Perspectives on the Securities Markets: **supervision and regulation**

CNMV 20th Anniversary
Commemorative Book

Perspectives on the Securities Markets. Supervision and Regulation

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1 Introduction and Opening Address

Julio Segura
Chairman of the CNMV

This book commemorates the twentieth anniversary of the CNMV's foundation. This is, therefore, a good occasion to review how Spain's securities markets have developed over this period and also to reflect on the challenges which remain in terms of financial integration and the adaptation of regulatory and supervisory structures.

To that end, it was decided to commission an analysis of the last 20 years in Spain's financial markets from an indisputable authority in the field and also to hold an international conference with the participation of chairmen of securities commissions and experts in the markets, coinciding with the annual meetings of the IOSCO Technical and Executive Committees in Madrid. This book contains that retrospective analysis together with the papers read at the conference.

1 20 years of history

In the last 20 years, Spain's financial sector has experienced a sweeping transformation coupled with rapid expansion with the result that it is now highly competitive and solvent and fully integrated into international capital flows, as evidenced by the percentage of trading and investment represented by foreign investors.

But let's take things in order. I will first discuss the institution's inception, and then the future challenges.

Two items of data indicate the remarkable progress of the Spanish stock markets in these 20 years. In 1990, annual trading volume amounted to slightly less than 10% of GDP; today, it amounts to 150%. And in the same period, market capitalisation has risen from 20% to 73% of GDP.

What factors led to this expansion? How did this all begin?

Twenty years ago, in 1988, Spain initiated a reform of its securities markets, articulated around the approval of the Securities Market Act.

It pursued two goals: to address the problems arising from Spain's disperse and obsolete regulations and adapt them to the needs of a modern market in a world with practically free movement of capital; and to strengthen the market with a view to consolidation of a European capital market in 1992, a process in which Spain

wished to play a role commensurate with its level of development.

A centrepiece of the reform was the creation of the CNMV as a public agency with independent legal status and responsibility for monitoring and supervising the securities markets. The CNMV's duties were to ensure the transparency of the securities markets, proper price discovery in the markets, and investor protection, guaranteeing the availability of all the necessary information.

The newly-created CNMV got to work with 15 professionals in a rented apartment in an old building in central Madrid.

In these 20 years, the efforts of many people have helped to build the solid institution that we enjoy today: 6 Presidents, 8 Vice-Presidents, 28 Commissioners and, above all, many highly qualified professionals have worked very hard in order to build an efficient organisation with a strong reputation in the domestic markets and among international organisations.

In this period, the CNMV has evolved to adapt to the major developments in Spain's securities markets and changing macroeconomic situations. In the 1980s, after the intense crisis that began in 1979 had been surmounted, and with Spain's full accession to the European Union in 1986, the Spanish economy benefited from a combination of factors that facilitated the development of the domestic markets and laid the foundations for the solid financial system that we enjoy at present. Five factors in particular are worth mentioning:

1. The process of financial liberalisation that increased capital movements.
2. The reorganisation of the various types of credit institution to eliminate barriers to competition.
3. A fiscal policy designed to encourage the development of certain institutions, such as collective investment.
4. A situation of unprecedented macroeconomic stability.
5. The implementation of new technology in parallel with developments in other countries.

The entry into force of the Securities Market Act in 1988 led to a number of measures aimed at making Spain's markets more competitive and helping them to adapt to the new economic framework. These include, in the area of market infrastructures, the 1988 reform of securities brokerage in which the pre-existing freelance brokers were replaced by financial institutions under the supervision of the CNMV; the implementation in 1990 of an interconnection system (electronic market) that combined trading on Spain's four markets; and the replacement in 1992 of securities certificates with book entries, which did much to facilitate trading.

In the area of financial innovation, two of the most notable milestones were the great expansion of collective investment institutions starting in the early 1990s, both in the number and type of institutions and in the volume of assets under management, and the first regulation on securitisation in 1992, which set standards for the development of a market that is today one of the largest in Europe, ranking second, after the UK, in total issue volume.

Whereas most efforts during the 1990s were devoted to ensuring a smooth transition to the euro, attention early in the 21st century focused on improving the single financial market on the grounds that greater integration was essential for the success

of the euro and European Economic and Monetary Union. The Financial Services Action Plan (FSAP) was the key milestone in this period.

The CNMV devoted considerable efforts to advising the Spanish government on transposing the Directives arising from the FSAP and to preparing the necessary implementing regulations. Simultaneously, with particular intensity in recent years, the CNMV has been actively involved through CESR in promoting consistent application of the new regulations in Europe and advancing in the convergence of supervisory practices.

We live in a world in which markets are increasingly interconnected and huge conglomerates operate, most of whose transactions are cross-border, which indicates that international cooperation between supervisors is vital to ensure effective supervision. For that reason, the CNMV considers it is essential to participate actively in the international bodies dealing with securities market supervision and has worked with the Government to strengthen Spain's role in this area, offering facilities to international bodies to locate their headquarters in Spain and providing all the necessary support for their work. The Instituto Latinoamericano de Mercados de Valores (IIMV) set up in Madrid in 1999, and it was followed by IOSCO in 2000 and the Public Interest Oversight Board (PIOB) in 2005.

2 Challenges in the future

After 20 years of existence, the CNMV has reached the end of an era, but it also faces a number of challenges in the future.

The markets are increasingly interconnected, as evidenced by the recent international financial crisis, which arose in a modest segment of the US mortgage market (subprime) and spread rapidly to the financial markets in every country, even to institutions not directly exposed to those risks.

The crisis came after a lengthy period of very expansive financial and macroeconomic conditions. Record low real interest rates and ample liquidity encouraged savers and investors to accept high levels of risk and leverage. There was also an intense process of financial innovation, exemplified by enormous growth in complex structured products, which were rated leniently by the agencies. These products were often mortgage-backed, did not consume regulatory capital and had a complex composition that rendered them relatively opaque. The process was reinforced by rapid growth in income and employment, a sharp increase in asset prices and generous credit, all enabling delinquency to remain very low.

In this economic and financial framework, the result was that banks eased lending standards both for mortgages (hence the subprime loans) and for M&A by private equity firms. There is strong empirical evidence that lower lending standards are ultimately reflected in a bank's bottom line and solvency after a lag of four to five years, when sufficient risks have been accumulated and economic and financial conditions tighten; that is exactly what happened.

Is there any distinguishing feature in this financial crisis? Possibly the intensity and speed with which two phenomena have occurred. Firstly, the spillover effect, through which companies not directly exposed to subprime risk were severely affected. Secondly, poor functioning by the price discovery system, leading to the practical disappearance of trading in certain assets and, in particular, the dearth of

action in the private fixed-income market, evidencing a major crisis of confidence.

This essentially belies the optimistic theory that, in any circumstances, any complex financial product will have a deep and continuous market, i.e. guaranteed liquidity. The construction of increasingly complex baskets of products in order to find buyers more readily than if individual buyers and sellers of each component in the basket had to matched made it ever more difficult to value these products, some of which were only available to buy-and-hold institutional investors, thus reducing the products' liquidity.

As a result, we market supervisors find ourselves in a situation in which financial innovation has greatly improved the scope for managing business risks and for savers to diversify their portfolios, but in which the final distribution of risk and the valuation of financial products are much more opaque.

The crisis has triggered an intense international debate, on both an academic and policy level, which has analysed the lessons to be learned from the experience and proposed measures to avoid the weaknesses in the future.

I will not discuss this area in detail since I am sure that the speakers who follow me today will do so from a position of deep knowledge and expertise, but I would like to mention the five points that I consider to be most relevant within the current debate, whose solution constitutes the main challenge facing supervisors and market participants at this time.

1 Improving transparency. A situation like the present one, involving a clear crisis of confidence, always indicates a transparency deficit. And transparency is not just a goal of market supervisors in itself; it is also the best tool for improving investor confidence and investor protection. Transparency needs to be improved in three aspects:

    - Firstly, there is insufficient or deficient financial information about companies, which raises doubts about their real situation; this is related to another issue that I will discuss shortly, namely: the accounting principles used in financial reporting. It is hard to restore confidence if there are doubts as to the extent to which the information that companies release accurately reflects the effects of the crisis on their results and equity.

    - Secondly, there is insufficient or deficient information about instruments such as structured products, whose complexity and importance have increased exponentially in recent years, whereas the information provided about them to investors has not been as transparent as would have been desirable. It is difficult to restore confidence if investors do not have accurate knowledge of the type and amount of the risks they are really assuming when they buy an asset.

    - Finally, there is defective or inadequate information on how, when and at what price transactions are conducted in some markets, primarily private-sector fixed-income securities. It is difficult to restore confidence if there are major uncertainties about what the assets are worth, especially relatively illiquid assets.

2 Rating agencies. The agencies' performance in 2007 has raised doubts about the extent to which they have become part of the market failures that detonated the crisis; those doubts had already been expressed in the crisis at the turn of the

century. Sharp, often belated, and occasionally poorly-supported changes in the ratings of certain products undoubtedly helped catalyse the crisis and, in some cases, may have been indicative of conflicts of interest. In this context, regulators are currently assessing the most effective response. In particular, the European Commission has issued a consultation paper that calls for the adoption of a set of substantive requirements for rating agencies to be authorised and operate.

3 The importance of international harmonisation of accounting standards. We live in a world with two financial reporting systems. Many countries have adopted IFRS, but US GAAP is still the benchmark for the bulk of the capital markets. However, the FASB and IASB have designed a work programme to achieve convergence between the two sets of accounting principles, which is necessary to attain uniform, comparable financial information throughout the world.

4 The need to improve information exchange and coordination between supervisors. Because of the interdependence of national economies and the financial markets and, in particular, of the growth in international securities trading, particularly cross-border transactions, international cooperation between different types of supervisors and between national supervisors is now vital.

The present situation has led to a redefinition of the concept of financial stability and of the various authorities' involvement in overseeing it. Increasingly, crises do not stem from solvency problems at a particular institution; rather, they arise in the markets and eventually bring solvency problems to the surface. And while it is true that only governments and central banks have the tools to address problems of insolvency, securities supervisors have a key role to play in both preventing and monitoring crises.

Moreover, supervision of the markets, where large financial conglomerates operate mainly on a cross-border basis, requires increasing coordination between supervisors in different countries. International organisations of securities market supervisors, such as IOSCO and CESR, have made great efforts to strengthen cooperation and have made very significant progress towards convergence in supervisory practices, which is a key factor in minimising supervisory arbitrage. However, I believe much remains to be done to achieve greater coordination, particularly in converging supervisory practices and the power to enforce the international bodies' recommendations and agreements.

5 The architecture of national financial supervision. The Spanish government has recently announced plans to implement a "twin peaks" model of financial supervision, which represents the main challenge of adaptation that the CNMV faces in the short term.

The broad range of financial supervision systems worldwide can be divided into three categories:

- The traditional model, in which a separate body is in charge of full supervision of each of the three financial subsectors: banking, insurance and securities markets.
- The single supervisor model, in which one institution (not the central bank) is responsible for overseeing all financial institutions, in terms of both solvency and conduct.
- The "twin peaks" model, in which supervision is divided between two agencies

which pursue different objectives. One of them, normally the central bank, addresses issues of solvency and micro-prudential supervision. The other, a financial markets authority, deals with compliance with the rules of conduct by all market participants.

Since the sector-based model has been rendered obsolete by developments in the world financial system, the Spanish reform had to decide basically between the single supervisor and the twin peaks models. Spain's current model is basically sectoral, with three supervisors: the Bank of Spain, the CNMV, and the Directorate-General of Insurance and Pension Funds, which is an organ of the Ministry of Economy and Finance. But, as I have just mentioned, the government plans to implement the twin peaks model; in my opinion, it is the one that is most suited to Spain's situation because of both the simplicity of its institutional design and of the fact that a single institution retains responsibility for micro-prudential supervision and aggregate stability, which has a long tradition and major synergy in Spain.

This poses a fundamental challenge for the CNMV in the short and medium term, since the reform requires it to assume major new responsibilities: protection of bank customers, insurance companies' clients and mutual fund investors, and supervision of conduct in the entire insurance industry. I hope that my successor will be able to celebrate the CNMV's 30th anniversary by showing that the institution proved able to fulfil those responsibilities and to rise to those challenges.

These issues are discussed in depth elsewhere in this book. Firstly, Gonzalo Gil, currently a director of Banco Pastor, discusses the transformation experienced by Spain's financial markets in an extensive and well-documented article. His enormous experience in financial matters, backed by 40 years at the Bank of Spain, where he held numerous positions in a number of areas—studies, operations, markets, payment systems—and where he was Deputy Governor between 2001 and 2006, is a guarantee of the quality of that paper.

It is followed by the presentations given at the international conference which the CNMV organized in September 2008 to celebrate its anniversary, with the participation of many securities supervisors from IOSCO member countries. The third section contains the papers that were read at the conference in order to put the securities markets in a global perspective. In this section, Jane Diplock gives us an overview of the prospects for financial market supervision and regulation worldwide from her twin perspective as Chairman of New Zealand's very innovative Securities Commission and as Chairman of IOSCO's Executive Committee. Kathleen Casey, Executive Director of the US Securities and Exchange Commission, reflects on the contribution by accepted accounting languages, such as IFRS and data exchange languages, to market integration. The second section is concluded by Joaquín Almunia, who gives his insight into financial regulation and supervision from a European perspective, an area with which he is not only fully conversant but also one which he has helped to shape as European Commissioner for Economic and Monetary Affairs, that is to say, the person responsible for coordinating and supervising the European Union's economic policy.

The fourth section of the book addresses the process of financial market integration and contains the roundtable discussions on this subject. The first speaker was Carlos Arenillas, former Deputy Chairman of the CNMV, who presented the roundtable on the role of various international institutions in financial integration. José Massa, Chairman of Iberclear, set out a range of measures for integration and reviewed

European initiatives for advancing in this direction. Alberto Giovannini, Chairman of Unifortune Asset Management, offered his views on the integration process, which he considers to be driven more by legislators than by the market. Professor Giovannini was chief adviser to the European Commission's Clearing and Settlement Advisory and Monitoring Expert group (CESAME) and was the prime mover of a study into the barriers faced by integration (since referred to as "Giovannini" barriers). Concluding this section is Eddy Wymeersch, Chairman of CESR and of Belgium's Banking, Finance and Insurance Commission, who proposes a number of programs that might serve as inspiration for improving cooperation between supervisors in different countries.

The final section of the book contains the closing address by Pedro Solbes, Spain's Deputy Prime Minister and Minister of the Economy and Finance, who reflects on changes in the institutional framework of the securities markets and outlines the proposed reforms to financial supervision in Spain.

I would like to thank all the contributors to this book for their generous assistance and all those who helped make the 20th anniversary celebrations a success, particularly Commissioner Soledad Abad, who coordinated the international conference. I would also like to thank all the staff at the CNMV, whose hard work and dedication have enabled the commission to build on a solid foundation and gain a good reputation in the markets and among its fellow supervisors. My thanks also to all current and former commissioners.

I trust that readers of this book will find it of interest and will join me in celebrating the CNMV's 20th anniversary.

2 The Spanish Financial System: current situation and medium term prospects

Gonzalo Gil
Counselor of Banco Pastor and ex Deputy Governor of the Bank of Spain

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Several people have kindly responded to my request to provide information, discussing confusing points, contributing suggestions and finally reviewing various part of the work. Also, N. García and F. Restoy have read the complete text in detail and their shrewd observations have contributed to its improvement. If errors have slipped in despite everything, the responsibility is obviously mine only, and the same with respect to the opinions put forward. I would therefore like to thank J. Aríztegui, J.M. Gómez. N. García, M. Martín, S. Núñez, J. Pérez, J. Priego, F. Restoy, J.M. Roldán, J. Saurina, J. Segura and F. Vargas for their help.

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I Introduction and Summary

The purpose of this work was clear and fully defined at the outset, but as stresses in markets –beginning with the subprime crisis in the United States and rapidly transmitted to the financial systems of other countries– acquired more gravity and their effects were amplified by the downturn in the general macroeconomic situation, clearly led by the decline of the real estate market and a rapid process of energy price rises, the general panorama changed and become more complicated in all respects, including preparation of this work.

In the case of Spain, compounding of the effects referred to played a special role. The driving force and key to our economy has for many years been the real estate market –development, construction and housing acquisition– which, propelled by favourable conditions in real interest rates, underwent accelerated development, accompanied by a strong increase in debt. The change in cycle which slowly began to appear from 2005/2006 has accelerated, accentuating the decline in the real estate sector and strongly affecting the deterioration in the macroeconomic situation.

Furthermore, although our Financial System is solid and the products, mechanisms and business models which provoked the crisis in the US were not involved in its operation, it was still affected since the crisis spread rapidly given the high degree of connection between global financial markets.

This accumulation of circumstances altered the situation in our financial market and, since the purpose of the work was and continues to be an analysis of its situation and functioning in a global environment, it became necessary to modify the initial approach, which will, hopefully, make the exercise more interesting.

The work is in two parts. The first, "Structure and Evolution of the System", briefly examines the elements which have configured our Financial System up to the present time. There have been three events in our recent history: the Moncloa Pacts, the banking crisis at the end of the 1970s, and our adhesion to the European Economic Community, which constituted the underlying bases of a process which in the last 25 years has facilitated a complete transformation of the Financial System. A system which, immediately before these events occurred, was given a very positive assessment in the evaluation exercise carried out by the International Monetary Fund/World Bank in all aspects of its structure and functioning, and in adequate compliance with all international standards.

The three processes were of a very different nature. Two of them are directly connected with crucial events to our country: the first, covering the initial democratic elections to signature of the Moncloa Pacts, gave rise to an important reform process which had begun timidly years before; the second, linked to all European Union development processes, led us to the current situation, some features of which are dealt with later on. The third, the outcome of the conjunction of a rapid process of liberalisation which broke the existing institutional deadlock and a situation of

economic crisis, gave rise to the most serious banking crisis which our country has experienced. Over 50 banks were affected at a time when there were no adequate instruments to tackle a crisis of this type. The lessons learned from these events led somewhat later to promulgation of the Act on Discipline and Intervention of Credit Institutions *(Ley de Disciplina e Intervención de las Entidades de Crédito)* which has been the basis of the supervisory powers of the Bank of Spain up to the present time.

The second part, "Looking to the Future", has one thread which runs through it, being the potential changes which may take place in our Financial System in the immediate future as the result of three series of factors which will be examined separately. I assume it will not be necessary to clarify that it is not a question of an exercise in intervention, but simply of analysis and interpretation of processes of transformation, already under way in some cases, and the possible outcome of proposals still at the development stage in others. Three areas are examined, completely different in their nature, content and effects. Their development, not simultaneously but within a fairly limited time span, will have very important effects on the structure and functioning of the System. A simple glance at their headings illustrates their content: "Lessons, responses and changes resulting from the subprime crisis", "Changes resulting from implementation of the European Agenda" and "(Spanish) Economic and financial evolution: scenarios for change". In this introduction various sufficiently brief, and I hope interesting, comments will be made to stimulate interest in continuing on to the body of the document and discovering what is not dealt with here.

Lessons, responses and changes resulting from the crisis

It seems generally accepted that the subprime crisis was, in its beginnings, the product of a series of failings which, with a greater or lesser degree of responsibility, can be attributed to all agents involved in markets; from institutions and their operators to authorities responsible for supervision/regulation, and taking in rating agencies. It is true, and appropriate to say it, that even though all systems have eventually been contaminated, neither actions prior to the crisis nor reactions after it have been comparable; neither supervisors/regulators nor institutions have acted in the same way in all financial systems.

Is this crisis new? It can of course be said that the recent crisis is different in the specific details of its development and in this respect it is "new"; this is not the case, on the other hand, if we look at the generic characteristics of the processes which were developing in its gestation period, since features can be found in them of other previous crisis processes which are well documented.

Surprising crisis? It is not a crisis which has arisen without prior indications that something was amiss. In the years before it erupted, during its years of gestation, there were alarm signals which were not heeded. Years before it took place the problems and their risks had come to light, but processes of euphoria are difficult to cut short during their development stages, as we are all fully aware moreover with our experience in markets. Corrigan was right when he said that whilst experience and history enable us to identify a certain common denominator associated with financial shocks, the specific triggers and transmission channels which produce contagion are always impossible to anticipate with a minimum degree of precision. It is no less necessary to try, however. This happened in this case and there have been a

large number of exercises in analysis of the crisis which have led to an overwhelming number of measures of all types to increase the "resistance" of the system and be somewhat better prepared for the next one.

The crisis in markets has highlighted the need to have an effective system for controlling liquidity. The virtual total disappearance of liquidity in all markets has been a genuine surprise to supervisors and institutions. It is thus fairly obvious to conclude that there was no system for treating this type of risk.

Under normal circumstances, i.e. in an environment free from stresses beyond those of normal banking business, there is confidence in the existence of available financing and therefore the liquidity risk is under-assessed. The appearance of structured products, designed to be held long term and not for the purpose of obtaining immediate financing, developed with a high degree of opacity, raised problems of valuation and this affected their liquidity. The rapid move by investors to parallel markets in search of disappeared liquidity increased stresses in the latter when settling open positions, which generated strong demand stress. The reference indicators of these markets lost their capacity for interpretation and this all increased their opacity. With the contagion "market liquidity" disappeared and any transaction became impossible. In this process there was a rapid contagion to the "financing liquidity" of individual institutions. The "market risk", although prolonged in time, was transformed into "financing risk", which can give rise to a solvency problem insofar as institutions are obliged to sell assets urgently and suffer a capital loss in order to meet their liabilities.

In this situation, only action by central banks in supplying liquidity is capable of putting the process back on back on course and maintaining the functioning of markets, not without difficulty as we are seeing. As mentioned in the work, they acted rapidly by liquidity injections. All their reactions, highly related to the structure of liquidity provision prior to the crisis, will contribute to perfecting the instruments which constitute the first line of action by central banks. For the present, the benefits have already been illustrated of participation by a substantial group of counterparties, particularly in cases of crisis, the importance of abundant collateral of adequate quality, and the desirability of acting over a broad range of periods of granting liquidity.

As well as the immediate effects referred to in the previous point, the crisis has had more long term effects and brought to light various more profound problems, particularly in the financial systems of the USA and Great Britain, which are frequently used as an example of good functioning. The apparent failures in Tripartite coordination (Treasury, FSA and Bank of England) and the difficulties experienced by the Bank of England and the Financial Services Authority (FSA) on the one hand, and the rescue and intervention operations by the Federal Reserve on the other, give rise to a series of reflections, not only regarding the practical functioning of their systems in this crisis but also more general strategic aspects.

The actions of the Federal Reserve –the rescue of Bear Stearns, the new liquidity facilities for investment banks and primary dealers, the exchange of Treasury Bonds for less liquid assets, etc.– have certainly been useful in mitigating the effects of the crisis, but they raise a series of questions regarding the validity of the traditional orthodoxy we have more or less lived with up to now. The situation is completely new as what is in reality being raised is extension of the "systemic perimeter", since due to the processes of concentration and interrelationship of markets a web has

been created in which the size of an institution is not so important as previously, smaller institutions can now become systemic and this is one of the aspects which has led to the current crisis. What is suggested now no longer, or not only, relates to operational aspects but also, on a fundamental basis, to a prior step, which is the decision to intervene. The extension of the role of lender of last resort is on a general plane reopening the currency of concepts such as "moral hazard" and "constructive ambiguity", etc., which although continuing to be firmly rooted in ideology, are increasingly eroded by the evolution of financial systems.

Furthermore, the US Treasury has announced a reform plan which deals with changing its current supervisory/regulatory structures, which are highly fragmented and with coordination problems, as has recently been illustrated.

The most immediate repercussion of the crisis in markets, apart from the United States, occurred in the British Financial System and materialised early in the problems of one bank, Northern Rock. Its characteristics –dominant position in the mortgage market, financing in short term credit markets– made it hugely sensitive to these disruptions, as rapidly demonstrated when a cessation took place of securitization business and a closure in financing markets.

The vicissitudes through which the bank passed, explained in the work, led to a nationalisation or, as the Chancellor put it, possibly not wishing to raise spectres of the past, "a temporary move to the public sector".

Since implementation of the institutional supervisory structure –change from a model of separate supervisors to another more consolidated model which occurred during the first years of this century– this is perhaps the most important crisis episode faced by the Financial Services Authority (FSA) and the Bank of England. Apart from the failings of the FSA, responsible for supervision of all entities in the system –which there were, very important and acknowledged by the institution itself– and the doubts raised by the action of the Bank of England at the beginning of the process, questions have again arisen relating to coordination in the Tripartite Authorities and the decision taken at the time by the authorities on relocation of supervisory powers from the Bank of England, taking them away from this institution and moving them to the FSA. Although this is of course highly arguable, and a diversity of models exist, it must be acknowledged that the events described provide foundation for defending the role of the Central Bank in the supervision of institutions, based on practical reasons. On this basis, this work defends the position maintained above regarding the importance of the Central Bank, not only in periods of crisis but in the long periods of normal functioning in which the elements of strength and weakness of systems are forged. Only continuous day-to-day contact with operation of the system enables its internal functioning mechanisms to be ascertained, possible problems anticipated, and their effects perhaps mitigated when they appear. It could be argued that the foregoing can be learned, and this is true, but what is not so easy is to transmit it and learning it takes considerable time. This is argued in the body of the work in more detail.

With respect to possible reform of the well-known Spanish supervisory model, it could be said that up to now the current model has functioned correctly and has tackled the scarce episodes of major crisis reasonably. There are also different reasons for not considering it appropriate to modify the model in the direction of an integrated supervisor of the type established at the time by the Great Britain Financial Services Authority (FSA), and the purpose of the discussion in our case must thus be

directed towards perfecting and greater coherence of the current structure of Spanish financial supervision. This work argues that this improvement should take place in the direction of consolidating a "Twin Peaks" model as close fitting as possible, since intermediate systems frequently accumulate defects in the two extremes. This would mean less drastic changes, examined in detail in the text, given our current structure in respect of which there is a certain theoretical consensus.

The proposals for reform raised by the Financial Stability Forum (FSF) include that of strengthening the action of regulatory and supervisory authorities in order to develop common action in the treatment of banking groups which act in different jurisdictions and sectors. These are in any event initiatives which are already under way within the EU, both by Community authorities and the private sector, and what the FSF raises is giving greater impetus to these efforts and a more international character. The origin of the concern is fairly clear: banking groups with operations in different jurisdictions, which play an increasingly major role in the unification of financial markets, are subjected to a series of restrictions and regulations which, deriving from different supervisors, are usually different and hamper development of the activities of those in a strongly competitive environment.

The most important step in this direction is provided by the Capital Requirements Directive (CRD), which in a series of articles configures the "consolidated supervisor", with a series of characteristics and functions which raise it as the key supervisor of a banking group with cross-border activities. The Committee of European Banking Supervisors is working on its content (Lamfalussy Level 3) and has developed a series of guidelines which will facilitate practical functioning of the CRD proposals. The industry (European Financial Services Round Table) has, as mentioned previously, also been working along the same lines for some time, on proposals which increasingly lean towards convergence with the Community proposals.

The problems deriving from the subprime crisis gave rise to a series of explanations and allocations of responsibility regarding the origin of the event. One of the most misguided was that which attributed an important part of responsibility for its occurrence to the Capital Accord (Basel II). This allocation of responsibility is based on two fairly obvious errors of different nature: firstly geographical, and secondly conceptual.

Regarding the former, it can be said that due to the long process of discussion by US supervisors regarding Basel II and its implementation, the Accord has not yet come into force in the USA. If Basel II had been implemented, the crisis would probably still have occurred but some of its problems would have been mitigated. The second allocation of responsibility, and the second error, maintains that the "models" of the Accord have not known how to discern problems and are not capable of establishing adequate monitoring of risk control by institutions; the Accord is not however a guide as to how banks must organise their business and the capital requirements established in it must assist in the creation of suitable incentives for risk takers and promote their good general treatment, nothing more.

The situation nevertheless makes it advisable to introduce changes based on the lessons learned, and this does not constitute a failure of the Accord; on the contrary, its capacity for adaptation, which will have to take place with or without crises, constitutes a basic element which favours its function of providing the Financial System with a reinforced resilience.

Independently of the correct or incorrect attribution of errors, the fact is that crises will continue to appear and what is most sensible is to be prepared as far as possible to deal with them. One catalysing element of the crisis was displacement of the banking business model from the "traditional", in which everything was held on balance sheet and total financial business was channelled through it, towards a model of "origination/distribution" in which the most important mediation process takes place in the market through the operations of a large group of institutions which produce the majority of assets and transfer them by complex and frequently opaque securitization mechanisms placed in off-balance sheet structures. The use of this model has given rise to the generation of new risks which have contaminated all sectors. It is therefore necessary to reconsider use of the model such that the problems indicated can be corrected, strengthening risk management and undertaking a reassessment of risks which cannot be gauged with traditional systems.

The Basel Accord is a suitable framework for assessing the importance of some of these problems and seeking a solution by inclusion of the necessary adaptations in it, as part of a more general adjustment process. Transformations have begun of the three pillars of the Agreement along these lines.

Transparency, asset valuation rules and the activities of Rating Agencies converge in one form or another in Basel.

Transparency to a large extent depends on the knowledge of managers of the instruments with which they work and this, which seems obvious was not so much the case with the subprime problem. If an understanding of them is not complete it is difficult for them to be subjected to an exercise in transparency; supervisors could have forced this, but this was not the case. A more consistent, quantitative and qualitative transparency of financial institutions is the path towards recovery of confidence in markets. This is the line which Basel is reinforcing through its Pillar 3.

In any event, it does not cease to be paradoxical that in the period in which the crises were gestating, and perhaps somewhat earlier, efforts towards transparency were abundant and standards or codes of all types proliferated and all international institutions, national authorities, banking supervisors, securities market supervisors, Basel, the IMF, etc. drew up a large quantity of rules supporting transparency; but the "transparency crisis" nevertheless occurred in these circumstances. This at least merits a reflection which does not attempt to question the fact that there is a need for transparency, which is undoubted, as well as the need for continuously updating it. It is a question of considering at this time, when additional reinforcement will be made in this area, whether on occasions these efforts by means of accumulation will not be transformed into an instrument for concealment and opacity. Put more directly, a qualitative transparency with adequate monitoring is essential for the functioning of institutions and markets, but not what we could call cumulative transparency which could give rise to the opposite effect.

Changes deriving from the European Agenda

Apart from the changes which can be expected in our financial system resulting from analysis of the consequences of the crisis in markets, and the reforms proposed to try and avoid its repetition, there is another continuously flowing source originating in application of the European Agenda for Construction of the Single Market. This work does not attempt to cover the Agenda in all its richness and therefore focuses solely on various proposals, at different degrees of development and nature, which

will affect markets and their infrastructures. The initiatives in progress, examined in the corresponding sections of the work – MIFID, Code of Conduct, TARGET2 SECURITIES and Single European Payments Area (SEPA)– will give rise to major changes in their functioning and favour their integration in European markets.

The Markets in Financial Instruments Directive (MIFID) has as its objective promoting construction of a Single Market for all transactions in securities, whether wholesale or retail. This Directive is possibly the most important catalyst for change in markets in the immediate period. The search for competition and operational equality between all existing markets, transparency in all aspects and at all stages of, and a wide series of rules to ensure investor protection are the elements comprising the body of the Directive.

The undoubted benefits of entry into force of the MIFID are difficult to exaggerate. Consequently, and in order to take full advantage of their implementation, it is appropriate to introduce the necessary adjustments into our system to promote its application. Various parts of our system –registration and settlement of Spanish equities– may stand in the way of full application of the Directive, preventing our markets from benefiting from all its possibilities. On the other hand, delay in implementing the necessary reforms could have a negative effect and may give rise to processes of relocation of dealing and settlement.

The Code of Conduct, which is voluntary, encourages the industry to adopt measures which eliminate the fragmentation produced by the "Giovannini barriers" and consequently enhance competition among post-trading systems. Transparency of prices and separation of services are the instruments for eliminating these barriers. The benefits of speed, being a Code and not a Directive which would take longer to promulgate, may be hampered by the fact that there is no initial establishment of minimum requirements acceptable to all, an element which could delay its implementation. For the organised post-trading system in Spain, adoption of the Code should not raise problems since Iberclear complies with it with its participants.

The increasingly more acute contradictions between a retail payment system, fragmented nationally, and a European economic area equipped with market unity, have been the stimulus for development of the initiative for a Single European Payments Area (SEPA) whose purpose is to eliminate all differences between national and cross-border payments, creating a single market for payments in euros, such that European citizens can make payments from a single account, using a single series of payment instruments, with the same simplicity as in the national area.

Plans for securities market and payment systems infrastructures (TARGET 2 and TARGET 2 SECURITIES) seek to eliminate the fragmentation of infrastructures of securities markets and the integration of wholesale payment systems throughout the EU. With respect to payments, work began many years ago with the creation of TARGET, a gross real time settlement system, which linked the systems of all central European banks under common standards, but with a limited degree of integration such that basic tasks remained with them. The development of this system, which was highly satisfactory, faced an increasingly consolidated environment which led authorities to propose its full technical centralisation, and thus in 2007 TARGET2 was created, which facilitates equal conditions amongst all European banking institutions and the concentration of liquidity in a single cash account, which makes cash handling more agile. With the improvement in efficiency and security of the payment system, the inadequacy was highlighted of the existing fragmentation in

forms of security settlement and a project was commenced, TARGET2 SECURITIES, which seeks integration into a single platform of the securities accounts of central depositories and in which combined settlement will be concentrated of securities and cash accounts.

The broader scope of the market, in which the foregoing projects were born, has also been transformed. Indeed, the trading and post-trading situation (registration, clearing, settlement) of securities has been modified in more recent years, with consolidation processes of unequal intensity at different stages (more intense in trading than in post-trading) taking place by mergers and acquisitions at national and international level. This movement has also taken place in Spain, but exclusively in the domestic sphere, by creation of the Stock Exchange and Markets Holding Company.

In relation to these processes of change and consolidation it is worthwhile considering the benefits or drawbacks of incorporating them, although if they are excessively delayed there would be clear risks from my point of view. In this respect there should be reconsideration, if this has not already taken place in the light of all consolidation and change processes analysed, what the immediate future of the Holding Company should be and to what extent there are factors in our system which make the decision difficult. The existence of "peculiarities" in certain areas of our domestic practice may be unnecessarily preventing or delaying the participation of Spanish systems in consolidation processes which are taking place in Europe, in both the trading and post-trading field. There is one specific Spanish feature along these lines which makes an integration decision difficult, which will eventually have to be taken, relating to equity settlement systems. This is the survival in our system of various equity practices which should have been eliminated some time ago: firmness at the time of trading instead of at the time of settlement and linked to the existence of Registry References. This all gives rise to a situation in which integration of the Spanish system into European projects of this type becomes difficult.

Economic and financial evolution: scenarios for change

The work ends with an analysis of the situation of our Financial System geared towards its possible evolution in the immediate future. In recent years the evolution of our system has been exceptionally good, as evidenced by all indicators –profit, return, solvency, efficiency, etc.– normally used in assessment of systems throughout the world.

All factors which have been contributing to strengthening the System are rapidly changing however, and this will condition development of our system for which a stage of uncertainty is opening up. During all this time the element driving the Spanish economy has been evolution of the mortgage market (construction, development and acquisition of housing). The macroeconomic situation in these years and favourable evolution in real interest rates have permitted its rapid development and a strong increase in debt.

Given the important dependency in our development model on general economic conditions in relation to evolution of the real estate market, a decline in it, such as that which is taking place, has negative effects for the general macroeconomic situation, and the Financial System as part of it. If we add to this rapid worsening of the macroeconomic situation the effects of the international situation, the rapid contagion of the subprime crisis which began in the United States with the disappearance

of liquidity and rapid rise in energy prices, we have a series of factors which point towards a major change with respect to the evolution which has taken place in recent years in our Financial System.

In this situation Spanish institutions will in the short term have to tackle the risk management which is implicit in the process of macroeconomic downturn. As the construction cycle shows clear signs of exhaustion, institutions will have to redraw the structure of their balance sheets in accordance with the new environment by a reduction in the relative weight of real estate, an increase in the financing of non-financial undertakings in other sectors, and reorganisation of credit to families with a relative increase in the higher credit quality segments. Together with this a reassessment of obtaining wholesale financing in international financial markets and an increase in capturing funds in the retail market, etc., are some of the possible courses of action which institutions will be aware of better than anyone. This change of strategy will inevitably make it necessary to tackle the evolution, or rather reduction, in profit and loss accounts.

In the medium term the question arises of the business model which, given the different nature of the institutions which operate in our system, will raise different difficulties for banks and savings banks. With respect to the latter, it is perhaps the time to make progress in correcting various specific features of their regulation and method of management, which would facilitate their adaptation to the new environment in which they have to operate.

Although less intensively than in the banking system, in other sectors of our Financial System –securities and insurance– the effects are also being felt of all these factors referred to.

II Structure and Evolution of the System

1 Background

Albeit in simplified form, taking into account that the process described forms part of an ongoing whole which goes further back in time, two periods can be highlighted which over the last 25 years have recorded the passage of a Financial System subject to very detailed regulation and highly inefficient to another which is more open, free and effective, and within it passage from a central bank totally subject to government directives, and therefore executing a passive monetary policy and equipped with few instruments, to an independent bank which develops a more active policy, which culminated in the present situation of single Monetary Policy and disappearance of the peseta, replaced by the euro.

Both periods are directly linked to crucial events for this country: the first covering the initial democratic elections and signature of the Moncloa Pacts, which gave rise to a major process of reform focused on establishing an economic policy with medium term objectives and the consensus of all agents, and the second, linked to all European Union processes, which has led us to the current situation, some features of which will be dealt with later.

Around the initial years of the first period, and faced with heavy entry of capital induced by international monetary disruptions –including the first two oil crises (1973 and 1979)– which fomented monetary expansion and inflationary pressure, the Bank of Spain (BS) undertook a series of reforms to recover control of liquidity, using market mechanisms non-existent until that time. It thus formulated a broad monetary objective, established a cash coefficient, supported the negotiation and formation of prices in markets, created new instruments, monetary regulation loans, and developed the money market. It was from the Moncloa Pacts that the transformation became more intense however and took place through various paths: strengthening of Monetary Policy instruments –unification of cash coefficients, establishment of auctions in liquidity injections; progressive liberalisation of active and passive interest rates in the banking system; progressive elimination of mandatory investment coefficients; improvements in the payment system; establishment of public debt issues and creation of a modern public debt market; uniformity of all institutions in terms of their operations and full autonomy to engage in their business and increase in ex post supervision, and liberalisation in opening branches; opening up the national market to foreign banks, which in turn effectively contributed to the development of financial innovation; reorganisation of official credit, creation of new financial intermediaries and strengthening of securities markets.

The conjunction of a rapid liberalisation process, as indicated, which led to a breach of the existing institutional blockage, coinciding with a situation of economic crisis, gave rise to the most serious episode of banking crisis which our country has under-

gone. Over 50 banks were affected at a time when there were no suitable instruments to tackle a crisis of this type. It suffices to consider that the Deposit Guarantee Funds (DGF) were created at the beginning of the 1980s (1980 banks, 1982 savings banks and cooperatives), largely coinciding with the crisis referred to, in order to help overcome these situations. The lessons from these events later gave rise to promulgation of the Act on Discipline and Intervention of Credit Institutions (*Ley de Disciplina e Intervención de las Entidades de Crédito* – Act 26/1988) which has been the basis of the supervisory powers of the Bank of Spain up to the present time.

The second period, which began in 1985 when Spain joined the European Economic Community, heightened the foregoing transformations and introduced new ones which radically changed our system. As from that time the most important transformations in the Financial System are a direct consequence of the unanimous desire to join in fully to the process of European integration.

Entry of the peseta into the European Monetary System (1989) put an end to a period of flotation and the existence of duality in Monetary Policy objectives which had produced constant imbalances and led to the 1992 crisis. The creation of the European Central Bank (ECB) in 2002 and the participation of Spain in it gave rise to legislative changes in the functioning of our Central Bank. Act 13/1994, by which full autonomy was given to the BS for design and instrumentation of Monetary Policy geared to maintenance of price stability and disappearance of monetary aggregates, fixing short term variable interest rates, and a system of auctions for liquidity supply, were the elements which made a change possible in the manner of doing things more in conformity with the new situation. The legal institutional changes referred to were accompanied by increased rigour in fiscal policy, more favourable interest and exchange rate prospects, salaries more aligned to inflation objectives and a more favourable economic situation, all factors which permitted Spain to join the first group of countries when the European Monetary Union was created in 1999. At the beginning of the year the Common Monetary Policy was put in place for all member countries of the EMU, designed by the ECB, with redenomination of all currencies in euros having taken place on the change of year (Act 46/1998). The physical conversion of notes and currencies would take place in 2002 (Rojo, A., 2005).

With respect to the Securities Market, this period was also decisive and marked a transition point from markets with scant infrastructures and fragmented supervision to others which, after the initial impulse, developed quickly and for the first time in our country a genuine securities market began to appear, which as from that time would develop in unison with the Financial System as a whole.

In 1988 the Securities Market Act (*Ley del Mercado de Valores* - Act 24/1998) came into force, based on which transformation of these markets began. "Stock and Exchange Agents", which already represented at that time an anomaly in relation to the functioning of these markets in other fields, were replaced by financial institutions, Securities Brokers and Dealers, supervised entities with own funds requirements which would operate in the sector after complying with a series of conditions.

At the same time the single supervisor of security markets appeared, the Spanish National Securities Market Commission (*Comisión Nacional del Mercado de Valores* -CNMV), with objectives entrusted to it by law: transparency of security markets, correct price formation and the investor protection. As from that time a series of processes developed which led to the current situation.

Indeed, in the final years of the 1980s and beginning of the following decade a definitive impulse was given to development of market infrastructures –Book Entry Public Debt, creation of the SIBE, AIAF and MEFF– and to clearing and settlement with the Book Entry Centre (CADE) and the Securities Clearing and Settlement System (*Sistema de Compensación y Liquidación de Valores* - SCLV). Special attention is merited during this stage to creation of the Single Market and the IBEX 35, and dematerialisation of certificates with replacement by book entries. All these factors, together with the entry of Spain into the European Monetary System (EMS), made investments in Spanish assets very attractive for foreign investors, and this accentuated the presence of non-residents in securities markets (Stock Exchange and Debt). Finally, other markets were created for trading in futures (oil) and organised trading systems such as the Latibex and SENAF.

