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PUBLIC STATEMENT

THE SIXTH MEETING OF THE MARKET PARTICIPANTS CONSULTATIVE PANEL

The Market Participants Consultative Panel held its sixth meeting on 10th June 2004 in Paris.

The discussion during the meeting was facilitated by the Chairman of CESR. In his opening remarks, he welcomed the new members of the Panel, appointed at the last CESR meeting: Theodoros Philippou (Accountant/Cyprus); Wieslaw Rozlucki (Chair of the Warsaw Stock Exchange/Polish); Rüdiger von Rosen (Issuers association/German); Zoltan Speder (Intermediary/Hungarian). Patrick Neary (Prudential Director at the Irish Financial Services Regulatory Authority) attended the discussion on credit risk transfer.

The discussion was mainly focused on two different subjects: credit risk transfer and the equivalence of third countries GAAP vis-à-vis International Financial Reporting Standards (IFRS).

1. Credit risk transfer

Following a presentation by Emmanuel Xanthakis (presentation is enclosed), the members of the Panel discussed the issues arising from credit risk transfer, with particular regard to the potential impacts for investors. This discussion serves the work that CESR is conducting under a specific mandate received from the Economic and Financial Committee, jointly with the other Committees in the field of banking (BSC) and insurance regulation (CEIOPS). Patrick Neary, who is responsible for the coordination of CESR work in this area, informed the members of the Panel of the initiatives undertaken so far by CESR, which consists of a questionnaire sent to all Members and the evaluation of its responses.

The members of the Panel discussed the recent ECB report on the credit risk transfer activities of EU banks. They considered that the market for credit risk transfer is still limited but that it is growing fast. The market reality is much more articulated than expected. Opacity of the market segment and in particular of some market participants (some hedge funds) was considered a serious issue. Therefore more transparency and disclosure are necessary to monitor the evolution of the phenomenon. Members of the Panel also observed that the management of an eventual crisis would be rather difficult in case of cross-border activities, which is becoming increasingly global and not only restricted to EU Member States. Therefore, it was suggested that access to information should not be restricted to EU Members only, but should include at least US and Switzerland. Regulators should gather information and elaborate them on the basis of risk indicators.

Some concerns were also expressed about the potential exposure to counterparty risk of some banks and the potential impact in terms of systemic risks this activity might have.

2. Equivalence of IFRS



Following a presentation by Theodoros Philippou the members of the Panel discussed the equivalence of third countries GAAP vis-à-vis IFRS. This discussion serves the work that CESR will conduct under a specific mandate by the Commission under the Transparency Directive and the Prospectus Directive and Regulation. In his presentation Theodoros Philippou addressed the main points of the mandate that CESR will receive and presented three different possible solutions as to the meaning of “equivalence”: a) through a *quantifiable test*, which should cover the issues of same scope, same answers and same disclosure of GAAP; b) through a *qualitative approach*, which might take into account whether: i) third country GAAP are already widely accepted in EU markets, ii) subject to proper enforcement mechanisms, and ii) well codified and documented; and c) through a *non-compliant approach*, which provides a quantitative disclosure of the impact of adopting IFRS by reconciling key financial statement components. The last option was presented as the preferred one.

During the discussion some Members of the Panel considered that the assessment of equivalence should take account of cost benefits considerations. There are risks and opportunities in the equivalence project: if third countries GAAP were not considered to be equivalent, EU financial markets might become less attractive to foreign financial players and issuers. From the other side it was recalled that convergence of IFRS and third country GAAP (in particular US GAAP) needs to be promoted.

As regards the timetable for CESR to accomplish its mandate, it was recalled that CESR will work in two different steps: the first devoted to define “equivalence” and to present a working methodology to assess such equivalence; the second on the detailed work of technical assessment. The final deadline for CESR to deliver its technical advice would be June 2005.

CESR has not been asked to give terms of GAAP convergence but only to assess the equivalence; this exercise should be general, but not ignoring key differences.

In terms of remedies, some members considered that, as a minimum, an explanation of material differences should be imposed, but not explanation of all possible GAAP differences. Some members underlined that, considering the differences between GAAP, restatement of financial statements from third country GAAP to IAS (or quantitative reconciliations) can result in totally different balance sheets and profit & loss accounts. Therefore, one must be cautious when choosing the most appropriate remedies and some members expressed the opinion that reconciliation of key figures and additional explanations would be necessary as a minimum for proper information of investors and analysts. Others underlined that even reconciliation of key figures such as equity and net result will inevitably imply restating all statements and that the proportion of direct investment by retail investors in American, Japanese and Canadian instruments is so limited that this choice would not be justified.

CESR will inform the Panel at the next meeting about the initiatives undertaken.

