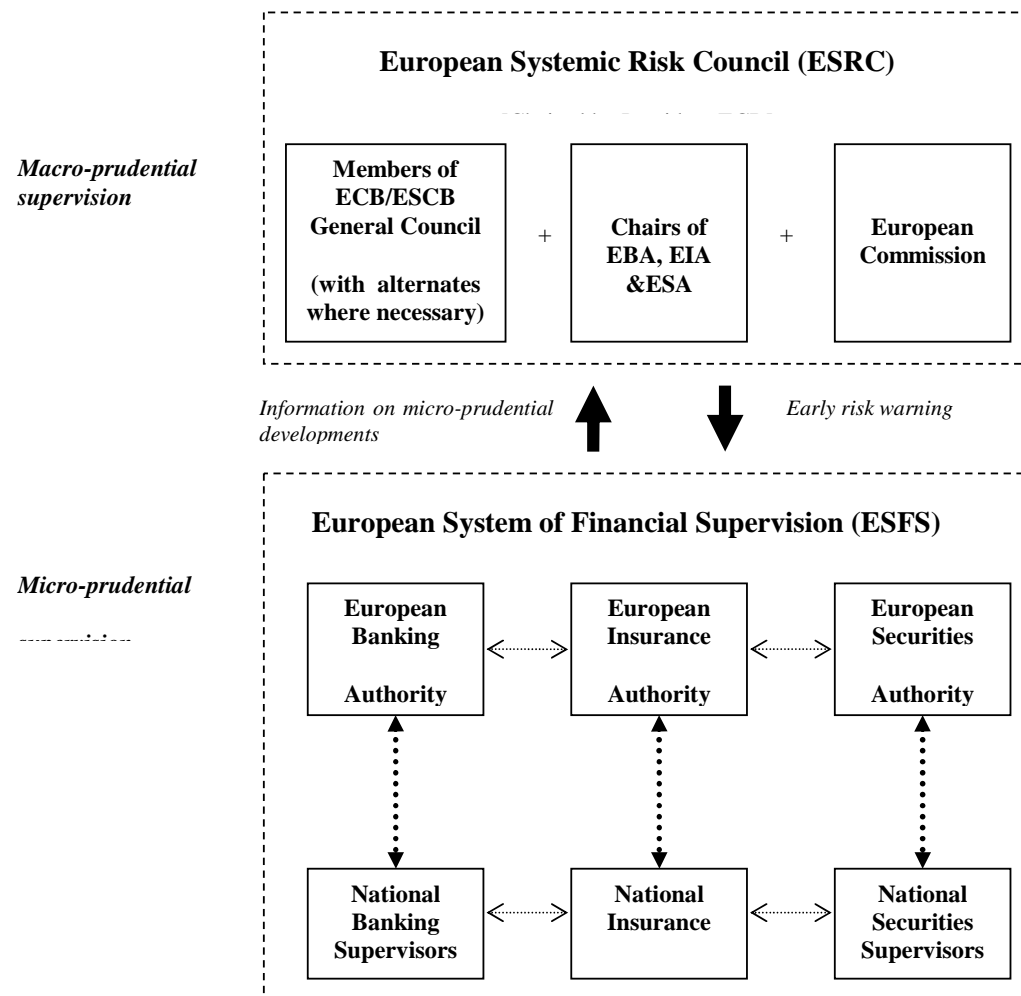
IV. GLOBAL REPAIR

In this chapter the Committee considers some necessary changes at international level to ensure the avoidance of such major crises in the future. The main proposal are for the FSF (Financial Stability Forum) to be put in charge of converging international financial regulation to the highest level. The FSF should link closely with the macro-focused IMF. The Group supports the establishment of global colleges of supervisors as soon as possible – with best practice determined by the FSF. For macroprudential surveillance – the IMF – with other bodies to assist- should develop a global financial stability early warning system – accompanied by a global risk map and credit register.

All IMF member countries should also commit to its FSAP programme – and provide reasons if they do not comply with the recommendations. IMF resources should be enhanced to strengthen its capacity to deal with finance on balance of payments distress. The report also emphasizes how important it is to organize coherent EU representatives in the new global economic and financial architecture.

Finally, the report emphasizes the opportunity and need for the EU to deepen its bilateral financial relations with all its major partners. There is an opportunity for global EU leadership to seize.