In the final part of this period, and virtually up to the present day, the structure of securities markets has undergone fairly major changes. The events which triggered the change were firstly elimination of the exclusivity of Dealers and Brokers as members of Stock Exchanges and therefore other financial intermediaries, in particular credit institutions, gained access to them, and on the other hand the demutualisation of Stock Exchanges. This gave rise to the process of unifying ownership of governing companies of markets which led to creation of "Bolsas y Mercados Españoles", the holding company of "Mercados y Sistemas Financieros, S.A. (BME)". The process culminated with flotation of this Company on the Stock Exchange in 2002 (Martínez M. and Rodríguez V., 2007).

From then on the international processes of consolidation and merger of Stock Exchange companies, the union of clearing and settlement mechanisms, the growing presence of European legislation, and in particular all initiatives deriving from the Financial Services Action Plan, together with cooperation with other national and international banking, insurance and securities regulators (Joint Forum, Level 3 Lamfalussy Committees) marked the development of securities markets in parallel with what was happening with other components of our Financial System.

Subsequent years have continued to record important changes in the Financial System, the causes of which include the elimination of all restrictions on capital movement, deregulation guided by the idea of greater confidence in market principles, extension of the range of financial instruments, the internationalisation of markets and the disappearance of borders between traditional sectors –banking, insurance and securities– technological innovations in communications, growing sophistication in markets and all in a process of globalisation capable of transmitting the positive effects deriving from the dispersion of risks which made an increase in the resilience of the system possible, but also, as we can see, a loss of control and growing opacity of processes which has led to disruption of markets with episodes of stress which are still ongoing when preparing this work.

2 Market Structure

The Spanish Financial System is made up of three different groups of institutions which operate in different but increasingly integrated markets of varying importance: the banking system, pension funds and insurance, and securities markets.

As indicated in Annex 1[1], within financial institutions the dominant group is that of Credit Institutions (*Entidades de Crédito*), with 77% of total assets. Looking solely at the group of credit institutions, banks represent 60% of assets, savings banks 25% and the rest belong to cooperatives and other credit establishments. Based on a very profound process of deregulation since the end of the 1970s, the system has undergone very rapid consolidation, creating a highly competitive environment, maintaining high indicators of efficiency and accentuating its international presence, particularly by banks. Internally they have given impulse to a strong orientation to the "retail", with a very wide network of branches and highly developed and solvent securitization processes which have permitted very intensivee access to savings, both national and international.

The strategies of the different groups have been different; thus, whilst savings banks have strengthened their industrial holdings, banks have expanded abroad, all without overlooking the demands for financing required by an economy which in recent years has experienced a strong process of economic growth and creation of employment.

Whilst the operational possibilities of the three groups of institutions are the same, as well as their regulation and supervision, this is not the case with ownership systems. Compared with banks whose system of ownership is the normal system (shares), savings banks do not have shares and are obliged, in order to feed capital, to use profits not kept in investments or in social and charitable projects. This situation of not being listed on the stock exchange and therefore not being able to be purchased (or not being able to be purchased with the ease with which other institutions can be), added to the asymmetry that they themselves can purchase, means an absence of elements of market discipline and transparency which are crucial to the functioning of markets and which therefore should be corrected. On the other hand, the existence of these two blocks of institutions has given a major stimulus to competition in national markets.

The generic name Securities Market includes a series of markets –equity and public and private fixed income– and the institutions which operate in them –Collective Investment Undertakings (CIUs) of a financial nature, CIUs of a real estate nature, and hedge funds. Together with these, there are the Investment Services Firms (ISFs) which comprise Securities Brokers and Dealers and Portfolio Management Companies.

As a result of their importance, Investment Funds should be highlighted which, with a total of 2,954 Funds, cumulative assets of 255 billion million euros and a total of over 8 million participants (2007 figures) and along with Investment Companies, 3,290 in number and with assets of 30.3 billion euros, are the principal agents in these markets, particularly Funds[2]. Their evolution, as we will see later, has been conditioned by the evolution of national and international markets, although maintaining a solvent position.

Under the regulation of the CNMV, financial instruments are all traded in different trading platforms and markets, previously with separate and independent action

1 In its first section the annex shows the structure of the complete Financial System by assets and of the Banking System in particular. The remaining information relates solely to the latter. Annexes 2, 3 and 4 contain information on the structure and composition of securities markets.

2 See Annexes 2, 3 and 4.

but which have undergone a process of consolidation, culminating in creation of “Bolsas y Mercados Españoles (BME)”, which concentrates all trading and post-trading activities (registration, clearing and settlement).

The Spanish insurance segment comprises 330 undertakings, most of which are joint stock companies (227), with the rest being mutual associations and a small number of Social Benefit Mutual Societies. The “non-life” sector is dominant in this market, absorbing between 50% and 60% of the 45,000 million euros of premium income in the sector, and within it the motor class is the most important.

The situation in the sector is healthy, its portfolio of assets is predominantly fixed income and operating patterns in the sector are in line with current international practices. It has resisted some problems in the recent past –falls in interest rates and adverse movements in securities markets over 2001-2003– and shown a high degree of resistance. Furthermore, there is also a public Insurance Compensation Consortium (Consorcio de Compensación de Seguros) which provides cover for extraordinary risks as a supplement to private policies and reinsurance and coinsurance in the agricultural field.

In recent years a private system of Pension Funds has developed which, of a conservative nature, has achieved very substantial levels (around 8% of GDP in recent years and 9.3 million participants, compared with 1.8 million five years previously). Demographic growth and the growing level of employment explain this increase, which is in any event limited given the compulsory nature of the public pension system.

An essential aspect of suitable development of markets is the security provided by secure and efficient infrastructures, basically the Payment and Clearing and Settlement Systems, to which we will return later.

3 Institutional structure of Regulation/Supervision

Regulation and supervision of the Financial System has three components which, albeit with a close connection between them, are each concerned with a particular area. Credit institutions are the responsibility of the Bank of Spain, securities markets are supervised by the Spanish National Securities Market Commission and insurance companies are subject to supervision by the Directorate for Insurance, which is part of the Ministry of Economy (ME).

With respect to credit institutions, it is the BS which is responsible for their supervision and regulation. The law clearly lays down the Ministry of Economy as the source of regulation of institutions, which establishes “delegations” to the Bank of Spain and exercises other aspects directly (very serious penalties must be approved by the ME, as with the revocation of licences, although the Bank of Spain itself proposes the corresponding penalty to the ME).

The system of prudential regulation and supervision geared to risk in any event satisfactorily complies with the Basic Principles of Basel for effective supervision. Capital requirements are adequate and more intensive than those established by international standards. The basis of supervision is a very stringent classification of loans and very strict rules for provisions and procedures. The intensive presence of supervision of the Bank of Spain in banks (on-site) is complemented by a very broad Risk Centre which permits specific monitoring of portfolio credit risks. In 2005 the

International Financial Reporting Standards (IFRS) were adopted, and the CAD (Basel II) is in a process of implementation at the present time.

The three types of institution which make up the banking system –banks, savings banks and cooperatives– .function. under the same supervisory system and are not basically subject to differences. Some do exist however in the case of Savings Banks as a result of the characteristics of these institutions, whose origins in and links to Autonomous Regions explain why the latter preserve various regulatory and supervisory powers (governing bodies, transparency, consumer protection, etc.), compatible in principle with the supervisory capacity of the BS which is common to the system as a whole in relation to solvency and financial stability.

The procedures for resolving potential problems on integration into the Eurosystem, are common. Apart from the standing facilities of the ECB, the BS can provide liquidity assistance to institutions with problems, outside the Eurosystem, but when this intervention could have implications for the whole area then consultation with the ECB Board is required. There is an exceptional procedure in the law which entitles the BS to appoint a manager with veto powers over all operations of the institution and replace the management of the company in the event that protection of depositor assets so requires.

There is furthermore a Deposit Insurance mechanism established in accordance with the lines of the corresponding directive. In the Spanish case, there are three deposit guarantee funds (one for each group of institutions) with identical rules whose actions are not limited to paying deposits in the event of a crisis but they play a much more active role in their treatment. They can even, by law, contribute to the capitalisation of an institution with problems. There is an agency which administers the three funds, and each of them furthermore has a board of eight members (four BS and four from the institutions belonging to the Fund in question). In the last 17 years intervention by the Fund has been fairly effective, but fortunately limited: five banks and seven savings banks have had to make use of the DGF. Only in one of the five banks was the institution closed, a small one, and the DGF had to meet the expenses, the amount of which was recuperated at the time of its liquidation. All funds are financed in advance on the basis of contributions by institutions.

Securities markets are supervised by the Spanish National Securities Market Commission (CNMV) –an autonomous public body– created by the Securities Market Act. The CNMV is supervisor of all undertakings which provide investment services, without excluding those credit institutions which are active in financial markets but solely in relation to this activity (see later for coordination). Transparency and investor protection are its principal tasks together with ongoing monitoring of practices and operations in the securities market. As with the BS it carries out intensive off-site supervision based on the information required from market entities and complemented with on-site components principally aimed at the areas of greatest potential risk. It also has an Investor Guarantee Fund. It complies adequately with the principles of IOSCO on good regulation and supervision of securities markets (IOSCO is the international body which advises competent national bodies in this field).

With respect to regulation, source powers, as with the case of the BS, are held by the Ministry of Economy which draws up and approves the prudential rules which the CNMV is responsible for implementing. Likewise, in the case of very serious penalties and the grant and removal of licences, the power is held by the Ministry

of Economy, although the proposal may originate from the body responsible for supervision.

Insurance and Pension Funds are supervised by the Directorate General for Insurance which forms part of the Ministry of Economy.

4 Governance and rendering accounts

With respect to the BS, its basic legislation consists of the 1994 Autonomy Act which reformed the previous law in force by reason of creation of the European Central Bank (ECB) and the incorporation therein of the Bank of Spain. This meant autonomy of the Bank in executing Monetary Policy. Subsequently, with creation of the Monetary Union this function was taken over in full by the ECB by decisions of its Board in which the governors of national banks participate, and with national banks being responsible for its instrumentation.

The second basic legislation is the 1989 Act on Discipline and Intervention of Credit Institutions (*Ley de Disciplina e Intervención de las Entidades de Crédito*), which is the basis for all supervisory action of the BS. The rules governing self-governance of the BS are the Internal Regulation of the Bank of Spain approved by the Government Council in 2000.

The governing bodies of the Bank comprise: (a) the Governor and Deputy Governor, appointed by the Government, with a non-renewable mandate of six years in both cases, (b) the Governing Board, comprising the Governor and Deputy Governor, six Members appointed on the proposal of the ME, with a mandate of six years each renewable once only, the Directorate General for the Treasury and the Deputy Chairman of the CNMV, and, with the right to speak but not vote, the General Managers of the Bank, its General Secretary and Personnel Representative, also without a vote, (c) the Executive Committee, comprising the Governor and Deputy Governor, two Members of the Governing Board appointed on proposal of the Governor, and the General Managers, without vote, and the General Secretary, also without vote.

In the case of the CNMV, its basic legislation comprises the 1999 Securities Market Act, the Act on Collective Investment Undertakings (*Ley de Instituciones de Inversión Colectiva* – 2003) and the Risk Capital Act (2005). Governance of the Institution is based on its Internal Regulations approved by its Board.

The governing bodies of the CNMV comprise: (a) the Chairman and Deputy Chairman, appointed by the Government, with a mandate of four years renewable once only, (b) the Board of the CNMV, made up, as well as by the Chairman and Deputy Chairman, by three Members appointed by the Government for periods of four years, renewable once only, and by the Director General for the Treasury and Deputy Governor of the BS, both by reason of their position, (c) the Executive Committee, made up of members of the foregoing Board, except for the representatives of the Treasury and the BS, (d) a Consultative Committee, chaired by the Deputy Chairman and made up of 17 members representing the different markets (which deals with circulars, very serious penalties, licences, etc.).

For its part, the Directorate General for Insurance is governed by basic legislation made up of the Act on Regulation and Supervision of Private Insurance (*Ley de Ordenación y Supervisión de Seguros Privados* – 2004) and the Act on Regulation of Pension Funds and Plans (2002).

Given its nature, it does not have governing bodies along the lines of those referred to for the previous supervisors. It has a Director General appointed by the Council of Ministers.

All bodies are under an obligation to submit reports on their management to Parliament at least once each year. The Governor of the Bank and Chairman of the CNMV must also account to Parliament as often as it may require.

5 Sector coordination

The Spanish Financial System has three separate supervisors and coordination between them takes place at both national level and in the global framework of the EU.

In the national field, the three supervisors have between them signed bilateral Memorandums of Understanding (MOUs) and they have all in turn signed collaboration agreements with the Executive Branch for the Prevention of Money Laundering and Monetary Infringements (SEPBLAC). The objective is to coordinate actions in those areas of activity which are common to them. With a similarly bilateral procedure they have established MOUs with all those countries in which Spanish financial institutions have a presence. These agreements previously existed on a voluntary basis but the Act on Reform of the Financial System (2002) established rules for collaboration and transparency which naturalized their status.

Their content relates to all activities regulated and supervised in their daily work. Their operation is very flexible: day-to-day activities, exchange of information on matters of common interest, etc., take place by direct contact of the corresponding professional teams. There are furthermore regular meetings (at least once each month) of the highest level representatives of the institutions. An additional element of collaboration is provided by exchange of directors: the Directorate General for the Treasury and the Deputy Governor of the Bank of Spain sit on the board of the CNMV whilst the Board of the Bank of Spain includes participation by the Directorate General for the Treasury and the Deputy Chairman of the CNMV.

The purpose of these Agreements is not to prevent and treat crises, which takes place by another procedure.

In the general course of activities of all EU institutions Financial Stability has become a priority objective and along with it concern for and implementation of activities for the prevention and treatment of crises. In recent years development of the Lamfalussy scheme with its extension to the three sectors and a series of formal Accords and Collaboration Protocols between different institutions and payment systems have reinforced aspects such as information exchange between supervisors, closer collaboration between them and central banks, etc., in relation to both times of normal activity and potential crisis situations.

The most important step in this field, aimed directly at the prevention and treatment of crises, took place in June 2008, when the Cooperation Agreement between Supervisory Authorities, Central Banks and Ministries of Finance of the European Union came into force (on cross-border financial stability).

This new agreement replaces that approved in July 2005. Its content is broader than the earlier one and it will be applied both during normal times –in order to reinforce preparations to deal with a potential crisis– and in crisis situations which affect the

stability of the financial system of any Member State with the possibility of systemic contagion in others[3].

Pursuant to decisions under the agreement prior to that now in force in Spain, a Financial Stability Committee (CESFI) was created (June 2006) which also includes the insurance and securities supervisors. It has now been operating since that time –supported by systematic exchange of information between members and strengthening the instruments to preserve financial stability and prevent crises– and the Committee deals with financial prospects in a regular manner, analyses regulatory implications and their potential reforms and promotes exercises in stress, crisis simulation, etc. (Vegara, 2006).

Apart from the foregoing, one matter remains to be mentioned with is laterally related to the foregoing processes, but which could have repercussions for the manner of solving crises. This is the institutional structure of financial supervision in the EU. It is an open question whose treatment has been taking place in the institutional framework of the Union and whose importance has been strengthened, as well as its urgency, as a result of the problems deriving from the subprime crisis. The reform responds to the fact that increasingly more European markets and institutions acquire greater global weight and are more integrated, whilst supervisory structures continue to be basically national despite very substantial progress in recent years.

6 Recent evolution of entities in the Financial System

6.1 Banking System

Spanish deposit institutions have undergone a long period of continuous expansion in their activities, high profitability and solvency levels fanned by an expansive economic cycle which started in 1994, after leaving behind the recession in the Spanish economy. During this period there was significant growth in the Spanish banking market, with considerable expansion of regional institutions beyond their traditional geographical areas of influence and with a growing internationalisation which has translated into a substantial presence of major banking institutions in Latin America and also the rest of Europe.

During this long period two important factors can be mentioned in the evolution of our Financial System. Firstly, there has been a process of concentration or consolidation in institutions and markets which has been fundamental in development of the system. Indeed, the acceleration at the beginning of the 1980s and joining the euro zone fomented rapid growth in financial service activities, a strong degree of competition between institutions and a major process in their consolidation. The number of institutions has tended to fall in recent years and the market share of those of larger size has increased. This concentration process has been stronger with banks

3 In very summary form the agreement contains: 1) its definition and scope, 2) common principles for treatment of a cross-border crisis (protecting stability, primacy of private solutions, no guarantee to use public money, etc., 3) cooperation agreements which at national level will be based on coordination groups already established (the CESFI, for example in our case) and the "parties" who share common concerns for financial stability must establish Cross-Border Financial Stability Groups, 4) method of activating procedures and delineation of responsibilities in a cross-border crisis, 5) levels of information exchanged, 6) public communication, its organisation and coordination in the event of crisis, 7) establishment of contingency plans, simulation exercises and stress tests. It should be indicated with respect to the nature of the agreement that it has no legal force, its provisions do not imply any type of mandatory action nor the adoption of specific decisions faced with a crisis.

than with savings banks.

In the same respect there has been a noteworthy concentration of activities on both the liability and asset sides. Approximately 75% of liabilities come from capturing deposits, both national (55%) and non-resident (20%). The expansion of credit has been much greater than that of deposits and with a strong focus on mortgage lending. This has accentuated the gap between financing and source of resources which has given rise to the major securitization processes which have taken place.

This has been complemented by one particular characteristic of our banking system, which is the attention shown to the retail business, backed by a large network of branches throughout the country. The existence of two segments (banks and savings banks) with similar operating capacity but of a different nature and form of ownership has introduced a strong degree of competition in the system, and despite the increase in concentration has substantially improved levels of efficiency.

With respect to securities markets, since conversion of physical certificates to book entries a process of dematerialisation of securities has developed, in which increasingly more developed information technologies and advances in telecommunications have made it possible to exploit economies of scale, scope and of network in the financial industry, and thereby fomented a process of integration and consolidation of securities markets, both in dealing systems and in those of clearing and settlement. It is true that this has been a process whose development, in most international securities markets has, albeit with particular features in each case, had an orientation led above all by the evolution of markets. If we limit ourselves to the European Union framework, we must add to the impulse given by the market forces previously indicated the "political objective" of bringing about the Single Market which has accelerated the integration of market structures at different levels, both in the European sphere and at national level[4].

In this context, and on the lines mentioned, in our country there have also been major changes taking concrete form in creation of the BME Group ("*Bolsas y Mercados Españoles, Sociedad Holding de Mercados y Sistemas Financieros, S.A.*") which has meant the integration of trading and post-trading structures under a single entity. Iberclear was created as the central national securities depository to manage the two major settlement systems which exist in Spain, one for fixed income and the other for equities. The table (see Annex 4) shows the organisation of Spanish securities markets after their integration.

From a long term perspective, mention should also be made of the development of foreign investment by credit institutions. After a long period in which Spain was basically a recipient of foreign investment, the situation changed and from the mid-1990s our integration accelerated in international markets and our system was transformed into a net exporter of investment.

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4 The background of regulations in this area starts with the Financial Services Action Plan which contained a series of measures to bring about consolidation of the market in the EU and promulgation of the Financial Services Directive (1993) which created the "European passport" and liberalised access by undertakings authorised in one country to membership of markets regulated in another. It was subsequently complemented by other directives until the Market in Financial Instruments Directive (MiFiD) which came into force in 2007 in Spain; for the time being it suffices to indicate, since reference will be made to it later, that this Directive establishes a new framework of competition for security markets, with the ultimate objective of contributing to creation of an integrated and competitive European Financial Market.

Two characteristics of this evolution merit highlighting. Firstly, the volume of these investments. At the beginning of the 1990s cumulative investment abroad represented 3% of GDP whilst in 2006 this percentage had increased to 41% (the average worldwide in that year was 26% and in developed countries 21%).

Secondly, the existence of geographical and sector patterns should be emphasised, with two distinct stages:

- In the second half of the 1990s (1995-2000) investment was focused in Latin America (45% of flows). Expansion into new markets, taking advantage of privatisations and deregulation or an attempt to gain access to raw materials and natural resources were the stimuli for the process. Cultural proximity also played a role. The second target was the EU (40% of flows).
- In the second period (2001-2006) there was a reduction of intensity in Latin America, partly because of the high level reached and decrease in the privatisation process and the financial crises at the beginning of this period.

  Participation in the EU was revitalised however, particularly in Great Britain. As a result of this Latin America fell to 15% on average for the period whilst the EU increased to 66%. On the other hand, direct investment in emerging Asian countries and new EU members is very small.
- In addition, concentration on the financial, telecommunications and service sectors has been very intensive and overall represents 70% of total foreign investment during the period.

The evolution in the banking system has been considerable and if, apart from the previous trends, we focus on the last three years, the characteristic features which define our system can be summarised as follows: total assets of Spanish deposit institutions grew between December 2004 and December 2007 by 62%, highlighting a very favourable evolution in bank balance sheets. At the end of 2007 total assets of Spanish deposit institutions exceeded 3.3 trillion euros. This growth was devoted to financing businesses and families. In December 2007, 70% of the balance sheet was resident private sector credit (63.5% in December 2004). A very significant part of this credit is devoted to the real estate sector in the broad sense: financing developers and construction companies together with credit for families to acquire housing.

The strong growth in credit was not accompanied to the same extent by the evolution in traditional deposits (cumulative growth of 46% from December 2004) which, moreover, have lost relative weight in overall financing (from 49.2% to 44.3% of the total balance sheet). The growing difference between credit and traditional deposits was covered by wholesale markets. In this respect, Spanish institutions have protagonised the issue of mortgage bonds and securitizations. At the end of 2007 Spain occupied second position in the European bond market, only behind Germany, and the second in the Asset Backed Securities (ABS) market, behind only the United Kingdom. It should be indicated that Spanish securitizations responded in particular to the desire to obtain liquidity and, to a much lesser extent, that of transferring

5 In the Financial Stability Report of April 2008 the Bank of Spain indicated that on average the Triple A tranche of securitizations represented 93% of the total securitized. Consequently, for this tranche to enter losses default probability levels are required more than three times higher than those seen in 1993 and losses in the event of default of the order of five times those of 1993 (in this part the assistance of Jesús Saurina has been fundamental).

credit risk[5], and therefore the problems caused by the subprime crisis have not taken place with them, but by means of contagion of markets.

This has been the case for several reasons. Firstly, because regulation is very stringent and obliges institutions which transfer credits, but continue to bear part of the risks, to make provisions as if the asset had not been securitized. Secondly, because the purpose sought in the Spanish case was basically, as we saw previously, having a source of additional financing to enable the existing gap between deposits and credits to be covered.

As well as this, absence of use of the orientation/distribution banking model has enabled risk to be maintained on the balance sheet, and therefore banks have had adequate incentives to maintain a rigorous policy. In short, there has not been a separation between the grant of credit and risk management[6].

In addition, Spanish securitizations have various characteristics which have distinguished them from the securitizations which were the source of the crises which began in the United States[7].

Firstly, in Spanish schemes loans linked to the mortgage market predominated as underlying (in 2006 these represented 83% of the total balance), and secondly Spanish securities have a high quality (a moderate LTV of 70%, the ratio between the value of the loan and that of the dwelling financed) due to the fact already mentioned of the low risk of the underlying; virtually all mortgage loans have a low default rate, very low levels of effective losses in the event of default and they are loans of high amount. Furthermore, the fact that institutions retain the majority of the risks also contributes to their quality. This is all translated, moreover, into the allocation of high ratings by Rating Agencies[8].

The favourable economic environment in which institutions have moved, both in Spain and abroad, explains the low level of doubtful assets shown at the end of 2007: 0.78% of credit investment. This low default rate was complemented moreover by a high coverage by means of insolvency provisions, the outcome of a degree of rigour with which the Spanish banking supervisor treated institutions, even in a regulatory framework which invited the contrary.

The expansion of bank balance sheets combined with a favourable economic cycle has been translated into strong growth in bank profits. Thus, in 2007 Spanish deposit institutions showed an attributed net profit of somewhat over 30 billion euros, a figure which in itself speaks of the high profitability of Spanish banking.

Return on equity (ROE) in 2007 was around 20%, a level maintained in recent years. This places Spanish institutions amongst the most profitable in Europe, despite the

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6 Where this has occurred a parallel market appears in which instruments taken off the balance sheet of institutions are consolidated with another type of instrument, giving rise to what some have called "markets in complex pieces of paper" which nobody is aware of or controls and which was the initial source of the present subprime crisis. As also seen in the recent crisis, the belief in insulation of the original issuer has been illusory and they have been obliged to assume substantial losses, whether for reasons of prestige or the existence of various agreements for the grant of support credit facilities if necessary.

7 The position of Spanish banks and the nil effect of the subprime in 2007 results is illustrated when comparing the pre-tax results of the two major Spanish banks (levels around 20%) with those of US and European banks, whose results have fallen or they have even suffered losses (EF).

8 Furthermore, this element of "security" is not going through its best times in the light of the ratings of these agencies in development of the subprime crisis in the USA. See later for treatment of the "problems" with rating agencies).

fact that the Spanish banking market is one of the most competitive in the continent.

The high profitability of Spanish deposit institutions has been based on a very high and growing degree of efficiency together with a very favourable evolution in the banking business, not only in terms of volume of transactions but also in improvement in providing services with greater added value. In this respect an important characteristic should be indicated of the Spanish financial market –already mentioned previously: there is high "bankisation", an element which translates into a very high presence by deposit institutions in the distribution of not strictly banking financial products. Spanish banks, savings banks and credit cooperatives thus control around 80% of the assets of investment funds, 50% of pension funds and a significant percentage of insurance companies in the life and mixed classes. This enables Spanish institutions to increase cross-selling of products in their branches and optimise very large and highly integrated networks in the country which, moreover, constitute a fundamental component in the provision of proximate banking services, something which Spanish customers, both lenders and borrowers, value highly.

In more detailed manner, the intermediary margin of Spanish deposit institutions in recent years was around 1.8% of average total assets, a figure which does not show a high differential between return on assets and cost of liabilities. Consequently, the profitability of Spanish institutions at the present time does not, unlike what may be happening in other European markets, derive from a lack of competition.

The foregoing is reinforced when analysing the relative weight of commissions to average activities (around 0.75%) in recent years. In relative terms, in other words in relation to volume of activity, commissions have not tended to increase in the Spanish banking system, contrary to the conclusion obtained if looking solely at absolute figures. Again, the profitability of Spanish institutions comes to a large extent from evolution of activities and the provision of value added services to customers.

The ratio of operating expenses to average total assets has tended to fall in the Spanish banking system. This improvement in efficiency, partly due to the good evolution of the business, explains a large part of the high profitability of Spanish institutions. The efficiency ratio, the ratio between operating expenses and ordinary margin, in December 2007 was thus 45.5%, almost 10 percentage points less than some years previously. This efficiency ratio is one of the best in Europe. Competitive pressure is probably the best mechanism for disciplining both business strategies and costs.

Insolvency provisions have not been low in recent years. This is not due to problems of default rate but to a system of provisions which, on the border of what is permitted by the IFRS, is conceived as a prudential and in turn transparent mechanism. On comparing the default rate in the Spanish banking system with other neighbouring banking systems the contrast is highlighted between a low default rate in Spain and the same or slightly higher provisions. This translates into a far higher coverage of doubtful assets in Spain, which has logically contributed to reinforcing the stability of the Spanish financial system, in particular since the turbulence in international financial markets began last summer.

A high profitability together with maintenance of a relatively stable pay-out has enabled the solvency of Spanish deposit institutions to be reinforced in a period of

strong growth in bank balance sheets, both organically and by acquisition of Spanish and foreign institutions. The strong growth in credit has nevertheless slightly eroded solvency ratios, which in December 2007 were 11.4% compared with 12.3% in December 2004. The basic solvency coefficient (the tier 1 ratio in regulatory jargon) was 7.5%, just 40 basis points below the level three years ago.

In short, recent years have shown a very favourable evolution in the Spanish banking system, partly based on the cyclical evolution of the Spanish economy and, for institutions with a significant presence overseas, of the international system, and as a result of a management of institutions which has not lost sight in general of the movements in costs and the business opportunities offered by the economic evolution.

Despite this positive balance, it should in turn be indicated that the Spanish banking system faces complicated situations in the immediate future, largely as a result of the difficulties being experienced by international financial markets as well as the general and Spanish macroeconomic situation and ongoing increase in energy prices.

6.2 Securities Market

In the most recent period securities markets have maintained a situation of instability characterised by major elements of uncertainty and a substantial increase in volatility. The different markets and agents which constitute the basis of this part of our financial system have evolved differently and have also been unequally affected by the problems deriving from the international financial crisis.

In the equities field there have been more intensive price corrections in real estate and financial sectors, with a general increase in volatility, with companies in the telecommunications sector being those which have acted as refuge.

With respect to public fixed income, the considerable increase in risk premiums, reduction in liquidity in markets and moderation of issues have been some of the most noteworthy characteristics of its evolution in this period. This was the outcome of the flight towards quality recorded as a result of the turbulence which has had the result of a substantial reduction in interest rates on long term public debt. Private fixed income spreads have increased substantially with respect to public. One important factor has been the reduction in issues and operations in markets deriving from the hardening of financing conditions for undertakings, an evolution which, as we will see in another part of this work, has led to substantial problems in asset valuation.

To the foregoing must be added the lack of confidence in structured products (even though in our system products similar to the subprime have not been used) which has affected our securitization market in terms of both trading volume, which has fallen, and in issues placed. This movement has been partially made up by the increase in securitization bonds used as security for refinancing operations in the BS.

With respect to the evolution of agents in markets, this has also been unequal: with Investment Funds and real estate collective investment undertakings being most affected and, to a much lesser extent, hedge funds (Investment Services Firms - ISFs).

A comment is required on the former. For some time (2006) Investment Funds have

been recording substantial repayments due to the fiscal change which reduced their comparative advantage in relation to other savings products, with a further contribution moreover from the increase in interest rates. Development of the crisis in markets which began in the USA aggravated this situation, which gave rise in 2007 to resources leaving Funds in excess of 20,000 million euros. This volume exceeded the return obtained by their portfolio which led to a fall in aggregate assets, which in turn dropped by over 5% of the figure in the previous year.

At the same time however, these agents have various characteristics which serve as protection, such as a low risk profile (despite a recent, albeit slight, increase in investment with increased risk) and a high liquidity. A recent report from the CNMV[9] assesses in detail the exposure of these agents to the international financial and mortgage crisis. It can be summarised thus: holdings directly related to the subprime mortgages are minimal: 14 collective investment products had "affected" assets which represented 0.01% of total assets, and furthermore investment in reduced liquidity products only affects 6% of the portfolio.

The report concludes that the "scant general exposure to instruments of difficult transferability, together with the high availability of very liquid assets, such as deposits and repos, which vary between 15% and 18% of total assets, suggest that in general Spanish financial collective investment undertakings are facing the current situation with sufficient room for manoeuvre" (CNMV, 2008).

With respect to real estate collective investment undertakings, the same trend can be seen towards stagnation, although somewhat more acute. Their assets did not fall but their increase (1%) in 2007 provides a significant contrast to the growth rates of previous years, 35% and 50%, respectively, in 2006 and 2005. The deceleration in the Spanish real estate market and its greater or lesser velocity will be determining when assessing risks, taking into account that it is of small size (3% of the total assets of collective investment undertakings commercialised).

Finally, the hedge funds (IIC de inversión libre) and Investment Services Firms (Securities Brokers, Dealers and Portfolio Management Firms) recorded an increase in results and in general have very comfortable solvency margins.

7 The outside view: FSAP

The financial crises of the 1990s, and in particular the Asian Crisis, were the origin of the creation of exercises in financial system assessment (FSAP)[10]. Their development and the speed at which they spread to different systems generated a state of concern which was translated into various initiatives to strengthen the international financial architecture, emphasising transparency and early detection of vulnerabilities in the system.

The collaboration between different agents, markets, countries, international organisations, etc. gave rise to a series of projects for change –as has occurred in the

9 The CNMV has begun half-yearly publication of a study into "Securities markets and their agents: Situation and Perspectives" included in its Quarterly Bulletin –the first study appeared in that for the first quarter of 2008–. It should be congratulated for this initiative, which will contribute to a better awareness of our securities markets and its agents, and at the same time will serve to supplement other existing reports. This part of the work was basically prepared from the report referred to.

10 Financial Sector Assessment Program

recent crisis– in particular, for present purposes, the Financial Sector Assessment Programs of the IMF and WB, and the preparation of international standards by the responsible International Organisations which, with support of the corresponding governments, sought an extension to the greatest possible number of countries of operating rules geared to improving the resistance and response capacity of the different systems.

The two instruments thus complement each other, since international standards are one of the tools used by the IMF/WB assessment program to analyse financial systems and recommend possible strategies for the prevention, or if necessary treatment, of crises[11].

Over the course of 2005, at the request for the Spanish authorities, the assessment took place of our Financial System which, following its normal methodology, was carried out under the direction of a team from the IMF/WB which worked together with the Spanish supervisory/regulatory authorities and with participation of a good number of financial institutions. In 2006 the exercise was completed and its results published, and all resulting documents were placed on the IMF website (www.imf.org).

The methodology of the exercise is in line with the objectives of the program "to measure the capacity and resistance of the system, reduce the possibility of systemic crises, limit the severity of crises which may eventually occur and solve existing weaknesses" (Baliño, 2006). In order to achieve these objectives it uses quantitative tools -stress tests[12], indicators of the health of the system– and qualitative tools –assessment of compliance with international standards– as well as the existing mechanisms for preventing and handling a crisis.

In its preparation the exercise had characteristics which increase its importance beyond the specific results and reinforce its consistency: (a) it is a "joint" task of a cooperative nature in the sense that not only staff of the two organisations participate –since standards of other institutions are used and experts not belonging to the Fund or the Bank participate in missions– even though they are not responsible for the program, (b) the results of the exercise are included in the annual IMF report

11 Up to now this voluntary exercise has been carried out in 103 countries (the most significant exception continues to be the USA). The highest degree of participation is from Europe and the American continent.

12 In the case of our system "stress tests" were carried out which measure the impact of different shocks on the seven most important financial groups, some carried out by institutions using their own internal models (2/3 of total assets of the System) and others with credit institutions as a group, carried out by the FSAP and BS team.
In order to measure the resistance of the System scenarios of greater tension were designed in order to calibrate the responses of market risks, interest rates, credit and liquidity. The effects were also studied of various adverse macroeconomic scenarios on credit institutions: a fall in housing prices in Spain, cumulatively over two years, of 21% and 28% respectively; an increase in oil prices to 80$/barrel, a fall in the dollar of 30% and a crisis in Latin America.
Overall the results of the exercise were as follows:
It was concluded that the System was "resistant" and was well prepared to absorb the losses associated with substantial but isolated adverse factors, and multiple shocks deriving from adverse macroeconomic scenarios.
The "stress tests" indicated the importance of the credit risk for some institutions, but without threats to capital. The most severe scenario, of deterioration over a three year period, resulted in average losses equivalent to 13% of the Basel regulatory capital.
Savings banks in general showed greater sensitivity in the exercises to the adverse shocks and crisis sce-

on the country, thereby establishing the necessary link between the analysis of the fundamentals of the financial system and the economic evolution of the country in question, thus providing more complete knowledge of it, (c) as stated previously, the exercise seeks to analyse the stability and degree of development of the financial system, attempting to identify vulnerabilities in it, but in no event is it intended to judge or assess individual institutions and therefore particular care is taken in order to carry out global analyses which do not directly or indirectly permit the identification of specific institutions.

The purpose of this part of the work is to indicate how our Financial System is seen from a third party perspective, along with its strengths and weaknesses, and the assessment exercise produced very satisfactory conclusions whilst at the same time indicating various points susceptible to improvement. This exercise took place some time, almost a year, before the crisis caused by the US subprime and deterioration in the general macroeconomic situation which commenced as a result of the real estate crisis and closely linked to the crisis in markets. The solidity of the fundamentals of our system, highlighted in the report referred to, does not insulate it against the problems and crises which have developed in markets since last August, nor the problems related to the real estate crisis, which is not surprising after a drawn out process of rapid and excessive growth in this sector in Spain.

In various parts of the work the strong points of our banking system are mentioned, and therefore there is no need to repeat them. Nevertheless, nothing indicates that things will not change, it is clear that they will and in fact are already doing so, which will oblige the banking system and financial system in general to reconsider many of the strategies followed up to now. I will return to this point in the final part of the work.

All these characteristics were set out in one form or another in the FSAP exercise and various vulnerabilities in the system were shown up, which I will mention later. Although the quotation is somewhat long it is worthwhile reproducing the general conclusion of the assessment of our System as formulated in the Report on the Spanish Economy (IMF, Art. IV of 2006) "...the Spanish Financial System as a

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narios (a reflection in part of their industrial holdings and exposure to mortgage and developer loans).
The relatively low impact of the "stress tests" is the outcome to a large extent of the solidity of the System, but in the opinion of the IMF is also influenced by application of the shocks to the macroeconomic model of the BS. Consequently, the Fund heightened the intensity of the test, assuming that employment and growth fell in line with what was recorded in the 1992-1993 crisis. The result aggravated the previous situation with losses to regulatory capital of 16% for the 12 institutions most affected.
The liquidity risk deriving from the analysis was small and large institutions had major and quite distinct sources of funds. In the light of what has occurred it is interesting to indicate that when analysing the minimal effect of the exercise on liquidity, the Report underlined: "for some of these institutions the contingency plans rely strongly on the issue of covered bonds, a strategy which could involve risks if market orientation or liquidity conditions deteriorate in the worldwide system, particularly given the growing dependency of Spain on incoming capital, the current account deficit situation and the prospects for evolution of the housing market in Spain".
This exercise was also carried out in the insurance sector on 27 insurance companies which represented 50% of the non-life market and 62% of the life market.
The System showed itself to be resistant in a broad range of shocks, but with different behaviour in the life, non-life and mixed classes. Two series of stress tests were applied: the first, with conditions similar to those applied to credit institutions (the largest impact for the System as a whole came from a fall in real estate prices of 17%, which reduced capital by 5.6%). The second battery of tests was based on risks specific to the sector.

whole is vibrant, resilient, highly competitive and well supervised and regulated. The strengths of the sector are clear: a high degree of financial mediation which contributes to effective mobilisation and placement of savings, low intermediary margins; well capitalised and professionally managed financial institutions, and a prudential supervisory structure at the forefront of innovation. The expansion of the Spanish Financial System was heightened from when the country joined the euro area in the context of a long period of economic growth and increase in employment. Lending to the private sector has increased more rapidly than deposits due to the strong demand for credit, especially for housing, in an environment of very low interest rates –negative in real terms–" (IMF, 2006). The macroeconomic and financial situation has changed from when this report was published, but the strengths indicated in it may be an important element in mitigating the downturn and achieving a more rapid recovery.

Apart from the positive assessment by the IMF, however, the exercise also highlighted the more uncertain points and various vulnerabilities of the system which, in part, were confirmed by subsequent developments. Very briefly :

1. Given the substantial size of the balance sheet of institutions involved in financing the construction sector –housing, construction, development– the principal risk was: a decline in the construction sector, particularly if combined with an adverse macroeconomic scenario , and indeed this has been the case.
2. Compliance with international principles on supervision of the financial system and its infrastructures is very high, although in some areas the existence was highlighted of elements of improvement: broader delegation of powers of the Ministry to supervisors/regulators in issuing rules and penalising conduct (that of greater seriousness both in the case of the BS and the CNMV), the need to give a real and formal independence to the Insurance supervisor/regulator (at the present time a Department of the Ministry), eliminate the "ambiguities" which, despite the full supervisory and regulatory capacity of the Bank over all credit institutions, derive from the role of Autonomous Regions in prudential supervision, etc.
3. In relation to competitiveness and governance of savings banks, the report highlights the necessary reduction of public sector presence in Governing Bodies and the adoption of measures to improve the quality of capital –capital shares– which would furthermore permit reinforcement of market discipline.
4. Non-financial investments by credit institutions are also the subject of concern in the Report, which in this respect backed the decision of the Bank of Spain to adopt a more conservative approach in the treatment of Basel II financial holdings. Also related to this was concern for the presence of representatives of institutions on the boards of undertakings, more specifically in the field of business-

13 A more detailed explanation of the results of the analysis can be found in IMF "Country Reports: Spain" (2006).

14 Amongst its proposals, the FSAP gave priority to moderating the expansion of housing credit, thereby supporting the recommendations of the Bank of Spain in its Financial Stability Reports.

15 In the dynamics of the FSAP exercises, national authorities make observations and discuss or qualify the recommendations from the exercise when they consider that they are not correct. At the same time, it is the national authorities which must approve publication in whole or in part of the results of the exercise. The Spanish authorities resolved to publish all documents and results of the exercise in full, which include the considerations of the team –those mentioned above are only part– and its opinion on them.

financial institution relations.

5. In relation to supervision of the Securities Market the Report emphasises the need for the CNMV to exercise effective supervision over activities of banking institutions in the securities market from their commencement, and also over their authorisation. It also makes proposals to increase the independence of the regulator by adopting a longer term of office without the possibility of renewal for members of the Board.

III Looking to the Future

After examining in the first part of this work the situation of our Financial System before the effects of the subprime crisis began to become patent, the purpose of this second part is to examine potential changes to it in the immediate future. It is not a question of guesswork but analysing the processes of transformation already under way in estimating its possible evolution and effect on our System.

The processes generating change are of a very diverse nature and originate from very different sources; moreover, their coincidence in time contributes to adding uncertainty to forecasts for immediate development. Without attempting to carry out an exhaustive analysis of them all, I have opted to focus on developments deriving from three basic sources:

Firstly the effects of the subprime crisis, beginning in the USA and rapidly spreading to industrialised countries. Its ramifications are multiple, they have affected and will continue to affect all types of entity, institution, market agents, etc. The degree of activity deployed in the analysis of the failings and proposals for action to correct them has likewise been overwhelming. Various considerations regarding the crisis and analysis of several of its aspects will be examined in the first block of this second part. Likewise, and bearing in mind the reforms anticipated in various countries, although not directly related to them, this part will include a consideration of possible reform of our institutional scheme of supervision/regulation on lines which are reinforced by recent events.