3. Discussion on the Post-FSAP

Based on the initial activity of the four Forum Groups established by the European Commission, members of the Panel discussed the priorities after the Financial Services Action Plan. The Chairman of CESR presented the main conclusions of the last meeting of CESR in Amsterdam and the preliminary findings of the strategic task force established by CESR to analyse how to handle issues that may arise in the near future. He mentioned that as regards new legislation, any new measures to be adopted should pass the criteria of adding something to integration of EU financial markets. The role of the task force is to adopt a strategy to analyse what possible problems regulators might expect to face in the next five years and what possible solutions regulators may propose to handle the problems. Once highlighted these problems, the task force should list all existing traditional tools that may be used by regulators (comitology, home/host relationship, network, cooperation) and which, among these instruments, may be possibly improved. Finally the Task force should consider whether some problems, if any, cannot be solved with the traditional instruments and therefore deserve a response at EU level; this



assessment can only be done on a case by case basis. An analytical paper will be presented by CESR in the autumn.

Members of the Panel took note of these developments.

Members of the Panel also discussed a draft letter to the Commission on Post-FSAP: it was suggested to strengthen the importance of conducting an impact analysis every time an EU legislative proposal is made. Particular support was expressed for the revision of the UCITS Directive, whilst the suggestion to enhance the EU regulatory framework on corporate governance was not shared by all Members.

In the field of cooperation between competent authorities it was considered that CESR should look at experiences of some trading and post-trading infrastructures active in several jurisdictions and those of some banks with significant activity in jurisdictions other than the home state.

In the field of supervision it was suggested that control on auditing firms should be taken at EU level, given the limited number of these firms.

4. Evaluation of the functioning of the Panel

Members of the Panel discussed the recent activities of the Panel and means for any possible improvements. Based on some contacts taken between the members of the Panel on the effectiveness of the Panel, it was observed that: meetings are informative and valuable; the diversity of Panel members (in particular the Practitioner/Consumer split) is helpful in tabling a range of perspectives; the quality of the meetings has improved substantially; and presentations by Panel members are welcomed. However, there is some room for improvement, including: early dissemination of background information and presentation by members to facilitate the discussion; CESR should do more preparatory work on the information material (including some summaries of material); and some feedback on the Panel's impact would be helpful and encouraging. CESR should also explain why certain Panel recommendations have not been taken on board. Overall the length and frequency of meetings is considered appropriate, though some members would like to extend the length.

It was also agreed that a revision of the Panel effectiveness and working methodology should be conducted at least once a year.

5. Oral report by the Chairman of CESR

The Chairman of CESR reported orally on the major decisions adopted by the Committee during its last meeting in Amsterdam on 3 and 4 June. In particular, he mentioned the Joint statement between CESR and the US SEC, the approval of the consultation paper on the draft technical advice to the Commission on the first set of implementing measures of the Directive on Markets in Financial Instruments, the adoption of a consultation paper on the first "Level 3" activity under the prospectus directive.

The report on recent CESR activity as well as the work programme for 2004 did not raise any objections from the members of the Panel.

The members of the Panel were also informed of the cooperation established with the other level 3 Committees, operating in the banking (CEBS) and the insurance (CEIOPS) sectors. Regular meetings between the three Chairmen and the Secretaries General of the three Committees are taking place to discuss issues of common interest.

Next meetings



It was agreed to hold the next meetings of the Panel in Paris, on 10th November 2004 and 17th March 2005.

A series of issues have been raised for possible discussion during the next meetings and in particular, follow-up to the discussion on the post-FSAP, the consultation practices of CESR, hedge funds, clearing and settlement, delisting of EU companies from US exchanges, multiple listing on European exchanges, public oversight of auditors, credit rating agencies and overall transatlantic competition, officially appointed mechanisms for dissemination of regulated financial information and, finally, the choice of legal instrument for CESR technical advice.

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The members of the CESR Market Participant Consultative Panel are:

- Pr Luis Miguel Beleza, Consultant of the Executive Board, Banco Comercial Português;
- Dott Salvatore Bragantini, CEO, Centrobanca S.p.A.;
- Dr Rolf E Breuer, Chairman of the Supervisory Board, Deutsche Bank AG;
- Mr Donald Brydon, Deputy Chair of the Financial Services Practitioner Panel and Chairman of AXA Investment Managers;
- Mr Ignace Combes, Vice-President, Management Committee of the Board of Directors, Euroclear Bank;
- Mr P.P.F. de Vries, Director, Association of Shareholders, Vice-President, Euroshareholders;
- Mr Lars-Erik Forsgardh, Chairman of World Federation of Investors and CEO, Swedish Shareholders Association;
- Mr Dominique Hoenn, Deputy General Manager of BNP Paribas, Vice-Chair of the Supervisory Board of Euronext;
- Ms Sonja Lohse, Group Compliance Officer, Nordea AB;
- Mr Theodoros Philippou, General Manager, The Institute of Certified Public Accounts of Cyprus, Cyprus;
- Mr Mariano Rabadan, Chairman of the Spanish Association of Investment and Pension Funds (INVERCO);
- Mr Wieslaw Rozlucki (Chair and CEO of the Warsaw Stock Exchange);
- Pr Rüdiger von Rosen, Managing Director, Deutsches Aktieninstitut;
- Pr Dr Emmanuel D. Xanthakis, Non-Executive President, Marfin Bank and Marfin Portolio Investment Company;
- Mr Zoltan Zpeder, Vice-President and CEO, OTP Bank RT, Hungary.