A new European Framework for Safeguarding Financial Stability



Main tasks of the European Systemic Risk Council: decide on macro-prudential policy, provide early risk warning to EU supervisors, compare observations on macro-economic and prudential developments and give direction on these issues.

Main tasks of the Authorities: in addition to the competences of the existing level 3 committees, the Authorities would have the following key-competences: (i) legally binding mediation between national supervisors, (ii) adoption of binding supervisory standards, (iii) adoption of binding technical decisions applicable to individual institutions, (iv) oversight and coordination of colleges of supervisors, (v) licensing and supervision of specific EU-wide institutions (e.g., Credit Rating Agencies and post-trading infrastructures), (vi) binding cooperation with the ESRC to ensure adequate macro-prudential supervision, and (vii) strong coordinating role in crisis situations.

Main tasks of national supervisors: continue to be fully responsible for day-to-day supervision of firms.

RECOMMENDATIONS

CHAPTER II: POLICY AND REGULATION REPAIR

Recommendation 1: *The Group sees the need for a fundamental review of the Basel 2 rules. The Basel Committee of Banking Supervisors should therefore be invited to urgently amend the rules with a view to:*

- *gradually increase minimum capital requirements;*
- *reduce pro-cyclicality, by e.g. encouraging dynamic provisioning or capital buffers;*
- *introduce stricter rules for off-balance sheet items;*
- *tighten norms on liquidity management; and*
- *strengthen the rules for bank's internal control and risk management, notably by reinforcing the "fit and proper" criteria for management and board members.*

Furthermore, it is essential that rules are complemented by more reliance on judgement.

Recommendation 2: *In the EU, a common definition of regulatory capital should be adopted, clarifying whether, and if so which, hybrid instruments should be considered as tier 1 capital. This definition should be confirmed by the Basel Committee.*

Recommendation 3: *Concerning the regulation of Credit Rating Agencies (CRAs), the Group recommends that:*

- *within the EU, a strengthened CESR should be in charge of registering and supervising CRAs;*
- *a fundamental review of CRAs' business model, its financing and of the scope for separating rating and advisory activities should be undertaken;*
- *the use of ratings in financial regulations should be significantly reduced over time;*
- *the rating for structured products should be transformed by introducing distinct codes for such products.*

It is crucial that these regulatory changes are accompanied by increased due diligence and judgement by investors and improved supervision.

Recommendation 4: *With respect to accounting rules the Group considers that a wider reflection on the mark-to-market principle is needed and in particular recommends that:*

- *expeditious solutions should be found to the remaining accounting issues concerning complex products;*
- *accounting standards should not bias business models, promote pro-cyclical behaviour or discourage long-term investment;*
- *the IASB and other accounting standard setters should clarify and agree on a common, transparent methodology for the valuation of assets in illiquid markets where mark-to-market cannot be applied;*
- *the IASB further opens its standard-setting process to the regulatory, supervisory and business communities;*
- *the oversight and governance structure of the IASB be strengthened.*

Recommendation 5: *The Group considers that the Solvency 2 directive must be adopted and include a balanced group support regime, coupled with sufficient safeguards for host Member States, a binding mediation process between supervisors and the setting-up of harmonised insurance guarantee schemes.*

Recommendation 6: *The Group considers that:*

- *Competent authorities in all Member States must have sufficient supervisory powers, including sanctions, to ensure the compliance of financial institutions with the applicable rules;*
- *Competent authorities should also be equipped with strong, equivalent and deterrent sanction regimes to counter all types of financial crime.*

Recommendation 7: *Concerning the "parallel banking system" the Group recommends to:*

- *extend appropriate regulation, in a proportionate manner, to all firms or entities conducting financial activities of a potentially systemic nature, even if they have no direct dealings with the public at large;*
- *improve transparency in all financial markets - and notably for systemically important hedge funds - by imposing, in all EU Member States and internationally, registration and information requirements on hedge fund managers, concerning their strategies, methods and leverage, including their worldwide activities;*

- *introduce appropriate capital requirements on banks owning or operating a hedge fund or being otherwise engaged in significant proprietary trading and to closely monitor them.*

Recommendation 8: *Concerning securitised products and derivatives markets, the Group recommends to:*