Secondly, the more or less immediate changes due to matters which originate in the policy of the EU Single Market. These are consequently Community projects in the form of Directives, Regulations or Codes of Conduct (self-regulation) which will in any event inevitably require changes and adaptations in our system. Particular consideration is merited in this section of both the Markets in Financial Instruments Directive (MiFID) and the retail Single European Payments Area project (SEPA) and projects under way for the payments and securities systems infrastructure (T2 and T2S). The Insurance Directive (Solvency II), in process of preparation, also forms part of this block of reforms of our system, driven by our membership of the EU.

Thirdly, all those transformations of our Financial System which derive from its very evolution will be included, and on which external factors have an influence, which they clearly do but in a more indirect manner. It is thus essential to consider possible evolution of our Financial System and what we could call the "model change", which our institutions will inevitably have to undertake as a result of the process of falling real estate investment which has in the last 10 years constituted a principal portion of their activities. Based on a series of strong points, institutions will have to take action –adjustments in size, balance sheet structures, seeking new content, etc.– which the institutions themselves better than anybody will be capable of finding. It is true that our system maintains important elements of strength as a result of the healthy evolution in recent years, but also that the macroeconomic and financial situation has substantially worsened and in these conditions no financial system can remain immune. The final part of the work will examine this situation.

8 Lessons, responses and changes resulting from the crisis

8.1 Lessons learned (?)

The crisis, which began to develop in the summer of 2007 in a very significant segment of the US market, extended rapidly to the majority of markets in developed countries, basically in Great Britain and the EU. It is not the purpose of this work to describe the beginning and development of the crisis, since the profusion of publications on this matter no longer leaves room for novelty[16]. The aim is rather to try and glimpse what the consequences could be and to what extent they will affect financial developments in the immediate future.

It seems fairly clear that the crisis in its beginnings was the product of a series of failings which, with a greater or lesser degree of responsibility, can be attributed to all agents participating in markets in one form or another; from institutions and their operators to the authorities responsible for their supervision and regulation, Rating Agencies, etc., all have some responsibility. "There was possibly a collective failing in analysis, i.e. an incapacity to understand and appreciate the magnitude and implications of the extraordinary degree of gearing which was quietly accumulating in the financial systems of principal economies. This failing is not only attributable to supervisors but mainly to the market itself" (Caruana, 2008)[17].

On this assumption, the episode has various very general characteristics and other more specific which are worthwhile briefly mentioning:

Analyses of the crisis have frequently offered very useful material for understanding it, and also the insistence on and duplication of themes has often been an irritating element as a result of their occasional lack of coordination. Nevertheless, an agenda can be obtained from all these of "to-do tasks", on a somewhat worrying scale which raises the question: Were things really that bad?

Well, probably not. The process of development and sophistication of markets, strengthening of financial institutions and, of course, of regulators/supervisors has given excellent results and made the system more effective, more capable of providing the necessary financing for development and, despite appearances, more capable of resisting stresses and reacting to them. Overall, to discover that progress carries risks is nothing new –on several occasions the death of cycles has been decreed, despite which we can still see how they are –and in this case also it cannot be said that what has happened– not its specific and detailed development but the fact in itself– is new or totally unexpected.

With respect to novelty, or lack thereof, it can be said that the recent crisis is certainly different in the specific details of its development and consequently is "new"; this is not the case, on the other hand, if we look at the generic characteristics of the processes which were developing in its gestation period, since features can be found in it of other crisis processes. Borio explains it very well: "...the crisis which occurred must be looked at as the natural result of a prolonged period of widespread and aggressive appetite for risk which turned out to have its epicentre in the subprime market. In other words, it represents the archetypical example of financial instabili-

16 Amongst others, the BS Financial Stability Magazine, in the May 2008 edition, is devoted to this single theme, analysed from different perspectives by contributors to the edition.

17 On this line of analysis and allocation of responsibilities: Ubide, 2008 and Borio, 2008.

ty with macroeconomic consequences, with potentially serious macroeconomic consequences deriving from the accumulation of financial imbalances in good times, in the form of balance sheets stretched to the full, concealed by the varnish of buoyant asset prices and strong economic growth. Idiosyncratic elements are without doubt present, including the threat of an unprecedented involuntary "re-intermediation" of banks and the dislocations associated with the new risk transfer instruments. But these elements represent only the most superficial aspects of the story. In many cases they are symptoms of more fundamental common causes". (Borio, 2007)[18].

On the other hand, it is not a crisis which has arisen without prior indications that something was going amiss. It is very complicated to say this, but in years before the bubble burst, in the years of gestation of the crisis, there had been some alarm signals which went unheeded. Years before the crisis occurred there had already been mention of the risks inherent in this process, but periods of euphoria are very difficult to break with during their development stages, since risk models cannot forecast completely new developments.

The position which was being maintained by Gramlich, Director of the Federal Reserve, for several years before the recent events serves as a well known example: "unlike the conservative prime mortgage market, with fixed interest rates, long term mortgages contracted under strict supervisory conditions, the subprime market was the Wild West, more than half of the mortgage loans were made by independent lenders without any federal supervision. A substantial part of them were placed by independent mortgage brokers without risks at stake –they simply placed the mortgage, collected their money and disappeared. A large part of them were at variable and very low rates ....." (Gramlich, 2007)[19]. The extended responsibility for this process –to which I will return later– is also underlined by the author: "One anomaly of subprime mortgages is that we have more supervision in the sector where we need less, and less in the sector where we need more; whilst in the prime market mortgages are long term and at fixed rate, in the subprime all types of exotic instruments are concentrated".

The greatest danger in this educational process is "regulatory bias" as a panacea. It will inevitably be necessary to introduce various changes or reinforce certain mechanisms, but the objective cannot be total elimination of risks, since they are inherent in the functioning of markets and to a large extent the reason for their existence. Regulations must be a corrective response to market failings and this must in general be their basic orientation.

18 For a subsequent more complete analysis with more cumulative information, see also the most recent Annual Report of the BIS, published in June 2008.

19 Reports relating to risks of the crisis in years prior to its occurrence existed in different areas. Although the clearest case is that of the aforesaid Director of the Federal Reserve, who on several occasions warned of the danger of the situation which was developing, in May 2004 he said "the increase in subprime lending has been associated with high levels of default, foreclosures and in some cases abusive loan practices" (cited in Krugman: "A catastrophe foretold". Herald Tribune 26/10/2007). See also Edward M. Gramlich: "Booms and Busts: The Case of Subprime Mortgages", an article presented at the Federal Reserve Bank of Kansas City symposium "Housing, Housing Finance, and Monetary Policy", in Jackson Hole, Wyoming, August 2007, and his recent book "Subprime Mortgage: America's latest Boom and Bust". A different case is that of the excellent report from the Institute of International Finance (March 2007), which provides a detailed analysis of liquidity in its different perspectives, but which in its introduction states "The Committee is favourably surprised by the growing sophistication of the firm focus on treating the liquidity risk and does not see any imminent reason for special concern".

This exercise in analysis is furthermore not free from frustration, "...whilst experience and history enable us to identify a certain common denominator associated with financial shocks, the specific triggers and channels of transmission which produce contagion are almost impossible to anticipate with a minimum degree of accuracy" (Corrigan, 2007), but it does not as a result cease to be necessary, and indeed the exercise has been undertaken with intensity and all aspects within it have been reviewed which have "triggered" the stress, generating the crisis, and measures have been proposed to try and prevent them, albeit with scepticism, in the future. Thus, from the beginning of stresses in the US market, both regulatory authorities and market members have been working on reinforcing the mechanisms for absorbing impacts and although a perfect crisis model can never be obtained[20], the proliferation of groups which have been working in recent months[21] has been intense. It consequently becomes impossible and of little use as a result of the inevitable duplication which it contains, to go into a detailed consideration of them all[22].

The general themes which arise from analysis of the crisis, summarised by the Global Financial Stability Report (IMF, 2008) point to the existence of a collective failing of all institutions, entities and market agents, which could be summarised as:

a) Firstly, the collective failing to appreciate the extent of gearing assumed by a large number of institutions in all fields and the risks associated with a rapid and disorderly process of undoing positions.

b) Then the fact that both private agents, with their inefficient control of risks and transparency failings, and the institutions responsible for supervision and regulation have always fallen behind innovation and change of business model, leaving considerable room for excessive assumption of risks and inflation of the price of assets.

c) The excessive confidence by all that the process of risk transfer by shifting it off balance sheet – a situation which in other conditions was very positive since the actual problem does not lie in the securitization but in what is done with it[23]– was forever. With materialisation of the risks an intensive process took place of return to the balance sheets of banks, both for contractual and reputational reasons.

d) Despite the intervention of central banks –in unprecedented action which made it necessary to reconsider many questions– financial markets have remained under constant pressure motivated by problems of liquidity and aggra-

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20 A general picture of the crisis and the paradoxes found in it: A. Greenspan (FT, 17 March 2008).

21 The certainly incomplete count of groups and institutions working on different aspects of the crisis made by the Global Risk Regulator (November 2007) amounts to 12 groups. The passage of time will certainly see an increase in the number of participants

22 A fairly complete picture can be obtained from the report which the Financial Stability Forum has prepared, following the mandate of the Ministers and Governors of G-7, on the causes and fragilities of the System and proposals for recommendations for improving the resilience of financial systems. The areas for which the FSF proposes specific action are the following:

- Strengthening prudential vigilance of capital, liquidity and risk treatment.
- Introduction of improvements in developing transparency and risk assessment processes.
- Restructuring and reinforcing the role and use of credit ratings.
- Reinforcing the receptiveness of authorities to risk.
- Increase in the solidity of cooperation in treating risks of the Financial System.

23 The problems with structured products, and in particular with their lack of transparency, has been a very

vated by a worrying macroeconomic situation, weakly capitalised institutions and a widespread return of gearing.

The repercussions of the crisis have been very far-reaching and will all unleash reform processes –some already under way– which will affect the majority of systems, including ours, in one way or another. From the failings seen in supervision/regulation systems which have placed in question organisational processes adopted with few doubts up to now –particularly of the USA and UK– to reconsideration of the actions of the principal central banks in their liquidity supply policy –which was the first and automatic rapid response but full of problems in some cases– taking in strengthening the treatment of crises in which entities participate which operate in different jurisdictions (consolidated supervisor, supervisor group), a series of reform proposals have been generated which are examined below. The possible effects of what we could call "lessons learnt (?)", materialising in recommendations from the multiple working groups formed, both public and private, will be analysed basically in relation to our system. The harvest is very extensive and not free from repetition, and therefore I believe it will suffice to focus –without going into the details of analyses which are easy to find– on the recommendations of the Financial Stability Forum on the one hand and of the Global Financial Stability Report of the IMF on the other.

Separate reference must also be made, although forming part of the foregoing group, to the proposals for strengthening certain aspects of Basel II and the criticisms which attributed certain responsibilities to it in the crisis. The role of Rating Agencies, which are an important element in functioning of the Accord, will be the subject of consideration in this part, along with aspects relating to the valuation of assets in times of crisis.

8.2 Repercussions in the area of regulatory/supervisory institutions

8.2.1 Initial reactions to the crisis: the operations of central banks

The crisis, which began with the problems of default on subprime mortgage loans in the USA, gave rise to a process of uncertainty in markets which accelerated when it was revealed that many of these securitized loans, distributed by banks in a rapid expansion of the origination/distribution (O/D) model, had become part of transactions carried out by "investment vehicles" in which they were mixed with other types of assets difficult to value and with no transparency. Development of this

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important component of the crisis. The negative judgment on them should however be qualified since, on the other hand, they have contributed to increasing efficiency and stability of the global financial system. A further aspect is that the recent development of these products has taken place in a manner which has not meant opening up of new investment opportunities but it has simply been devoted to packaging different existing assets in successive stages. As Restoy states (2008, b)) "from a point of view of social well-being the emergence of structured financial products is unquestionably a favourable development. It has helped to complete markets and opened the doors to more efficient distribution of credit risk...", but clearly the phenomenon has exploded.

In relation to the recent development of these products and the influence of regulatory arbitrage on it, particularly in relation to bank capital requirements and accounting transparency standards, and their role in the future ("they represent a technological shock to the financial industry...transcendental, permanent and which will extend to balance sheets beyond those of the banking system") see also, as well as the previous citation (Restoy, 2008, b)), (Duffie, D., 2008) and (El-Erian, M. 2008).

rapid process extended to other countries (basically GB and the EU), immediately giving rise to a disappearance of financing possibilities in money markets. This obliged central banks of the systems affected to rapidly draw up means of providing additional liquidity.

The crisis in markets has highlighted the importance of having an effective system of liquidity risk control. The virtually total disappearance of liquidity in all markets has been a genuine surprise to all entities and supervisors. It could be said that at all levels there was no adequate system for dealing with this type of risk.

Under normal circumstances, i.e. in an environment free from stresses beyond those of normal banking business, there is general confidence in the existence of available financing, which means that institutions relax their position with respect to the liquidity risk and therefore undervalue it. The appearance of the first problems with structured products, designed not for immediate trading but for prolonged holding and their opacity raised problems of valuation, which affected their liquidity. This effect was rapidly translated to markets for other types of assets in an attempt by the parties affected in the first round to seek a supply of liquidity by liquidating open positions in the latter. These sudden pressures on the demand side altered the functioning of their normal indicators which, on losing informative capacity, gave rise to greater confusion.

In this process "market liquidity" –the possibility of trading on markets without a substantial price alteration– disappears and makes any trading impossible. On the other hand, and something which was infrequent in previous situations, there was a rapid contagion to the "financing liquidity" of individual institutions, such that they can encounter difficulties in financing their positions. The liquidity risk, as it is prolonged, becomes a solvency risk insofar as institutions, given the differences in asset and liability maturities (longer in the former than the latter) are obliged to liquidate the former in order to settle their liabilities, which can give rise to capital losses and insolvency problems (GFSR, 2008).

This situation, as previously indicated, led to recourse to central banks as ultimate source of financing to maintain market activities.

In normal circumstances, CBs implement their monetary policy in a situation of structural liquidity deficit, since this is the most satisfactory way of achieving the objective of fixing interest rates –a fundamental objective of CBs– in the most efficient and secure manner. To this end CBs offer financial institutions, dealing directly with them, a supply of liquidity in order that by transmitting it to the remainder of the financial market they can manage to maintain a stable relationship between the interest rate fixed by the CB and the long term rate which affects the economy as a whole (Alonso, 2008).

This is the normal functioning which was completely disrupted from the very beginning of the crisis, such that no liquidity was sufficient to maintain market functioning, more specifically liquidity "disappeared", thereby endangering financing of the economy. In this situation CBs, in order to keep financing markets and institutions functioning, were forced to make major interventions.

After the crisis began, the starting positions of banks in their "normal" supply of liquidity conditioned their initial reaction to it. The three principal agents –the Federal Reserve, the European Central Bank and the Bank of England (Fed, ECB, BoE)– impelled by the situation, proceeded to make urgent changes in their liquidity sup-

ply mechanisms which will certainly be consolidated in some manner in the future as the first lesson of the crisis.

Virtually all elements in the arsenal underwent variations: the amount of liquidity offered, the types and characteristics of collateral usable as security for transactions, the number of counterparties who interact directly with the CB, the forms used for its supply and recourse to interest rates[24].

At the beginning, the FED and ECB tackled the strong demands for liquidity by offering substantial amounts to maintain the alignment of rates. The BoE, on the other hand, preferred to maintain the initial situation, letting the "standing facility" function on normal terms (Gray, I., Stella, P., 2008). As the situation developed, the different CBs reacted with different strategies, with the Federal Reserve being the one which has remained most active in the whole process, changing virtually all previous practices[25].

Of all these operations it is worthwhile, as a result of its particular future effects, highlighting the "help" by the Federal Reserve to the business bank Bear Sterns which may contribute to displacing –by extending its content– the concept of systemic entity as it has been considered up to now: "when the financial market is in a situation of fragility, an entity of small size or an entity which does not have depositors but which, as a result of forming part of a complex financial market, is overly interrelated with others to assume the cost of its failure, is "too connected to fail", can be systemic (Caruana, 2008).

It is true that all of the reactions mentioned, closely related to the structure of liquidity supply before the crisis, will contribute to perfecting the instruments which constitute the first line of action of CBs; meanwhile, the advantages of participation of a substantial group of counterparties has been illustrated, particularly in cases of crisis, along with the abundant availability of collateral and a greater variety of

24 This latter factor is possibly not related so much with the supply of liquidity as with concern for macroeconomic conditions in a process of slowdown after a period of growth with low inflation and little volatility in markets.

25 From the beginning of the period of financial turbulence in August 2007, the Federal Reserve has made six cuts in its interest rates, implemented a new one-month Term Auction Facility in which there was also indirect participation by Swiss and euro zone institutions, extended the program of securities lending by a 28 day loan instrument (Term Securities Lending Facility) and created a new loan facility (Primary Dealer Credit Facility) in order that all market makers (including investment banks) can access the discount window.

For its part, the Eurosystem, which has not changed its reference interest rate since before this period of difficulties began, added two three-month complementary operations to its normal system of intervention –and recently two more at six months– and in collaboration with the Federal Reserve has facilitated the participation referred to of European institutions in the Term Auction Facility operations of the US monetary authority.

The BoE found itself in a different situation, the need to finance the NR with substantial amounts obliged it to reduce the volume of its Open Market Operations in order to compensate the liquidity supplied and at the same time accepted a greater variety of collateral in its three month operations (Alonso, 2008).

In April the Bank of England placed a "special liquidity system" in operation which will permit banks with difficulties to find financing in markets based on their mortgage securities, exchange them for Treasury Bills with the objective, complementary to ease of obtaining liquidity, of injecting confidence in markets. It will be instrumented by one-year term swap operations renewable up to three years. Only assets which already existed at the end of 2007 will be accepted. The private banks will assume all losses which occur and will have to provide more assets (or return Treasury Bills) if the value of those offered in the exchange is reduced. The window will be kept open for six months.

terms. This is probably not all necessary in normal times in which the structural liquidity deficit is due to other influences, but it is necessary in any event to maintain a willingness to modify instruments when the occasion arises.

Of the agents analysed, it is probably the ECB which, as a result of having the most adequate arsenal of instruments and practices, has found itself in the most suitable situation to deal with this initial problem and consequently, although touching up can be expected in the instrumentation which can always be improved, it should not be very substantial. In this field our System is fully integrated into the ECB and therefore nothing very different can be expected in the near future.

The action of the US Treasury could, however, have greater implications for the future, extending the aid beyond what used to be the normal perimeter of what is “systemic”, a matter to which I will return later.

8.2.2 Proposal for reform in the United States

The effects of the subprime crisis, the analysis made of it and the proposals for reform in different fields have been the subject of attention in other parts of the work. Its development has had various effects on the actions of supervisory/regulatory institutions. Apart from the specific actions taken –initially changes in the supply of liquidity, financial support for certain institutions, what some have called “extending the systemic perimeter”, etc.– in the United States a more comprehensive reform has been raised which aims to act on the whole institutional structure of regulatory/supervisory mechanisms. Although the institutional structure of regulation in the USA has undergone partial reform on the occasion of various isolated episodes of turbulence, it has been basically maintained with the system in existence in the 1930s[26], and therefore the current proposal will in principle be the biggest reform undertaken since that time.

As rightly argued in the "Blueprint for Regulatory Reform" (April 2008), the current situation is unsustainable and the recent subprime crisis has clearly illustrated the failings in the current system. Indeed, a structure which maintains separate regulatory agencies for securities, futures, insurance and for different business segments cannot be maintained with the characteristics of current financial markets. Faced with their internationalisation –consolidation both at national and international scale and the appearance of large financial conglomerates which cover all types of services and supply all classes of products– the current situation “creates jurisdictional disputes between regulators, makes the provision of services and distribution of products difficult and more costly, with the result that the former and latter are displaced to more flexible and adaptable markets"[27].

In this situation the report referred to raises a general reform, not applicable in the short term and which can be seen to be full of difficulties. Based on a regulation

26 Paulson. H. "Blueprint for Regulatory Reform" (2008).

27 For example, until Congress eventually forced a resolution, approximately one decade of disputes between agencies delayed agreement between the Federal Reserve and the Securities Market Commission on regulation which defined the permissible activities of banks in the Securities Market. Other examples can also be cited such as the prolonged process of discussion between agencies of the development of Basel II in the United States or characterisation of a product as “security” or future, "Treasury Releases Blueprint for a Stronger Regulatory Structure" (2008).

which must be grounded on objectives and not on functions, the report indicates three of the former whose fulfilment will be sought by the creation of three separate regulatory agencies, but with mechanisms for coordination between them: “Financial Stability Regulator”, “Prudential Financial Regulator” and “Market Practices Regulator” (“Conduct of Business”).

The basic contents of the proposal are very briefly as follows:

a) Financial Stability Regulator:

This will be responsible for establishing the conditions which promote development of financial stability in all markets and institutions of the System (Macroprudential Regulation). Following the path taken previously by other central banks, it will be the Federal Reserve which will assume this responsibility, but equipped with additional powers and instruments enabling it to act throughout the Financial System, receiving all necessary information, collaborating in the preparation of legislation and drawing up the principles which the financial situation may make advisable. This allocation of responsibilities in relation to Financial Stability carries with it removal from the Federal Reserve of the microprudential functions which it has been exercising up to now in relation to deposit institutions, “now, rather than focusing on the financial health or failings of a particular financial institution, there will be concern for overall assessment of the exposure of the Financial System as a whole to risk" ("Blueprint, 2008").

This means –I will return to it later– that all activities related to day-to-day Supervision –“the first line of analysis will disappear”– will fall outside the responsibilities of the new regulator. On the other hand, this new regulator will continue to maintain all current functions of the Federal Reserve connected with the design and instrumentation of Monetary Policy, the supply of liquidity to the System and all maintenance and development of payment systems.

b) Prudential Regulator

Monitoring and analysis of the financial condition of each individual entity, risk control practices, etc., will be tasks of this new figure. The establishment of standards, fixing adequate capital requirements, limits on certain investments, minimum capital, monitoring transactions, i.e. all day-to-day activities of individual entities, will be its responsibility. The scope of its action will comprise all those institutions which receive any type of guarantees from the Government ("Insured Depositors Institution"), will consolidate the regulation of all state banks[28] and will further extend to insurance, unifying the dispersion of authorities and regulations which exist at the present time.

c) Market Practices Regulator

This will be responsible for the protection of consumers and investors and for the conduct of business in all types of financial institution. This logically covers the organisation of all information systems necessary for monitoring all types of financial products and services, and vigilance of capacity and expertise of entities in engaging in their business ("fit and proper").

28 At this time there are three different regulations for deposit institutions with guarantees: the National Bank, the Federal Savings Association, and the Federal Credit Union, all three with separate regimes and governing structures and different regulation.

As well as these three institutions, which constitute the central nucleus of the proposal and whose activities focus solely on financial institutions, the project also includes the creation of another two institutions: a “Federal Guarantee Insurance Corporation” which will function as Insurer for all entities regulated by the Prudential Supervisor, and a "Corporate Financial Regulator" which will be concerned with vigilance of general matters connected with securities markets. It will include the current responsibilities of the SEC for "Corporate Governance, accounting, auditing, etc." The standard and rules which this regulator establishes will be applied, as well as to all undertakings which trade in securities, to financial institutions themselves whenever they offer securities to the public.

This “optimum” regulatory structure, as referred to and put forward by the Treasury Report, ends with a series of proposals which complete the design: (a) reinforcement of an existing body to facilitate information and coordination between all regulators, chaired by the Treasury Secretary, which will decide on potential disputes and promote coordination, (b) financing of the prudential regulator and of market practices will be borne by the entities regulated by applying a surcharge, and (c) those responsible for this structure must be guided by specific principles which relate to standards for implementing the regulatory process (of all, public consultation), mechanisms to be applied in promulgating standards (use of cost/benefit or other systems), review of legislation (monitoring Congressional legislation).

The maze of regulations, legislation, interlinked competence and different interpretations when various regulators converge, etc., which emerges from reading the Treasury Report is such that it is valid to ask how such a system of regulation has been able to function, and it is not surprising on the other hand that what in the light of the foregoing appeared very possible has occurred.

The new model is not completely closed, but aims to stimulate discussion on the basic lines indicated by it. The proposals which it makes are long term and must pass through a long and complicated discussion process –as the report itself states– given the complexity of the model to be transformed. The central piece comprises the three “objectives” based agencies and their configuration follows the lines of the transformations carried out in the first years of this century in systems such as that of Great Britain or The Netherlands, although the report itself appears to “claim” the model established in Australia as its most immediate reference. Indeed, it distinguishes itself from both the Dutch system, which maintains macro-Financial Stability and the supervision of entities (micro-stability) in the Central Bank, like in Great Britain, in the sense that it divides the contents of the current FSA into two separate regulators, attributing supervision of banking institutions to the Prudential Regulator, leaving the Federal Reserve with a role similar to that of the Bank of England, and attributing vigilance and regulation of market practices to the new agency.

The reasons for the change in orientation to which the report refers are well known: the profound process of change in all sectors of the economy and particularly in the financial sector, the rapid growth (in relation to GDP) of financial activities, technological advances and data processing, etc., which have given an impulse to initiatives for change in supervisory authorities, in both their specific content and manner of acting[29].

29 Reasons given for the changes in a document from the World Bank on a group of 15 countries (De Luna-Martínez, J. and G Rose, T., 2003).

8.2.3 Situation in Great Britain

The period of stress in markets, somewhat attenuated but which has not totally disappeared at the time of writing this work, has had major repercussions on the financial systems of virtually all developed economies, particularly those which have used sophisticated and non-transparent instruments to disperse risks off-balance sheet. The most immediate repercussion, apart from that of the United States itself, took place in the financial system of Great Britain and materialised early in the problems of a bank, Northern Rock, with a dominant participation in the mortgage market and with a business model highly susceptible to being affected by this type of disruption, since its financing base was the process of securitization and financing in short term credit markets. These characteristics made it hugely sensitive to these disruptions as rapidly shown when a cessation took place in the securitization business and a cessation in financing markets.

The situation of the institution and movements to withdraw deposits by individuals gave rise to the initial, albeit late, actions of the Bank of England. These centred on offering guarantees to depositors of the security of their deposits, guarantees which were reiterated and extended with the passage of time. Furthermore, and as a complement, it made loans to the bank and established guarantee schemes, in an attempt that Northern Rock could obtain market financing –a waste of time in those circumstances, given the problems of liquidity and the special situation of this bank in particular.

Before the situation deteriorated the Tripartite authorities (Treasury, Bank of England, Financial Services Authority) opened up a period for NR to attempt to find a buyer. The Tripartite itself established an agreement which served as basis for considering and deciding on possible offers[30]. In this context, two offers were made: one from a Virgin Consortium and another from part of the management of NR itself. Both proposals were rejected "since they involved a large risk to depositors and a very substantial subsidy by the Treasury". This situation –which had already gone on for too long– gave rise to nationalisation of the bank or, as the Chancellor stated, "a temporary move to the public sector". As from this decision the bank will continue operating, the Tripartite maintains, as an ordinary commercial bank with directors (appointed by the Government) who will act independently, with the idea of returning it to the market as soon as possible and always complying with the objectives previously referred to[31].

This event is probably the most visible aspect of the repercussion in GB of the stresses begun by the subprimes. Since implementation of the supervisory institutional structure –the change from a model of separate supervisors to another more consolidated model– which took place during the first years of this century, it is perhaps the most important crisis episode which the FSA, the Bank of England and the Treasury have faced.

30 The agreement established various principles which would have to be fulfilled in any acquisition: 1) Protection of contributor interests. Substantial sums of public money had been mobilised and must be recovered. 2) Protection of depositors is a priority. 3) Protection of Financial Stability.

31 A complete and detailed review of the Northern Rock affair can be seen in "The Run on the Rock. The United Kingdom Parliament Select Committee on the Treasury" (Fifth Report).

Leaving aside for later the question of separation of the supervisory function of the corresponding Central Bank and the situations raised by it –not of course admitted by the Tripartite authority– it is necessary to emphasise another aspect of the functioning of the Great Britain system which indicates the transparency with which the supervisory authorities have analysed the situation and its problems. In this respect, it is worthwhile emphasising the analysis of the Internal Auditor of the FSA of the failings in the process of supervising Northern Rock and the proposals for its rapid improvement ("FSA self-flagellates")[32].

The four fundamental failings set out in the report are as follows:

1. Lack of sufficient regulatory commitment to the bank, in particular failure of the supervisory team to rigorously monitor management by the bank and the vulnerability of the business model to changes in market conditions.
2. The inadequate vigilance exercised by "management" over the quality, intensity and vigour of supervision of the bank.
3. Inadequacy of the resources devoted to direct supervision of the bank.
4. The insufficient attention of the FSA to ensure that all available information regarding risks was being adequately used in its supervisory activities.

This analysis does not lead the FSA to question its supervisory model at all –which will continue to be based on a risk orientation and principles-based regulation and the practices developed for applying it outside the Bank of England– but serves to transmit the tone of the analysis of the failings, and therefore it is worthwhile highlighting its two basis conclusions: "we cannot ensure that the existing scheme for assessing risks has been applied adequately in relation to Northern Rock, and consequently neither that the supervisory strategy was in line with the risk profile of the institution ..." and "the supervision of Northern Rock indicates a significant combination of failings. Our general conclusion is that the supervision of Northern Rock was at the extreme end of the spectrum of the supervisory practices which we apply" (FSA, 2008).

This analysis of the important problems and failings of the supervision of Northern Rock was complemented by a serious of measures approved by the Tripartite to prevent the appearance of similar new cases which could threaten financial stability. As well as the measures taken for the specific improvement of supervision, further initiatives have been taken relating to the control of liquidity, new regime of bank insolvency and reinforcing Deposit Guarantee Funds[33].

8.2.4 Cooperation between supervisors

Amongst others the reform proposals which the Financial Stability Forum recommends in its report is that of reinforcing the action of regulatory and supervisory authorities in order to implement common action in the case of banking groups which act in different jurisdictions and sectors. These are initiatives which are al-

32 Financial Times, 28 March 2008.

33 Analysed in the following documents: "Report of the Internal Audit of the FSA on the Supervision of Northern Rock". FSA, March 2008. "Review of the Liquidity Requirements for Banks and Building Societies", FSA, December 2007. "Financial Stability and Depositor Protection", Tripartite (FSA, Treasury, B of E), January 2008.

ready under way within the EU but whose content can be extended in greater depth to a wider sphere, i.e. internationally.

The comment-question from the Commissioner for Financial Services (McCreevy) "What would have happened if Northern Rock had been an important bank in six European countries?" has given an impulse to again give priority to the figure of the Consolidated Supervisor, which for some time has been the subject of debate both within the EU and in the private financial sector.

Indeed, since the beginnings of the Community initiative there has been increasing focus on the actions of banking groups operating in different jurisdictions which, representing an increasingly substantial role in the unification of financial markets, are subject to a series of restrictions and legislation which, issued by different supervisors, are usually different and give rise to hampering the development of their activities, in a strongly competitive environment. This situation, which has and continues to be an objective to be fulfilled, has in recent years guided the development of European initiatives aimed at improving regulatory and supervisory harmonisation, thereby bringing about their greater convergence which, furthermore, is followed through in the treatment of financial crises.

As we have just seen, at different times directives have shown concern for the treatment of supervision up to now in fundamental respects in a purely national sphere, and the contradiction thereof with increasingly globalised markets with entities operating with the same global concept.

The most important step to try and alleviate this contradiction was taken by promulgation of the Capital Requirements Directive (CRD) which, in a series of articles, proposes the figure of the "consolidated supervisor" with a series of functions and characteristics which qualify it as the key supervisor of a banking group with cross-border activities" (Articles 124-143 of the Directive)[34].

Working on the content of the CRD in relation to consolidated supervision, the CEBS has developed a series of "guidelines" which permit practical functioning of the provisions of the Directive. Its task is consequently focused "on how supervisors must work together in order to achieve a more effective and efficient interaction in terms of information exchange and cooperation, to make the prudential supervision regime of the CRD -particularly in matters relating to consolidated supervision– more effective and efficient" (CEBS, 06/09).

In parallel with the work of the CEBS, the industry (European Financial Services Round Table) has in recent years been defending the need to establish a supervisory figure (lead supervisor) which responds directly to the needs raised by banking groups with increasingly cross-border activities.

In this respect, in their Report (EFR, 2007) they base all proposals under discussion in the context of the EU on reforms of Committees and furthermore consider necessary:

34 Its role is developed on the following lines:
a) The consolidated supervisor will be concerned with coordinating the collection and dissemination of information and the planning and coordination of supervisory activities, both in normal and urgent circumstances.

a) The preparation of MOUs between supervisors with minimum requirements and of public nature.

b) The definition of minimum standards for supervisor groups.

c) Complete harmonisation of information requirements and the most important matters.

d) Cooperation of EU and non-EU supervisors.

e) The formulation of principles by which efficient supervision must abide.

The Group considers that the current situation is not only ineffective from the point of view of business and delays what is the objective of the EU, but moreover constitutes a risk to Financial Stability.

Despite explicit recognition of the "official" advances made since the Group began to disseminate the idea of the "lead supervisor", and sharing and supporting their development, they continue to consider that there are still important points to be resolved, including:

a) Financial groups have a multitude of requirements of different types caused by the abundance of "national discretion" in directives which gives rise to diverging actions amongst supervisors.

b) Despite the declared intentions, the attitude of supervisors with respect to co-operation and exchange of information varies greatly.

c) The activities and involvement of members of groups is different in some cases than others.

d) The pan-European legislator has been promulgating rules which go beyond the traditional division of authority between home-host, but they are requirements which have been applied over the course of time without responding to a common purpose and which make the task of the home-host structure more complex, which continues to have a large dose of inconsistency.

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b) The collegiate system will be used to take decisions on requests by banking groups to use "advanced models". All members of the group will work in collaboration to seek a joint solution based on an application submitted by the group. If there is no agreement within six months, the consolidated supervisor will take the decision.
c) On the appearance of a situation of urgency within the group, the competent supervisor will warn it as soon as possible. Furthermore, when the consolidated supervisor requires any information which has already been provided to another competent authority, the latter will be contacted to avoid duplication of information.
d) With a view to facilitating effective supervision, the consolidation authority of a group and the remaining competent bodies must establish written agreements for coordination and cooperation between them. They will be able to "commission" additional tasks from the consolidated authority and specify procedures for decision-making.
e) The authorities responsible for authorisation of a parent company may "delegate" their responsibility for supervision of subsidiaries by a bilateral agreement to the competent authorities who have authorised and supervised the parent undertaking.
f) The competent authorities will cooperate closely with each other and mutually provide any information which is essential or relevant for exercise of supervision by the other authorities.
g) They may determine in which cases consolidation must take place and in which manner.
h) The competent authorities will require all credit institutions to comply with the requirements of the Directive –maintaining own funds exceeding the minimum level, requiring application of a specific policy for provisions, restricting or limiting businesses, etc.
i) When the parent company and subsidiaries are in different Member States the latter will communicate all information necessary to facilitate the consolidated supervision.
j) The competent authorities may require institutions to have adequate internal control mechanisms and risk management systems, specific information regarding significant operations, etc.

e) The different powers, instruments and responsibilities of national supervisors make cross-border collaboration more complicated and areas are created of legal uncertainty and problems of accountability.

With respect to the L3 Committees (under the Lamfalussy scheme), the Round Table supports the changes and highlights the fact that some supervisors develop local rules (gold plating) without any type of coordination within the EU, and they do so in order to rectify an urgent requirement and move ahead with the aim of exerting influence, etc. This gives rise to substantial delay and it is therefore necessary: “for national regulators/supervisors to discuss annual programs on the relevant L3 Committee in order to avoid diverging initiatives which put even more pressure on the already burdened Regulatory Agenda of the EU”.

In the context of the L3 Committees, particular attention is paid to the CEBS and to the developments which it is introducing deriving from the position of the CRD on the “consolidated supervisor”. In fact it is considered that the “lead supervisor” could be developed on an extension of it, which it has defended for several years. It is completely in agreement with the changes which are taking place and the proposed reforms and considers that the characteristics of the “lead supervisor” can be developed on the basis of the provisions of the CRD.

We have seen however that coordination between supervisors –a process which has been given an impulse as a result of the contagion problems deriving from the crisis– has been analysed in the previous text in the limited context of banking supervisors, since it is this sector which has up to now suffered problems with greatest intensity, even though it is not the only one. In reality, raising this cooperation is of a more general nature and also, as well as banking supervisors (CEBS), it affects those responsible for the “Securities”, “Insurance and Pension Funds” sectors (CESR and CEOIPS, respectively). These are all N2 Committees of the "Lamfalussy Scheme"[35].

One of the things which the crisis has made clear is that in an increasingly interlinked financial system sector supervisors need to develop joint working practices. Consequently, for several years –when only some isolated experts considered the possibility of a crisis– the Level 3 supervisory committees previously mentioned have been working, as well as on individual matters in each sector, on coordination of their activities and their basic functioning, drawing up joint reports for EU authorities, exchanging experiences and sharing information. To this end they have established a joint working plan for the immediate future.

The Inter-Institutional Monitoring Group (IIMG) –responsible for periodic review of the so-called “Lamfalussy Scheme”– is responsible for reviewing institutional agreements on financial stability, supervision and regulation in the EU; and in carrying out this function it emphasises a series of areas which include, as far as this matter is concerned: promoting a common training platform for supervisors in cross-border activities which will facilitate the exchange of executives in order to give an impulse to the development of a common culture amongst all supervisors of the EU; the establishment of a “mediation mechanism” for all sectors which, following the model

35 The Level 3 Committees are: Committee of European Banking Supervisors (CEBS), Committee of European Securities Regulators (CESR) and Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). Within the Lamfalussy Scheme they play a double role: firstly, they advise the European Commission on the preparation of Directives, and secondly they assist in implementing them in a coherent and consistent manner in each of the Member States.

prepared by the CESR, and has the purpose of helping to resolve possible conflicts of interest which may arise between national supervisors. As well as this, consistent application of the Directive on Financial Conglomerates is being developed jointly by the CEBS and the CEOIPS, with participation by the CESR as observer.

All of this is just a sample of the work which is being carried out by these Committees in order to "bring about transparent supervisory cooperation across sectors and reinforce consistency between them such that work carried out in one sector is consistent with that carried out in others" (CEBS, 2007).

It is not necessary here to go further into the important work of these Committees –since this is not the purpose of the work– not just in advising the Commission and in the consistent application of directives. Detailed information on their tasks and all areas of action can be found in their annual reports in which, as well as developments in the period, the work programmes for the forthcoming years can be found.

The final agreement on this project will be an important landmark in the consolidation of groups with cross-border activity, both for those which have the group parent in their jurisdiction –in which case the new situation requires a series of reforms by them and the assumption of additional responsibilities, but in parallel it will strengthen their international role– and for those which are not in this situation, even though they belong to a group –which will have greater information and more active participation in the group.

8.2.5 The Spanish Supervisory model: a proposal

Although possible reform of the supervision/regulation model of the Spanish Financial System is not a result of the subprime crisis, it is true that the processes of change in other jurisdictions will influence our own system.

The current Spanish supervisory model is well known. The Bank of Spain (BS) is responsible for systemic stability, it supervises the solvency of credit institutions and watches over depositor protection; the Directorate General for Insurance and Pension Funds (DGSFP) supervises insurance companies and pension fund managers, and finally the Spanish National Security Market Commission (the CNMV) supervises transparency and compliance with standards of conduct in financial markets, the solvency of investment services firms and investor protection[36].

If this model were to be baptised, it could be done with the label of imperfect "Twin Peaks". Twin Peaks because, in substantive terms, the BS is concerned –apart from stability– with questions of solvency of credit institutions and the CNMV with matters of conduct of financial undertakings in markets and their correct functioning. Imperfect because the supervision by the Directorate General for Insurance and Pension Funds (DGSFP) is a response to a sector criterion and it is furthermore the regulator of activities, a role which is not attributed to either the BS or the CNMV since regulatory competence lies with the Ministry of Economy and Finance. This situation does not comply with the Basel "Core Principles" for effective supervision, as indicated by the IMF in its assessment of the financial sector in Spain carried out in 2005 and mentioned in the first part of this work.

36 This part of the work, on the Spanish supervisory model, is taken from Gil, G. and Segura J. (2007).

Is this an adequate model? Up to now it has functioned correctly and in the last 18 years has dealt with the few major crisis episodes in reasonable manner. Furthermore, there are various reasons for not considering it desirable to modify the model in the direction of an integrated supervisor like the FSA. Apart from the arguments already made, two additional ones can be mentioned, of relevance in this case. Firstly, the costs of modification of the institutional architecture in terms of legislative initiatives required would be very high[37]. Secondly, a single supervisor would have a power and size difficult to administer efficiently, it would be more subject to the risks of capture by those supervised and, moreover, it would be less effective in resolving the existing conflict of interest between solvency and conduct supervision. In addition, as Restoy (2008) states, the connection between the risks of liquidity and solvency raises doubts regarding the model which entrusts responsibility for solvency of institutions and management of their liquidity to different agencies. As shown by the Northern Rock case, referred to in another part of this work, the lack of coordination between the two agencies may produce a solvency crisis which could have been avoided with liquidity support.

As a result it makes little sense to raise the question of a possible radical change in the Spanish supervisory model, and therefore the aim of the discussion should be that of perfecting and greater coherence of the current Spanish financial supervision structure. This improvement must be in the direction of consolidating a Twin Peaks model as closely as possible, since intermediate systems frequently accumulate defects of the two extremes.

From this point of view, the first step would be elimination of the supervisory competence of the DGSFP, which means determining a new allocation for it. It seems clear that the prudential supervision of solvency of insurance companies should pass to the BS, and vigilance of their codes of conduct and those of pension fund managers should reside with the CNMV. Such a decision would overcome the single inconsistency of the Spanish model, but two small outstanding adjustments would remain which would involve a modest transfer of powers and functions between the CNMV and the BS.