Presentation by Manolis Xanthakis

CREDIT RISK TRANSFER BY EU BANKS

A short presentation

May 2004

-The report was prepared by the Banking Supervision Committee, a forum among national central banks, supervisory authorities of the EU and the ECB.

- It was based on local interviews with over 100 banks from 15 EU countries and 5 large, internationally active, non-EU banks and securities houses in London.

-The interviews were conducted in the latter half of 2003. One third of the banks were large international institutions, while two thirds were national or regional banks.

- Interviews focused on asset-backed securities (ABSs), collateralized debt obligations (CDOs) and credit derivatives instruments, such as credit default swaps (CDSs) and credit-linked notes (CLNs).

-CRT activities have been taking place since at least the 1970s, when bank loan syndication emerged as a widespread activity and shortly afterwards by securitization.

CRT activities can be classified as:

- banking/capital market solutions
- insurance solutions (not examined here)

The first category includes products like credit derivatives and structured products. They are instruments that can be bought and held by investors (banks, insurance cos, hedge funds), but they can also be actively traded. The provider of these CRT instruments can be any financial company.

Table 1 Overview of the credit risk transfer markets

| | "Banking/capital market solutions" | | | | "Insurance solutions" | | |
|---|--|--|--------------------|--|---|----------------------------|---|
| | Credit derivatives | Structured products | | Loan sales | Surety bonds | Underwriting of guarantees | Credit insurance |
| | | Asset-backed securities | Synthetic products | | | | |
| Typical products | Credit default swap, Total return swap, Credit spread option, Credit-linked note | Asset-backed commercial paper, Mortgage-backed securities etc., Collateralised debt obligation (CDO) | Synthetic CDO | Syndicated loans | Construction, Performance, Customs bonds | Financial guarantees | Trade credit insurance, Export credit insurance |
| Typical protection buyers (<i>risk shedding</i>) | Banks (as well as insurance companies, other financial institutions) | | | Commercial banks (secondary loan market) | Banks, other financial institutions, non-financial firms | | |
| Typical protection sellers (<i>risk taking for investment purposes</i>) | Banks and investment banks, insurance companies, other financial institutions | | | Various investors | Not relevant; no transfer to third parties typically occurs | | |
| Typical intermediaries/ providers (insurance solutions) | Banks and investment banks | | | Commercial banks | Specialised surety companies and multilines | Monolines (and multilines) | Credit insurance companies |

The CRT markets have grown very fast in recent years due to a number of factors:

- the increased focus of financial institutions on risk management and risk diversification.
- the lower funding costs to take risk positions
- new risk/return positions offered by structured products.
- the availability of "arbitrage" gains arising from tax, accounting and capital regulations.

The credit derivatives market, consisting mainly of default swaps, rose 25 percent to \$ 2,690 bn in the first six months of 2003, according to the International Swaps and Derivatives Association.

Banks are involved both ways:

- for diversifying of hedging risks in their banking book or improving funding (portfolio management). They generate CRT products from their balance sheet assets.

- for intermediation, they create CDOs from a set of loans and bonds to meet customer demand.

In the last few years hedge funds have become more active on both sides of the market.

CRT market liquidity has improved significantly, especially with the launching of credit indices (iBoxx and Trac-x)

Why banks are involved in CRT activities?

On the portfolio management side a bank buys protection to hedge both aggregate risk and concentration risk.

A bank sells protection to diversify the risk. Some banks consider CRT business a good substitute for traditional credit (e.g. corporate bonds of similar rating), since it provides higher margin income.

A bank is involved in intermediation to earn fee income and to broaden the services offered to customers. Intermediation will potentially become more important in the future, as corporate clients and government entities/municipalities are increasingly interested in ABSs, which banks could sell on to investors.

In the surveyed banks protection buying varied from 1% to 13% of total assets for credit derivatives and as high as up to 30% for structured products.

Protection selling was up to 10% for credit derivatives and up to 9% of total assets for structured products.

Usually, banks in EU are involved mainly in either of the two, with the exception of some French and Italian banks.