- *simplify and standardise over-the-counter derivatives;*
- *introduce and require the use of at least one well-capitalised central clearing house for credit default swaps in the EU;*
- *guarantee that issuers of securitised products retain on their books for the life of the instrument a meaningful amount of the underlying risk (non-hedged).*

Recommendation 9: *With respect to investment funds, the Group proposes to further develop common rules for investment funds in the EU, notably concerning definitions, codification of assets and rules for delegation. This should be accompanied by a tighter supervisory control over the independent role of depositories and custodians.*

Recommendation 10: *In order to tackle the current absence of a truly harmonised set of core rules in the EU, the Group recommends that:*

- *Member States and the European Parliament should avoid in the future legislation that permits inconsistent transposition and application;*
- *the Commission and the level 3 Committees should identify those national exceptions, the removal of which would improve the functioning of the single financial market; reduce distortions of competition and regulatory arbitrage; or improve the efficiency of cross-border financial activity in the EU. Notwithstanding, a Member State should be able to adopt more stringent national regulatory measures considered to be domestically appropriate for safeguarding financial stability as long as the principles of the internal market and agreed minimum core standards are respected.*

Recommendation 11: *In view of the corporate governance failures revealed by the current financial crisis, the Group considers that compensation incentives must be better aligned with shareholder interests and long-term firm-wide profitability by basing the structure of financial sector compensation schemes on the following principles:*

- *the assessment of bonuses should be set in a multi-year framework, spreading bonus payments over the cycle;*
- *the same principles should apply to proprietary traders and asset managers;*
- *bonuses should reflect actual performance and not be guaranteed in advance.*

Supervisors should oversee the suitability of financial institutions' compensation policies, require changes where compensation policies encourage excessive risk-taking and, where necessary, impose additional capital requirements under pillar 2 of Basel 2 in case no adequate remedial action is being taken.

Recommendation 12: *With respect to internal risk management, the Group recommends that:*

- *the risk management function within financial institutions must be made independent and responsible for effective, independent stress testing;*
- *senior risk officers should hold a very high rank in the company hierarchy, and*
- *internal risk assessment and proper due diligence must not be neglected by over-reliance on external ratings.*

Supervisors are called upon to frequently inspect financial institutions' internal risk management systems.

Recommendation 13: *The Group calls for a coherent and workable regulatory framework for crisis management in the EU:*

- *without pre-judging the intervention in future individual cases of distressed financial institutions, a transparent and clear framework for managing crises should be developed;*
- *all relevant authorities in the EU should be equipped with appropriate and equivalent crisis prevention and crisis intervention tools;*
- *legal obstacles which stand in the way of using these tools in a cross-border context should be removed, with adequate measures to be adopted at EU level.*

Recommendation 14: *Deposit Guarantee Schemes (DGS) in the EU should be harmonised and preferably be pre-funded by the private sector (in exceptional cases topped up by the State) and provide high, equal protection to all bank customers throughout the EU.*

The principle of high, equal protection of all customers should also be implemented in the insurance and investment sectors.

The Group recognises that the present arrangements for safeguarding the interests of depositors in host countries have not proved robust in all cases, and recommends that the existing powers of host countries in respect of branches be reviewed to deal with the problems which have occurred in this context.

Recommendation 15: *In view of the absence of an EU-level mechanisms for financing cross-border crisis resolution efforts, Member States should agree on more detailed criteria for burden sharing than those contained in the existing Memorandum of Understanding (MoU) and amend the MoU accordingly.*

CHAPTER III: SUPERVISORY REPAIR

Recommendation 16: A new body called the European Systemic Risk Council (ESRC), to be chaired by the ECB President, should be set up under the auspices and with the logistical support of the ECB.

- *The ESRC should be composed of the members of the General Council of the ECB, the chairpersons of CEBS, CEIOPS and CESR as well as one representative of the European Commission. Whenever the subject discussed justifies the presence of insurance and securities supervisors, the Governor could choose to be represented by the Head of the appropriate national supervisory authority;*
- *The ESRC should pool and analyse all information, relevant for financial stability, pertaining to macro-economic conditions and to macro-prudential developments in all the financial sectors.*
- *A proper flow of information between the ESRC and the micro-prudential supervisors must be ensured.*

Recommendation 17: an effective risk warning system shall be put in place under the auspices of the ESRC and of the Economic and Financial Committee (EFC).