The first[38] because at the present time the CNMV is concerned with the solvency of Investment Services Firms, a task which should be assumed by the BS. This is so not as a result of a mere desire to have a pure supervisory model, but because this function could be carried out by the BS with less than by the CNMV –for which this task involves consuming proportionately significant resources given its size– and the added benefit of the greater experience of the BS in the field of solvency supervision. It should further be taken into account ISF also belong to banking groups.

37 This is a well known matter in academic literature on fiscal reform in which a very different treatment is given to the case in which an existing fiscal system is reformed in a country from the case when there is implementation of a fiscal system in an economy which lacks one.

38 This is in fact so; the financial supervisor has two basic responsibilities which determine the nucleus of its activity: the solvency of financial institutions on the one hand, and the functioning of markets and actions of agents therein on the other. The CNMV has its most important responsibilities in the second field, since its prudential activity is limited and basically relates to investment services firms and market infrastructures. Thus the objectives laid down for it by the Securities Market Act: overseeing transparency, correct price formation and investor protection. This would be the first part of the "adjustment" referred to in the text; the second part, which would involve a transfer of authority in the opposite direction, would be the supervision of the activities of institutions in markets and with their customers (Segura, 2008).

The second partial adjustment would be in the opposite direction: supervision of the activities of credit institutions, in markets and with their customers, should reside without practical ambiguities with the CNMV. Again for two reasons, firstly that with credit institutions absorbing a very high percentage of operations in financial markets, it makes little sense for their inspection to be away from the supervisor of market transparency and conduct. Secondly, overseeing conduct involves a type of action in which the CNMV has advantages of specialisation over the BS. And transfer to the CNMV of protection of the customers of credit institutions and the functional dependency of Guarantee Funds (depositors and investor), designed to protect the customers of undertakings which provide financial services, also seems consistent with a Twin Peaks model.

The third point susceptible to improvement derives from the fact that a perfect Twin Peaks model, whose advantages in the Spanish case are more than justified, requires, in order to function efficiently, a close and loyal collaboration between the two supervisory institutions. It is not just a question, albeit important, that inspection activities and information requests be coordinated between the BS and the CNMV such that the costs are minimised of credit institutions and financial services firms, an aspect in which there has been much progress recently. It is also a question of having flexible –and preferably institutionalised– mechanisms to resolve possible conflicts of interest which may arise between the two supervisors.

Put in simple terms, a solvency supervisor responsible for financial stability has incentives, on a possible crisis of a financial institution which could involve systemic risks, to allow practices which the conduct supervisor considers inappropriate. For its part, it is reasonable for the latter not to consider the effects on solvency of its actions in correction of inappropriate conduct, because it can neither calculate them nor does it constitute an element to be taken into account in its decisions under normal conditions. It is not arguable that the final decision as to the actions of each supervisor be the exclusive competence thereof, and consequently that the extreme case may arise of an irreconcilable conflict in which the prudential supervisor allows practices which are penalised by the conduct supervisor. But it is reasonable to have mechanisms for exchange of information and discussion which could allow a balance to be reached, in defined cases which involve quantifiable relevant risks to stability, in the actions of the two supervisors.

The fourth matter susceptible to improvement relates to the substantial existing differences at the present time in the institutional status of the two supervisors. It suffices to compare various sections of the Bank of Spain Autonomy Act (LABE) of 1994[39] with the Securities Market Act (LMV) of 1988[40]. Section 1.2 of the LABE expressly provides that it is not subject to the LOFAGE[41] and Section 14.2 of the LMV subjects it to the legislation. A comparison between Sections 4.1 of the LABE and 14.8 of the LMV is also significant: the Annual Budget of the BS is for expenses and investments and is not consolidated with the General State Budget, that of the CNMV is complete and consolidated; deviations below 5% in the budget of the CNMV must be authorised by the Ministry of Economy and Finance and, if this percentage is exceeded, by the Government, but budgetary deviations of the BS do not

39 Act 13/1994 of 1 June.

40 Act 24/1998 of 28 July

41 Act 6/1997 of 14 April on the Organisation and Functioning of the General State Administration.

require any authorisation. Or the different application made in the two cases of legislation on incompatibilities. What is significant about the divergences does not derive from the fact that both institutions need to be identical in the supervisory field as a result of a mere legal formalism, but that the greater restrictions on the actions of the CNMV in various aspects take away flexibility –and therefore efficacy[42]– in its functioning and budgetary autonomy is a clear indicator of functional autonomy.

There are also asymmetries in the configuration of their governing bodies and senior officers. The differences in size and composition of their Boards and Committees or Executive Committees may not be relevant[43], but those which exist in the duration of appointments of their members and their renewable nature or otherwise are significant. A possible single renewal of the appointment of the Chairman, Deputy Chairman and Directors of the CNMV (no renewal of the Governor and Deputy Governor, in the case of the BS, although Directors can be renewed) goes against the logic of the autonomy of the institution. Their appointment for four years (six in the BS), clearly coinciding with the duration of the electoral cycle and for a period which is from all points of view short –all the more so if not renewable– is another aspect which can be improved.

Brief considerations can be made in relation to the Governing Bodies in general and their practical functioning:

The Chairman must be maximum authority, even though decisions need to be taken on a collegiate basis. It must also be ensured that the Chairman and Deputy Chairman are in tune without seeking balances other than those relating to competence and complementing each other technically. The Chairman should play a fundamental role in proposing the appointment of the Deputy Chairman. There are different forms of organising this and all may be valid if compliance with the foregoing requirements is ensured.

The role of Boards –their composition, functions and selection of members– is fundamental in order that institutions can carry out their functions in suitable manner. An adequate definition of Boards, key to good governance of the entity, provides important support in internal accountability, thereby reinforcing its independence. The selected model of Board (or Boards) in each circumstance depends to a large extent on the institutional scheme in force in each country, and its socio-economic and financial circumstances. There is consequently a diversity of cases and it is not a question of cataloguing and assessing each one.

It is fairly general for appointments of members of such Boards (independent or non-executive directors) to be made by the Government "solely on the basis of their individual integrity and experience". Their functions in each institution will depend on its manner of functioning; on the other hand, it is normal that they have defined periods for exercising their functions, with or without renewal of appointment, and that they are replaced gradually in order to maintain continuity and for them to have real independence in carrying out their functions.

On occasions the functional model is different and Boards include other types of non-independent directors than in the sense referred to. These are persons who,

42 Consider the rigidity involved, for example, of being subject to a Public Employment Offer.

43 And it can be maintained that in these respects the configuration of governing bodies of the CNMV is more suitable than that of the BS.

carrying out their functions in the institutions of origin, whether independent or State agency, carry them out at the same time as similar functions on the Boards of other public bodies. The desire for a greater degree of coordination between different institutions and the management of processes of transformation or merger of agencies are the most frequent causes for this situation. As a result of their very nature, these situations should be temporary, in some cases because the coordination procedures have encountered other more effective ways to achieve it through the development of financial systems (for example, cooperation agreements) and in others because the transformation or merger processes have been completed.

Despite the utility of these mechanisms it should be taken into account that they present various potential risks deriving from the fact that since their tasks are not defined –this is virtually impossible– they may have to take part in specific decisions for which they may not be prepared and conflicts of competence may affect them (Gil, G., 2007).

Finally, a matter more open to opinion: penalty powers of supervisors. In both cases matters initiated by the BS and the CNMV constitute proposals to the Ministry of Economy and Finance which, in the case of very serious penalties or removal of licence, require the approval of the Government. It is possible to defend a system in which penalties need not be approved by the executive, which would present obvious advantages in relation to the autonomy of supervisory bodies.

8.2.6 Various reflections

The immediately previous sections examined the reactions of regulatory and supervisory authorities to the disruptions recorded in financial markets. The measures put into effect were described, principally in the most well known cases: the USA and Great Britain. Development of the crisis has highlighted the existence of important failings in all sectors, but also in the supervisory/regulatory mechanisms of the two countries, which are normally presented as models.

Independently of this, the series of measures adopted to alleviate the effects of the crisis and reduce its systemic intensity have entered areas which have been scarcely frequented up to now, which raises a series of problems worthy of brief reflection.

As we have seen, at the beginning of the crisis all elements in the arsenal of central banks and supervisors underwent changes of varying scope and the Federal Reserve and the British authorities making up the Tripartite (Treasury, Bank of England and Financial Services Authority) were no exception, but quite the contrary, since they entered areas far from what had constituted orthodoxy.

Firstly, with some of the measures taken –the rescue of Bear Sterns and the new possibilities for access to financing for investment banks and primary dealers through access to the discount window, together with the exchange of Treasury bonds for less liquid assets– the Federal Reserve began a handling of the new crisis which was not free from a certain controversy. This action, which was certainly useful in mitigating the effects of the crisis, makes it necessary to reconsider various aspects of the financial orthodoxy which has existed up to now, to a more or less serious extent. On the other hand, it is strange that whilst in recent years reference has been made to the changes experienced in international markets as the basis for the necessary adjustments in supervision/regulation schemes and the necessary cooperation between supervisors –all from a purely instrumental point of view– no attention has

been paid until now to the dilemmas which arise from certain interventions which are far from those considered "orthodox". Various reflections emerge from this line of action by the Federal Reserve in the crisis:

Firstly, if the Federal Reserve is going to finance investment banks and primary dealer entities which it does not supervise by "special facilities", it appears that a reasonable counterpart would be for the Federal Reserve itself to exercise some supervisory task over the latter entities and apply its regulation to them. The public with whom commercial banks act, depositors, are completely different from investors with which investment banks work, and this complicates their treatment. At the present time, this is a problem subject to discussion both between the Federal Reserve and the Securities and Exchange Commission[44] and between the investment banks themselves[45]. As we saw previously, there is a very ambitious project on the Treasury agenda for reform of the institutional structure of supervision, which attempts to alleviate this and other problems which appear in it.

The actions referred to mean that the Federal Reserve and other central banks in different jurisdictions have widened their role as lender of last resort and on a general level are reconsidering the traditional focus of moral hazard. This "paradigm" of what the action of a Central Bank should be, even though it continues firm in the ideology, is increasingly eroded by the evolution of financial systems and the nature of modern crises.

The current state of financial markets and functioning of institutions is raising new situations which inevitably affect the traditional concept of interventions by central banks and their effects on the system as a whole. It was always accepted that the criteria for aid should be restricted to those systemic institutions which could raise problems for the system as a whole and that it should be granted on certain conditions, such that the cost thereof is furthermore recovered to a large extent from their managers and shareholders.

The problem now arising is completely different for several reasons. To begin with, the "systemic perimeter" has hugely widened since, due to the process of concentration and inter-relation of markets and institutions, with rapid contagion to distant entities, a network has been created in which the size of an entity in crisis has ceased to be the only relevant factor.

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44 Since the appearance of the problems with Bear Sterns, the Federal Reserve and the Securities and Exchange Commission (SEC) have been working together in order that primary dealers and investment banks (of which the SEC is the "consolidated supervisor") can strengthen their positions in order to meet future crises. This took the specific form of signature of a "Cooperation Agreement" between the two institutions. It must be taken into account that until now supervision was based on voluntary agreements by the SEC with undertakings. This requires a change and the consolidated supervision must be obligatory (Bernanke 2008).

45 The controversy amongst investment banks derives from a decision by the Federal Reserve, indicated in the text, and its potential implications for the functioning of these banks. Goldman Sachs, one of the least affected by the crisis, considers that the prior situation need not change and does not wish to accept restrictions by the Federal Reserve. Those most affected, Lehman Brothers for example, are prepared to maintain access to the Federal Reserve, even if this "means restrictions on assuming risks". In the middle (wait and see) can be found Morgan Stanley.

Finally, as could be expected, some large commercial banks, JP Morgan Chase, Citigroup, maintain that investment banks should be subject to the same rules, "it makes no sense that there can be [FED loans] for investment banks and not ask them to comply with the same level of requirements as ourselves" (FT, 28 May 08).

Was Northern Rock an old-style systemic entity? It does not seem so. It was a not very large institution which experienced problems at a time of unstable markets, with a lack of confidence, risky policies and opacity, and consequently with a propensity to contagion. In other words, any medium-sized entity in an environment of stress could raise systemic problems. This is another of the multiple aspects which the recent crisis has opened up. The questions which remain not only relate to operational instruments but also, importantly, to a prior step, the decision to intervene.

The problem which arises is difficult to foresee in advance. The economy is cyclical and the financial system also, and this is inevitable and therefore the decision on the moral hazard dilemma and its erosion as a result of the reasons explained will require a re-balancing based on regulation in order to prevent the incentives for developing adequate strategies being diluted. Put another way, this effect of dissolution of moral hazard must be treated by developing supervision and regulation which seeks to ensure the resistance and capacity for reaction of the system.

The situation raised thus requires a different approach from the traditional, a preventative focus which facilitates the absorption of potential shocks and strengthening of capital which accentuates anticyclical characteristics by increasing reserves. This position has been applied and explained clearly from the Bank of Spain, "...the BS, through its dynamic provision model has been trying to reduce the strong procyclical trend of the loan cycle. Although the mechanisms are complex, the idea is simple: there is a gap between credit risk accepted and credit risk on the profit and loss account of banks –insofar as provisions for loan losses are removed in order to cover damaged assets, bad loans; Who can now argue that credit risk losses are not related to the excesses deriving from the boom days in the world economy? Our dynamic provision stimulates banks to accumulate provisions during good times, when credit grows rapidly, so that they can be used when bad loans begin to appear some years later. To some extent it can be seen as a correction of the reasonable value of the loan portfolio which prevents excessive profits being distributed during boom periods, all done in a transparent manner with clear rules and knowledge of the market" (Roldán, 2008).

Another important matter which has arisen, or rather has resurfaced, with the recent crisis is that of consideration of what the role should be of central banks in relation to the supervision of financial institutions. A matter which, since reform of the British supervision system at the beginning of this century, has not ceased to be the subject of attention. Indeed, apart from possible failings by the FSA, responsible for supervision of all institutions, and the discussions regarding the position of the Bank of England at the initial point in the crisis in markets –which led to stating its disagreement with the Federal Reserve and European Central Bank on initial injections of liquidity, basing itself on considerations of moral hazard– a specific question has re-emerged of coordination between the three authorities of the Tripartite, and on a more general basis regarding the decision taken at the time by the authorities on relocation of supervisory powers of the Bank of England by granting them to the FSA. With this precedent, the plans for reform of the US Treasury, as we saw previously in its Reform Plans although in a different manner to that carried out by the British Treasury, have also put forward a new role for the Federal Reserve which distances it from its prudential micro-supervisory responsibilities for financial institutions.

There are many arguments which support the desirability of maintaining the super-

vision of financial institutions with the central bank. The possibility that the Banking System may undergo systemic crises and the fact that the prudential macro-and micro-aspects of Financial Stability are progressively more inter-related reinforce the position of keeping these capacities together. The change promoted by the US Treasury in the activities of its Central Bank is problematical. The impression that by reforming the Federal Reserve it would emerge strengthened in its role of manager of Financial Stability may not be correct and cast doubts regarding the efficacy of the change in the allocation of responsibilities. The Chairman of the Federal Reserve at least seemed also to think so, who in a recent speech formulated the problem under discussion thus: "the supervisory activities of the Federal Reserve give access to a great wealth of information on the Banking System. Furthermore, its supervisory activities provided it with information on financial institutions which it does not directly regulate and on developments in the Financial System as a whole. It also permits it to obtain valuable information on undertakings which do business with banking undertakings which it supervises" (Bernanke, 2007).

There does appear to be a fairly broad consensus, which is of course a generally accepted position, that Central Banks and supervisors must work in close collaboration whatever the organisational structure which is adopted. Goodhart (2000) defends this position in the case of developed countries "maintaining the case that some form of supervision must continue to exist, banking/financial supervisors must work closely with central bank, and vice versa, whatever the organisational structure".

The involvement of the Central Bank in supervision is based both on the fact that the banking system may suffer systemic crises, and that macro- and micro-prudential aspects of financial stability are progressively more inter-related. Furthermore, the involvement of Central Banks in prudential supervision permits substantial information synergies to be obtained. (Brouwer, 2002) argues this position in detail[46].

46 Since the banking system may undergo systemic crises, central banks must be involved in financial regulation and supervision. In the national field this involvement may take different forms depending on the specific financial structures and political preferences... The involvement is important for three basic reasons. Firstly, central banks are responsible for financial stability and there is a close relationship between this and prudential supervision. Central banks involved in supervision are in an optimum position to assess the difficulty of an individual bank, the operation of common factors which affect the stability of groups of intermediaries, and the probability and potential impact of macroeconomic shocks on national and international markets. Furthermore, central banks are lenders of final resort and play an important role in the treatment of crises.

The second reason is that the macro- and micro-prudential aspects of financial stability are increasingly more closely inter-related. Micro-prudential regulation may have macro-prudential and macroeconomic consequences. This has been clear, for example, in discussions on the possible economic effects of the new capital requirements and specifically the sector consequences of capital requirements based on risk. Furthermore, thought can be given to the impact of bank provision policies in the debate on "full fair value accounting" or on country risk policies. Finally, the competence of central banks will also be necessary in discussion on the supervision of liquidity. Given these connected studies between micro and macro aspects of prudential supervision, it is no coincidence that the Basel Committee on Banking Supervision includes as many supervisors as central banks.

Thirdly, central banks must be involved in prudential regulation and supervision because there are important synergies in relation to information. The involvement of central banks in international financial markets, in payment systems and in monetary policy operations is extremely valid for exercising the tasks of supervision. At the same time, the best knowledge obtained in carrying out prudential supervision is important for adequate implementation of monetary policy and vigilance over payment systems" (Brouwer. H. 2002).

It is worth emphasising two aspects relating to the relationship between Central Bank and supervision: the fact of a possible loss of information and the problem of periods of instability. Goodhart (2000) stresses, in relation to the first of these, the fact that the possible loss or inaccuracy of information, in the event that the supervisor is not the central bank but another separate entity, is not due to the fact that there is no desire to inform the Central Bank but on the loss of internal mechanisms which within the CB lead to this search for information. In relation to the second point, Goodhart raises the problem that if the CB is deprived of obtaining microeconomic information on institutions, could it know what to ask the separate agency responsible for this task before the problem has appeared? And would it be too late?

The same idea is reinforced by Ferguson (2000), who indicates his concern as to which point at which the loss of contact with day-to-day matters could deprive a CB of the capacity to adequately interpret regular daily information, thereby rendering decision-making more difficult, which could take place before effective appearance of a crisis. Another interesting argument is that formulated by Paddoa (2002), who emphasises that supervision has been increasing its attention towards risk measurement, a factor which will increase in importance with implementation of Basel II. Given the direct knowledge and operational participation of Central Banks in banking and securities markets, which has made them experts in this measurement, and given that in the near future the most important supervisory tasks will be related to measurement and validation of risk calibration models in the context of Basel II, the key role which Central Banks are going to play in the development of supervision appears inevitable[47].

A recent analysis carried out by the European Central Bank (ECB, 2006) supports the foregoing considerations, "the analysis confirms that central banks in general are extensively involved in supervisory activities... and in the cases in which the central bank is not the authority responsible for final decisions in this area, there are agreements which ensure the involvement of the central bank in the supervision".

Finally, other reasons can be put forward which support the role of the Central Bank in supervision, including the fact that "synergies between the requirements of prudential and systemic supervision are greater than between prudential and market supervision; the independence and credibility of central banks are well established; the flows of information obtained from their intervention in markets are basic given the need for the information to carry out the function of lender of final resort, etc.". (Llewellyn, 2006).

From a point of view in time closer to the crisis in markets and after an analysis of its different aspects (Ubide, 2008) concludes by stressing the importance of supervision of systemic institutions being based in the corresponding Central Bank since it has the information which will enable it to take the necessary decisions quickly. The fact that the most important failings have taken place in those systems in which supervision lies outside the Central Bank reinforces this position[48].

Finally, a very effective and graphic way of demonstrating the problems to which the separation referred to can lead and the difficulty of replacing the task of one institution, the Central Bank, with direct information, by information exchanged

47 See also Gil and Segura (2007).

48 A treatment of the different aspects of the crisis can be found in the conference organised by Bank of Spain: "Bretton Woods II Under Stress?"

or by the creation of a Committee (apart from the fact that this is all necessary) is found in a reading of the spontaneous dialogue exchanged between the Governor of the Bank of England and Mr. Fallon in appearances at the British Parliamentary Treasury Committee[49].

8.3 Basel II

During the period which has elapsed of disruption in markets, the diagnoses, explanations, opinions, suggestions, etc. have multiplied and one of the aspects of this flow was the "search" for those responsible: supervisors/regulators, financial institutions, rating agencies, boards, etc. Only the most discerning ventured the hypothesis of collective responsibility, with greater emphasis on market agents, and established the origin of the crisis in the characteristics of the period prior to its outbreak. A long period of economic growth, low interest rates, risk premiums at unknown levels, a strong appetite for risk and search for profit, all mixed and fed by a major "boom" in real estate construction, were the events which were fuelling a bomb which burst in the summer of 2007.

After the burst explanations appeared and, as I said earlier, a varying allocation of responsibilities. One of the most erroneous was what that which focused a substantial part of the responsibility on the Basel II Capital Accord. The criticisms most frequently made were along the lines of: "the Basel II models have failed", "the excessive pro-cyclical nature of the Accord has accentuated the crisis", etc. It is worthwhile making some comments on this attribution of responsibility to Basel II since it is based on at least two errors: one geographic and the other conceptual.

The first of these, the geographic, is simple to clarify. Attributing responsibility to Basel II, albeit partial, for the events which triggered the crisis is mistaken, since due to the long process of discussion which is taking place on the Accord and its implementation by US supervisors, it has not yet come into force in the United States. If Basel II had been implemented the crisis would probably have still taken place but the new accord constitutes some very important improvements over the earlier one and perhaps it would have been possible to mitigate some of its problems, for example in the case of securitization, the risks of which were not provided for by the old accord (Caruana, 2007). It should be taken into account that the fact of the existence of the limit debt level in the United States, applicable to balance sheet positions, accentuated the arbitrage which had a negative effect by accelerating the growth in off-balance sheet positions, not subject to this limit.

The second element of criticism maintains that the Accord has failed, its "models" were unable to discern the problems and it was not capable of establishing adequate

49 p.23. Mr. Fallon: "OK, let me return to the question from the Chairman as to who is really in charge of this matter (the problems of Northern Rock). You provided additional liquidity which Northern Rock desired, but you are in the Bank isolated from its operations; the FSA said that it was solvent but it cannot intervene in markets; and the Chancellor guaranteed deposits. Who is really in charge?"
Mr. King: "I think that all those actions were important and there is a person responsible for each one. This would not have been different without the Cooperation Memorandum".
p.24. Mr. Fallon: "Who was in charge?"
Mr. King: "What do you mean by "in charge"? Could you define it?"
p.25 Mr. Fallon: "What our voters (constituents) want to know given this disaster is: who is in charge of it? Who is the person responsible? "The Run on the Rock". The United Kingdom Parliament Select Committee on the Treasury (Fifth Report)".

monitoring of risk control by institutions. This criticism derives from an important conceptual error as to what a model is and the role and content of the Accord.

Basel Ii is not a model "billed" to banks and neither does it "authorise" the use of risk valuation models which fail in a period of stress. What Basel requires of banks is that they undertake the development of series regarding failures, losses, recoveries, etc. which include a crisis period. This is the data which should determine capital levels, through the capital structure laid down by supervisors. It is not a compact block which conditions the activities of institutions. In this respect, it can be recalled that with or without crisis the Accord is subject to an ongoing process of adaptation or reform, such that it is not a closed and immovable structure. It is thus an open process which in reality constitutes the only possible response to processes of financial change, whether traumatic or not. Consequently, aspects will have to continue to be reconsidered which arise in the face of crisis situations, such as this one or those in the future, in order to alleviate their effect and acquire experience in foreseeing possible disruptive events.

The introduction of changes, some of which will be mentioned later, does not imply a failure of the Accord, but this capacity for adaptation in fact constitutes a basic element which favours its function of providing the Financial System with greater capacity for resistance and recuperation. The Accord cannot aspire to a complete forecast of the future and crises produce valid information to improve its functioning: "the recent turbulence in markets has supplied information which will help the Basel II risk measurement models to function in a more effective manner than they did before the turbulence" (Reich, October 2007).

In summary, the Accord is not a guide on how banks must organise their business and the capital requirements which are established in it must help to create the appropriate incentives for risk takers and support their good general treatment. The capital requirements cannot however prevent banks from committing errors, they do not attempt to substitute the responsibility of directors of institutions. Furthermore, the problems which occur in any market are clearly beyond the objectives of adequate capital structure (Caruana, 2007). What happened in markets, from the inadequacy of the standards used, the lack of transparency and of due diligence by investors, to the fictitious removal, as certain off-balance sheet operations turned out to be, etc., are all elements which fall outside the Accord, as they must do, since they depend on individual actions or the corresponding board authorisations, as in theory must be the case.

The three pillars of the Accord provide the model with the necessary degree of flexibility to perform its functions.

Pillar 1, the treatment of capital must be reviewed and it will be, as we will see later, in order to reinforce requirements relating to the securitization of complex products. In Pillar 2 an important element is carrying out "stress tests" which enable institutions to ascertain whether the "cushions" which they maintain above the minima are sufficient to deal with adverse scenarios. And in this case the fact is that there is a trend by banks to limit their scope and not run them to extreme although unlikely conditions. Insofar as innovation enables the banking book of banks to be covered or traded, it becomes necessary to strengthen the intensity of the stress tests, improving them beyond current boundaries, since various problems have appeared which were non-existent until then (Caruana, 2007). Pillar 3 is a fundamental element in market discipline, and above all in the problem of transparency, the absence

or inadequacy of which has played such an important role in the recent crises. One element which will have to receive preferential treatment, also key, and which fails when creating incentives for professional investors to use this information in optimum manner, is that of off-balance sheet transfers by the use of complex financial products. Of the criticisms recently made by Benink and Kaufman (2008), the one which considers an important reinforcement necessary on the question of transparency is of interest. Their argument is that even though it is true that Basel contains elements which reinforce transparency requirements, "it does not create incentives for professional investors to use this information in optimum manner"[50].

Another of the criticisms of Basel II centres on a matter which was already the subject of intense discussion at the time of preparation of the Accord. The "pro-cyclical nature of Basel extended the effect of the crisis" is how this could be formulated, which is important and on occasions unfocused and exaggerated.

It is obvious, firstly, that financial systems have a very clear slant towards a pro-cyclical nature; supervisors must be, and are in fact aware of this and try to perfect financial adjustments in order to tackle this inevitable phenomenon. The only manner is to be prepared for it when times are good, since increase in capital in periods of downturn is a difficult task.

On the other hand, it is impossible to establish a distinction between risks and mechanisms for their protection if there is no real fluctuation in the capital required, in other words "sensitivity to risk must inevitably be linked to the stability of capital over the course of the cycle".

The path taken by Pillar 2, already mentioned, offers the possibility of putting this protective task into practice by carrying out stress tests with the characteristics already mentioned. Since the beginning of the programming of the Accord this question of pro-cyclical nature was particularly studied and measures established attempting to mitigate any effect of this nature by the introduction of anti-cyclical elements in the three pillars of the Agreement, particularly in Pillar 2 which requires banks to be vigilant of evolution of the cycle in order to take it into account in their internal assessments of adequate capital.

The inherent pro-cyclical nature leads to underestimating the risk in good times and overestimating it in bad. Consequently, it should be in the good times when adequate "dampers" are established for bad times, which makes good sense since it is in good times when future conflicts are generated. "The peak of the cycle is the best time for financial institutions to make provisions, but the incentives of banks in response to the fall in margins on maturity of the cycle is to rush to capture the marginal borrower" (Goodhart and Persaud, 2008)[51].

50 According to them, this is largely due to the fact that insofar as potential investors have a perception that the large banks are "too big to fail" or that deposits are fully protected, they will tend to think that their design is not in danger, and therefore there will be less incentives to use the information published carefully.

51 The critical position of Goodhart and Persaud can be found in the text indicated: "the problem is the lack of counter-cyclical control instruments". "The Basel regime of "capital adequacy" does nothing to prevent or limit booms. Its effect, if it has any, is to further accentuate the depression". "The convergence of market measures for risk measurement with regulatory capital appears sophisticated and makes life easier for banks. But it is surprising because market measures of the risk of a bank must figure in the centre of the regulation...". It defines "that capital requirements should be not only counter-cyclical but also related to the rate of change of bank lending and the price of assets in the relevant sectors". (Article cited).

8.3.1 Reform measures

There is no doubt that a new crisis will occur at some time or another and it is appropriate to be prepared for it. One catalyst of the current crisis, which requires careful attention, was displacement of the banking business model from the "traditional" in which everything was kept on the balance sheet and the total financial business was channelled through it, towards an "origination/distribution" model in which the more important process of mediation developed in the market through the operations of a major group of institutions (global investment banks, securities firms) which originated the majority of the assets and transferred them by complex securitization mechanisms, frequently opaque and placed in off-balance sheet structures. A major part of the loan business was thus transformed into a volume business in which adequate risk assessment became somewhat secondary in relation to rapid growth and thereby the generation of income (Ubide, 2008).

This model developed in parallel –who drove who?– with a very rapid process of financial innovation and was complemented by the strong development of institutional investors (Welling, 2007). The intensive development of this model, which has had important positive effects in maintaining a significant flow of financing and promoting a risk distribution mechanism, partly as a result of its very functioning mechanisms and partly as a result of inadequate use thereof, meant the appearance of problems which gave rise to the current crisis. "Furthermore the origination/distribution model it is strongly dependent on the continuing existence of liquidity –if there is no demand for securitization of loans there is no growth in loans– and in this way banks become less liquid" (Ubide 2008)[52].

The effects of its use have thus become manifest in the generation of new risks, a total lack of transparency, extreme difficulty in the valuation of new products, a rapid growth in counterparty risks, etc., which have led to a chain of operations which, after the first problems appeared, rapidly spread to other segments of the US market itself and the markets of industrialised countries.

Consequently, amongst other tasks it is necessary to reconsider use of a model which, with a view to the future, enables these problems to be corrected; reinforcement of risk management in those areas which present greater vulnerability, an assessment of risk which cannot be gauged with the system of traditional measurement, etc.; all in order to achieve a more resistant financial system capable of reacting quickly.

The Basel II Accord is a suitable framework for evaluating the importance of some of these problems and seeking a solution by introducing the necessary adaptations into it. In this respect, the responsible authorities have indicated the need to maintain the structure in force with incorporation of the lessons deriving from the crisis (Basel 2008). In this respect it is appropriate to accelerate the implementation of Ba-

52 Ubide explains it thus: "in the old model banks were "risk absorbers", during bad times they could maintain loans until maturity having made adequate provision in good times. In the origin/distribution model the final holders of the loans are not "risk absorbers" but "risk managers" –and if the risk increases they can dispose of it. In a certain sense the new model is more resilient to small shocks in which liquidity remains abundant but it is more fragile in the event that liquidity disappears. They are not absorbers but rather geared players".

sel II in those jurisdictions which have still not done so, which will permit problems to be faced with greater security.

In summary, the changes considered necessary are: with respect to Pillar 1 and the treatment of capital in relation to structured and complex products, capital requirements are necessary which are more in line with risk.

At the same time, the implementation is urgent of liquidity facilities to cover exposure of the trading book –illiquid instruments with credit risk, similar to those of the Banking Book but with less capital requirement– which has grown rapidly and whose normal treatment is no longer adequate, since it does not enable extraordinary events to be covered which can affect such exposure. The Committee must also review new capital requirements over the course of the cycle and take measures for the problems which are detected.

In Pillar 2 the crisis has highlighted important weaknesses in control and treatment of the risks of institutions. Supervisors will have to reinforce the stress testing which they carry out, paying greater attention to that carried out on contractual and non-contractual contingent credits. In the recent episode it has been seen how banks were obliged to restore to their balance sheet the "exposures" which they possibly never thought they would see again; and this was so in some cases as a result of the existence of more or less formal commitments (credit facilities) and in others for purely reputational reasons.

Also in Pillar 3 various reinforcements are necessary of the current structure. The lack of transparency and difficulties in valuing complex products have contributed to accumulated illiquid structured credits in the banking system. This has had the effect of a rapid development of loss of confidence in the situation of institutions; a lack of confidence which has been accentuated by the total lack of transparency in risk positions. This situation requires reinforcement of the transparency processes implemented by institutions and at the same time it is proposed to develop guidelines which supervisors can use to estimate the risk of the valuation processes implemented by banks.

As well as the measures previously agreed by the Committee in relation to the three pillars, there is another matter which is not dealt with in sufficient extent in the original Accord. This is the treatment of the liquidity risk in which Basel appears to continue supporting a focus of recommending good practices and not legislation, which is what has been used for other risks. It is possible that the implicit reasoning for this difference in treatment is based on the opinion that banks, with a strong capital base, will not have such propensity, like others with weak capital, to be affected by problems of liquidity, something which has been demonstrated to be totally untrue as previously seen in this work.

The fact is however that the apparent "protective" role of capital has been shown to be insufficient in the recent crisis to protect institutions. In any event, all analyses, both official or carried out by institutions and private associations, decant for the option of "guidelines" when dealing with liquidity risk. On the other hand, before the crisis work had already begun on the treatment of liquidity risk and accelerated in its development with publication in June of a consultation document on this matter. Greater integration is sought therein of the liquidity risk with the remaining balance sheet risks already provided for in Pillar 2 and the new focus stresses a reinforcement of stress tests on liquidity, improvement in off-balance sheet products for cap-

turing contingent positions and verification that solid plans exist to cover forecast and potential liquidity needs[53].

8.3.2 Transparency, valuation and rating agencies

Transparency, asset valuation rules and the activities of Rating Agencies converge in Basel II, with related actions.

It is clear that financial markets cannot function adequately and fulfil their purpose if there is no information and transparency, both to participants in markets and to regulators and supervisors, a matter which has been made totally clear in the case of the crisis in markets which has not yet been resolved.

It is true that new instruments, the development of complex derivatives and the opacity of instruments, amongst other factors, prevent adequate valuation of the losses of financial institutions, as well as the impossibility of revealing who has possession of "toxic" assets (Roubini, 2008), and what the latent losses may consequently be. Uncertainty grows, and all agents try to protect themselves, etc. In short, the lack of transparency gives rise to disappearance of the market[54].

This merits at least one reflection that does not attempt to question the need for transparency, which is undoubted along with the need to continuously update it. It is a question of considering at this time, when there will be reinforcement in this field, whether on occasions, by means of an accumulation of legislation, it is not being transformed into an instrument for concealment rather than clarification. Put more directly, a "qualitative" transparency with adequate monitoring is essential for the functioning of institutions and markets, not what we could call "quantitative" transparency, which can produce the opposite effect. It is also true that transparency facilitates the maintenance of Financial Stability, even though stresses may be recorded at times. Indeed, "in the short term the degree of transparency required for the functioning of markets cannot coincide with that which minimises the complexity of the situation in times of stress" (Restoy, 2008).

Transparency depends largely on the knowledge of managers in respect of the instruments with which they work, which seems obvious but was not so obvious in the subprime crisis. If the understanding of them is not complete, as a result of opacity or any other reason, it will be difficult to subject them to an exercise in transparency, and it is in fact more likely that they avoid it. The actions of supervisors could have strengthened transparency, and in fact this is generally the case, but it was not so in the situation we are dealing with. In the subprime market "more than half of the loans were made by independent lenders with no federal supervision", in the words of Gramlich (2007). A more consistent quantitative and qualitative transpar-

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53 It is possible that this focus –the guidelines– will need to be supplemented by the requirement (recommendation?) of quantitative cushions of liquidity in entities for good management of this risk.

54 It does not in any event cease to be paradoxical that in the period in which the crises were gestating, and perhaps somewhat earlier, efforts towards transparency were abundant and standards of all types proliferated for all institutions (codes for the transparency policies used in assessments of financial systems by the IMF/WB (FSAP), Principles of Corporate Governance of institutions, Principles for Securities (IOSCO), for insurance (IAIS), etc., all international bodies, to which should be added those prepared by national authorities following the former); we also have the Basel II pillar 3 on transparency, already transposed into several jurisdictions, that of Solvency II in progress, etc.) since it is in these circumstances that the lack of transparency occurred.

ency of financial undertakings in respect of exposures to all risks, including those off-balance sheet, is the path to help in restoring confidence in markets. This is the line which Basel is reinforcing through its Pillar 3.

Another of the aspects which the market crisis has brought to the fore has been use of reasonable value, and in particular its use in circumstances in which the liquidity of markets disappears, trading is scarce and therefore there is no structure of market prices which can be used in valuing financial instruments. In these circumstances it is necessary to carry out the valuation by use of models which raise a series of difficulties and whose perfection has been set in motion as a result of recent events.

The use of "reasonable value" has developed rapidly in the recent past and has demonstrated its utility in several fields, including that of valuing certain products in which the use of historic cost provides less, or more confusing, information on price signals issued by markets. Compared with "historic cost", "reasonable value" offers a series of advantages which facilitate trading in markets becoming more reliable, taking place with greater security and therefore increasing their efficiency.

It is true on the other hand that the automatic application of "reasonable value" without taking into account the underlying circumstances can, by activating automatic mechanisms for executing orders of entities to liquidate portfolios, lead to the requirement of additional margins as a result of the price drop, or the requirement of additional security. This all leads to unnecessary losses in institutions which contribute to further price falls and aggravation of the general situation.

As well as this, the application of "reasonable value" can mean the appearance of another series of circumstances due to its limitations, which can obstruct its functioning: an increased subjectivity implicit in the use of the "models" for its calculation in the event that there are no liquid markets in operation. This subjectivity to a greater or lesser extent is always present and is inevitable since the models require a series of assumptions and these may produce errors and asymmetry of information.

Consequently, market use can introduce greater volatility on the balance sheets of institutions, on profit and loss accounts and therefore on the regulatory capital banks need to maintain. Volatility which, moreover, can induce the creation of inadequate incentives in decisions by executives who would give greater importance to short term decisions.

All these limitations have been highlighted with greater clarity as a result of the crisis in markets, "in short, the financial disruption has highlighted significant weaknesses in the application of "reasonable value" in at least the three following areas... From a quantitative point of view it has revealed the failings in the design of valuation models, which have not been capable of capturing the characteristics of the more complex products... From a qualitative perspective problems have come to light of Governance since adequate systems have not been established to assess and verify the valuations made... The information communicated to markets does not seem to have been sufficient to enable users to understand it" (Viñals, 2008).

Solution of these problems cannot in any event include the elimination of "reasonable value", under normal circumstances and even less in critical circumstances –nobody appears to support this– as a result of both the fact that there is no valid substitute and reasonable value introduces important elements of transparency and market discipline which cannot be replaced (much less at the present time), thereby reinforcing what is established.

Both the existence of failings which the crisis has made manifestly clear and the conviction of the need for a mechanism like that of "reasonable value" which functions adequately in diverse circumstances, make a more detailed analysis of it necessary in circumstances such as the present ones, and there is also a need in institutions to apply measures and standards which instead of automatically "triggering" transactions, function as a signal to proceed with a reconsideration of the situation at that time.

This will enable "...use of the analysis produced by the application of reasonable value to obtain better information on buy-sell decisions instead of using a signal which triggers a compulsive sale and stimulates undertakings to more carefully consider the prospects for the future cash flows of their assets" (GFSR, 2008).

In this respect, courses of action need to be developed in order to define a valuation structure based on "reasonable value" capable of combining "...requirements of great importance to the Financial System: the provision of reliable and comparable information in order that investors can adequately take their decisions, and at the same time contribute to financial stability..." (Viñals, 2008)[55].

This all raises new problems which, as shown by the Financial Stability Forum (FSF, 2008) report, are being tackled by various institutions which prepare standards and guides[56].

As well as the above there is the functioning of Rating Agencies. Basel II accords a very important role to these institutions in relation to the ratings of institutions and instruments. Their activities in the recent past have not been characterised by their brilliance and a large part of the responsibility for acceleration of the crisis can be attributed to them.

Rating Agencies are a fundamental element in trading on financial markets, very important to less sophisticated investors, a category which in development of the recent subprime crisis takes in virtually all of them.

The actions of these agencies have clearly accentuated the problem. The allocation of high ratings to complex structured products based on inadequate or scant historic data, or on badly based models which have undervalued correlations in the return on structured products, have favoured ratings for investment products without much foundation. Their rapid overvaluation and their still much more rapid devaluation have strongly contributed to precipitating the crisis. "After assigning high ratings between 2004-2007 to some structured products (RMBS and CDo)[57], thereby contributing to the rapid growth of subprime lending, since mid-2007 they have announced

55 In the work cited an analysis is made of approaches capable of improving valuation mechanisms such that they give a more true and clear picture of the risks and benefits which institutions assume over the course of a cycle. On these lines the work analyses two approaches capable of improving the functioning of "reasonable value": the establishment of "valuation reserves" to be created by institutions in respect of products valued at market prices, which will facilitate recognition in accounting terms of the uncertainties associated with the calculation of "reasonable value" under special conditions, and the creation of a dynamic provision, already dealt with in another part of this work.

56 The IASB has a project in progress which is intended to improve the valuation of instruments in situations such as those referred to, in which a "mark to model" valuation must be made. The Basel Committee is working on strengthening the capacity of institutions to make valuations in stress processes, and the International Auditing and Assurance Standards Board is trying to improve external audits of valuation processes and their transparency.

57 RMBS, Residential Mortgage Backed Securities. CDO, Collateralized Debt Obligation.

an accelerated fall in the ratings of these instruments; this has raised doubts regarding the quality of those initial ratings given to structured products" (FSF, 2008).

The problems which have arisen with quality of work have been diverse, not only in relation to ratings but also in their internal processes and other aspects of their functioning. Firstly, the clear conflicts of interest which the financing model of these agencies raise, very profitable in recent years based on the "payment by issuer" model, both from granting ratings and carrying out consultation work, modelling processes, etc. Secondly, implementation of the internal analysis process conditioned by a lack of historic data or use of adequate analysis scenarios; and together with these, the absence of public information on historic results of their ratings and methodologies used, are similar problems which have led to the work of these agencies being questioned.

As well as the above, a further aspect of a different nature, but similarly concerning, is that produced by the restriction on competition in the sector due to entry barriers and the de facto semi-official role of agencies in general and in Basel II in particular.