The quality of underlying assets – a key factor for assessing the amount of risk transfer – was reported to be investment grade, often very highly rated, especially in protection selling. Only a small part of CRT activity involves assets rated BB or below.

Table 2 Protection buying and selling by individual banks according to the survey

| | Protection buying % of total assets | Protection selling % of total assets | Number of institutions surveyed |
|-----------------------|--|--|--|
| Germany ¹⁾ | 7.8% credit derivatives | 8.7% credit derivatives | 10 |
| Greece | 0.02% | 0.2% | 3 |
| Spain | 3-15% structured products | n.a. | 4 |
| France ²⁾ | 0.6-12.9% credit derivatives 0.2-1.5% structured products | 0.3-9.6% credit derivatives, 0.1-8.5% structured products | 3 |
| Ireland | 0.13-4% credit derivatives 1-10% structured products | 0.6-7% credit derivatives 0.2-0.6% structured products | Protection buying: 6 Protection selling: 9 |
| Italy | 0.5-5% credit derivatives 0-6.5% structured products | 0.1-5% credit derivatives 0.2-7.5% structured products | 4 |
| Luxembourg | 0.5% credit derivatives 0.5-1% structured products | 1.7% credit derivatives 1.5-2.5% structured products | Estimate for the entire national banking sector |
| Austria | 0.7% credit derivatives | 3.4% | 8 |
| Portugal | 5-30% structured products | 2-3% credit derivatives | 4 |

1) Protection buying and selling reported as an average of the ten surveyed banks.

2) Data as at end-June 2003.

The majority of banks were reported to be net protection buyers in 2003. Net protection sellers were smaller regional German banks, Danish, Greek, Luxembourg, some Austrian and two large Irish banks.

Trading in CRT instruments was found to be increasingly a bank-to-bank business. Insurance companies had a declining involvement, while hedge funds were found increasingly willing to take on credit risk in the form of CDOs.

Banks' views on the functioning of CRT markets are that:

- They are functioning well
- Secondary market liquidity could be improved in some segments.
- They are opaque
- Single –name CDSs still are the most important instruments for hedging individual exposures. Traditional ABSs structures have also gained momentum.

The potential for disruption for the CRT markets was considered to be small in general. However, market functioning could be affected by some systemic events, such as:

- the exit of a major counterparty
- a large credit event leading to settlement difficulties
- fraud leading to a loss of confidence in the market.
- major legal, tax or regulatory changes.
- a double default of a major underlying firm and a counterparty could potentially test the market.

On the types of risk that could be faced in CRT markets:

Protection buyers mentioned counterparty risk
correlation risk

Protection sellers mentioned credit risk
model and pricing risk
liquidity risk

In intermediation all the above risks were mentioned as relevant.

For all participants legal and documentation risks were considered significant potential sources of risk.

Views of interviewed banks on risk management:

- existing risk management tools: (internal and external ratings, market-based estimates of probability of default, credit portfolio models) were regarded as adequate, as long as a bank's CRT activity remained relatively limited.

- In intermediation, a need was identified for sophisticated risk management systems.

The growth in CDOs has highlighted the risks from correlations, price jumps and reliance on market liquidity for dynamic hedging. At the same time, the increased availability of credit indices has provided an important tool to hedge CDO risks.

CRT is likely to influence banks' business models over the long run, particularly with respect to larger corporate customers. The banks foresee important developments in business models and strategies in the future:

- instead of granting and holding loans, strategy will tend to shift towards attracting loans and transferring them to the parties most willing to bear the risk
- a more integrated approach to credit risk assessment and management is likely to develop including more market-based pricing.
- increased banking competition is expected, leading to a greater focus on comparative advantage and increased consolidation in the banking sector.

Policy implications: Macro-prudential oversight.

- a systemic market event is a potential threat.
- the increased involvement of hedge funds might lead to instability, implying an inherent vulnerability.
- counterparty and concentration risks should always be under scrutiny.
- there appears to be a relatively low degree of actual net risk transfer. There should be ongoing monitoring and the specifics of particular transactions should be examined.
- Although CRT instruments potentially improve efficiency in financial markets, a major problem is the opacity of CRT market. Transparency and disclosure are important areas for improvement.

Micro-prudential oversight:

- Banks use CRT in a great variety of ways and have a variety of risk management systems.
- Banks should incorporate CRT exposures into consolidated credit risk positions. Measures of CRT need to be accurate and meaningful.
- Risk management systems vary considerably within each of the groups (intermediaries of portfolio managers), suggesting that banks should be compared with the best practice of their peers.
- Regulatory arbitrage was not thought to be an issue, especially since the involvement of insurance companies has declined.
- Concerning reliance on rating agencies' assessments, the degree of reliance seems to be inversely related to the size and sophistication of the bank.