- *The ESRC should prioritise and issue macro-prudential risk warnings: there should be mandatory follow up and, where appropriate, action shall be taken by the relevant competent authorities in the EU.*
- *If the risks are of a serious nature, potentially having a negative impact on the financial sector or the economy as a whole, the ESRC shall inform the chairman of the EFC. The EFC, working with the Commission, will then implement a strategy ensuring that the risks are effectively addressed.*
- *If the risks identified relate to a global dysfunction of the monetary and financial system, the ESRC will warn the IMF, the FSF and the BIS in order to define appropriate action at both EU and global levels.*
- *If the ESRC judges that the response of a national supervisor to a priority risk warning is inadequate, it shall, after discussion with that supervisor, inform the chairman of the EFC, with a view to further action being taken against that supervisor.*

Recommendation 18: A European System of Financial Supervisors (ESFS) should be set-up. This ESFS should be a decentralised network:

- *existing national supervisors would continue to carry-out day-to-day supervision;*

- *three new European Authorities would be set up, replacing CEBS, CEIOPS and CESR, with the role coordinate the application of supervisory standards and guarantee strong cooperation between the national supervisors;*
- *colleges of supervisors would be set up for all major cross-border institutions.*

The ESFS will need to be independent of the political authorities, but be accountable to them.

It should rely on a common set of core harmonised rules and have access to high-quality information.

Recommendation 19: *In the first stage (2009-2010), national supervisory authorities should be strengthened with a view to upgrading the quality of supervision in the EU.*

- *Member States should give consideration to the following reforms: aligning supervisors' competences and powers on the most comprehensive system in the EU, increasing supervisors' remuneration, facilitating exchanges of personnel between the private sector and supervisory authorities, ensuring that all supervisory authorities implement a modern and attractive personnel policy.*
- *The level 3 committees should intensify their efforts in the areas of training and personnel exchanges. They should also work towards the creation of a strong European supervisory culture.*
- *The European Commission should carry-out, in cooperation with the level 3 committees, an examination of the degree of independence of all national supervisors. This should lead to concrete recommendations, including on the funding of national authorities.*

In this first stage, the European Commission should immediately begin the work to prepare legal proposals to set up the new Authorities.

Recommendation 20: *In the first stage, EU should also develop a more harmonised set of financial regulations, supervisory powers and sanctioning regimes.*

- *The European Institutions and the level 3 committees should initiate a determined effort to equip the EU with a far more consistent set of rules by the beginning of 2013. Key differences in national legislation stemming from exceptions, derogations, additions made at national level or ambiguities contained in current directives should be identified and removed, so a harmonized core set of standards is defined and applied throughout the EU.*
- *The European Institutions should set in motion a process leading to far stronger and consistent supervisory and sanctioning regimes in the Member States.*

Recommendation 21: *The Group recommends an immediate step-change in the working of the level 3 committees which can be dealt with at once. The level 3 committees should therefore:*

- *benefit from, under the Community budget, a significant reinforcement of their resources;*
 - *upgrade the quality and impact of their peer review processes;*
- *prepare the ground, including through the adoption of adequate supervisory norms, for the setting-up of supervisory colleges for all major cross-border financial firms in the EU by the end of 2009.*

Recommendation 22: *In the second stage (2011-2012), the EU should establish an integrated European System of Financial Supervision (ESFS).*

- *The level 3 Committees should be transformed into three European Authorities: a European Banking Authority, a European Insurance Authority and a European Securities Authority.*
- *The Authorities should be managed by a board comprised of the chairs of the national supervisory authorities. The chairpersons and director generals of the Authorities should be full-time independent professionals. The appointment of the chairpersons should be confirmed by the Commission, the European Parliament and the Council and should be valid for a period of 8 years.*
- *The Authorities should have their own autonomous budget, commensurate with their responsibilities.*

In addition to the competences currently exercised by the level 3 committees, the Authorities should have, inter alia, the following key-competences:

- i) *legally binding mediation between national supervisors;*
 - ii) *adoption of binding supervisory standards;*
 - iii) *adoption of binding technical decisions applicable to individual financial institutions;*
 - iv) *oversight and coordination of colleges of supervisors;*
 - v) *designation, where needed, of group supervisors;*
 - vi) *licensing and supervision of specific EU-wide institutions (e.g. Credit Rating Agencies, and post-trading infrastructures);*
 - vii) *binding cooperation with the ESRC to ensure adequate macro-prudential supervision.*
- *National supervisory authorities should continue to be fully responsible for the day-to-day supervision of firms.*

Recommendation 23: *The Group recommends that planning for the 2 stages of the new system be started immediately. To this effect, a group of high-level representatives of the Finance Ministries, the European Parliament, the Level 3 Committees, and the ECB to be*

chaired by the Commission, should come forward before the end of 2009 with a detailed implementation plan.