The FSF (2008) proposes recommendations, some of which are already in preparation, on the aspects referred to: the improvement in quality of rating processes, differentiation between structured products and others, improvements in the quality of the underlying data used and in the use of ratings by regulators and investors. Put another way, and formulated from a non-official point of view, the area for change should cover: opening the sector up to competition, disappearance of the semi-official role which agencies play in Basel II and in investment decisions of managers, a prohibition on activities with conflicts of interest, changes to the "remuneration model" from issuers to investors (with the application of measures to avoid investor free-riding), etc. The agencies have lost a good part of their reputation and only serious and credible reforms –and not simple cosmetic changes– will be capable of restoring their credibility in the rating business" (Roubini, 2008).

Independently of functioning, the difficulties in valuation of certain instruments, etc., the root problem which has been arising for some time is that of the type of regulatory and supervisory regime of Rating Agencies. At the present time there are two models: in Europe self-regulation is in force with an IOSCO Code of Conduct to reinforce the aspects referred to, the final version of which was published in May 2008, and compliance with which is overseen by the European Committee of Securities Regulators, and that of the SEC in the USA, responsible for drawing up standards and evaluating compliance with them and granting official recognition. The problem is not simple, it has been arising for a long time and there is no clear solution since both models have difficulties of different types. Firstly, self-regulation has clear difficulties in compliance and its functioning obstructs the appearance of new members (it operates under a natural monopoly regime). The SEC model also raises operational difficulties and requires a volume of knowledge, assessment techniques, etc. which are difficult to achieve, and at the same time problems could arise with the obvious demonstration of public oversight.

The reform measures indicated in the report from the Financial Stability Forum, without being sufficient, are highly necessary while waiting for resolution of the basic problem. In this respect, a possible path for change could be explored (Restoy, 2008 a and b) inspired by the bodies which at the present time are drawing up international standards of financial information and others.

9 Changes deriving from the European Agenda

The second block of reforms which will contribute in the immediate future –some are already doing so– to change in our financial markets in general, and securities and market infrastructures in particular, have their origin in the European Agenda for construction of the Single Market. Of the different initiatives, those of greatest repercussion on our System are examined in this part of the work.

9.1 Markets in Financial Instruments Directive (MiFID)

One of the basic pieces of legislation aimed at construction of the Single European Market in the field of Securities Markets is the Markets in Financial Instruments Directive (MiFID), which aims to promote the construction of a single market for all transactions in securities, whether wholesale or by retail clients[58].

Although approval of the MiFID is possibly the catalyst for more important change in the immediate period, there are other initiatives at different stages of development which will also contribute to modelling the future of entities which act in the securities market and which require special attention from the market supervisor. It is of interest to refer to at least two of them before entering into an analysis of the MiFID.

Completion of the process of transposing the Directive on Transparency of Issuers with securities admitted to trading on a regulated market will be another important development. The new framework for disseminating information which incorporates responsibility declaration obligations of directors, the harmonisation of publications and the more precise obligations of communication and notifying relevant events, are some of its elements. The chance to reinforce transparency questions, a fundamental task for the market supervisor, becomes more opportune at this time when we are still suffering the consequences of turbulence in markets in which the lack of transparency has been a factor which has made a very powerful contribution to unleashing the crisis and its subsequent worsening.

Publication of the Takeover Royal Decree, which simplifies earlier mechanisms, clarifies competences between operators and attempts insofar as possible to avoid the use of subjective criteria by the supervisor, and also constitutes another element which will contribute to the development of securities markets along the lines of efficacy and flexibility.

Returning to the MiFID, it can be said that the increase in competition between securities trading centres, elimination of the obligation to concentrate all operations in regulated markets, the harmonisation of operations in them and in the alternative trading systems, and recognition of internalisation as a means of contracting, the capacity to select the trading systems for operations, and improvement in investor protection by additional transparency requirements, internal organisation and codes of conduct, are the instruments which the Directive uses to bring about an efficient and competitive integrated market. This Directive is set in the framework of the objective of constructing the Single European Market and its manner of prepara-

58 Transposition of the MiFID, and therefore its incorporation into the Spanish legal structure, has taken place through modification of the Securities Market Act which, as well as the MiFID, has incorporated the new legislation on adequacy of the capital of investment services firms and credit institutions.

tion is based on the "Lamfalussy Scheme"[59].

The contents of the MiFID

The purpose of this work is not to discuss in detail the contents of the Directive but to highlight its importance for the transparency of all elements –agents, clients, regulatory authorities, etc.– which configure the structure and functioning of securities markets. The search for competition and operating equality between all existing markets, transparency in all aspects of trading and in all its stages, and a broad range of requirements to ensure investor protection –by the "Best Execution rule"[60]– are the elements which form the body of the Directive. It is therefore an ambitious Directive which will bring about the transformation of securities markets but which is not free from difficulties and will require significant efforts by entities which engage in any activities in securities markets. Furthermore, it will without doubt involve substantial cost in the early stages of its implementation, although at the same time opening up important business prospects[61].

In a very simplified way it could be said that the Directive[62]:

- Changes the scope of application of its predecessor, the Investment Services Directive (there is now inclusion of investment banks, portfolio management firms, collective investment undertakings, corporate financial undertakings, futures market firms, raw materials, etc.).
- It reiterates the right to free provision of services in all jurisdictions for those undertakings which have been approved by one Member State.
- It harmonises the operating requirements for all existing trading systems. It thus poses a new trading environment, partially now incorporated, but with important changes in the areas of structure, organisation and functioning of markets. The three types of trading system which exist in European markets –Multilateral Trading Systems (MTS), Regulated Markets and Systematic In-

59 This is the first regulation in accordance with the different levels established by Lamfalussy: the MiFID is Level 1, there are directives and regulations of Level 2, and recommendations and criteria of Level 3.

60 Some parties raise problems of interpretation prior to the task of applying them. One case discussed is "Best Execution", definition of which can have different components, with the possibility of weighting them which may vary in different circumstances, regarding which the industry has shown concern.

61 In estimates of costs and benefits of applying the measure made by the FSA in its ongoing "Impact Assessment" programme of all legislative measures, the asymmetry was established which exists in the nature of the regulation, since the costs are relatively easy for undertakings to define and quantify, whilst the benefits are difficult to establish "... it is clear that implementation of the MiFID represents a cost to the industry, particularly in the first years, but it creates the potential for opportunity for income in the long term (FSA, 2007).

As it is not national legislation, the impact analysis does not have the same scope as in the case of those in which the calculation is more stringent and can contribute to its acceptance or rejection, amongst other reasons because compliance in the case of any directive is obligatory and therefore independent of the results of the assessment of its impact.

Quantification of the impact showed that application of the Directive could generate 200m£/year in recurring profits (basically by reduction in compliance and transaction costs). The one-off quantification of costs could be between 870m and 1b£ and a recurring cost of100m£/year. It goes without saying that these figures are aggregate and that the effects on each industry may be very different as a result of the manner in which the Directive affects each one (FSA, cited).

62 On this point I am following the article by Nieves García "MiFID: A new framework of competition of security markets". REF No. 12 (May 2007).

ternalisers (SI)– will act under equal conditions and may freely select clearing and settlement systems. They may also participate directly in them if they belong to another Member State.

- It requires the establishment of strict organisational and conduct requirements of firms and transparency in all parts of the business, including client service.

  These proposals involve implementation of a work programme of extraordinary scope and undoubted benefit for the industry. From the extension of responsibilities of Boards, taking in the function of legislative risk compliance and internal audit, to consideration of non-compliance as a risk which must be prevented –like any other risk– and providing adequate policies, are some of the new requirements which will come into effect with the Directive. Together with these, the preparation of contingency and continuity plans and attention to operational functions which relate to client relations –strengthening the "know your customer" principle– will complete the new framework.

  Client protection constitutes a central point of the MiFID and to this end it establishes a series of requirements relating to relations with clients, beginning with their classification –retail or professional– which involves different treatment and communication to clients of their classification and the rights and obligations which it brings with it.

- It implements the principle of "best execution" in all transactions. The most radical changes established by the MiFID are "breaking with the rule of concentration of securities markets, generalised transparency requirements and the obligation of undertakings to execute orders from their customers in the best possible manner" (García, N., 2007). The content of this principle is broad and is subject to problems of interpretation in the practice of undertakings. There are nevertheless several clear obligations: having operational resources which facilitate management in the direction of the objective established (best execution), documentation of the policy which is to be implemented in order to achieve the objective, and endeavouring to make this consistent and capable of being demonstrated.

- It covers not only securities but all financial instruments which can be traded: exchange rate derivatives, shares in collective investment undertakings, etc. Furthermore, all markets, trading systems, financial intermediaries who provide such services and investment managers who trade financial instruments will be obliged to comply with its rules.

Differences in MiFID treatment - banking institutions

In addition, banking institutions also provide investment services and the MiFID is of a comprehensive nature. The definition thereof does not take into account –possibly it could not do so– that its application extends to more complex entities in which the operation of financial services, regulated by the Directive, is just another of those provided by banking institutions.

To the already important problems of interpretation deriving from the principle of "best execution" can be added a greater degree of difficulty when we consider the framework of banking institutions. We have seen that the Directive establishes categories for clients with very specific practical effects in their treatment. This is so because the classification established by the Directive is a response to activities

which are different in their nature from those of banking institutions.

The characteristics of banking institutions are more complex as a result of the nature of their business. Not all customers hold financial instruments, but may do so at any time. This being so, what happens with respect to client classification? The principles of the MiFID are clear, but the problems which arise in relation to the bank customer group are complicated to resolve and information on them is not always available. The commercialisation of products also raises uncertainties in relation, above all, to those originated by the institution itself. The Directive[63] appears to indicate that recommended products must, as well as being adequate for the customer, be the best which exist in markets. The manner in which this is put into practice could lead to conflicts of interest in banking institutions.

The fact that the legislation in its application to banking institutions obliges them to deal with similar activities with different requirements may also be relevant. This is so because the MiFID could not take into account the characteristics of the personal service which banks offer to customers, since banking and financial products in general are not isolated on the basis of their legal nature but, on the contrary, the borders between traditional investment products (deposits, securities, insurance, etc.) have been permeable for a long time.

The foregoing is just part of the, rectifiable, conflicts which could arise in interpretation of the different regulations which converge in complex entities (more complex of course (certainly more complex than covered by the MiFID). The problem "is not in the contradiction between some provisions and others but in the global focus of the requirements, based in one case, the specific case of activities with securities, on a detailed mandatory regulation, however much it is qualified by the principle of proportionality to size and complexity of the services provided, and in another case on supervisory principles for the organisation as a whole which will be dealt with in the context of the relationship between supervisor and supervised, and very much in particular the assessment by the former of the exposure of the latter to the risks of its overall activities" (De Miguel, 2007).

The problem of transparency of markets, or to be more precise the lack thereof, has acquired emphasis in recent months as a result of the subprime crisis. The objectives sought by the MiFID will only of course be fulfilled when transparency is effective and therefore the requirements laid down by the Directive include those of transparency for all financial service providers. These obligations established by the Directive are set down in different articles. For Regulated Markets and MTS they are the same, and different for internalisers. In the case of the former, which are mechanisms for public dealing, the requirements are broader and more general than in the case of the latter.

Competence and coordination

There are two aspects relating to its structure which merit additional comment: the first is that relating to its cross-border application and the second relates to the effect on the banking system. The need to improve the ISD gave rise to the MiFID

63 If a restrictive criterion is adopted in the definition, two groups of clients will be separated without any prudential justification, since they are all subject to offers from financial institutions. On the other hand, a broad focus could create insecurity and alarm amongst clients who in no way expect the communication required by the MiFID.

in order to provide cover for and facilitate the development of markets within the Single Market Plan. To this end, the Directive seeks to harmonise and delineate all organisational requirements and rules of conduct, assigning to the Member State of origin full supervision of those ISF which engage in cross-border activities under the regime of free provision of services and establishes, in the case of a branch, the competent authority of the host Member State which will be responsible for the services provided pursuant thereto complying with the obligations laid down.

With respect to cross-border aspects, as occurred with the work of the CEBS, the CESR (Level 3 Committee) has been working on perfecting the regime of cross-border activity in various articles of the MiFID "in order to achieve maximum harmonisation of procedures for notifying passports, and the establishment of bases which reinforce collaboration between host and origin supervisors, both in the process of authorisation and in subsequent supervision" (Martínez, S., 2007). Of the different matters dealt with by the Committee[64], that of most import and controversy was that relating to the responsibility of the supervisor of origin and that of the host, to the point that the only recommendation of the CESR under this heading is to urge Member States to commit to continue working to find a means of practical cooperation.

The potential effects on internal organisation are also important, since compared with the details of the MiFID, the Banking Directive establishes general principles of good organisation, although the European Committee of Banking Supervisors is developing these general principles by their publication in guides (some on internal control procedures have now been published) which can give consistency to the application of both pieces of legislation, helping to alleviate the problems of differences in approach.

The conjunction of these two realities, different in their nature –banking institutions and securities firms– will obviously require a process of adaptation which should not be easy given the different nature of the two. Nevertheless, the problem has a solution and it must be sought through the preparation of national provisions transposing the Directive and the joint coordination of the Level 3 Committees which are already working on these matters with a more coordinated vision.

A final consideration should be taken into account in relation to the activities of supervision which, as is known, are at the present time distributed between the BS for banking institutions whilst the CNMV is responsible for supervision of the Securities Market, including when the operator concerned is a credit institution. As already mentioned in another part of this work, the desirable change in the current supervisory model, which is markedly sector-based, towards another in which the solvency of all entities lies with the BS and all functioning of securities markets with the CNMV, will help to resolve these problems.

64 Timetable, passport of tied agents, activities of representative offices, cross-border agreements, harmonisation measures taken, etc.

9.2 Insurance Directive: Solvency II

Another important regulatory change in the EU area will without doubt be the future Solvency II Directive. Although provision for its approval sets a still distant date (2012), the process of preparation and different exercises carried out are clearly anticipating the change in the EU insurance field.

This project, with a structure parallel to that of Basel II, has the aim of carrying out an in-depth review of standards of solvency in the EU insurance sector. The accord in very general terms seeks a predominantly, but not solely, economic focus, for use in assessing risks on the balance sheets of insurance companies. The specific proposals of the Accord deriving from this general intention are (ECB, 2007):

1. Strengthening protection of policyholders by improving the financial fortitude and resilience of the industry.
2. Full integration of the European market for insurers.
3. Improving the competitiveness of the latter.

The Accord was approved by the Committee in 2005 and its transposition as a Directive is forecast for 2012. This Accord will cover life and non-life insurance and reinsurance. As with Basel III it will have three pillars:

Pillar 1, establishing the capital requirements of undertakings and aiming to reinforce their sensitivity to risk, as happened in the case of banking. In this case capital requirements have two levels: Capital Solvency Requirements and Minimum Capital Requirements. The first relates to the necessary level of capital which the undertaking must have in order to ensure that unforeseen losses can be absorbed in a year with a degree of probability. The second requirement indicates the threshold of capital below which the supervisor must take immediate action[65].

Pillar 2 has the purpose of harmonising supervisory procedures and stimulating suitable treatment of risks and governance. The qualitative assessment of risks not taken into account in Pillar 1 will take place in this Pillar.

Pillar 3, as with Basel, will be concerned with supervisory information and transparency in order to promote market discipline.

One important aspect of the accord is that it will favour, or at least this is one of its objectives, consistency of prudential supervision of the banking and insurance system which constitutes an important element in promoting stability of the Financial System as a whole, given the close relationship between the two sectors. For this reason the impacts of this accord will go beyond its effects on the insurance sector and it will have repercussions for the whole Financial System, and in particular the banking system.

The ECB report already referred to highlights these potential effects which range from the promotion of convergence mentioned to a reduction in deficiencies in the allocation of capital between sectors (by reducing the possibilities of regulatory arbitrage) and taking in the fact that, as a likely result of the Agreement, on a greater incentive being produced to invest in corporate bonds the banks which are their

65 As well as the risk covered by Basel II, Solvency II includes those of mortality, longevity, catastrophes, etc. in line with the cover offered by the insurance sector.

principal issuers will be benefited and by less pressure on differentials the cost of capital will be reduced. This latter aspect is of doubtful effect, however.

This future Directive is being prepared in the framework of the Lamfalussy Scheme and therefore the general structure of the Directive will be approved by the Council of Ministers and European Parliament, foreseeably before the end of this year. In the meantime, the QIS 4 is being carried out which is trying to measure the impact of the project on the regulatory framework of the insurance industry.

The discussions on Pillars 2 and 3, supervisory review and transparency have also led to important agreements. There are still some problems of agreement in relation to the "supervisor group" regime and consequent appointment of one group supervisor (on the lines of the Basel Directive) with clear responsibilities for supervising all activities of the group in the EU and establishing a regime to facilitate the treatment of capital within the group.

In any event, those responsible for preparing the Accord are considering to what extent the effects of the crisis on the Basel II Agreement –now in operation in several jurisdictions and analysed in another part of this work– may have a bearing on aspects of their work, thus taking advantage of the possibility of extracting lessons applicable to its preparation process.

9.3 Single Euro Payments Area (SEPA)

As happened in other areas, the increasingly accentuated contradictions between a nationally fragmented retail payment system and an economic area with a unity of market have been the stimuli which have impelled development of the SEPA initiative, "Single Euro Payments Area", the purpose of which is disappearance of differences between national and cross-border payments, "creating a single market for payments in euros such that European citizens can make payments throughout the zone from a single bank account, using a single series of payment instruments and with the same simplicity and security with they do so now in the national sphere" (ECB, 2006).

The project arises from self-regulation and not legislative initiatives, although it is true that European and national authorities –central Banks, governments, public administrations and the European Commission– are supporting the process and participating very effectively in its development[66].

In very general terms the project covers four basic areas:

a) Electronic instruments. Paper instruments fall outside its scope which, on the other hand, includes transfers, direct debits and cards. For these the European Payments Council (EPC) has drawn up technical and business standards for transfers and direct debits and a framework of rules and principles for payments by card.

b) Infrastructures for processing payment instruments. By separating infrastructures and instruments, the project attempts to ensure the inter-operability of

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66 As a response to publication of Parliament and Council Regulation 2560/2001 on cross-border payments in euros, the banking community launched the SEPA project, creating a "European Payments Council" (EPC) responsible for design and direction of the project.

the former, permitting the automatic processing of orders from beginning to end. Having achieved this objective, functioning of the market will probably lead to a reduction in the number of operators.

c) The preparation and application of common standards will guarantee that interbank relations and those of institutions with other agents participating in order processing are implemented in an efficient manner.

d) The legal sphere in which payments take place is definitive for their proper functioning. In other words, fragmentation in the legal field is an important barrier. The EC has developed a Directive which defines the necessary harmonised framework[67].

The timetable for implementation has two important dates:

1. SEPA for citizens. At this time instruments will begin to be available for bank customers for both cross-border and national transactions.
2. SEPA for infrastructures. Full harmonisation must be a fact. In the first part of 2008 the infrastructure are already available for processing both the old and new instruments. At the end of 2010 migration must have taken place of the new instruments such that a critical mass is reached which makes the process somewhat irreversible.

The foregoing is a very summary description of the SEPA functioning structure which will mean an important impulse for construction of the single market in financial services. The process which already began to function on the planned date –in April 4,000 banks had already joined in to the transfer scheme with a volume of 100,000 transactions daily[68]– raises the logical uncertainties of a process of this type which generates substantial costs over a long period of time. It makes sense to comment on some of these aspects:

Firstly, what is considered fundamental to driving the project is the participation in it of Public Administrations (PA). In the EU these represent approximately 50% of GDP and are involved in some 15%-20% of all payments, and therefore their early participation in the project will contribute to creating a critical mass which would drag the industry with it, eliminating vacillation.

In the case of Spain, PA are as a group the biggest users of payment systems since the most recent estimates indicate that they generate around 20% of payments. The problem which arises here and throughout the EU is therefore knowing whether PA will adopt the changes raised by the SEPA, and whether they will to do so quickly. Despite all good intentions, and the continuing appeals by Community authorities –Commission, Parliament and Council– reticence can be seen in some areas[69].

The procedures for handling payments in Spain are usually different for the different public bodies. Given the importance of some of them in processing their operations, such as tax or social security contribution collections, there are specific

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67 The Payment Services Directive was approved by the European Parliament on 24 April and by the Council on 15 October, with 1 November 2009 fixed as the deadline for its transposition. In each country national organisations and Central Banks are working to this end.

68 McCreevy (April 2008): "Single Euro Payment Area: Releasing the Power of Payments".

69 For and against: Political declarations of support for SEPA, both in ECOFIN and on the Financial Services Committee, are accompanied by clear statements that administrations, like any other user, will not change

mechanisms outside the National Electronic Clearing System (NECS) with their own regulatory framework. Should these different procedures move to the common rules which the SEPA wishes to establish? What will happen with those procedures which fall outside the rules which the SEPA wishes to put in place?

Three principal areas of impact on Spanish systems can be distinguished[70]:

At a technical level, the changes in formats for communicating information between entities or between themselves and their customers; in Spain those of the NECS have been used, whose transformation is necessary and not difficult, for example by the use of converters. With respect to the area of banking usage and practice we can particularly mention use of the IBAN as account identifier, return periods and the SHARE expense clause.

Finally, the competitive framework could also be substantially affected both in processing and in relations with customers. In the first case, the separation of schemes and processes will be consecrated. After unification of schemes participants will be able to elect the processing infrastructure which they prefer (all the more so taking into account the requirement of inter-operability between them) which will be a stimulus for competition.

The same phenomenon will occur in relation to gaining customers. One particular case will be that of direct debiting of bills which takes place by large issuers through bank accounts throughout the country and by the use of the national payment system. This constitutes a certain obstacle to competition since foreign entities do not have access to the National Electronic Clearing System (or it would not be profitable for them). This disappears with the elimination of technical barriers, making it possible for any issuer of invoices to use the services of any entity in the geographical area of the SEPA, and furthermore access is opened up to national payment systems which will take place under the same conditions and requirements independently of the country of origin of the foreign entity, making it possible for foreign entities to participate in the SNCE.

Another aspect which will have particular repercussions throughout the EU and which will make important changes necessary in an extraordinarily active market are the reforms brought about by the SEPA project for cards. At the present time in the EU area there are 350 million cards in circulation, which are used for over 12 billion payment transactions and 6 billion withdrawals from ATMs each year.

The purpose of the reform is to create a safer environment –"SEPA Card Framework" (SCF)– in the EU and establish the conditions which cards must fulfil which wish to operate in it. The idea pursued is that European citizens can use the cards in any area of the zone under identical conditions throughout it and with full freedom of selection for both them and for traders.

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to new processes and instruments which mean a deterioration in current conditions. To this must be added the fact that the decision to migrate to SEPA requires a certain period of time for administrations which have to make the corresponding provisions in their budgets to adapt their payment processes. In short, no clear trend can be seen for administrations to be "early adopters" in SEPA (except in Belgium).

In Spain, the administration is working on preparations for the migration, working groups have been formed, although it is not expected that the migration to the SEPA by public administrations will take place before 2010.

70 In the article by A. Orland and J.L. López (2007): "Impact on the Spanish banking community of the SEPA project" (BS).

The area of operation it is intended to create will have the following characteristics: "a) consumers will be able to choose between the diversity of competing card schemes, b) a reliable and cost-efficient competitive market will be created, including infrastructure providers, c) all technical contractual provisions, business practices and standards which have led to segmentation in the EU area will disappear. In particular, there will be no obstacle for traders to accept any type of card which complies with "SEPA conditions" (ECB, 2006)

From the Eurosystem point of view, in order to comply with the SEPA standards card networks must guarantee inter-operability with cards and terminals of other networks, apply the same rates throughout the euro area and making them public and explaining their manner of calculation, comply with the principles of the Commission, maintain an effective separation between governance of networks and operating processes, enable the issuer and acquirer to select processing centre and avoid practices which favour own processing services, contribute to design of open standards, fight against fraud, etc.

The SEPA environment defines three options in order for a card to be "acceptable" in the new environment it is wished to create: 1) replacing the national scheme by an international one (which is now "adequate"), 2) alliances with other systems or expansion throughout Europe, and 3) developing the co-branding system.

The first option would require the international scheme to adapt its services for the euro area to the SEPA requirements. The ECB considers that several national systems are given thought to this solution which would represent a simple manner of adopting the SCF, but it is concerned that the higher rates which these international schemes apply may translate into higher costs to traders and competition would be reduced to these two schemes (VISA, Master Card). The second option could materialise in creation of a European scheme accepted by all, or alliances between European schemes with independent functioning of each. The third, co-branding, is that being used today in Spain. This solution, if widespread and continuing over time, would perpetuate the current situation and would not fulfil the SEPA objectives, since the schemes would be applied to the national sphere and there would be no economies of scale. In the light of the foregoing "the Eurosystem expects that at least one European card scheme may appear in forthcoming years" (BCE, 2006)[71].

Impact Analysis

The Commission entrusted Cap Gemini with an assessment study of the costs and benefits of the SEPA for the 2007-2012 period for banks (provision of services) and consumers (demand). This is not the time to analyse or describe the work and the following will suffice as a summary, to give us an idea:

71 From a study carried out by Accenture –working with 47 large European banks (seven of them Spanish), suppliers, organisations and specialists from the payment industry of 13 countries– various interesting opinions emerged regarding the future of the industry in the next five years:

- In the opinion of those surveyed, the two international card schemes will be the competitors of US and EU undertakings. In 2010 First Data, Master Card and VISA will be the three most significant in this market.
- 66% of entities do not believe that the European domestic schemes can survive beyond 2010.
- They think that in Europe there will be strong consolidation. Credit and debit cards from 11 (now) to four; domestic interbank processors from 15 to seven; ACH from 11 to seven.
- The most likely consolidation scenarios are cross-border mergers of domestic interbank processors.

In the most "favourable" scenario –that in which banks are very proactive in relation to the SEPA and users exert strong demand– the study estimates profits (cumulative in six years) of 123 billion euros. The distribution of this net profit would mean 175 billion of profits to users and 52 billion of losses to banks. In this scenario the loss by banks –the report reasons– is due to the fact that the SEPA leads to a more rapid convergence of prices in comparison to the alternative without SEPA.

In the least favourable scenario –there is no interest in the change from either demand or supply– the total result would be losses of 43 billion euros (16 billion euros to users and 27 billion to banks). The principal reason for this result is that firstly there are no cost savings, whilst secondly the participants incur the expenses deriving from participation in the SEPA and the costs of maintaining dual processing systems during the transitional period.

9.4 Infrastructures of Securities Market Systems and Payment Systems (TARGET 2/TARGET 2 SECURITES)

Construction of the Single Market requires the implementation of very diverse activities. Apart from those already mentioned in previous chapters, elimination of the fragmentation of the infrastructures of security markets and integration of payment systems throughout the EU is an essential step in bringing about this desired result.

With respect to the infrastructure of "large payments", which in a secure and efficient manner supports transfers of cash throughout the EU, work had already begun several years ago with creation of TARGET by the European System of Central Banks, as a real-time gross settlement system which connected all systems of European central banks under common standards, but which were maintained in each CB. Development of this system, which was highly satisfactory, faced an increasingly more consolidated financial environment which led European authorities to propose its total technical centralisation and the introduction of additional improvements. TARGET2 was thus created, which, having begun to operate in 2007, enables all European banking institutions to operate under equal conditions and adds the advantages of being able to concentrate all liquidity in a single cash account, making cash more agile.

Having thus improved the efficiency and security of payment systems by their concentration, the inefficiencies came to light arising from the existing fragmentation in the forms of settling securities. Consequently, a project began, "TARGET 2 Securities" (T2S) by the integration into a single platform of the securities accounts of "Central Securities Depositories" (CSD) in which combined settlement of cash and securities accounts will be concentrated[72].

The situation of trading and post-trading infrastructures (which include registration, clearing and settlement) which support the securities market, as mentioned previously, justify the need for a change. Nevertheless, the situation has in fact changed

72 The opening of cash accounts and securities accounts will continue to take place as up to now and all trade-deposit, transfer, etc. relations will continue from a legal point of view without change. The final decision as to whether this project will be implemented or not will not be taken by the Governing Board of the ECB until summer –July 2008. It may be that it has been decided before publication of this work.

in recent times since in recent years consolidation processes of unequal intensity have occurred in different stages. Thus, in trading a more accelerated process of consolidation is taking place at both national and international level, by mergers and acquisitions. This movement[73] has also taken place in Spain but, unlike others, in our country it has been of purely national scope and has taken the form of the exchanges and markets holding company (BME), as mentioned in another part of this work. Now is not the time to speculate on the advantages or drawbacks of remaining isolated from these movements and joining them late, but to be excessively late has clear risks[74].

In this respect there should be reconsideration, if not already carried out, as to what, in the light of all consolidation and change processes analysed, the immediate future of the holding company will be and to what extent factors exist in our system which could make a decision difficult. The existence of "peculiar features" in certain areas of our domestic practice may be unnecessarily preventing or delaying participation of Spanish systems in the consolidated processes which are taking place in Europe, both in the area of trading and post-trading. Specifically, it is a question of survival in our system of various practices in equities which should have been eliminated some time ago: firmness at the time of trading instead of at the time of settlement and, connected to it, the existence of Registry References. The above all gives rise to a situation in which integration of the Spanish system in European projects of this type becomes difficult[75].

In post-trading integration has been less and a large number of depositories remain which are monopolistic in their respective countries[76].

This unequal situation of fragmentation, legal frameworks, technical standards and different market conventions in different countries –the "Giovannini Barriers"– clearly came to light in the reports of "The Gionvannini Group, 2001 and 2003" which served as a spur for EU authorities to adopt a series of measures.

Firstly, the European Commission was contemplating the idea of a new Directive to eliminate the obstacles to creation of a Single Market but did not carry out the project whilst awaiting for the results of the Code of Conduct which Commissioner

73 Mention can be made at the beginning of 2007 of the merger of the NY Stock Exchange and the Euronext Group, the consolidation of Nordic and Baltic markets in the OMX Group, in June 2007 the merger of the London Stock Exchange and the Italian Stock Exchange Group, which in turn emerged from a process of vertical consolidation of Italian trading, clearing and settlement infrastructures, creation of the Deutsche Börse Group, the result of a vertical concentration process of national scope which includes Clearstream, the holding company of Spanish Markets and Stock Exchanges also arose out of a process of national vertical concentration.

74 On the other hand, in the structure of the Spanish holding company there is an anomalous but secondary element, being the participation by the Bank of Spain in its ownership. This is perfectly comprehensible given the conditions of the process for creating the holding company –to which the Bank of Spain contributed the Public Debt Book Entry Centre– but despite this and the Bank having already reduced a substantial part of its holding, it is logical that it should disappear in full, since its presence could introduce "noise" into any merger project which it is wished to undertake.

75 In the CNMV Report already mentioned in the Bulletin for the first quarter of 2008, the situation of agents in the market and their prospects are analysed more fully.

76 In particular: the Euroclear Group -CSDs of France, Belgium, The Netherlands, United Kingdom and the Euroclear Bank international securities depository– which is developing a common settlement platform for national CSDs and another similar platform which has been developed by Nordic countries (NCSD Group).

McCreevy promoted and which was signed by the industry[77]. The inter-operability of trading and post-trading infrastructures and between each other is the objective in order to establish full competition and a reduction in costs of cross-border transactions. It is a voluntary self-regulatory code, applicable in principle to equities only but capable of extension to other securities. Its measures include: price transparency, access and inter- operability conditions, administrative separation in the accounting and price fields and monitoring of the Code by the promoters themselves and by the EC.

As indicated in the CNMV-BS Report on systems for clearing, settlement and registration of securities in Europe[78], together with the advantages represented by self-regulation, in the sense that the long periods of any directives are not needed, its monitoring by authorities must be stringent and promote objectives beyond what the industry would establish for itself. It further mentions, as a complicated aspect, the fact of promoting competition without the a priori existence as initial starting point of a harmonised regulatory framework which permits competition under equality of conditions. The assumption that the increase in competition between jurisdictions by service providers must translate into automatic reduction in prices in cross-border operations will depend much on the costs deriving from establishment of the inter-operability and lack of level starting point which I mentioned previously.

For the Spanish post-trading system transparency of prices and services have not meant major changes and Iberclear will have to exchange services with other infrastructures, although the latter will have to comply with the requirements applicable in the issuer's country.

From the point of view of the Eurosystem, the possible systemic nature which failings in market infrastructures could have does of course affect the backing for transactions in securities. One incident of this type could disrupt the clearing-settlement processes and block movements in cash channelled by the T2 platform, in the event that the settlement of securities cannot take place. No less important is the fact that monetary policy operations and all CB credit operations must be backed by securities –now deposited in Central Securities Depositories (CSD)– and therefore the existing fragmentation in their settlement and absence of foreseeable market solutions gives rise to thinking that in this field consolidation is more important than in any other "...and to the point that if we reconsider solely the operational and settlement risk control point of view, what is desirable is consolidation of settlement of all securities in the same system or platform, such that failures can be minimised in deliveries of securities and therefore settlement risks minimised. Given the interdependence between the payments and securities system it is safer and more efficient to maintain securities and cash accounts on a single platform which facilitates the process of delivery against payment in the provision of credit by Central Banks, virtually automating it when the period is intra-day" (Nuñez and Jiménez, 2007).

77 The Code of Conduct announced by the Commissioner for Financial Services, Mr. McCreevy, "European Code of Conduct for Clearing and Settlement", was signed in June 2006 and published in November of the same year.

78 The document drawn up jointly by the Spanish Securities Market Commission and the Bank of Spain which exhaustively examines post-trading and the infrastructures which support it, its situation in Europe, regulatory framework and initiatives in progress, already referred to in the text. It also analyses their impact in Spain and the possible path to follow.

The foregoing considerations led Eurosystem to promote the creation of a platform which concentrates securities transactions in euros, where the securities and cash accounts would reside. The platform would manage both types of account, such that it would facilitate the management of liquidity and that of securities which act as collateral. It will merely be a technical support to facilitate settlement without aiming to remove any of the capacities or operations of CSD with their clients, such that registration, custody, trading, administration, etc. will continue to take place as up to now.

The purpose of this work is not to describe the functioning and characteristics of this platform (which is done in detail in several of the articles cited in the bibliography), but rather to illustrate how, as well as eliminating the high cost of cross-border transactions produced by fragmentation, there will be multiple benefits for the system. The article cited, amongst others, mentions: settlement of cross-border transactions (delivery against payment), reducing the principal and liquidity risk, increasing efficient operation of national and cross-border transactions, benefiting from economies of scale and network typical of this type of activity, simplification of the web of technical connections between depositories, favouring inter-operability, etc.; in short, cross-border management of collateral will be simpler, free choice and access by undertakings in the sector and by trading infrastructures to the different settlement systems will be possible, etc.

Obviously the characteristics of business in Spain will be affected with varying intensity in different areas.

With respect to fixed income, with decentralised bilateral trading, or on market platforms but in any event with individual settlement transaction by transaction (Iberclear-CADE), major changes cannot be expected. The situation of equities may be more complicated, since in this case not only is the model different but market legislation and various administrative practices will require substantial reforms[79].

Participation in these European projects –much more in this area of payment infrastructures in which Spain has maintained strong positions– is essential. In fact, in the first stage of the project representatives of the Spanish authorities, Iberclear, credit institutions, etc. have been participating in the different organised working groups and the Bank of Spain forms part of the group of four central banks which will develop it.

The confluence and complementary nature of the three projects referred to in this and in other parts of the work –T2S, MiFID and the Code of Conduct– mean that their effects are mutually reinforced in order, in the medium and long term, to bring about the international diversification of portfolios, easier access to other markets and elimination of the need to resort to international custodians, which will in short

79 With equities the changes will indeed be more important. Trading takes place in a single centralised multilateral market which settles its transactions in Iberclear in several settlement cycles –gross in securities and net in cash– which is a different model from that of T2S. As stated in the text, the rules for functioning of the market and some of the administrative processes which underlie it, covered by the exclusivity of stock exchange business, registration, clearing, etc., will be difficult to fit in. These processes which will be difficult to adapt also include the problem of registry references. The requirement of firmness of the transaction at the time of contracting and the requirement, as a prior step to settlement, of justification of transactions carried out on the Stock Exchange (RR) cannot fit into this new framework and will have to be reviewed, something which should have been done some time ago.

mean less complexity in the chain as a whole, trading, clearing, settlement and registration, and cost savings.

10 Economic and financial evolution: scenarios of change

10.1 Banking system

In earlier parts of this work the evolution was examined of the Financial System in recent years. The exceptionally good situation of all ratios which are used to define a particular situation: profits, return, efficiency, solvency, provisions, etc. have demonstrated a very favourable evolution of the Spanish Financial System.

All factors which have been contributing to the development in the last ten years are undergoing major changes which will condition the development of our system, and without doubt open up a new stage which will require the provision of new strategies in an attempt to maintain the solvency and security of the system.

During the whole of this time, the element driving the Spanish economy has been the real estate market (developers, construction and housing acquisition). The macroeconomic environment has helped in this process. During most of the period the economy has been recording real interest rates which have permitted rapid indebtedness and accelerated development of the construction sector. In parallel with this development, and partly propelled by it, an extraordinary flow of immigrants has been recorded which, as well as covering labour requirements, has enabled wage increases to be controlled.

As from 2005 a gradual increase in interest rates in the euro zone began to take place which, acting on a market of variable rate mortgages (virtually all), has given rise to major elements of stress in it –this is shown by the fact that the debt/disposable income ratio of domestic economies has grown so rapidly. In this context the most prejudicial element is the fall in employment and consequently, as it deteriorates, the situation will become more aggravated.

Apart from the situation of domestic economies, consideration of the problem from the point of view of development and construction also raises a negative panorama. The process of financing these sectors from the point of view of banks, and in particular savings banks[80], has thus generated a very substantial volume of activity and level of exposure which in a context of scant liquidity, and therefore with problems of financing and lower demand for housing, has meant that these sectors which have been involved in a process by all accounts excessive, have been placed, together with the financing institutions, in a difficult situation in which it can only be expected –and this is now happening– that there will be an increase in insolvencies and a rapid adjustment of undertakings devoted to development and construction. This process is inevitable given the degree of involvement of all agents participating in it and whose full development is the only way of restoring the situation without

80 Developer and construction loans have on average represented 46% and 23% respectively of all growth in the last five years. In the last ten years growth in these risk segments in the business was more intense in savings banks than in banks (savings banks have maintained the intensity of the process when in recent years banks have begun to slow down. The explanation is related to the strong geographical expansion of the former in this period).

resorting to actions which are usually presented as magic solutions, but which are often simply self-seeking.

It is worthwhile pausing in order to place the situation of the real estate crisis in suitable perspective. The problems which are appearing in the construction sector are not, as frequently heard, "a consequence of the crisis", the crisis and its problems are the result of prior behaviour by participants in one form or another in the real estate business: construction companies, real estate agents, financial institutions, local or regional authorities, etc., which are therefore responsible in the first place for what is occurring. It is true, as stated in another part of this work, that not everyone has acted in the same manner, but the current has been fairly powerful. It is true, furthermore, that the growth has been based on conditions favouring demand (economic situation and real interest rates) which have stimulated business. But this justifies nothing and it is somewhat embarrassing to have to say it.

All this process fed a bubble financed by institutions which concentrated the majority of their business, not all to the same extent, in it while not heeding the continuous warnings of prudence from supervisory bodies. Indeed, both international bodies (IMF/WB) and the Bank of Spain itself had warned of the risks of the situation and the need for moderation.

The former, as indicated in another part of this work, in 2006 warned that evolution of the housing market was one of the most worrying elements of the system and that it presented greater risks for the future. Furthermore, the WB, on the same lines –at meetings with institutions, in public statements and speeches by its authorities and in its publications, the Financial Stability Report and Economic Bulletin– has been warning of the risk of the evolution and need for moderation as well as recommending a strict application of loan conditions. With a nil outcome it was only in the middle of 2006 when any signs appeared of concern and slow-down in the policies in some institutions in the banking sector.

To this situation was added the international crisis, the contagion of the subprime crisis of the United States in the evolution of markets and negative evolution of energy prices. This series of factors foretold a radical change in relation to the growth process of the last ten years. Faced with this change and from the financial point of view it is sensible to consider which are the strong points of the Spanish Financial System and on the basis thereof explore which are the most suitable measures for reorientation of activities, in an attempt to maintain the excellent functioning and solvency parameters of the system.

On the positive side of our institutions there is firstly the fact that in our Financial System there has never existed a phenomenon similar to that of the US subprime, and therefore the problems of other jurisdictions have not arisen since securitization in the Spanish system has been a form of obtaining liquidity "...for banks, enabling them to diversify their investment bases and contribute to the medium term increase in bank liabilities as well as matching assets and liabilities in terms of maturity. Maintaining risk on the balance sheet has helped to support the quality of mortgages and consequently maintain capital cushions" (Moody's, 2008, Financial Stability Report, April 2008).

Another important aspect is that the banking system has been capable of generating sufficient assets to obtain financing from the ECB. The Spanish securitization market in 2007 reached an issued volume of 143 billion euros, approximately half of

which was issued in the second six months of the year and was basically used to secure ECB loans. It is true on the other hand that Spanish institutions have increased their recourse to the ECB and, contrary to biased interpretations, the fact is that this increase in participation in auctions in order to obtain financing from the ECB, initially at very low levels, has not exceeded 10%, which is the figure for participation by Spanish institutions in total assets of the Eurosystem.

The widespread network of branches of Spanish institutions throughout the country, and together with this their particular proximity to customers, has also, in a short period of time, enabled substantial amounts of financing to be obtained via deposits, reversing the trend of imbalance in previous years –for example the fact that after the market stresses in the summer of 2007 Spanish deposit institutions managed to capture 71 billion in deposits, the highest level since 2002 (Moody's, 2008)–. Together with these elements of strength mention should be made all those related to the presence of a "proactive and conservative" regulator which has in good times ensured a high volume of anti-cyclical generic provisions which provide substantial coverage.

Despite the elements of fortitude present in our system, the fact is that the general situation –macroeconomic and financial– has worsened, giving rise to the appearance of a high concentration of risk in entities in the construction sector on deterioration in the capacity of household economies to meet debt payments with ease, and a fall in volume of business which will inevitably condition the evolution of institutions, raising the need for them to adapt their operations to the new situation.

Consequently, in the short term Spanish deposit institutions will have to tackle the risk management which goes hand in hand with all economic deceleration processes. The response in general will be proportional to the intensity of the credit expansion process which has been carried out by institutions in recent years, and in particular their higher concentration of credit in those business segments which present a higher degree of risk: real estate development, credit with mortgage security to acquire second homes, new business segments (immigrants) on which there is little historic information regarding capacity for payment in unfavourable conditions, etc.

To the extent that the construction cycle shows clear and accelerated signs of exhaustion, Spanish deposit institutions will have to: redraw the structure of their balance sheets in accordance with the new economic environment, which will without doubt include a reduction in the relative weight of construction company and real estate development financing, and an increase in business with non-financial undertakings in other sectors, a large part of them SMEs[81]. In domestic credit institutions will also have to tackle the need for reorganisation, with a relative increase in

81 The financing of production activities at the end of 2007 was close to a trillion euros, with annual growth exceeding 13%. Of this total, approximately half related to construction and real estate activities and the remainder to undertakings in other sectors. Diversification among the latter will logically be clearly aimed at the more active sectors: IT, insurance and other business activities, although those with higher GAV are: commerce, hotel and catering and transport ("Crisis and Cycle Change: Strategic implications", AFI, 2008). The process of population aging and new financial requirements which are being created –assuring dependency, extraordinary needs to be covered, etc.– are also being considered as a possibility for diversification, which is occurring with the financing of SMEs which some institutions are contemplating. Attention will have to be paid to the risks inherent in these strategies at times of slowing activity.

higher credit quality segments. These changes in balance sheet structure normally take place slowly.

A further aspect which requires a substantial short term effort is obtaining wholesale financing in an environment of international financial markets, which will be difficult. The ease with which Spanish institutions placed their issues of mortgage bonds and securitizations has completely disappeared. Since August 2007 investors in these products, mostly foreign, have literally disappeared from the market. Institutions face a hostile market in which there is no appetite for Spanish fixed income securities, and in any event the only operations take place at interest rates substantially higher than those seen scarcely one year previously.

In this context, institutions have redoubled their efforts to capture funds in the retail market, both through an increase in prices offered for deposits and by selling them more aggressively compared with other alternative products (including investment funds). The high "*bankisation*" of the Spanish financial system (it should be recalled that deposit institutions, through their collective investment management companies, control more than 80% of the assets of investment funds and more than 50% of pension funds, as well as half of the life insurance business) will facilitate the process of substituting financing obtained in the wholesale market with retail financing.

The foregoing as a whole will give rise to the need to tackle evolution in the profit and loss account. The difficulties in wholesale financing will firstly increase financing costs and secondly contribute to a deceleration in credit. Although Spanish deposit institutions have historically shown a high capacity for passing their financial costs on to asset rates, it may be thought that this capacity will be resented in an environment of economic deceleration and lower pressure of credit demand, together with reorganisation towards segments of higher credit quality. Institutions will therefore bear a high degree of pressure on their margins.

Although Spanish institutions have a high degree of efficiency, the fall in activity will put pressure on these ratios, in particular because structural costs are not normally adjusted downwards at the same rate as business. Part of the efficiency gains of Spanish institutions have been due to a strong expansion of business which has diluted expenses. If business stops, operating expenses will begin to put pressure on the results of institutions.

Unlike other economic deceleration phases, in the short term the increase in defaults will not translate into a very marked worsening of insolvency provisions thanks to the counter-cyclical mechanism created in 2000 and reformed in 2004. This mechanism constitutes a basic element in the Spanish regulatory framework, reinforcing the stability of Spanish institutions in a transparent manner. If other bank regulators had adopted a similar scheme and common strategy with those creating accounting standards, the lack of trust which pervades international banking institutions would very likely be reduced.

In the medium term the question arises of the business model. The design undertaken by institutions may be diverse, firstly as a result of the different characteristics of the two groups of institutions present in our system, banks and savings banks. This could be the time for a coming together by introducing various "market" elements in the functioning of savings banks, which in turn would reinforce their capital position –I am thinking of capital shares– and would make them more uniform with other institutions. It is true that thought should be given to issuing shares which, in

accordance with their original design, at the desired pace grant holders voting rights in the management of saving banks, which would inevitably lead to a restructuring of their governing bodies.

Secondly, a decision must be made on the intensity of specialisation in retail business, a business which will be subjected to growing pressures by remote competitors (supported by information technologies). Another aspect to take into account is the geographical dimension of this retail business. Until when will the model of geographical extension of branches which we have seen in recent years be valid? Could a consolidation process be considered? This appears complicated, both because the position of the two large groups in the banking sector does not appear to be propitious for very significant movement, and as a result of the legislation governing savings banks.

Thirdly, reconsideration must be given to the nature of the business to be undertaken, in particular by saving banks which, if they go down the path of international growth, will be progressively questioned as a result of their lack of shareholders, and on the other hand if they progress towards the shareholder path their very essence will be questioned. I believe it makes sense to reflect on this matter and its importance to savings banks. Financial evolution in recent years with its emphasis on real estate financing has for savings banks –much more than for banks whose business model has been more diversified and open– meant a very important change in the structure of their balance sheet since a large part, approximately 25%, has been fed by resources deriving from international markets. The new economic and financial environment of the banking business will oblige institutions to change in several directions. For savings banks, a medium term objective would have to involve ensuring the international financing which has been difficult to obtain in the recent past and maintenance of which in the future will require substantial operating changes. The objective should be to try and maintain external financing levels for which some savings banks are certainly more prepared than others, but a reconsideration is necessary by them all which enables them, so to speak, to make themselves visible in these areas by well known procedures (marketing networks, presence in markets, etc.).

This whole process obviously faces difficulties in another important respect: the legislation on saving banks which in this new stage is requiring major changes which facilitate their adaptation to the new environment in which they will have to operate. Indeed, their legislation raises various major difficulties. In the sector itself, mergers and acquisitions between institutions are subject to approval by the Regional Authorities in question. Furthermore, the merger or acquisition of a saving bank by banking institutions is also not free from difficulties. Indeed, there is general allusion to the impossibility for a saving bank to be the subject of acquisition as a result of its special nature. It is true in this respect that neither the regime of governance of saving banks nor their capital structure conforms to the common parameters of commercial companies, which will make their acquisition by third parties hugely difficult[82].

82 This situation prevents the full exercise of market discipline. As a complement to regulation this in an incentive for institutions, in their search for individual profit, not to introduce instability into the Financial System. The mechanism functions on the basis of the price formation process, which absorbs information from the market –taking it from different sources– and transmits it to all market participants –investors, institutions, agents, etc. This process of price formation can condition the financing, in amount or price or

Nevertheless, such acquisition is possible indirectly by legal mechanisms such as total or partial assignment of assets and liabilities, which in any event will usually be subject to prior authorisation by the Regional Government in which the saving bank is domiciled, as happens in the cases of merger or demerger.

On the other hand, shares would be an initial step which would help in a more profound transformation of the structure of governance of saving banks, giving them greater autonomy of governance and business decision-making. It is worth mentioning on this point that in the recent assessment of the Financial System made by the IMF/WB it was recalled that the Basel Principles for effective bank supervision were not compatible with regulatory/supervisory capacities in relation to saving banks and the appointment of part of the members of their governing bodies.

Although some of these changes are very important, experience with Spanish deposit institutions over the last 30 years is very promising. Institutions have been capable, as seen at the beginning of this work, of transformation and adaptation from a completely regulated and protected environment to another with more competition and open to the world. They have (as do we) a process of exploration before them and all alternatives represent opportunities, risks and difficulties in implementation.

10.2 Insurance Sector

One year on from the beginning of the crisis in markets, various reports from the Committee of European Insurance and Occupational Pensions (CEIOPS) indicated how its impact appeared to be reduced in this sector up to that time.

The obvious channel for influence by the subprime crisis on this sector will be that of exposure of companies to structured products and Asset-Backed Securities (ABS), but it appears that up to now there has been no negative effect. The only cause for concern now, and where most risks are perceived, is in the monolines sector, active particularly in the USA but not in Europe, apart from some subsidiaries of those which basically operate in Great Britain. These are companies with activities, other than those of insurance companies, consisting of providing credit improvement to bond issuers[83]. Their activities were traditionally focused on municipal bonds in the USA, but recently they have diverted a large portion of their activities towards the territory of structured products, granting credit improvements to certain (senior) tranches of various securitizations which, on occasions, had poor quality assets as underlying. The problems experienced by the latter products have endangered the

timing, etc., which an undertaking wishes to obtain in the market by issues or any other procedure. The system of market discipline has various preconditions in order to be able to function effectively. One of these is transparency of information to the market, a matter of which there has been much talk. It is true and forms the basis of everything that the market cannot exercise its function without it. But there is an additional step which gives force to the whole system and makes it function effectively: the element of "penalty" which must go with it. This can take different forms, from restricting or increasing the cost of the available volume of financing for a project which is not attractive in terms of risk/return, to closure of a business or acquisition by a competitor. The degree to which this function can be exercised will condition the efficacy of the mechanism of market discipline.

83 These undertakings give better credit to bond issuers, which typically takes the form of a unconditional and irrevocable guarantee of principal and interest on the bonds which are guaranteed. This enables issuers to obtain a higher credit rating than would have been granted in the absence of the insurance offered by the monolines (IEF, 2008).

ratings of the monolines (some agencies have already announced their review) in such manner that quotations have fallen, and this could affect the ratings of the bonds which they had guaranteed, which could in turn affect and aggravate the situation in credit markets.

Market pressure has recently also affected these undertakings which have experienced losses in their positions on being valued at market prices, and this has translated into a fall in their stock prices. In general, these entities must meet their commitments when the corresponding bank which has been guaranteed is challenged. Before reaching this point however, insofar as the losses referred to in their positions reflect a worsening in the quality of the securities, the likelihood will increase that monolines must in the future meet their commitments, and therefore they will be negatively affected in their ratings by the corresponding rating agencies. This is what some agencies have already announced.

With respect to Europe, these repercussions have been very small (with the exception of Great Britain) given the zero presence of these undertakings. Furthermore, continuing with the European context, the impact of the crisis has been very minor on what we could call traditional companies. The big companies have invested very limited amounts of their investments in structured products (2%-10%), whilst small and medium-sized companies have not up to now recorded appreciable exposures, as indicated by the analysts and Rating Agencies[84].

In the European context the situation of Spanish insurance companies continues to be fairly healthy, without "toxic" exposures. The most recent data on evolution in business shows a deceleration in the sector during 2007, which seems to be maintained in the first half of 2008 (although the cyclical nature of activities always translates into a first quarter of strong growth which can induce error as to evolution of the first part of the year).

Despite the slowdown mentioned, some indicators can give an idea of the favourable situation of these companies up to now:

- With respect to volume of insurance premiums: whilst in the life class (and in unit-linked) 2007 showed a growth, in 2008 the recorded growth was greater (without doubt as a result of the seasonal effects mentioned).
- Balance Sheet Assets: investment policies have been maintained without substantial change with respect to evolution in the more recent past. The most important item of assets is "other financial investments", which in the first quarter of 2008 represented the largest part of assets, at 67% of the total (148,000 Level 3). 74% of this total is made up by fixed income and the remainder by equity investments. The preponderance of fixed income is a traditional characteristic of the Spanish insurance sector, and this indicates that it has a lower risk than that existing in other European companies in relation to fluctuations in stock exchange markets[85].
- Coverage of technical provisions: this element also illustrates the strength of

84 Some concern has begun to make itself apparent in the European context regarding the indirect exposure which these companies may have with hedge funds to the extent that the latter may be exposed to structured vehicles.

85 One of the most recent reports from CEIOPS which analyses the investments of European insurers clearly indicates the favourable position of our insurance market.

undertakings, although it has fallen in recent years. Provisions in the first quarter of the year reached values of 110,000 and 30,000 million euros in life and non-life, respectively. These levels constitute an excess of 7% in life and over 30% in non-life.

- Solvency margin is also solid, with an excess in percentage over minimum requirements of 107% in life and 240% in non-life.

The foregoing data and analyses up to now indicate that in Spanish insurers, as with European, the exposure to "toxic" products deriving from the subprime crisis has been minimal. Despite the safety margin provided by the situation described, however, the existence of risks in areas other than that mentioned could, by their materialisation or worsening, end up affecting companies and other market agents. As the macroeconomic down turn accentuates, any sector in the economy will feel its effect. One clear example may be the reduction in wealth of household economies which in this crisis context, with a strong negative effect of the real estate sector, could amongst other effects reduce demand for any type of insurance, and in particular that which has a strong savings component.

10.3 Securities Markets

As with the banking system and insurance companies, in the securities market dealer and broker sector major exposure has also not been seen to elements of the crisis which began in the USA more than a year ago. This does not mean that in the immediate future stresses may not arise, deriving not so much from the appearance of the products mentioned but rather the general worsening in the overall macroeconomic situation.

On the other hand, it should be taken into account that the sectors included in this section and others will be additionally subject to a series of operational reforms and alterations in their scope of operation deriving from the reform processes undertaken by the EU.

Several currents of change which, it may be thought, will thus undergo satisfactory development given the excellent starting position of undertakings in the sector, will nevertheless require additional efforts by them all. One important group of investment vehicles which operate in security markets are the Investment Funds, which, as already seen in another part of the work, have a very low risk profile (2/3 are fixed income or guaranteed), a high level of liquidity and little "exposure". On the other hand they have other risks which could materialise –and are already doing so– deriving from changes in expectations of investors, who have been diverting investments from funds to bank deposits, this latter trend reinforced by the policy of banks in search of liquidity. It should be recalled on this point that a large part of banking institutions are managers of these funds (they manage approximately 80% of the assets of investment funds and around 50% of Pension Funds) which could influence this diversion of investments.

Furthermore, the worsening in the economic situation, and in particular the real estate sector, introduces a risk in the actions of these agents. One clear case is that of "Real Estate Collective Investment Undertakings" whose risks have rapidly increased their exposure. Their size is small, however, and a strong negative influence on the sector is not expected.

Hedge funds, of recent appearance and very limited importance up to now, also belong to this group of investment vehicles.

With respect to Investment Services Firms (ISF)[86] which perform certain functions (client orders, management of investments, etc.) in relation to security markets, they record satisfactory profitability and maintain adequate solvency.

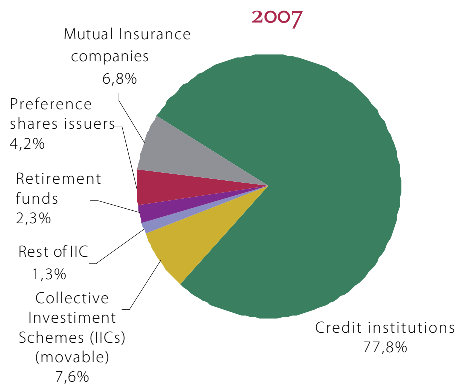
The increase in activity, income and wealth in recent years has contributed to an increasing diversification by the public in their forms of saving, by the acquisition of insurance, investment funds and pension funds. Insurance companies have experienced an expansive cycle, with strong increase in activity and, to a lesser extent, premiums obtained. One part of the expansion of these products is due to the increase in income and another, with growing importance, has been encouraged by the strong growth in the real estate business (household insurance, mortgage assurance, etc.). The favourable evolution of activities has translated into high profitability and solvency margins way above the regulatory minimum. In summary, for insurance and securities a stable situation for the time being (adequate solvency, liquidity and profitability) without exposure to the risks deriving from the crisis, but subjected to a short term process of reform in a situation highly conditioned by development of the Spanish economic crisis.

86 Securities Dealers, Securities Brokers and Portfolio Management Companies.

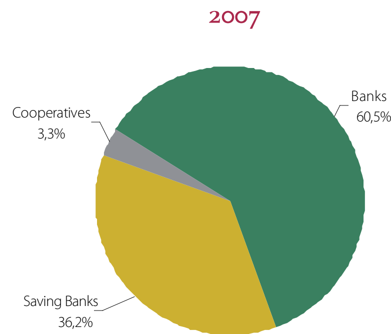
ANNEX I

Characteristics of the Spanish Financial System

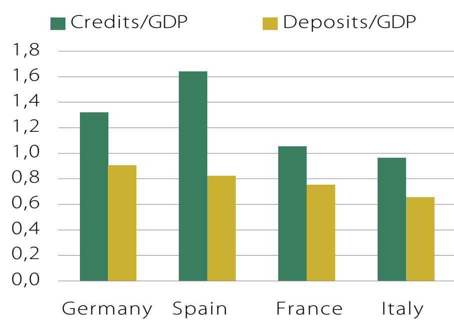
Structure of the Spanish Financial System. 2007



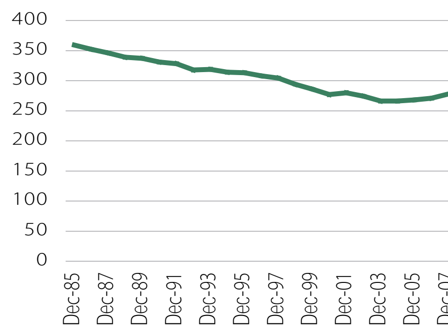
Banking System. 2007



Financial Meditation. 2006



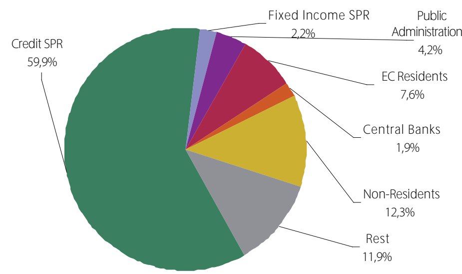
Number of Deposit Institutions



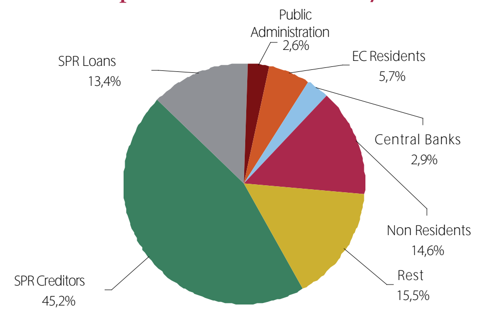
Efficiency Ratio. 2006

Number of branches per million inhabitants. 2006

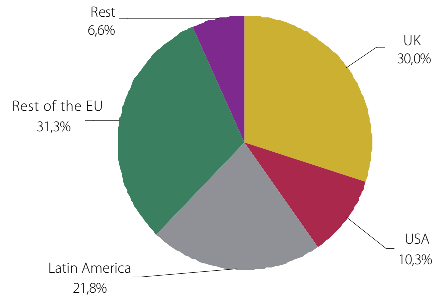
Breakdown of Balance Sheet. Assets. Deposit Institutions. 2007



Breakdown of Balance Sheet. Liabilities. Deposit Institutions. 2007



Geographical distribution of assets Deposit Institutions. 2007



Source: Bank of Spain.

ANNEX II

Number of collective Investment Undertakings (IIC), Collective Investment Under¬taking Management Companies (SGIIC), IIC Depositories and Risk Capital Undertak¬ings (ECR). 2007[1]

Type of entity	
Total IIC of financial nature	**6.296**
Investment funds	2.954
Investment companies	3.290
Hedge fund IIC	31
Hedge funds	21
Total real estate IIC	**18**
Real estate investment funds	9
Real estate investment companies	9
Total foreign IIC commercialised in Spain	**440**
Foreign funds	225
Foreign companies	215
IIC Management Companies (SGIIC)	**120**
IIC Depositories	**126**
Risk capital entities	**210**
Risk capital funds	76
Risk capital companies	134
Risk Capital Entity Management Companies (SGECR)	**66**

Source: CNMV.

1. Data at 31 December 2007.

Market share of credit institutions in the investment services market in 2007[1]

Amounts in millions of euros	
Market share of credit institutions	
Placement and underwriting	84.0
Sale and purchase of securities	40.1
Asset management	61.5
Administration and custodianship	96.2
Commercialisation of investment funds	92.2

Source: Bank of Spain and own preparation.

1. Data at 31 December 2007.

Entities which provide investment services 2007[1]

Type of entity	
National entities	**110**
Securities Dealers	46
Stock exchange members	36
Non-stock exchange members	10
Securities Brokers	53
Stock exchange members	8
Non-stock exchange members	45
Portfolio Management Companies	11
Foreign entities	**1.394**
With branch	29
Under free provision of services	1.365
Pro memoria:	
Representatives of ESIs	**7.287**

Source: CNMV.

1. Data at 31 December 2007.

List of Organised Markets

Equities

Stock Exchanges

- Continuous Market
- Corros
- Second Market

Alternative Stock Exchange Market (MAB)
Latibex

Public Fixed Income

Book Entry Debt Market
Stock Exchanges
SENAF
MTS-Spain

Private Fixed Income

AIAF
Stock Exchanges

Derivatives

MEFF

- MEFF Equities
- MEFF Fixed Income

Stock Exchanges (warrants, certificates and others)

Olive Oil Futures Market

Clearing and Settlement

Iberclear

- Iberclear CADE
- Iberclear SCLV

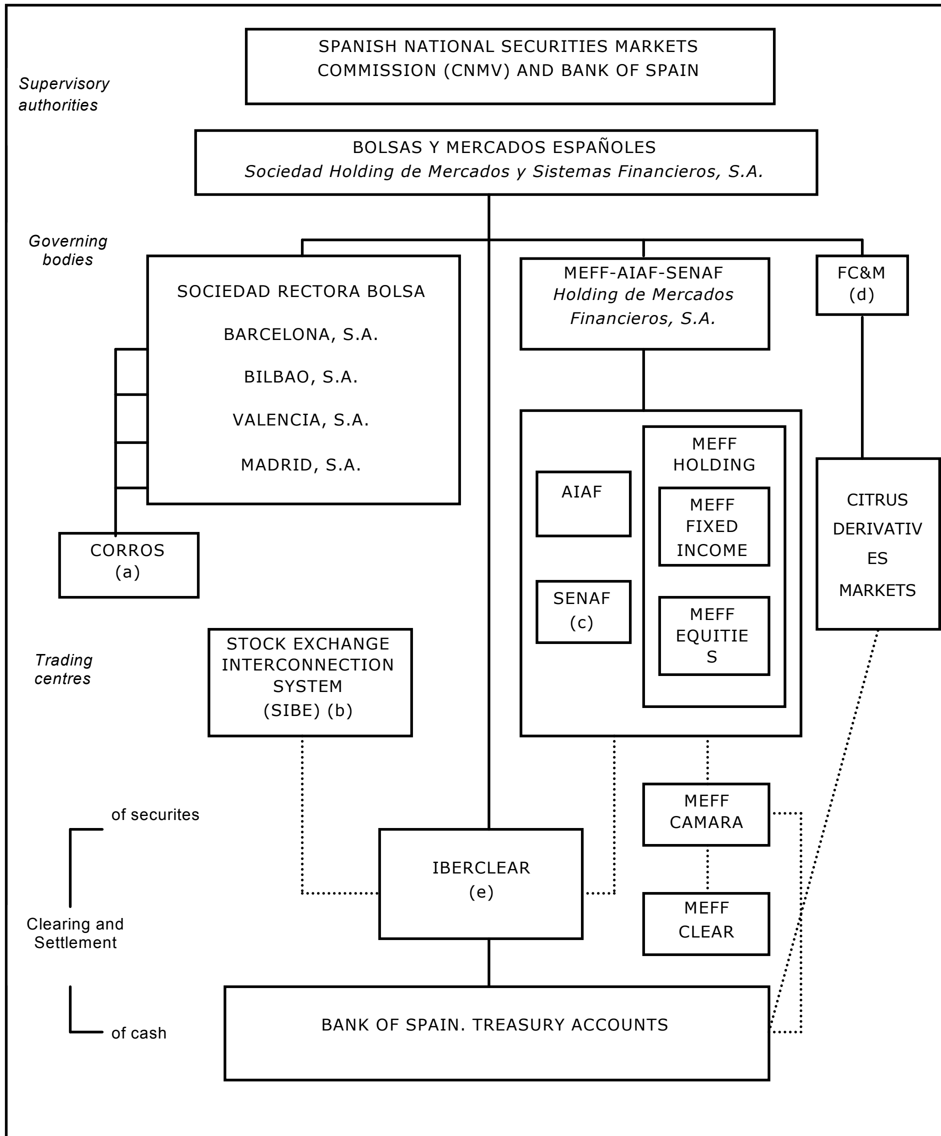
SCLBarcelona
SCLBilbao
SCLValencia
MeffClear

MiFID regulated markets: official markets pursuant to the Securities Market Act have this status (Stock Exchanges, AIAF, Book Entry Public Debt Market and MEFF).

Organised Trading Systems under the Securities Market Act (MiFID Multilateral Trading Systems): Latibex, MAB, SENAF and MTS-Spain.

Source: Own preparation.

Organisation of Spanish Securities Markets



Source: Bank of Spain.

a. The stock exchange fixed incometraded in Corros is currently settled in the ambit of stock exchange governing companies.
b. In the SIBE shares, fixed income and warrants are traded.
c. Book entry public debt blind trading system.
d. Mercado de Futuros y Opciones sobre Cítricos, S.A.
e. Iberclear is the Spanish Central Securities Despository responsible for book entry registration and clearing and settlement of securities. It integrates the technical platforms of the SCLV and CADE.

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VI Addendum

The foregoing work was completed on 2 September and could not therefore take into account important events subsequent to that date. With preparation for publication now advanced, the publishers have given me the opportunity to complete its contents with the most recent important developments.

A Developments

The crisis, the first external manifestations of which occurred now somewhat over a year ago, initially arose - thus its name - from the problems deriving from sub-prime mortgages and collapse of the real estate market in the USA. The phenomenon of bubble creation is nothing new, it has been well studied and generally explained very well after the event. It is a recurring phenomenon which is difficult to detect even if supervisors/regulators and financial institutions develop their capacities and obligations in a reliant manner, something which has not always happened and not now, of course, in several jurisdictions.

In the case we are concerned with, the heavy falls in interest rates over the course of the first years of the century (2000-2005), negative in real terms over a large portion of the period, provoked high liquidity, excess capacity in financial institutions, and the development by some banks of an Origination/Distribution model which facilitated a considerable capital saving on securitising and taking all transactions off the balance sheet, with those involved automatically losing concern for the risks implicit in them. This model, which also produced positive effects and has facilitated important developments in the past, is susceptible to dangerous utilisation, as was the case.

This phenomenon gave rise to high leveraging, an uncontrolled and opaque development, with intensive implementation of improperly denominated "financial innovation".[87] The inter-relationship of institutions and financial markets transformed it into a phenomenon without borders and these circumstances were the germ which gave rise to the developments which have led us to the current situation.

A further fundamental element which, in very general terms, facilitated development of this crisis was the failing in some cases of regulatory/supervisory mechanisms, which permitted the market processes referred to to develop without clear rules, or outside them if they existed.

87 From the point of view of the financial institutions which actively participated in developing the situation, and which placed themselves and the system in a situation of excessive exposure, the analysis of one direct participant is of particular interest. See "A personal view of the crisis: confessions of a risk manager". The Economist (7 August 2008).

Somewhat over one year of crisis, if we take it from August 07 to the present time[88], with two very distinct stages in terms of analysis of the situation and the adoption of measures. In the first of these the main concern, and problems, were focussed in particular in the USA and to a lesser extent in Great Britain, whilst EU Member countries basically thought that it was an American problem. During this first period, apart from the actions of the Federal Reserve (FED), the Bank of England (BoE) and the European Central Bank (ECB) which articulated the first response to the liquidity problems which were arising, few additional initiatives could be seen and, of course, those which there were developed without any type of co-ordination. Nothing of what happened later had been forecast, particularly the acceleration which took place in the most recent stage.

It is noteworthy that during this first part there was a multiplication of analyses of the process, its causes and possible remedies, in which both public and private bodies participated, a fact which contrasts strongly with the scarcity of practical measures and, when there were, they were always individual.

The second part of the period is characterised by a strong acceleration in all processes, the effects of which extend to increasingly broader areas of the financial systems of all countries. The acceleration took place not only in the United States but also moved to Europe, although its authorities initially maintained a more distant position which, during the first stages, prevented them from reacting quickly and, of course, when they did it was without any type of co-ordination. The co ordinated action of central banks in the downward movement of interest rates was the first of this type, and others came later.

Meanwhile, in a couple of weeks the panorama of the North American financial system changed radically.[89] The political and financial authorities tried all types of strategy to halt the process of deterioration: rescues, aid, mergers, takeovers, insolvencies, etc., until finally (leaving aside the principles of Moral Risk, Too Big to Fail, etc.), and aware that none of this was functioning, they opted for a global approach, the "Paulson Plan", which, not without problems in the Congress, was eventually approved on 8 October with 700 billion dollars to rescue toxic assets from the market (and an increase in cover of deposit guarantees was simultaneously approved).

This stage eventually culminated with the conviction, on both sides of the Atlantic, that the crisis cannot be tackled except in a co-ordinated manner since this is the only way of acting given the circumstances of the international financial system

88 Since at least since April 07 problems began to be detected which, isolated at the outset, accumulated as a clear signal that something was not working. Already by the beginning of April the New Century Financial Corporation collapsed, the second sub-prime mortgage lender in the USA, shortly after UBS announced closure of its Dillon Read hedge fund as a result of losses on sub-prime. As from the that time a chain of negative events developed related in one manner or another to sub-prime mortgages. The role of rating agencies was decisive, hundreds of reductions in ratings of ABS and other types of bonds were made by Moody's, Standard and Poor's and Fitch. At the same time, Hedge Funds of other entities, BEARN, BNP etc., closed. The most important event in this period was perhaps the problems of Northern Rock which had to request emergency liquidity and which ended up passing to the public sector, a form of nationalisation without using the name, which was very much overshadowed as a result of what happened later, at the second stage. Other banks, HSBC, West LB, and HS Nordbank and Citigroup were obliged to finance their off-balance sheet vehicles or integrate them into it. Meanwhile Citibank, UBS and other banks obtain Sovereign Funds and other banks have obtained funds from Sovereign Funds, a flow which lasted little time.

89 In a couple of weeks Fannie Mae and Freddie Mac were nationalised, Lehman collapsed, Bear Stearns and Merrill Lynch were purchased by commercial banks, Morgan Stanley and Goldman Sachs were converted into ordinary banks - which meant the disappearance of investment banks in the USA which had existed since 1934; the insurer AIG, the biggest in the world, had to be rescued, and the "Shadow Banking System" which represented the most deregulated part of the system - money market funds, securities dealers,

with a very intensive degree of interaction[90]. Together with this, as we will see later, the conviction was reached that the only way of redirecting the process and attempting to reduce the risks which were now becoming manifest was assistance from public authorities.

B The problem

In the long gestation period of the crisis, the decisions taken by the Euro Group, in the second weekend of this month of October, laid out the general lines of a Plan in the framework of which national governments would have to act. This Plan, together with that adopted by the British authorities, gave rise to all countries undertaking the most appropriate actions based on their respective situations in co ordinated fashion.

All the proposed actions have an immediate purpose which, simplifying somewhat, can be said to be orientated to making it feasible for the process of "deleveraging" to take place as soon as possible in order to avoid the crisis, the financial crisis, becoming more difficult and delaying solution of the economic crisis.

The task of undoing the leveraging process of financial markets has been developing in recent months - based solely on private initiative - but in a disorderly manner which adds difficulty to a task which is already confusing and difficult in itself. The process is complicated because it is a question of putting a series of strategies in place which should act simultaneously and which are very difficult to apply as a result of the institutions themselves in this financial market situation.

As indicated in the most recent report from the IMF "Global Financial Stability Report" (GFSR)[91]: deleveraging requires a series of actions which affect the whole balance sheet of institutions... thus, on the liability side, these strategies involve obtaining new capital and ensuring diversified, lasting, long-term sources of financing. On the asset side, the strategy consists of avoiding concentration of exposures of illiquid or risky assets and adopting adequate coverage strategies which accurately conform to the exposures assumed.

On the basis of this document it is worthwhile devoting some comments to this problem, which is at the core of the situation.

The first problem is that of capturing capital. During the first moments of the crisis, institutions in general were capable of capturing new capital driven by the high leveraging with which they were working. IMF estimates are that from the second half of 2007 until September of this year global banks have been able to capture capital of around 400 billion dollars)[92]. Circumstances hardened very rapidly however as the crisis developed.

Indeed, as the process advanced, the general macroeconomic, and not just mortgage, situation continued to deteriorate. Losses recorded by shareholders, those of Sovereign Funds which came in at the beginning contributing capital and also recording losses, the scant acceptance of new issues in markets, etc., made it an impossible task to attract capital.

hedge funds, etc. - rapidly changed their operations.

90 As well stated by the recent Nobel prize winner: "The possible agreement must in its key aspects be international, because the financial system is so: a crisis which begins with a bubble in Florida chalets and California mansions has created a catastrophe in Iceland". (P. Krugman. El País, 12 Oct.)

91 See: "Financial Stress and Deleveraging. Macrofinancial Implications and Policy". Global Financial Stability Report. Oct 08.

92 Together with this figure, for the same group insolvencies reached a figure somewhat higher than 500 billion dollars with a strong concentration - the three biggest losers accounting for 30% of the total and the series of the biggest 20, 75%. 90% of these were in Europe and the United States.

If the estimates of the World Economic Outlook (WEO) for the international economy are fulfilled - a slow beginning of recovery right at the end of 2009 and a slowdown in the fall in prices on the real estate market - the prospect for gains could improve and thereby the possibility of recapitalisation of institutions. If this happens, the estimate continues, global banks could attract around 675 billion in forthcoming years, as from 2010.

The second problem is on the assets side, since their sale is complicated and also generates losses which aggravates the problem of capital. Furthermore, in this situation markets exercise strong discrimination which adds to the scarcity of resources and makes financing processes difficult. In this context institutions with an excessively concentrated business model are discriminated against in relation to those who have more diversified models and strategies: the disappearance of the Investment Banks, a banking model in existence since 1934, provides a good example.

This in no way means that commercial banks are in a more relaxed situation; this is not so and discrimination based on their involvement in the mortgage market and the nature of their sources of financing is also very much in evidence when attracting funds. Use of the market price/book value (P/B) indicator is an excellent measure of this situation.[93]

In the United States, before the crisis the average P/B for banks was above 2 and has now fallen below 1. In Europe, banks more exposed to the mortgage market (Great Britain, Ireland, Denmark) have seen how their valuation has fallen rapidly. Spain would be in this group, although it is in a better situation than other Europeans since, as the Report states, there is another series of factors which also “qualify it” and permit a more complete valuation of banks. It thus uses the Spanish case to complete its argument: “Spain, despite having very important exposure in real estate, is above other Europeans since it has maintained a P/B ratio of 1.6, higher than them. This could be a reflection of low leveraging rates in comparison with other European countries, greater confidence in financing via stable deposits and a better regulatory environment”.

Furthermore, neither are alternative sources of financing buoyant, securitisation has in Europe ceased to be a market instrument (it continues to be so for obtaining financing with the ECB) and private placements or cross-border financing do not offer much relief in these circumstances.

In summary, this process of “deleveraging” is complicated and its effect is to reduce the availability of credit, increase its cost and in all cases accentuate the recession in the economy. In any event, up to now it has been impossible to resolve it, but it should be borne in mind that without it there is no possible exit and delay in achieving it is already having visible effects in the United States and Europe, with prognoses of a fairly tough 2009 in the light of international report.

An exit from this situation requires a series of changes and actions which are difficult for financial markets and institutions to instrument in isolation, and this has led to the conviction that effective support will be needed of political, financial and monetary authorities in order that the effect on the economic situation is mitigated as far as possible.

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93 A P/B below 1 would mean a lack of confidence of markets regarding the ability of banks in their respective countries to cope with with the potential losses.

The report previously cited raises the question very clearly: ”A process of disorderly deleveraging, where the private sector cannot inject new capital into banks, or remove damaged assets, the evolution in credit will become rapidly negative, having an equally negative impact on the real economy. Intervention by the government, injecting capital and removing assets with problems, is necessary in order to avoid such a development”.[94]

C The solutions

The complex characteristics of the process which has just been seen, left solely in the hands of the private financial sector - and this was so for several months - led to the conviction that only the participation of public authorities would make it possible to mitigate, if not totally eliminate, the negative effects on the macroeconomic situation.

Thus, during the second weekend of October, 14 months after what is considered to be the beginning of the crisis, an agreement was reached in the Euro Group which establishes a framework for action by Member Countries (the Paulson Plan and that of Brown were earlier, on two and eight October, and the latter set out the lines to be followed). The characteristics of the plan are its global and systemic nature and the co ordination of solutions. US experience in its first attempts at rescue “case by case” had revealed their inefficacy and tendency to aggravate processes and this was taken into account; in addition, the global nature is perfectly compatible with each country placing more emphasis along the lines of the plan on some aspects than on others, or ceasing to apply some of the proposals. Clearly, as the situation is, it can only be hoped that all countries will move towards reaching maximum agreement, following the known trend which has largely led us to this point.

All plans approved in the course of the week following the agreement thus attempt to combat what The Economist calls “the three-headed monster”. In other words, they try to resolve, alleviate would be more accurate, the key problems of the crisis: Solvency, Financing and Liquidity.

All of the Plans have a similar content in general terms:

- Ensuring short-term liquidity, basically by actions by central banks.
- Recapitalisation of banks by purchase of preference shares or other instruments for the same purpose.
- State guarantees of issues necessary for refinancing. This is the core, and then there are also other possible actions: purchase of healthy assets, purchase of toxic assets, direct financing of undertakings (commercial role), extension of guarantee funds, etc.

94. The IMF has carried out an exercise in estimating sensitivities which covers three scenarios depending on whether aid has been given or not.

There is no contribution/capitalisation from the Public Sector and the private sector does not function.

The evolution in credit to the private sector would be:

US	UK	EU (without UK)
-7.3%	-6.3%	-4.5%

With recapitalisation from the private sector. No public.

US	UK	EU (without UK)
-2.7%	-2.2%	-1.3%

With capitalisation from the Public Sector ($2 trillion)

US	UK	EU (without UK)
-0.1%	-0.1%	-0.2%

D The Spanish Plan

Starting with the Euro Group agreement all countries have thus been drawing up proposals based on proven lines but their precise content is still changing and their concrete outcome in practical measures varies from some countries to others. An estimate of the amount committed for the time being under the plans, in their current situation, gives a figure of around 2.5 trillion euros in Europe (around 20% of European GDP). The figure for the US plan, not included in the foregoing figure, is 700 billion dollars.

The elements included in the Spanish Plan within the lines of the Euro Group agreement are as follows:

a) A Fund for the acquisition of financial assets with the following characteristics:

- Its purpose is to purchase financial assets issued by credit institutions and securitisation funds, backed by credit to individuals, undertakings and non-financial entities which will in all cases be quality assets.
- The amount devoted will be 30 billion euros, which can be increased to 50 billion.
- It will be financed from the Budget.
- The fund will be attached to the Ministry of Economy which will endeavour that the financing reaches firms and individuals.
- The Fund's governing bodies will comprise a governing Council and Executive Committee, chaired by the Secretary of State for Economy. It will have the ancillary assistance of the Bank of Spain and the Spanish Securities Market Commission (CNMV) and will be monitored by the General Comptroller and Parliament (see annex).

b) Increase in the Deposit Guarantee Fund to 100,000 euros (this was a measure taken before the Plan).

c) Guarantees. These have the purpose of providing a State guarantee for new financing operations via promissory notes, bonds and debentures admitted to listing on national markets (the State guarantee will assist in their placement). The possibility is provided for extending them to interbank deposits (doubtful).

The characteristics known up to now are as follows:

- Access to them will require compliance with the obligations established by the Ministry of Economy and Finance, including the solvency conditions established by the Bank of Spain.
- The maturity period of transactions will be 5 years.
- The period for granting guarantees will end on 31 December 2009.
- This year up to 100 billion euros may be granted.

d) Recapitalisation of entities. Until 31 December 2009 the acquisition is authorised of securities issued by entities which need to reinforce their own funds, including preference shares and capital holdings. A prior report from the Bank of Spain will be required[95].

This is the approved content of the Plan up to now, and its detailed functioning is under study at the time of writing this work.

95 The initial position is that this latter recourse is unnecessary given the current situation of capitalisation of our financial system. In any event, even if everything stays the same, if the other banks in the area resort, as they are already doing, to recapitalisations, the competitive playing field will be clearly imbalanced. It

E Some uncertainties

The problems raised by the process previously examined, and the solutions which are being sought to them, leave much room for many uncertainties regarding the post-crisis period. It is worthwhile pausing to consider some of these, mainly those relating to the crisis and its treatment, potential after-effects on the financial system, particularly on the question of regulation-supervision, and possible effects on public accounts.

1 The treatment of the crisis

After one year from the beginning of the crisis, in September 2008 a series of events followed each other for which individual solutions were sought with a case-by-case treatment which did not manage to resolve the problem and which led to the conviction that institutions in themselves could not overcome the situation, and thus the need for public intervention. This took the specific form of preparation of a series of bailout plans by political and financial authorities of the USA, Great Britain and the European Union, with the basic content already mentioned. The common intention of all of these is as far as possible to reduce the existing leverage in the system such that credit begins to flow, avoiding the crisis in the real economy receiving additional pressures which make its recovery even more difficult and lengthy.

Having reached this point, the maximum priority would have to be to clarify the "small print" which guides effective application of the plans approved. This is the priority task which should focus all efforts. As a result, the organisation of summits to discuss the architecture of the new financial system is not practicable and could contribute to increasing the confusion.[96] There should be concentration on effective application of the Plans, the results of which remain to be seen at the present time. Many things will change but it is not known what the situation will be in the financial field after the battle.

It is true that the level reached by the solution finally adopted that necessary, but at the present time what is perceived in markets is an extraordinary confusion. It should be taken into account that if the plans are applied promptly the negative effects of the financial crisis on the situation in the real economy will be mitigated. The success of the bailouts will be substantially to alleviate various circumstances but this will not mean containment of the economic crisis, which everything points towards requiring a long recovery period.