Recommendation 24: *The functioning of the ESFS should be reviewed no later than 3 years after its entry into force. In the light of this review, the following additional reforms might be considered:*

- *Moving towards a system which would rely on only two Authorities: the first Authority would be responsible for banking and insurance prudential issues as well as for any other issue relevant for financial stability; the second Authority would be responsible for conduct of business and market issues;*
- *Granting the Authorities with wider regulatory powers of horizontal application;*
- *Examining the case for wider supervisory duties at the EU level.*

CHAPTER IV: GLOBAL REPAIR

Recommendation 25: *The Group recommends that, based on clear objectives and timetables, the Financial Stability Forum (FSF), in conjunction with international standard setters like the Basel Committee of Banking Supervisors, is put in charge of promoting the convergence of international financial regulation to the highest level benchmarks.*

In view of the heightened role proposed in this report for the FSF, it is important that the FSF is enlarged to include all systemically important countries and the European Commission. It should receive more resources and its accountability and governance should be reformed by more closely linking it to the IMF.

The FSF should regularly report to the IMF's International Monetary and Financial Committee (IMFC) about the progress made in regulatory reform implementing the lessons from the current financial crisis.

The IMFC should be transformed into a decision-making Council, in line with the Articles of the IMF agreement.

Recommendation 26: *Barring a fundamental change in the ways that banks operate, the Group recommends that the colleges of supervisors for large complex cross-border financial groups currently being set up at the international level should carry out robust comprehensive risk assessments, should pay greater attention to banks' internal risk management practices and should agree on a common approach to promoting incentive alignment in private sector remuneration schemes via pillar 2 of Basel 2.*

The Financial Stability Forum (FSF), working closely with other relevant international bodies, should ensure coherent global supervisory practice between the various colleges and promote best practice.

Recommendation 27: *The Group recommends that the IMF, in close cooperation with other interested bodies, notably the FSF, the BIS, central banks and the European Systemic Risk Council (ESRC), is put in charge of developing and operating a financial stability early warning system, accompanied by an international risk map and credit register.*

The early warning system should aim to deliver clear messages to policy makers and to recommend pre-emptive policy responses, possibly triggered by pre-defined "danger zones".

All IMF member countries should commit themselves to support the IMF in undertaking its independent analysis (incl. the Financial Sector Assessment Programme). Member

countries should publicly provide reasons whenever they do not follow these recommendations.

The IMFC/Council should receive a report, one or twice a year, on this matter.

Recommendation 28: *The Group recommends intensifying co-ordinated efforts to encourage currently poorly regulated or "uncooperative" jurisdictions to adhere to the highest level international standards and to exchange information among supervisors.*

In any event, in order to account for the increased risks, group supervisors should increase capital requirements for those financial institutions investing in or doing business with poorly regulated or supervised financial centres whenever they are not satisfied by the due diligence performed or where they are unable to obtain or exchange pertinent information from supervisors in these offshore jurisdictions.

The IMF and the FSF, in cooperation with other relevant international bodies, should assess the existing regulatory standards in financial centres, monitor the effectiveness of existing mechanisms of enforcing international standards and recommend more restrictive measures where the existing applied standards are considered to be insufficient.

Recommendation 29: *The Group recommends that EU Member States should show their support for strengthening the role of the IMF in macroeconomic surveillance and to contribute towards increasing the IMF's resources in order to strengthen its capacity to support member countries facing acute financial or balance of payment distress.*

Recommendation 30: *The Group recommends that a coherent EU representation in the new global economic and financial architecture be organised.*

In the context of a more ambitious institutional reform, this could imply a consolidation of the EU's representation in the IMF and other multilateral fora.

Recommendation 31: *In its bilateral relations, the EU should intensify its financial regulatory dialogue with key partners.*