Many elements of the financial situation will be affected since many of them have been placed in doubt over the course of this crisis. Firstly, one key element of this crisis is the participation of the public sector which, albeit necessary as everyone accepts, should be accompanied by a clear indication of its temporary nature. The functioning of Rating Agencies, or the application of market value in difficult cir-

could be thought that it may b therefore e necessary to use it. For example, in Great Britain they have already opted for recapitalisation: Royal Bank of Scotland, Lloyds and HBOS. For its part, the USA has already devoted 250 billion dollars for this purpose: 50% distributed between Bank of America, JP Morgan Chase, Citigroup, Wells Fargo, Goldman Sachs and Morgan Stanley, and the rest to be distributed between smaller entities.

96 The biggest financial crisis since the Great Depression merits a "comprehensive and measured response and careful diagnosis as to how the global economy should be directed. But what the world will hear is an exercise in grandiloquence, with tired old ideas taken out of the cupboard dusted off and reconverted into daring new initiatives" (FT 17 October 08).

cumstances, or the situation of Basel II itself: What is the function left of capital coefficients as an element of risk control and discipline, with all the capitalisations by governments?; To what extent are these capitalisations actually selective and do not turn into an instrument which upsets the competitive playing field?

If we pause a little on our particular case we can ask whether, even though it is true that the financial system is better capitalised and this planned measure does not need to be applied at the moment, it would be desirable not to make too much "noise" since everything may depend on how the recapitalisations in other systems are carried out (because the information is fairly scanty) and the imbalance which could arise in the competition field.

And how will Guarantee Deposit Funds function if one country says that it guarantees everything but this is a political decision which is not contained in any law? And since in many cases they are Funds for which provision is made after the event, what may happen when an "exhausted" but functioning bank has to provide resources for another which has already collapsed?

2 Supervision/regulation

Although it is clear that during the incubation period of the crisis, in this and in others, there have been macroeconomic, monetary and financial decisions which have laid the ground, the fact is that there are a series of factors, particularly in this case, which are responsible for its development. In the current situation it is thus clear that there have been important regulatory and supervisory failings in some financial systems which have played a crucial role in everything that has happened.

The most important risk in these situations is that thinking automatically moves towards a strong increase in regulation, and this is an area in which a careful balance must be maintained. It is clear that it is a difficult matter to deal with, particularly taking into account that the failings have been very substantial and have ended up by affecting everyone. It is true that this must be corrected, but a more intensive regulation does not protect from crises but ends up hampering functioning of the financial system and paralysing all economic development.

It is worthwhile recalling what M.S. Sholes recently said: "during the heavily regulated period which took place after the Depression in the 1930s, Western economies were not capable of generating value until well into the 1970s".[97] Neither can it be overlooked that for many years a controlled reduction in regulation has been producing important benefits, not only to financial institutions but to the economies of many countries which have thus been able to lay down the basis for their development.[98]

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97 Formulated in a debate organised by The Economist in October 2008. Furthermore, our experience could also support this opinion. All economists of my and close generations began our professional lives in a strongly regulated system, not just financial, and we also recall how it ended up.

98 The current financial crisis is frequently used as a reason for "sounding the retreat" - returning in financial dealing to the simpler methods of yesterday. This would be a mistake. On the other hand, the current situation is actually an opportunity to redouble our efforts, to rethink and improve our systems of risk control, the structure which underlies our increasingly sophisticated financial sector. Despite the present crisis, modern finances have produced historic achievements in recent decades and this is a powerful driving force for economic growth, from driving on businesses in the private sector to supporting vital research in universities and the construction of schools and hospitals in the public sector", in Robert J. Shiller, "The Subprime Solution" (2008).

On the other hand it is not just a problem of regulation or absence thereof, since the actions of supervisors have left much to be desired in some systems which have been decisive in precipitating everything which has happened.

The problem which arises in this field after the crisis is overcome is not, or not just, that of an absence of specific and detailed regulation, compliance with which must be reviewed by the regulator and penalised if necessary. And it is not so because this approach minimises the supervisory function and places it in a situation of sterility, since its task during these times is much more complex, in line with the evolution and interrelationship and complexity of markets.

Regulation is clearly necessary, as well as overseeing compliance with it, but to accumulate regulation on regulation and be restricted to its vigilance would probably not cover fundamental aspects. Nor has principles-based supervision, which had aroused hopes and which was the flagship of regulation in the UK, been very brilliant; its application has possibly been more rapid than desirable and more than institutions and supervisory bodies could absorb.

Reinforcing risk-orientated supervision, with rules which must be respected and overseen, but at the same time with a greater intensity of involvement by supervisors in knowing businesses, the environment in which the activities of a specific undertaking take place and that of the system as a whole, and a more macro-focus which enables trends, etc. to be detected. In short, a difficult problem to resolve in practice but which a simple accumulation of rules does not resolve, or if it does so at costs which are difficult to support.

3 Public accounts

Despite considering the public bailout to be something which is inevitable given the circumstances, it should be borne in mind that this decision will inevitably have a repercussion, which is difficult to specify at the present time, on the evolution of public budgetary accounts and government levels of indebtedness. It is clear that, although difficult to quantify[99], there will be increases in deficit and the volume of public debt issued. With the plans approved at the present time in the USA, debt will increase by 10 points, which will lead it to 70% of GDP, in the UK the debt will increase from 44 to 50% of GDP and in Spain from 37 to 42%.

Will this lead to any alteration in markets? And what will happen to the stability and growth plans and/or the agreements on excessive deficits established in the EU?

Since interventions *de facto* translate, at least initially, into a transfer of resources from shareholders of financial institutions, it is inevitable that shareholders will suffer the corresponding dilution.

On the other hand, an important point the repercussions of which are difficult to an-

99 In the United States the public deficit in the 2004 -2007 period went from 413 billion dollars to 162 billion, to a large extent as the effect of the high tax receipts, occurring not so much as a result of the increase in collection but deriving from the increase in income during the boom in these years, but also as a result of their redistribution. Compared with these figures the fiscal deficit for 2008, which in September ended at 455 billion, was way above that projected in July of the year. For 2009 the Director of the Budget Office estimated in October that the deficit could reach 750 billion as a result of the added impact of the cost of unemployment insurance and costs associated with the government bailouts. The estimate is that the deficit could be 5% of GDP. (The Economist, 25 October 08).

ticipate is that of the participation of public authorities in private banks, a partial de facto nationalisation. However necessary it has been, and even at the time of writing its extent can still not be clearly seen, nor the manner of doing it and its influence, this decision raises a fairly uncertain horizon with respect to the future situation. The action of some managers and the exercise of supervisory regulation have clearly been just as negative, giving rise to the appearance of this rescue force which governments represent. And although on this occasion the rescue is not ideological but pragmatic and based on the certain fact that non-intervention would have been infinitely more costly, it is necessary for the operation to be carried out by minimising the cost to taxpayers and to shareholders seeing a clear dilution in their capital.

Having taken the decision, what is important now is that it functions as rapidly as possible such that the intervention can be withdrawn and not give rise by continuing to the generation of greater moral risk and the politicisation of loans or of the banking business in general. And this purpose should be clearly formulated in order to avoid additional damage.[100]

100"The Asians state that the West appears to be moving towards a more "directed" model: "the Teachers have some problems", said a Chinese leader. Article on intervention and capitalism from a general point of view, "Capitalism at bay". (The Economist, 16 October 08).

3 Securities markets: global perspectives

3.1 Jane Diplock
Chairwoman of the New Zealand Securities Commission
Chair of the IOSCO Executive Committee

Introduction

I take as my theme today the future of global securities regulation. For those who are concerned that this might be crystal ball gazing or fortune telling, I note a recent reflection of Professor Alan Kay: "The best way to predict the future is to invent it."

I believe that we have the capacity to invent the future of securities markets regulation and we are well on the way to inventing it.

The Spanish capital markets are now significant players in the global arena. The Bolsas y Mercados Españoles – or BME – Spanish Exchanges were last year the fourth largest exchange in terms of market capitalization in Europe, after Euronext, London and the German exchanges and is ranked 10th in the world. They have the second highest number of listed companies registered in the world, and showed the 4th highest value of trading in Europe and 7th globally last year. Spain has clearly embraced the global markets of the 21st Century, and continues to demonstrate growth and leadership in this arena.

The challenges of global capital markets

But let's think about the challenges of today's financial markets. The last year has been a traumatic year for the world's capital markets. The aftershocks of the US sub-prime market crisis continue to reverberate around the global financial markets, and a number of the world's economies are suffering or in recession. Certainly the financial markets of the world face the most severe turbulence of recent times. And what there is no question about now is that the world's capital markets are truly global. Globalization encompasses the extraordinary growth rates of cross border capital flows and investment, and the increasing interdependence of markets in different national jurisdictions. The very form of markets is changing. Today market operators have the capacity through technology, as well as the financial incentives with demutualization of market ownership structures, to expand their global reach. Exchanges (and other trading platforms) are now motivated by maximizing returns to shareholders, and thereby competing to capture the broadest customer base through various types of strategic alliances, host relationships, franchises and outright mergers. They are motivated to respond to the demand for ever more cost effective mechanisms for trading.

The international dynamism in today's capital markets coupled with the trauma of the current financial turbulence has heightened the intensity of a very important discussion which has challenged regulators and the financial community for at least a decade. This discussion relates to the future global financial architecture. From a regulatory perspective how do we manage the tension which arises in the face of rapidly growing global markets and burgeoning cross border trade, while our regulatory infrastructures remain nationally based?

Jurisdictions around the world have their sovereignty concerns and domestic priorities, and they come with different histories, and legal, cultural and political backgrounds, with different rules and traditions around commerce and trade, and with a great diversity of market systems. This is true of developed and emerging markets.

The issue of evolving the most effective and appropriate global regulatory architecture to cope with increasing globalization has challenged us for over a decade now. There has been discussion of the "holy grail" of financial regulation, the proposition that there needs to be a "super regulator" of global capital markets. A number of options have been proposed but all are to my mind impractical. All require that the domestic regulators cede jurisdiction to the "super regulator" at a time when domestic regulation in many jurisdictions is undergoing significant change to accommodate the changes in those domestic markets, and competition for the capital to further develop markets and economies is high. All solutions posited have been structural ones.

The volumes of domestic savings and investment make it also a political issue, and the very recent turmoil has demonstrated the power of the markets in driving economic activity.

I recall at a conference about 5 years ago being asked this very question from the floor. I was asked when we would see a single global regulator set up to regulate the financial markets around the world. My response at that time, and a view supported by my IOSCO colleagues, was:

"Probably not in my lifetime"

At that time we were all thinking about a concrete structure, or entity, a body or institution.

Today, if I was asked that same question I would not be quite so sure. I will make a bold (some might say rash) prediction about what the future of the global financial architecture could look like. My view is that we need to look to conceptual (or virtual) solutions of the 21st Century for the regulatory outcomes suitable for the truly global capital markets of this century.

Contrary to my reply some five years ago I do believe we may be seeing the beginnings of what might be called virtual super regulation. But unlike suggestions of some 5 years ago, this would be in a form very much more suited to the 21st century. My suggestion is that this concept of virtual super regulation could emerge (it is only just beginning) from the network of recognition agreements that are being mooted around the world. These arrangements recognize and ensure the differences necessary in domestic regulatory approaches. Rather than requiring mirroring of regulatory approach, they rely on regulatory equivalence.

So the exciting prospect of virtual super regulation is, in effect, the sum of the recognition agreements entered into by the major capital markets of the world.

IOSCO's Principles and the MMOU will be at the center of these arrangements although domestic concerns may mean other "add-ons" on a case by case basis. I will come back to IOSCO and what I mean here shortly.

Mutual recognition

But let me explain a little more about where we are with mutual recognition.

Mutual recognition is a system which is gaining international acceptance and recognition. There is an increasing international acknowledgement of mutual recognition as a solution for effective regulation in the world of cross border trade.

To explain mutual recognition: Rather than envisaging standardized model frameworks across jurisdictions, mutual recognition allows domestic laws and regulations to reflect national imperatives while providing the capacity for cross-border cooperation and enforcement.

To work effectively, mutual recognition requires coordinated responses and consistent approaches to regulating cross border transactions. As a first step for achieving mutual recognition, one must agree on a common basis of principles on which to assess the effectiveness of foreign regulations and the work of the foreign regulator. The IOSCO Principles which I will explain shortly provide such a basis.

A worldwide application of mutual recognition is still a long way off. However, there have been a number of steps adopted in both bilateral and multilateral agreements recently which are edging towards a broader mutual recognition approach. There was, for example, the MOU of 2006 between the US Commodity Futures Trading Commission and the UK Financial Services Authority dealing with consultation and cooperation in relation to some US and UK exchanges. And within the European Union itself there are significant forms of mutual recognition.

The US Securities and Exchange Commission (US SEC) announced in late March a series of actions to further the implementation of mutual recognition with a number of countries, notably Australia, Canada and the EU. Since then on 25th August they signed a mutual recognition agreement with the Australian Securities and Investments Commission (ASIC) which provides a framework for the US SEC, the Australian Government and ASIC to consider regulatory exemptions that would permit US and eligible Australian stock exchanges and broker dealers to operate in both jurisdictions, without the need for these entities (in certain aspects) to be separately regulated in both countries. Processes have also commenced which are ultimately aimed towards achieving mutual recognition regimes with Canada and with the EU. New Zealand and Australia have earlier this year introduced mutual recognition of securities offerings. This regime allows New Zealand businesses to raise capital in Australia using New Zealand offer documents – and vice versa. Investors will also benefit from having a wider choice of investment opportunities.

Not only in the developed markets however are we seeing the application of this mutual recognition solution. A number of emerging markets are embracing the approach. One example is a voluntary opt-in scheme for mutual recognition of general/non-specialised collective investment schemes offered to non-retail investors developed through a working group of the IOSCO Regional Committee for the Asia-Pacific Region which was endorsed at that Committee's meeting in Seoul last November. This arrangement is currently open to IOSCO members from the Asia-Pacific region, which comprise a majority of emerging market economies – provided that specific requirements, including implementation or relevant IOSCO Principles, are met. It is an important first step to possible wider recognition arrangements.

All these arrangements, and there are other examples I have not mentioned, recognize the importance of local regulation applying to local markets and create mecha-

nisms for consultation and cooperation between regulators. Mutual recognition does not require adoption of identical legislation. What will be core to the effectiveness of arrangements based on mutual recognition is confidence that the respective regulatory arrangements aim to achieve, and are capable of achieving, the same regulatory outcomes. Confidence in the capacity and willingness of the other regulators to enforce and cooperate will be equally critical. Put simply, it requires a comparable but not identical regulatory framework, and a similar appetite to take action. Domestic regulators who recognise the advantages in mutual recognition arrangements will need to look at their own regulatory arrangements and ensure that they have regulatory frameworks and enforcement capabilities in place that others can recognise and interact with. Under mutual recognition there would be true confidence in the regulatory frameworks of both, and indeed multiple, jurisdictions.

IOSCO has been conducting a dialogue with industry and one of the significant themes is the need for regulators to facilitate cross-border transactions and to ease the compliance burden of these. Mutual recognition can achieve this. Indeed I quote the example of the EU-US Coalition (the Coalition) on Financial Regulation (a group of global financial industry associations) which has noted mutual recognition as among the requirements necessary to form the basis for regulatory modernization.

I return to my bold idea that there could emerge over the next 10 years "virtual" super regulation as the sum of the recognition agreements entered into by the major capital markets of the world. I would like to elaborate a little more on how I think this might in fact occur.

Of fundamental importance to any economy, as all finance ministers and other political players know, are strong markets with sustainable growth potential. That's where mutual recognition arrangements add particular value. Far from merely facilitating regulatory activity, as they mature these recognition arrangements provide frameworks that effectively enhance the liquidity and resilience of markets. Once there is sufficient momentum in some of the world's large capital markets opening up access to deeper and more liquid markets, it is likely that the issuers, investors and other market participants in markets without such arrangements will bring pressure for similar arrangements to occur in their markets.

Mutual recognition provides a framework to exponentially leverage on the strength of markets around the world – bringing diversity, driving best practice and efficiency and opening up a multitude of opportunities for the local financial services sectors, business and consumers.

As a result, it is likely that a market value will emerge for participation. In turn, politicians will wish to ensure that the benefits of greater liquidity flow to their domestic markets. It will be the demand from market participants which is likely, in my opinion, to provide the political will in jurisdictions to undertake these exercises.

Looking over the horizon then, I see a world where all major markets recognize the others throughout the full gamut of their financial market activities. From the issuers and issues of securities, to brokers and other intermediaries, to exchanges, managed funds and other entities all could come under recognition regimes. The regulation of cross border entities and transactions could all be covered, as could multinational agencies such as credit rating agencies. This network would cover the globe ensuring that there were high standards, based on the IOSCO Principles and the IOSCO MOU. Hopefully it would lead to a world wide raising of standards as

each jurisdiction strives to ensure its standards were high enough to be considered equivalent to others for the purposes of mutual recognition.

Such arrangements do not require linkages with any other international frameworks. Free trade agreements, investment protocols or other such arrangements can remain independent of mutual recognition arrangements. This enables complex external issues which may have trammeled other discussions, such as tax or subsidies, to remain outside discussions on mutual recognition.

The analogy that resonates most forcefully in my mind is the very mechanism that underpins the internationalization of financial markets. The Internet and associated technological advances have created a closer, more connected marketplace. Its fundamentals are not one centrally controlled brain, but a series of inter-connected systems, vibrant in their differences but connected through adherence to a set of agreed protocols that facilitate the sharing of information. Can we as custodians of the laws that drive the world's financial markets learn from this paradigm? I think so. How much more elegant and sustainable is the concept of fostering and growing an interconnected web of mutual understandings, than a quixotic search for a centralized regulatory big brother. So I exhort you to reflect further on this concept of virtual super regulation.

IOSCO

I have mentioned IOSCO several times in the context of this concept of virtual super regulation. This is because, as I have said, mutual recognition is enabled by a benchmarking process, by being able to recognize equivalence in each others regulatory frameworks. IOSCO, the International Organisation of Securities Commissions, in my view provides a set of necessary benchmarks which would constitute the fundamental core of mutual recognition arrangements.

Many will be aware of IOSCO and its work as the recognized global standards setter for securities regulation. With its 109 regulator members IOSCO actively promotes its 30 broad Principles for securities regulation for full implementation in the regulatory framework of every member jurisdiction. These Principles do not constitute rules and regulations which if implemented would achieve convergence between regulators. They are rather a set of benchmark standards against which any jurisdiction is able to measure and align their own laws in a manner consistent with their own priorities, traditions, market developments and conditions and legal frameworks. As such they provide a foundation or set of building blocks to enable mutual recognition, or recognition of equivalence between jurisdictions to occur.

Another important element of any mutual recognition arrangement will, of course, be the ability for regulators to share information and co-operate to engage in effective enforcement across borders. To this end too, IOSCO has developed the facility, through its Multilateral Memorandum of Understanding (IOSCO MMOU) to which members can sign up. As signatories the securities regulators can gather information from their counterparts overseas on cases of insider trading or other securities law violations that they are investigating. There are currently some 65 jurisdictions from around the world that have either signed on to the IOSCO MMOU or committed to making the changes necessary to do so, and IOSCO has set the bold objective of having all member jurisdictions signed up or committed to do so by 2010.

IOSCO is pivotal in bringing together securities regulators from around the world,

and its Principles and MMOU are fundamental building blocks to the achievement of cooperation. Some other developments have occurred more recently which are providing the pathway for mutual recognition to more easily occur.

Notably the work being done by the International Accounting Standards Board (IASB) towards a truly global set of high quality accounting standards is critical. It has opened up a mechanism for greater levels of convergence or co-operation across jurisdictions. The work towards the goal of a single set of global accounting standards, known as the International Financial Reporting Standards (IFRS) regime has been an ambitious and laudable undertaking, which has now gained global momentum, international recognition, and increasing commitment from around the world. The vision behind this is that a single worldwide set of standards will permit investors around the world to benefit from a high level of comparability and consistently high level of quality in financial reporting.

The impact of this work will be reduced if different interpretations of IFRS spring up around the world. This is why IOSCO has stated that any national variations must be clearly disclosed. It is also developing mechanisms to encourage sharing of views amongst IOSCO members on this topic, such as through the IOSCO IFRS database for example. However more work needs to be done here.

The engagement by the US in this harmonization project and the removal of the reconciliation requirement of US GAAP has greatly accelerated the IFRS project. Furthermore, on 27th August the US SEC announced that it would publish for public comment a proposed Roadmap that could lead to the use of IFRS by US issuers beginning 2014. The SEC will make a decision in 2011 on whether the adoption of IFRS is in the public interest and would benefit investors. The SEC's release announcing this noted that "the increasing integration of the world's capital markets, which has resulted in two-thirds of US investors owning securities owned by foreign companies that report their financial information using IFRS, has made the establishment of a single set of high quality accounting standards a matter of growing importance."

The vision of virtual super regulation, being a network of recognition arrangements spanning the global capital market, will have a number of critics and nay sayers. In fact I have heard some rather cynical views from fellow regulators daunted by the practical difficulties recognition agreements face. They are not simple and can require significant political will. These should not be underestimated, as there will need to be significant thought leadership, as well as practical leadership in facing challenges along the way.

Some of these challenges will include the question of legitimate national interests that would need to be considered in the world we live in. There are likely to be voluntary opt in arrangements that jurisdictions will choose to participate in. Enforcement models such as the lead regulator model compared with the exemption route will need to be considered.

There will need to be further exploration of issues around asset freezing. Compensation and dispute resolution models particularly in regard to retail investments will need to be considered. Also it will remain encumbent on IOSCO to ensure its standards remain at a high and relevant level. Through the establishment of a MMOU Monitoring Group we have set up a process to ensure that jurisdictions keep to the standards they undertook to maintain when they signed onto the MMOU. There is a

mechanism to deal with jurisdictions falling below the agreed standards.

In my view the challenges to be confronted in evolving the way forward as I see it will not in fact be insuperable.

Allow me to remind of the significant progress IOSCO has already made in circumstances that have required significant political will. If 10 years ago, somebody would have suggested that a number of jurisdictions well known for their banking secrecy would have carved out or abolished that secrecy for the purposes of an international IOSCO MOU, he might well have been laughed from the room, and yet that is precisely what has been achieved. It has been achieved because the reality is that there is a market value perceived in being a signatory to the IOSCO MOU which issuers, investors and other market participants require, and to which political forces have responded.

It is my belief that a similar set of forces could well be liberated as domestic market participants, investors and issuers see, and demand, the deeper more liquid markets that recognition agreements will enable. Of course mutual recognition (or unilateral arrangements for that matter) will be easier and will probably start between like-minded jurisdictions which have close links in foreign policy or other spheres. In some cases they are likely to commence in the wholesale markets as the potentially more thorny issues of protections for domestic retail investors are worked through. It is my belief that they will probably not stop there. The demand of market players for access to deeper liquidity will only increase and the demand for access to others markets will also increase.

The challenges for recognition agreements between jurisdictions which do not have close ties in other spheres may be difficult, but the success of the IOSCO MOU demonstrates that members of IOSCO can, and do, work together even though the foreign policy of the various governments may differ and I believe this comity in the regulatory space will extend through mutual and unilateral mechanisms. The drivers will be the increased liquidity that the increasing globalization of the capital markets delivers and the appetite for participation in other markets, as well as the need for the participants to be appropriately regulated. The arrangements will vary but underpinning them will be adherence to the IOSCO Principles and signature of the IOSCO MOU.

It is probable that there will continue to be a need for some 20th Century structural solutions for specific problems that arise. For example, it is still an open question as to whether there needs to be a global IOSCO structure to oversee credit rating agencies or whether national regulatory frameworks and the IOSCO Code of Conduct will suffice. IOSCO has recently updated its *Code of Conduct Fundamentals for Credit rating agencies.*

Concluding comments

The current consensus-based international framework of securities markets regulation, through the work of IOSCO, provides a sound basis for future developments in the global financial architecture. Building on the foundations laid by this organisation I now see a possible solution to challenges which have confounded financial markets players, national governments and regulators alike. An answer may be attainable, and attainable in our lifetime. While we might have been chasing a dream based on traditional settings, I believe if we adopt a 21st Century approach we might

fulfil that dream. I do see that there is a real probability, and one driven by market forces in today's globalized world, that we might indeed see in our lifetime the concept of super regulation – virtual super regulation that is a network of recognition arrangements spanning the globe.

What role IOSCO will play in those future developments remains an open question. But one thing is very clear, IOSCO will be an instrumental and important participant in the exciting developments of the future. IOSCO will certainly be at the centre of the invention of the future of the global securities markets regulation.

3.2 Kathleen Casey
Commissioner of the U.S. Securities and Exchange Commission

First of all I would like to give my honest recognition to the important role Spain played in developing our modern understanding of what a capital market should be.

A superficial understanding of economic history credits the great Scottish moral philosopher Adam Smith with creating modern capitalism, even though, in his elucidations of it, he never used the word.

Indebted as we should be to the author of The Wealth of Nations, the truth is that more than two centuries before them, at the University of Salamanca, Spanish scholastics were intensively laying out a cosmological framework for modern economics.

These were neo-Thomist, prominently including Francisco de Vitoria and Francisco Suárez, sometimes called the father of international law, who boldly separated the civil and the divine realms of power.

Mere monarchs, they argued, possessed no power over individual souls, who were expected —indeed they possessed a natural right— to roam the temporal world and engage in acts of commerce.

Vitoria, Suárez and their studious brethren mediated a great deal on the principles of what constituted mercantile society and the need to defend it around the world. The natural order, they believed, required "freedom of circulation" of people, goods and ideas. Freedom, they faithfully predicted, would build global brotherhood.

The School of Salamanca, as historians call this body of 16th Century thought, developed sophisticated ideas on money, value, price, and interest. Indeed, Joseph Schumpeter praised these Spanish scholastics as the true founders of economic science. We are their legatees, as we work, in the words of IOSCO's Core Principles, to protect investors, ensure that our markets are fair, efficient and transparent, and reduce systemic risk.

Our role should be seen as a logical and necessary manifestation, in our own time, of this timeless order of economic freedom.

What, then, might we imagine to be the progress of our universal mission when other 20 years have gone by?

One thing I think we can safely say is that global markets may well demand a global language. Provided, of course, that we do not sacrifice accuracy and quality for universality, a common accounting language around the world would give investors greater comparability and greater confidence in the transparency of financial reporting world wide. Why, after all, should comparability stop at the same borders that capital now crosses with such stunning ease?

The increasing integrations of the world's capital markets, which has resulted, from our perspective, in two-thirds of U.S. investors owning securities issued by foreign

companies that report their financial information using IFRS, has made the establishment of a single set of high quality accounting standards a matter of growing importance.

As evidence of our enthusiasm for this global development, since March 2007, the SEC and its staff have held three roundtables to examine IFRS, including one in August regarding the performance of IFRS and U.S. GAAP during the subprime crisis. Nearly a year ago, the Commission issued a concept release on allowing U.S. issuers to prepare financial statements using IFRS.

Recognizing the value of a lingua franca for accounting, just last month the SEC voted to publish for public comment a proposed Roadmap that contemplates we join many jurisdictions around the world in permitting the use of IFRS in our market. The Commission will make a decision in 2011 on whether adoption of IFRS serves the public interest and benefits investors. This is a multi-year plan, which lays down several milestones that, if achieved, might eventually lead to the use of IFRS by all U.S. issuers.

And, of course, the SEC is not alone in recognizing the potential advantages IFRS offers. Today, more than 100 countries around the world, including all of Europe, currently require or permit IFRS reporting. Approximately 85 of those countries require IFRS reporting for all domestic, listed companies.

So, 20 years from today?

I envision that IFRS will have grown in quality and universality to such a degree that we will wonder how w could have lived without it, so instinctively will issuers and investors, not to mention a new generation of accountants, have learned to circulate their vital information in a common language of financial reporting.

In fact, I see all the market-integrated countries of the world using IFRS.

But, of course, a global language for a global market is only the start. To be useful, a language must not just be understood, but it must convey information. Accordingly, combining IFRS with new interactive data technology will be critical to helping investors not just draw comparisons, but to draw comparisons in ways they find most valuable to their investment goals.

Towards this end, for more than six years, the SEC has explored, invested in, and progressively promoted the adoption of interactive data in its several forms, including, most importantly, XBRL, for the tagging —by companies, investment funds and other filers— of their financial reports.

Now, we are preparing to consider final rules that will facilitate its benefits for investors, retail and institutional alike, and would make interactive data —with its benefits of being faster, cheaper, and better— a permanent part of the capital markets in the US, as they are now in a number of other nations such as Japan, Israel, China, Korea.

And many other national regulators and markets are preparing to consider such technology, too, which will —even before any potential adoption of IFRS— enhance the transparency of markets and the flows of capital globally.

Next month in Washington we will host the next global XBRL International conference, where we expect to share and see even more advances in interactive data, and more ways in which such data are being brought to international capital markets.

In fact, one of the collateral benefits is the open and vigorous cooperation between securities regulators in terms of how to get XBRL up and running.

The coming several years will see interactive data take a rightful place as the global standard by which financial reporting information will be filed, and by which it will be sliced, diced, crunched and otherwise used by investors, analysts and regulators alike.

Part of our mission is to assure the orderliness of markets, and so, as we welcome and cheer the race to adopt interactive data around the world. I cannot stress enough the importance of setting universal standards and best practices if interactive data is to achieve its highest purpose and use for investors.

I am therefore delighted to see XBRL International recognizing the need for a single, global authority over interactive data —surely as critical a need as the role ICANN and WC3 plays with regard to the Internet.

The SEC appreciates the leadership shown by XBRL International and offers its support to attain this goal, which no doubt will be high on its agenda as it meets next month in Washington.

But getting investors the information they need in a language they understand and a format they can use is not enough to make a market truly transparent. The disclosures we require of issuers must be useful and timely. Accordingly, in August the SEC also voted unanimously to update and modernize disclosure requirements for foreign companies with securities in U.S. markets, making it easier for U.S. investors to gain access to timely financial information that can help them make better informed investment decisions.

These rule amendments reflect advances in technology and other recent global changes in global capital formation and the markets it fosters, bringing the SEC's foreign company disclosure requirements into the 21st Century.

After a period of transition, foreign reporting companies also will be required to file their annual reports with the SEC two months earlier, making those submissions timelier and therefore more useful to investors. These amendments also bolster the ability of U.S. investors to participate in cross-border tender offers and other business combinations.

To assist us in getting the right information to investors when they need it, we at the SEC have unveiled an IDEA. Our IDEA is an acronym for Interactive Data Electronic Applications, and we believe that it, too, points the way toward making micro-economic truths reasonable, intelligible and accessible to investors around the world.

The new system will give investors faster and easier access to key financial information about public companies and mutual funds.

IDEA will at first supplement and then eventually replace the SEC's current EDGAR filing system, which will become an archive of SEC filing made prior to the new era of financial reporting in interactive data format.

The SEC has formally proposed requiring U.S. companies to provide financial information using interactive data beginning as early as next year, and separately has proposed requiring mutual funds to submit information from their public filing using interactive data.

The decision to replace EDGAR marks the SEC's transition from collecting govern-

ment-prescribed forms and documents to making the information itself freely available to investors in a user-friendly format they can readily use.

Instead of sifting through one form at a time in EDGAR and then re-keyboarding the information to analyze it, investors themselves will be able to use interactive data to instantly search and collate information to generate reports and analysis from thousands of companies and forms through IDEA.

The ease with which interactive data will make financial information more readily available also is expected to generate many new Web-based services and products for investors.

IDEA's launch represents a fundamental change in the way the SEC collects and publishes company and fund information —and in the way investors and the markets will be able to use it.

So, the reasons for having this IDEA are obvious. By making accurate financial information easily and universally accessible, IDEA brings the act of investing down to the most human scale.

In his wonderful little book, The Riddle of the Compass, Amir D. Aczel searches for the origin of that indispensable navigational instrument —a tool that made economic empire possible. Thirteenth century Italy can make a good claim, but Eleventh century China perhaps can make a better one.

Aczel, having conducted his exhaustive historical detective work, arrives at the arresting conclusion that humanity's uses for technology often lag for years, sometimes centuries, behind its actual development or discovery.

As securities regulators with access to currently available technology, we can over the next very few years make long leaps as we advance our pro-investor missions.

However, as we look to the future, the capital mobility we see today demands not just that we, as individual regulators, seek new solutions to the old problems of disclosure and accounting. The future also demands that we regulators look at new ways of working together to protect investors better as they navigate this brave new market.

For the past two decades, the SEC has been at the forefront of building relationships throughout the world to improve investor protection. This past August, the SEC embarked on what I believe to be the next step in cross-border cooperation by forging an alliance with the Australian Securities and Investments Commission. The SEC and ASIC are putting in place mechanisms that would make our oversight and enforcement systems more cooperative, and have signed a new supervisory MOU and an enhanced enforcement MOU as a first significant step towards this goal.

Mutual recognition arrangements of the kind that the SEC and ASIC entered into on August 25 are designed to help end duplicative regulation and lower the cost of capital for U.S. companies. But, more importantly, it would also increase investment opportunities while enhancing U.S. investor protection and the SEC's ability to pursue securities law violators effectively across international borders.

But bilateral relationships, such as the new mutual recognition arrangement between the SEC and ASIC, are not enough. We must also strengthen the multilateral relationships we have built over the past decade.

Accordingly, as we imagine what our markets will face over the next 20 years, we

should reflect on the important role that IOSCO itself should play in this future. While we regulators are careful to note that past performance is not guarantee of future performance, if the past is any indicator of future trends, IOSCO will play a critical role in developing the international consensus necessary in order to make our global markets work together smoothly. I've mentioned a few things about the SEC's own initiatives, but for the most part, these address just one market. Other jurisdictions have their own initiatives. IOSCO's strength in the future, as it has been in the past, likely will be as a bridge between our markets and our regulation.

As just as an example, we can consider the role IOSCO has played in developing the Multilateral MOU, or "MMOU", on enforcement cooperation and information sharing. While hardly a household word, there are few investors in the world today who have not indirectly benefited from the MMOU's existence. Our markets today are so interconnected, and those who commit securities fraud can so easily reach across borders, that without the MMOU, our jobs as regulators to protect the integrity of our markets would be much more difficult.

Likewise, consider the common understanding of what constitutes good securities regulation that has evolved from IOSCO's Core Principles of Securities Regulation. These Core Principles form a baseline understanding for regulators around the world, and are now used by entities such as the International Monetary Fund in assessing potential risks to the international financial system —as well as a basis for discussions among securities regulators in even their own bilateral discussions.

Going forward, IOSCO must keep up the good work, because we all rely on it so much today. And I have no doubt that IOSCO will keep up this work, because only IOSCO combines the expertise and opportunity for international consensus that our global markets so desperately need through the ebbs and flows of the future.

3.3 Joaquín Almunia
European Commissioner for Economic and Monetary Affairs

These are very complicated times, and I will make some reference to the situation. But I think that now, more than ever, we need strong supervisors that are well equipped to discharge their duties and contribute to restoring trust.

I believe we will all agree that 2008 is proving to be quite a difficult year in economic terms. Our economies have been, and continue to be, exposed to a series of global shocks. We began with what has been termed "financial turbulence" in August 2007, but that has spread gradually throughout this year and nobody has a clear idea of when the international financial systems will return to normality. Since the end of 2007, we have witnessed an increase in the prices of commodities and food, particularly rising energy prices. Those increases have had a negative effect on inflation and, consequently, on our growth prospects.

Those shocks have inevitably had a deleterious impact on growth both in Europe and worldwide. Growth in the euro area shrank by 0.2% in the second quarter and, as we published last week, the prospects for the remainder of 2008 are worse than we expected when we published our previous projections. [1.3 compared with 1.7]

The general situation is quite uncertain. Business and consumer confidence has declined substantially, which is evidently a cause for concern. Moreover, the news coming practically every weekend from across the Atlantic (Fanny, Freddie, Lehman, AIG, etc.) is doing little to boost confidence.

However, the picture is not entirely gloomy.

Europe's labour market has responded quite positively to date, although the situation may change.

Inflation, which reached 4% in the euro area at the end of August, has probably peaked. The recent decline in oil prices will undoubtedly help ease inflationary tensions. Nevertheless, we should not underestimate the "second-round effects".

How, then, should we Europeans respond to these challenges in a way that also enables us to safeguard our future stability and growth?

The response lies in coordinated use of all the components of economic policy: fiscal and monetary policy, financial markets, structural reforms, and the foreign agenda.

Fiscal and monetary policy

Starting with monetary policy, we are all aware how damaging inflation can be to an economy. It represents an obstacle to sustained growth and is particularly harmful to the most disadvantaged sectors of society. In this respect, it is important to maintain the ECB's independence in its role as guarantor of price stability. May I say that the ECB is doing a good job in very complicated conditions; for that reason, it deserves not only our trust but also our support.

In the current circumstances, it is very important for the Member States, particular-

ly those in the euro area, to maintain budgetary discipline. As a result of budgetary consolidation in recent years, encouraged by the reform of the stability and growth pact, the Member States currently have room for manoeuvre to address the current situation using the automatic stabilisers.

But we must also extend the level of coordination and macroeconomic oversight in the euro area. We must pay more attention, in a joint and coordinated way, to competitiveness, external imbalances, structural inflation and labour costs so that we may encourage each country to adopt the appropriate policies to address the challenges of the future while also ensuring the stability of the euro area as a whole.

Financial Markets

I will now turn to the financial markets. Maintaining financial stability is at the core of our agenda to restore growth.

Unfortunately, and particularly after Bear Stearns, the hope that the financial markets had stabilised has proved to be optimistic. Recent events have shown that, more than a year after the subprime debacle, the sector is still in crisis.

The markets are still limping. In the current circumstances, investors prefer low-risk assets, with the result that the spread between sovereign debt and high-risk assets has widened considerably.

The banking sector has been particularly hard hit. The ECB has managed to avoid a credit crunch in the system, but the interbank system is still operating at a very low level and there are no signs of an improvement in the short term.

Back in July 2007, very few people would have predicted the losses that have been announced recently. The figure is close to 500 billion dollars, and estimates put the total at over one trillion. About half of that amount has been reported by European banks, though few of them are from the euro area. Those losses, combined with the decline in credit quality of debtors—be they individuals, companies or banks—are creating a situation in which banks are applying increasingly strict lending policies, thereby reducing the amount of available credit.

If banks want to continue lending, they need to maintain sufficient capital, but that has been eroded by the subprime losses and rising delinquency. And it is difficult to increase capital when the economy is ailing, the banks' own prospects are not very good, and there is widespread mistrust of the financial system's solvency. In these circumstances, investors' appetite has clearly waned, which poses difficulties for recapitalising some banks.

We can confidently say that the world financial sector is at a crossroads. We must improve risk management by financial institutions and increase the transparency of bank balance sheets and of price discovery mechanisms in the organised and OTC markets, especially for derivatives. Only with good information about the risks in the system and who holds them will we be able to restore the climate of trust that is so necessary for the markets to work properly.

We welcome the fact that the industry has decided to organise and present initiatives to address the various problems that have come to light during this period of instability. I believe that the self-regulation proposals are positive, but they are not sufficient. It is also imperative that we improve our system of regulation and supervision.

And that is what we are doing. Since October last year, when the ECOFIN adopted the roadmap, we have been working to the schedule set in that document. We have extended transparency in the area of asset-backed securities. We are preparing initiatives to amend the Capital Adequacy Directive in early October. Based on suggestions from bank regulators, we will improve the mechanisms for managing liquidity risk, and the treatment of asset-backed securities for capital adequacy purposes. We will also regulate rating agencies.

Europe's economy ministers and its supervisors attach great importance to the effects that regulations, particularly capital and accounting requirements, may have on the economic cycle. I am referring to the procyclical application of regulation. For that reason, in September in Nice we decided to create a working group to study the issue before year-end so that we are in a position take the appropriate measures if the need arises.

All these measures, plus others that may need to be taken, may involve a substantial change either in the business models that currently obtain in the banking industry or in the way in which those models have been implemented. Stability clearly comes at a price, but that price may be infinitely lower than what we are all paying at present.

I would like to take advantage of the occasion offered by the CNMV to emphasise the need for the European Union to have a system of supervision that is capable of meeting the challenges posed by the integration of markets and financial institutions. If the key players in European finance agree on anything, it is that fragmented supervisors cannot oversee an integrated market.

For that reason, both the European Commission and ECOFIN have made two crucial decisions. The first is the adoption of Lamfalussy + in order to ensure that all European regulators apply EU regulations in the same way. And it is necessary to put an end to "gold plating". The second measure consists of an agreement on general principles for the organisation and supervision of transnational entities. The best approach to date would appear to involve giving a greater role to the lead supervisor while creating a college of supervisors.

Structural Reforms

I will turn now to the third component in our agenda for palliating the effects of the current deceleration; namely, structural reforms.

It is crucial to make a determined effort in this area. An ambitious agenda of structural reforms will boost confidence and purchasing power on the part of both consumers and investors; therefore, it will be very useful in the current economic situation.

Moreover, in the medium and long term, structural reforms may not only increase our economy's growth potential but also improve its capacity to absorb future shocks. Measures aimed at improving flexibility in the labour and services markets will assist a more efficient redistribution of resources between sectors and regions, thereby enhancing our economies' ability to adapt and making them better able to handle the changes that arise in an ever-more globalised and interdependent world.

Since it was launched in 2005, the Lisbon Strategy has played a key role in putting structural reforms at the top of the agenda both Europe-wide and at national level.

But the progress made to date is insufficient; in the current circumstances, it is clear that we must advance more quickly. In my opinion, the following reforms need to be implemented urgently:

Firstly, it is essential that the Services Directive be applied. In particular, that Directive includes a number of measures to foster competition in retail and distribution and in the services sector in general that will be very valuable in the current situation, given the services sector's major role in inflation.

Secondly, we must eliminate barriers to competition in the energy sector.

Thirdly, by measures to reform the labour market, governments can contribute to alleviating the impact of the current situation on disadvantaged segments of society. Removing constraints on the free movement of labour in the internal market may also assist in the adjustment.

Foreign Agenda

Since the shocks I have mentioned are essentially global, any response must also be coordinated at a global level.

When I discussed the financial turbulence, I mentioned the importance of making decisions at a global level; the same principle applies in other areas, such as the problem of the world's economic imbalances and the risk posed by their disorderly removal.

Considering that no single country can overcome or even address these global imbalances on its own, I believe it is time to adopt a multilateral approach to this issue.

Coordinated action worldwide is also needed to preserve and persevere in the liberalisation of trade and investment. The signs of a resurgence in protectionism augur ill for the world economy, in my opinion.

However, if we want Europe to have an influence on the global stage, we must speak with one voice; to that end, the countries in the euro area must establish a coordinated strategy with respect to euro's "external aspects".

Conclusion

This is a time of great challenges, both short and long term. To respond to those challenges, we must act on all possible fronts, which requires a global strategy of reforms and restructuring.

No one should expect an immediate solution, but it is clear that the more coordinated our actions within Europe, the better the strategy will be. We have been affected by a number of global phenomena and must join forces in order to respond. If we can do that, I am convinced that we will not only be able to surmount the current difficulties more quickly, but we will also be better placed to face issues of concern in the future.

4 Integration of European securities markets: situation and prospects

4.1 Carlos Arenillas
Former Deputy Chairman of the CNMV

The financial history of the last 20 years has a number of clear characteristics: growing globalisation and sophistication of the financial markets. These features have led to changes in the behaviour patterns of issuers, intermediaries and investors, and have substantially altered the range of products on offer.

Although markets have become more efficient, the successive episodes of turbulence and crisis throughout the world in recent years have brought to light a number of notable deficiencies. Those episodes, though differing in nature, reveal a common pattern: for example, their impact is increasingly felt throughout the world, affecting a growing number of regions and markets and often significantly impairing economic growth and employment.

Accordingly, the relatively recent concept of financial stability has been modified gradually to reflect the growing complexity of the financial system by adding the concept of proper market functioning to the traditional component of bank safety and soundness. At the same time, the goal of financial stability so defined has been gaining in importance in the framework of public policy.

In this context, the functions of financial supervision and regulation are essential in order to achieve proper functioning of the financial markets, maximise their efficiency, protect investors and minimise the systemic risk.

The transformations experienced by the financial markets in recent years have led to a variety of approaches with regard to regulation and supervision. At times, their apparent smooth operation for lengthy periods of time may have lulled regulators and supervisors into complacency with regard to the level of oversight that is required.

Nevertheless, situations like the present one, following the turbulence experienced by the markets in the last year, raise the need to review and improve both financial regulation and supervision, the goal being to avoid the sort of phenomena that have led to the current crisis, and to mitigate their possible consequences. I am sure that, in the future, we will face other problems that are difficult to conceive at this time, but that should not prevent us from seeking to make progress now in obtaining a reasonable diagnosis of the deficiencies that have brought us to the current crisis.

There is broad consensus that the recent crisis has revealed a significant mismatch between the reality of totally global interconnected markets and the supervision function, which continues to be performed partly or wholly on a national level. Recent publications by the Financial Stability Forum and the International Monetary Fund have expressed a similar view.

Therefore, it is necessary to increase international cooperation. I believe this means that multilateral organisations must become more important in the immediate future since only through them is it possible to palliate, albeit partially, the deficiencies detected in financial supervision.

IOSCO is a clear example of such necessary international bodies. IOSCO performs invaluable work in coordinating supervisors and issuing standards and best practices recommendations in many areas, inspiring a range of legislation that is currently in force in many jurisdictions. IOSCO is also a member of the Financial Stability Forum. I suspect that IOSCO's role and importance will increase in the coming years.

In the specific context of this roundtable discussion, the European Union is the prime example of a project that has transcended the purely domestic sphere and attained high levels of integration, coordination and joint action, particularly in the financial sector.

Down through the years, it has created a framework of legislation to achieve a varied range of goals. The Financial Services Action Plan (FSAP), launched in 1990, is the best example of this structure. In parallel, it has created a number of committees whose purpose is to establish common rules and apply them as coherently and homogeneously as possible, while also facilitating cooperation between supervisors.

In this context, financial markets are a prime exponent of the level of integration and coordination in the EU. The process of integrating Europe's securities markets has advanced considerably in recent years. In that sense, investors are integrated, the markets enjoy total symbiosis, trades can be made worldwide from anywhere in the Union, and there is major scope for arbitrage.

This, for instance, provides a framework in which to apply the best execution rule introduced by MiFID since there are credible alternatives for trading. The area of UCITS is also fully integrated, although there are some pending issues such as the passport for UCITS operators.

However, there are some persisting areas of lower integration, such as takeover bids and post-trade. Some of these problems are due to national barriers or to factors such as differing market structures in different Member States. One of the reasons why the integration process is proceeding more slowly than expected is the financial market infrastructure.

For example, the difficulties facing integration in post-trade, i.e. clearing and settlement, include most notably the persistence of Giovannini barriers and the existence of over 50 supervisors in Europe. A number of interesting initiatives, such as the Code of Conduct and Target2Securities (T2S), have been introduced in order to make progress in this area.

There is no doubt that integrating the EU's financial markets necessarily requires convergence between its supervisors. Supervisory convergence is being pursued by a number of means such as mutual recognition, the procedures established in MiFID, etc., but the key factor in the current approach is the role of the Level 3 Committees such as CESR. Level 3 Committees must ensure effective coordination and convergence between all supervisors in applying the rules, even though their procedures and powers are subject to revision in pursuit of greater effectiveness. Delegation of functions is an instrument for this purpose.

Although much progress has been made in recent years in the development and integration of the EU's financial markets, the architecture of financial supervision in the European Union is excessively complex and, in my opinion, suffers from major weaknesses that have been brought to light by the recent crisis. It will be interesting to hear the opinion of those who attribute the subprime crisis to the "balkanisation"

of the US supervisory system when it comes to considering the case of the EU[1].

A partial explanation of this complex structure—apart from the characteristics of the European construction process itself—is that the EU has three generic models of supervision. The United Kingdom, Germany and Poland have a single supervisor. France, Italy and Spain, among others, apply the institutional model. So far, only The Netherlands has adopted the "twin peaks" system, although other countries, including Spain have announced plans to adopt it in the short term.

This diversity of systems often hampers further progress towards more homogeneous regulation but, above all, poses many problems for the development of harmonised supervisory practices throughout the EU.

In the last few years, there has been a debate on how to overcome these difficulties, in more or less explicit terms. Arguments have been proposed in favour and against a range of proposals, but little progress has been made[2]. The most notable ideas are the creation of a "college of supervisors" to coordinate supervision of big transnational conglomerates, and the introduction of qualified majority voting in the European institutions. The importance of qualified majority voting is nuanced by the fact that the decisions of the EU's Level 3 Committees (CESR, CEBS and CEIOPS) are not legally binding.

These are steps in the right direction, but they are not enough.

When dealing with financial markets that are much more integrated (particularly the securities markets), the supervisory architecture is complex and varied, which poses a risk for financial stability as I mentioned earlier.

The EU, or at least the euro area, should move determinedly to improve its financial supervisory architecture. The current crisis should provide renewed political support which, as a first step, should strengthen level 3 supervision: CEBS in the banking industry, CESR in securities, and CEIOPS in insurance. To that end, it is vital to strengthen those Institutions' decision-making mechanisms by making their decisions binding and giving their secretariats sufficient legal and financial resources. One possibility would be to give them the status of European Agency.

It is very important to advance towards standardisation of national supervision systems. The single supervisor and the twin peaks systems are the most appropriate ones.

But we should not rule out the possibility of moving determinedly towards a federal system of supervision like the European Central Bank's Eurosystem. To achieve this, the architecture would have to be defined first. As I have said on many occasions, I believe twin peaks to be the most robust system of supervision available, particularly for large markets such as the EU. A decision of this type would not prevent each EU Member State from applying its own system, although it would also undoubtedly facilitate harmonisation at national level also.

I know there is resistance to the idea of a sole centralised supervisor for the EU, but it

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1 Recent progress towards the goal of preserving financial stability includes the signature of a memorandum of understanding on crossborder financial stability by supervisors (of banking, securities and insurance), central banks and finance ministries of the EU (118 in total). The MoU came into force on 1 June. The MoU is a major achievement within the EU but the number of signatories reveals a problem of efficiency due to the proliferation of supervisors and regulators.

2 The proposals ranged from creating a lead supervisor to reinforcing the current system.

is very likely that we will soon see something similar, namely a network of European supervisors with a powerful centre, a role that could be played by CESR. This will probably occur for the simple reason that supervision must not and should not lag behind market realities. Globalised markets will require more global supervision.

The other three participants in this section will have much to say about this and other issues. I am sure that their contributions will provide the reader with valuable insight into the situation and prospects for the process of integration of Europe's securities markets.

4.2 José Massa
Chairman of Iberclear

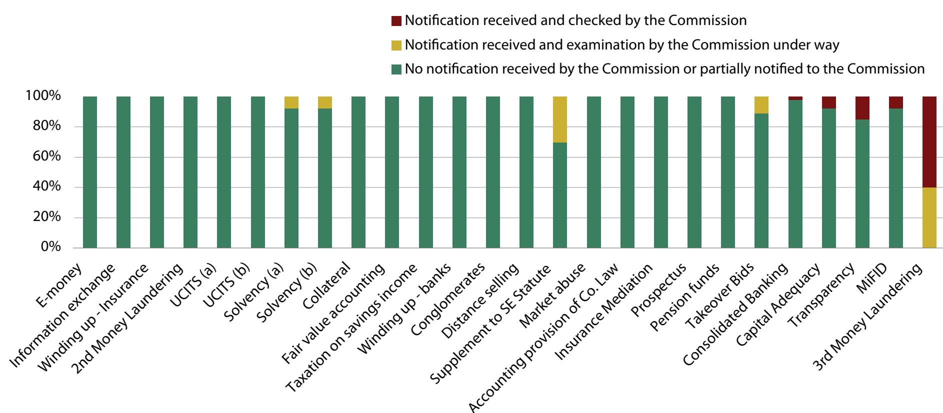
This article deals with the integration of financial markets in Europe. Being a broad subject, it's impossible to cover it in full, so I'll restrict my commentary to the integration of securities markets, with special focus on clearing and settlement. I will also make, at the end of it, a couple of remarks on possible ways of moving forward.

A single market in financial services has long been an objective of the European Union. The ideas of economic growth, higher productivity, lower cost for issuers and investors and more and better financial products appear once and again in public-policy statements, professional papers and speeches on financial integration.

The conviction in the advantages of an integrated financial market is what led the EU to endorse, eight years ago in March 2000, the Financial Services Action Plan, which is a set of measures intended to provide a legal and regulatory environment that supports the integration of European financial markets.

The overall idea is that financial institutions authorized to provide financial services in one Member State should be able to provide the same services throughout the entire European Union, competing on a level playing field within a consistent regulatory environment and under adequate supervision.

Transposition of FSAP Directives. View per Directive. State of play as at 06/20/2008 FIGURE 1



Source: European Commission.

The measures included in the FSAP have taken the form of Directives and they range from e-money to solvency, money laundering, collective investment or MiFID.

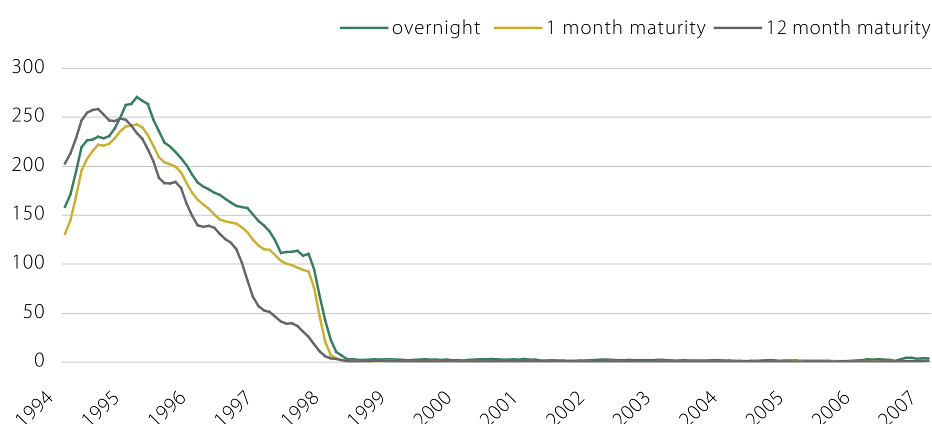
As we can see on Figure 1, which is a reproduction of the report made public by the European Commission in June this year, most of the measures of the Plan have been implemented (green bars) and the overall rate of execution is close to 100%.

This leads us to evaluate what the current state of integration of the European financial markets is after the tremendous regulatory effort set off by the Financial Services Action Plan.

Obviously, the launch of the euro has acted as a very powerful catalyst for further integration, and, at the same time, now that fifteen EU countries share a single currency, the barriers and obstacles that still remain appear to be much more prominent and, in fact, increasingly difficult to understand by market participants.

At the same time, it has to be said that the integration of financial markets in the EU has progressed much further and faster in wholesale than in retail financial services, with these retail financial services still largely segmented along national lines.

Euro money markets. Cross-country standard deviation of average unsecured interbank lending rates across euro aera countries (61-day moving average, basis points) FIGURE 2

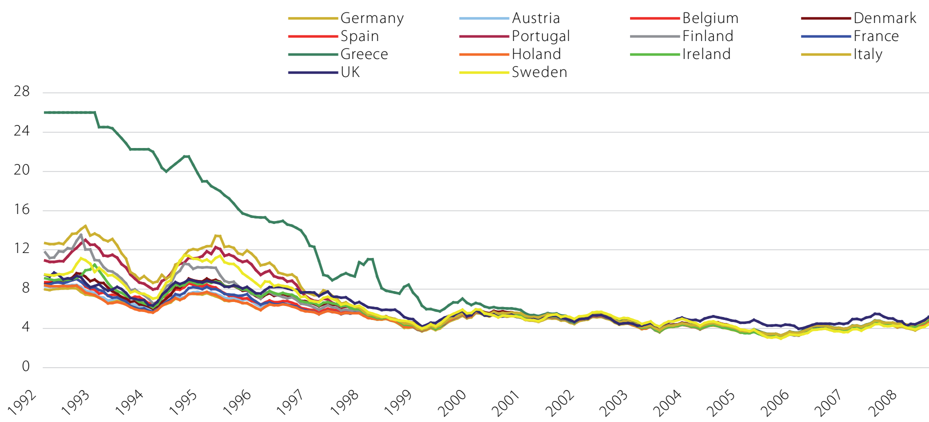


Source: European Commission.

We see on Figure 2, European money markets appear to have been integrated after the introduction of the euro. This is closely related to the efforts of the European Central Bank and the whole Eurosystem and has been possible, thanks to the launch and smooth functioning of TARGET and more recently TARGET 2.

10-year Government Bond yields
Bond markets

FIGURE 3

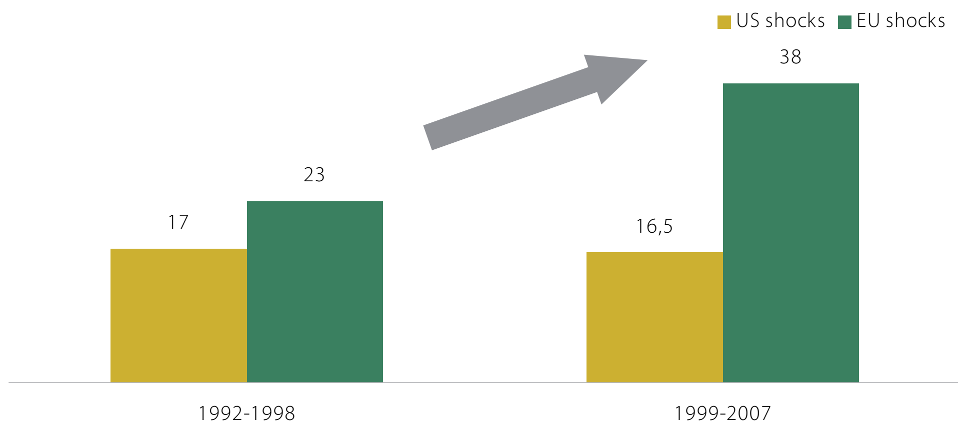


Source: Bank of Spain.

The situation is very similar in the Government Bonds Markets (Figure 3) with very minor deviations among the different national Bonds since the introduction of the euro. The differentials that remain can be clearly explained by the market perception on the liquidity and credit quality of the issuers and are absolutely compatible with an integrated market.

Equity markets. Proportion of variance in local equity Returns explained by euro area and US shocks

FIGURE 4

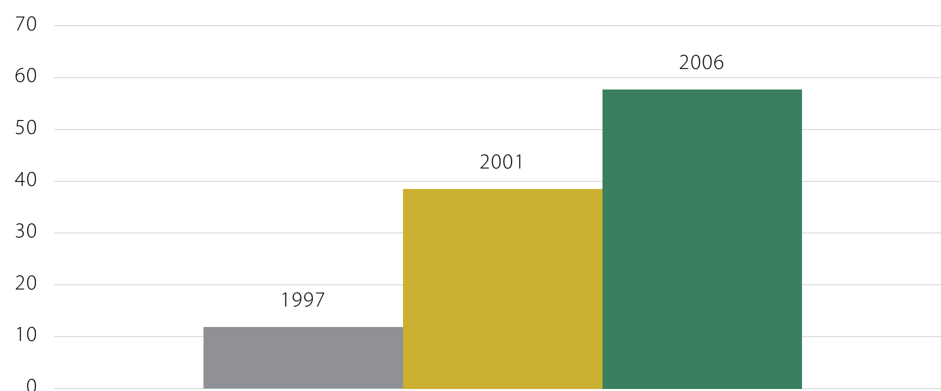


Source: European Central Bank.

As for the equity markets, the nature of the instrument rends it somewhat more difficult to make outright comparisons. In any case, there's clear evidence of growing integration within the European equity market (Figure 4).

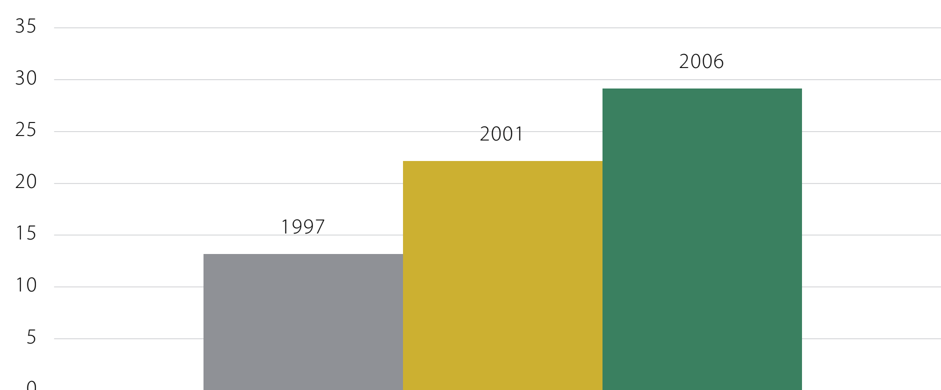
In summary, market prices in Europe have undoubtedly converged after the introduction of the euro. In this sense, European markets are reasonably integrated.

Cross-border holdings of long term debt securities issued by euro area residents (%) FIGURE 5



Source: European Central Bank.

Cross-border holdings of equity issued by euro area residents (%) FIGURE 6



Source: European Central Bank.

One effect of the increased integration of the European financial markets has been a significant growth in intra-Europe cross-border transactions.

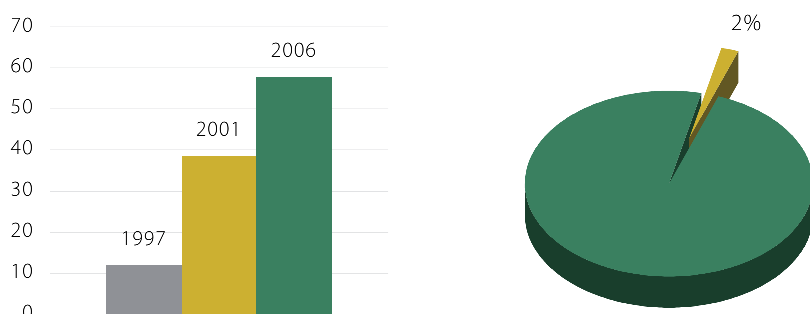
One way of looking at it is analyzing the evolution of European residents' holdings of non-domestic European financial assets. Figure 5 reflects the evolution of this magnitude for Bonds, where cross-border holdings have grown from 10 to almost

60% in the last ten years.

Figure 6 shows the same information for equities, where the growth has been from 10 to 30%. A tremendous growth in cross-border demand.

And this takes us to what is, at present, one of the main foci of attention.

Cross-border demand and balances of other CSDs in Iberclear FIGURE 7



Source: Iberclear.

Figure 7 shows the growth of holdings mentioned, together with a new graph, a pie that shows the balance of holdings from other CSD in Iberclear as a percentage of total Iberclear holdings. It is around 2%. This figure is very similar to the situation at other CSDs.

This 2% figure can be considered as a proxy to the current cross-border settlement capacity, or supply, if you prefer. It compares to the 60% cross-border settlement demand.

My point here is that the growth in cross-border demand in Europe has not been accompanied by a parallel growth in cross-border settlement capacity. Or, in other words, integration of post-trading activities seems to be lagging behind.

To sum up, the first thing is that the integration of financial markets has long been an objective in Europe.

The second thing is that the implementation of the Lisbon Agenda, together with the introduction of the euro, have generated significant levels of integration and have also brought about a relevant growth in cross-border demand within Europe.

Finally, the integration of post-trading activities seems to be lagging behind. And this is one of the current foci of attention for European authorities, because a smooth and efficient cross-border settlement is needed if we want well integrated markets.

The fact that cross-border arrangements are more cumbersomeand complicated than necessary has made the EU considerably step up its efforts in this field, because, as I mentioned before, the introduction of the euro makes the remaining barriers seem much more prominent and increasingly difficult to understand.

Four EU initiatives in this field deserve to be mentioned.

The first one is the identification of the Giovannini barriers, which are fifteen barriers that contribute to maintaining fragmented markets and that are grouped under the three headings of technical requirements, taxation and legal certainty. Mr. Alberto

Giovannini contributes to this book, so I will not dare elaborate more in what is his work and field of obvious knowledge.

The second EU initiative is the so-called Code of Conduct on Clearing and Settlement, which is an effort of soft self-regulation undertaken by the industry, obviously under the scrutiny of the EU. Among other things, the Code contains certain clear provisions on common access and interoperability among the different market infrastructures.

The third initiative is the MiFID, one of the Directives stemming from the FSAP deployment. It contains some provisions on cross-border access and freedom of choice that have the potential of bringing aboutsignificant changes in the current European landscape.

And the fourth public initiative is the launch of the TARGET 2 Securities –or T2S– project by the ECB, the Eurosystem. It is, to say it briefly, a project to develop a single technical platform that would substitute the current platforms of the different CSD and, thus, via technical integration, achieve true market integration.

It has to be said that the last tree initiatives are quite recent and it's probably too soon to be able to adequately assess its impact, because in some cases they have not even been implemented yet.

But besides the public-sector initiatives, the private sector has its own way of looking at the same problem.

The graphs on Figure 7 have already been mentioned. They show a market segment (the subsector of cross-border settlement of securities transactions) where the demand has reached a holdings level of almost 60% while the CSD's supply hardly reaches 2%.

If we look at it through business eyes it's not difficult to conclude that we are facing an obvious business opportunity to increase the quality of our service and expand our range of activity.

And in fact this business opportunity has been identified by all the European CSDs and has been approached by them with two different answers, so far.

One is the road undertaken by Euroclear, which consists of a process of CSDs consolidation by means of a process of mergers and acquisitions and of the development of a single technical platform, a single settlement engine.

The second answer has been Link Up Markets, which is a joint venture of seven European CSDs aimed at developing a technical solution for the interoperability among the CSDs concerned.

And, in my opinion, the fact that a public-policy issue can be viewed as a business opportunity by the private sector deserves to at least be recognized. And, although it is a different discussion, it raises the question of whether public-policy issues are a question of lack of regulation or are problems of bad design of incentives.

I'll now briefly describe the Link Up Markets initiative.

Link Up Markets is a joint venture of the seven European CSDs: Clearstream, SIS, OeKB, VP, VPS, Hellex and Iberclear. Formally it's a company registered in Madrid, Spain.

With Link Up Markets, we will establish a common central infrastructure, which

will facilitate the easy implementation of links between the participating CSD, and, through these links, we will be able to offer seamless and efficient DvP cross-border processing between the different markets.

The idea is to use the current efficient domestic infrastructure to offer cross-border access, using the existing infrastructure and the current means (and formats) of connection to the local CSD.

The idea is that each CSD "supplies" its huge domestic knowledge to the other CSDs, through Link Up Markets, who acts as a router of the information and as its translator between the different languages.

This setup, only possible thanks to the current level of technology, will allow each CSD to offer its banks/customers, cross-border access to the other markets via the present connection.

As the model is all about being practical by leveraging existing infrastructures and processes, it can be provided quickly and with minimal adaptations to the participating markets. We expect customers to have access via their chosen CSD during the first half of 2009.

The beauty of Link Up Markets is that market participants can continue to use their existing local CSD infrastructure and processes, with which they are already familiar, to access best-in-class core settlement and custody services in seven different European markets. In other words, Link Up Markets overcomes the need for customers to maintain multiple interfaces in different markets and the associated complexity and costs.

To sum up, the creation of a Single Financial Market is a EU objective. FSAP measures seem to have been effective, because there's been increased integration. I've also pointed out that post-trading activities have been attracting increased public attention, because they seem to be lagging behind. And, finally, I've presented the Link Up Markets joint venture that, like Euroclear's single settlement platform, is a private initiative aimed at effectively updating the post trading infrastructure in Europe.

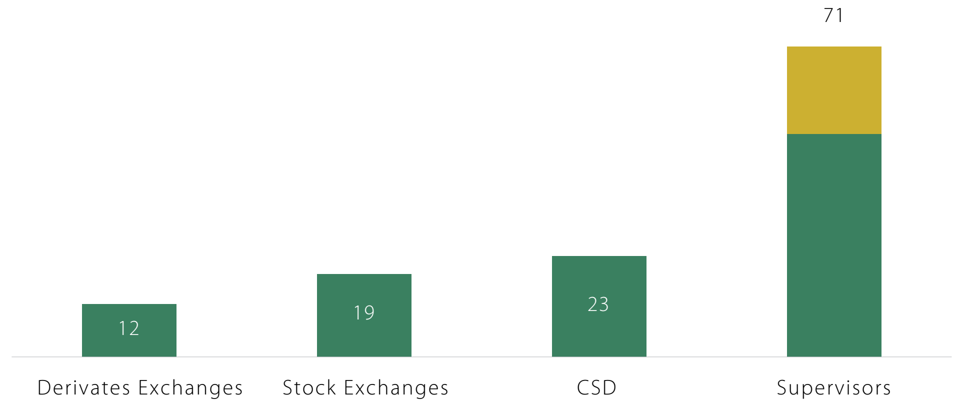
The conclusion, then, is that currently, European wholesale financial markets are reasonably integrated and the remaining missing parts are identified and solutions are on the way. Therefore, one could say that the FSAP has fulfilled its objectives, although much detailed work remains to be done.

Having reached this point I think that in Europe we need a new guideline for public policy action. And I believe this for two reasons:

- one, that the measures included in the FSAP are implemented; it's time to assess, analyze and decide on what to do next;
- the second reason, very powerful in my opinion, is that the events that have unfolded in financial markets in the last fifteen months are clearly generating a new environment; we are facing a new situation, we have to adapt to it and public-policy plans and priorities have to be defined with this new, very relevant information.

If you allow me, I will devote the last two paragraphs of my article to trying to clarify this last remark, because I consider it of paramount relevance. I will present two examples of areas where I think some careful evaluation is needed.

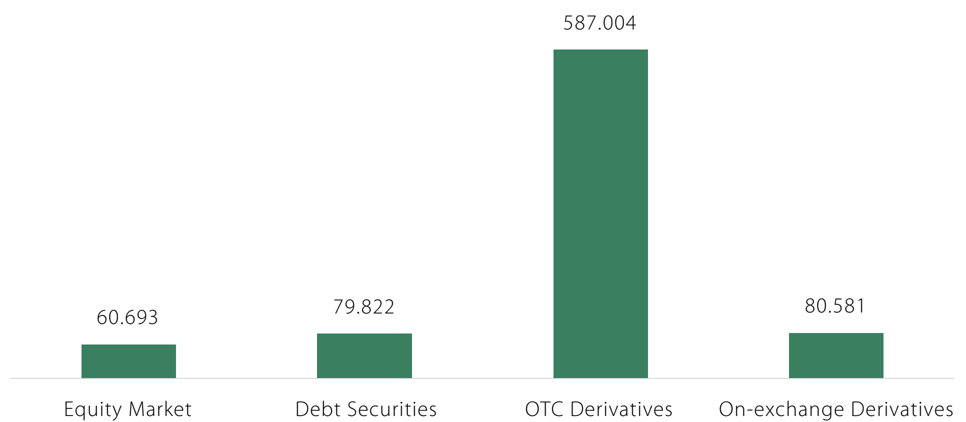
Number of stock exchanges and depositaries vs. number of supervisors (EU) FIGURE 8



Source: WFE and BIS.

The first one, prepared with the explicit goal of being slightly provocative, is the fact that in Europe we have, after the recent wave of consolidation, twelve derivatives exchanges, nineteen Stock Exchanges, twenty-three CSDs and seventy-one, yes, seventy-one supervisors, including insurance supervisors (Figure 8).

Size of the markets FIGURE 9



Source: WFE and BIS.

The second example is about the size of the different markets. Figure 9 shows the size of the different markets, measured by outstanding amounts, in trillion dollars. The biggest market, by far, is the OTC derivatives and, within it the fixed-income part.

Most of the measures and public policy issues I've been mentioning mainly refer to the equity market, which is the little bar on the left. The time has probably come to address the bigger part of the market, which, by the way, is where the problems have appeared in the current crisis.

There are, of course, lots of other issues which deserve attention, could even be more urgent than these two I just mentioned, but impossible to raise within the limits of this brief article.

And I say almost, because I want to make a formal last statement, taking advantage of this opportunity.

It has to do with the Lehman Brothers insolvency event and the operations that Lehman had pending in the Spanish regulated markets. In my position as Chairman of Iberclear I'm very pleased to be able to confirm to you that all pending operations from Lehman at the Spanish Stock Exchange, Public Debt Market and Derivatives Exchange have been orderly settled, that all safeguarding mechanisms have performed as planned and that in this respect, and on this occasion, we have effectively fulfilled our role of absorbing and eliminating systemic risks.

4.3 Alberto Giovannini
CEO of Unifortune Asset Management

The current financial markets crisis raises relevant questions about the actual and potential role of financial markets infrastructures. Infrastructures have performed egregiously in the wake of huge dislocations and spikes in the volume of transactions to be processed. There is much congratulation to be owed to those individuals who have made this possible. But we should also look ahead. Many of the aberrations that are currently observed are due to the grossing up of assets and liabilities that occur when balance sheets get to be liquidated, and in particular when very large and diversified financial institutions like Lehman Brothers enter bankruptcy. We know that efficient post-trading infrastructures can reliably pool counterparty risk, and support risk reduction processes through this key function. It is time that post-trading infrastructures take center stage in the discussions leading to reform of the world financial system. Currently, there are initiatives considering the setup of central counterparties in the interbank deposit market: if successful, such initiatives will in one stroke restart the interbank market, currently blocked by concerns on counterparty risk in the banking system. More constructive roles are conceivable for post-trading infrastructures. For example, regulators should consider processes whereby securities or derivative contracts that experience significant growth and take on important shares of trading volume in the global financial markets, be subject to standardization and channelled through appropriate post-trading infrastructures, aimed at minimizing aggregate risk. I wanted to share with you these thoughts to highlight that it is not only what we have here and now that matters in our work and in our efforts, but also what we could have.

I want to talk about my own experience and perspective on the integration of European financial markets. My views can be summarized as follows: in Europe markets are becoming more integrated, but not fast enough. Policymakers, not markets, guide the integration process, through various regulatory reforms. My recent experience illustrates and can teach some lessons on the challenges to the construction of efficient post-trading infrastructures, which so far remain inefficient.

A view that has been aired repeatedly, not just by market participants but also by some regulators, most notably Alan Greenspan, was that financial markets have a way to adapt on their own, and as such they need minimal leadership by lawmakers and regulators. This view was justified by some correct observations, such as that the practice and functioning of markets is best known by markets themselves, and attempts to fix markets by outsiders may cause more damage than good. Nowadays, the number of those willing to defend this view has dramatically dwindled. Well before the financial crisis, I always thought that such a view is a dangerous mistake. That lawmakers and regulators need to do their homework to understand the way markets work, but cannot shy away from their role. My own experience following the integration process of European markets really has convinced me more and more of how important the role of authorities is in a well-functioning financial market.

Authorities provide the central pillar of market institutions. Market institutions are a set of devices that allow market participants to interact well. In the absence of good market institutions market participants do not interact well. So, the role of authorities is always central. Specifically, the role of authorities is central when you are trying to change things and this will be very evident in a moment.

What do I mean when I say that in Europe markets are becoming more integrated, but not fast enough? Economists have often used the concept of integration to measure international efficiency. The method typically adopted is that of sizing deviations from the law of one price. The study of deviations from the law of one price is a useful device to identify where distortions are, and is routinely carried out, also by official institutions. In the Euro Area, the European Central Bank publishes reports on the integration of financial markets that apply these methods.

However, the measure of deviations from the law of one price has limitations. First, it is often the case that identical assets cannot be found, and therefore the law of one price cannot apply. In these cases researchers resort to equilibrium pricing models, so that the hypothesis of integration gets to be merged with the hypothesis that the pricing model is correct. In addition, when the analysis becomes very detailed (in general-equilibrium analysis a good is defined not only by its nature but also by time and place) the test of the law of one price loses power. Therefore it is not appropriate to rely only on the law of one price to determine the degree of integration and efficiency of financial markets.

An alternative method to discuss integration is to ask whether similar or identical assets are traded in different markets or in the same market, and what defines a financial marketplace. Consider the case of the European Union (EU) or, more narrowly, of the Euro Area, and consider securities for simplicity. Can we say that in the EU or the Euro Area securities markets are integrated? Macroeconomist would tend to believe that it should be the case, based upon two observations: first, throughout the EU there is freedom to trade securities among the different member states; and, second, in the narrower Euro Area there is no foreign exchange risk, so the comparison of different asset prices is straightforward and the last barrier to securities trade is gone. Yet, the actual picture of European securities markets is very different. This discrepancy is due to the fact that the basic implicit tenet which allows to associate freedom of trade with perfect integration is full competition and absence of distortions: both conditions are not verified in practice. So when we talk about the European financial markets unless we have one sustain that provides that very efficiently, we still have major quantum efficiency improvements available to us which we should try to exploit as fast as possible.

What is interesting in particular in the case of Europe is that the domestic markets by many standards are efficient. The barriers that prevent integration are not barriers designed to prevent people from accessing foreign service-providers; they are just devices that were created to enhance efficiency of each national system in isolation. The old concentration rules of stock markets or the familiar obligations for issuers to use one single security depository--which grant monopoly power to the security depository--are meant, especially in countries where such infrastructures are public, to maximize efficiency and minimize their cost to users (the higher the volume, the lower the average cost). And there is where the problem comes in. Now people want to access other markets, but the devices that were conceived to make national markets efficient, make the cost of access to other markets very high, and prevent

the integration of the post-trading infrastructure.

When the Financial Services Action Plan was first drawn it did not contain financial market infrastructure. So it was sort of a wake up call when the group organized by the Commission that I chaired started producing work that raised serious concerns about the efficiency of post trading in Europe. Several years ago I made a presentation to the EFC, the Economic and Financial Committee, using a metaphor. EFC officials were satisfied to have a single currency and liberalized capital flows. I told them that the condition of EU securities markets was analogous to that of a population after a war: everyone rejoices about the newly gained freedom, but they overlook the gigantic problems of surviving with minefields, no roads no aqueducts and no electricity. In the Euro area there is fragmentation coming from the fact that they were world designed and functioning domestic market but there was no way to really put them together in a proper way. The freedom of investors is in stark contrast with the state of market infrastructures.

When thinking about financial markets infrastructure, the first thing to focus on is the technology utilized by infrastructure suppliers. I argue that the technology of financial markets infrastructures is as close to a zero marginal cost technology as one can get in our world. Post-trading involves the processing of very large volumes of information, but it does not involve any action or decision on each individual transaction being processed. Transactions processing is one of the most easily scaleable businesses in finance. Supplier of post trading services, like other financial market infrastructures, have been going through a process of de-mutualization about a decade ago. In other words, the post-trading companies have been transformed from mutual (user owned) or state-owned companies into private, common stock companies, in some cases listed in stock exchanges. Since de-mutualization the profitability of these companies, as measured, for example, by their return on equity (ROE) has been very high. I would like to raise the question of what factors account for these high ROEs. In equilibrium, I do not expect these companies to have very high ROEs, as the business they carry out is low risk (some kind of utility business). But just like utilities, in each country market infrastructures enjoy monopoly status, either by law or de-facto (recall the zero marginal cost observation above). Thus such high ROEs may be explained more satisfactorily by the monopolistic nature of the business. If this hypothesis is correct, it is important to start re-considering governance of financial markets infrastructures. In particular, the possibility that such monopolistic companies be controlled by shareholders whose interests are not aligned to those of users raises the possibility of inappropriate strategies and pricing policies.

Consider now the reform process. With the EU Commission we have studies the geography of post trading in Europe, and suggested a reform path. These ideas were published in 2 reports that I have authored with a group of financial markets experts. There were two reform strategies available. A top-down strategy, inspired by the US experience, would have involved a coordinated horizontal consolidation of post-trading firms. This idea was obviously outside the realm of possibilities from the viewpoint of the private suppliers. But it was also dismissed by the Commission, in part because of the very resistance of the actors involved, but in part also for an economically sounder reason: a top-down consolidation of the industry would in no ways eliminate the very real barriers that characterize the post-trading environment in the EU. The technical standards, market conventions, regulations and laws pertaining to clearing and settlement are still largely inconsistent across EU member

states. Until those inconsistencies are eliminated, the cost of transactions processing will remain high, whether supplied by integrated suppliers or not.

Hence it was decided that there would be a bottom-up reform process. It was a very sophisticated design: because there were a number of actors, pubic and private, and a number of member countries, it was essential to provide a coordination device. The Commission provided it, by setting up the CESAME group, whose tasks were to collect information about what every party involved was doing and push it out to everybody. CESAME was conceived to be a consultation body that would also collect and disseminate information about the progress of the reform. It is important to underline here that, as far as standards and conventions were concerned, things that had to be changed by private market participants, the reform process is an entirely voluntary one. By contrast, regulations and law could only be changed by new regulations and laws, through the well know EU political process.

The following table reports the work plan (organized around the different barriers to be removed) and a very terse assessment of its progress so far:

Number	Barrier	What happened	Dismantled? If no, when?
1	Differences in IT standards and interfaces	New SWIFT Protocol	No; 2011
2	National restrictions on the location of clearing and settlement	MiFID Code of Conduct	No
3	Differences in rules and processes relating to corporate actions	New standards being finalized	No
4	Absence of intra-day finality between systems	Standards finalized	No; 2008
5	Impediments to remote access	Some progress in MiFID. Code of Conduct	No
6	National differences in settlement periods	No progress	No
7	National differences in operating hours/settlement deadlines	New Standards	No; 2008
8	Differences in issuance practice	Coordination in issuance and distribution by numbering agencies	Yes
9	National restrictions on location of securities	Being studied by ad-hoc Legal group	No
10	National restrictions on activity of primary dealers and market makers	Under consideration by Commission	No
11	Domestic withholding tax regulations serving to disadvantage foreign intermediaries	Ad hoc fiscal group has identified problems and proposed solutions	No
12	Transactions taxes collected through a functionality integrated into a domestic settlement system	Ad hoc fiscal group has identified problems and proposed solutions	No
13	Absence of a EU-wide framework for the treatment of interests in securities	Being studied by ad-hoc Legal group	No
14	National differences in the legal treatment of bilateral netting for financial transactions	Collateral directive solves the problem	Yes
15	Uneven application of national conflict of law rules	Being studied by ad-hoc Legal group	No

Most of the barriers require government intervention. But an analysis of the table leads to the following simplified observation: what has happened is that part of the private sector has moved but authorities have not moved. That's the long and

the short of the whole story: the private sector has moved some and the authorities have not moved. Could the private sector have moved more? My opinion is that the private sector could have achieved more only if authorities had shown more leadership. Since reforms like these involve major investments, private market participants would be ready to spend only if they knew that governments would soon do their part to ensure a barrier-free post-trading market in Europe. But in the absence of concrete signals by national governments, what would be the need to become involved in costly changes? This is my simplified interpretation of the slow progress of the private sector's initiatives.

It is interesting, and a bit embarrassing, to note that when the whole reform strategy was presented, our forecast was that the whole process would take about 4 years to complete. That was in 2003. Admittedly this estimate was rather aggressive, but it was not wholly unrealistic. There has been a lot of resistance to the issuance of a post-trading directive, on the grounds that the process to make a directive effective would be too long. After many years since this reform was started, such concern appears unconvincing. The following table discusses some of the forces at play that may explain the political economy of this reform:

	Status Quo	Reform
Users: Intermediaries, Investment Managers	Pay high costs, though costs are passed through	Lower costs. Gains from new business opportunities are there but not so visible
Suppliers: for profit market infrastructures	High profit margins, relatively low volumes, protected market share	High volumes, low margins, potential prize becoming the sole supplier, or sanction of being taken over

The table describes the preferences of the different players between the status quo and the reform. The table shows that the political economy of this reform is unlikely to deliver success on its own. Why? Because users would certainly stand to gain from this reform, but their perception of the gains is very vague. In particular, as I said in my introductory remarks, the gains are not from cheaper costs of what we are doing here and now, but rather of what we could do if we had a different system. Somebody said very nicely: the future can only be predicted by those who invent it. The gains from a deeply integrated securities market in Europe are still to be invented. Hence, users do not have concrete reasons to push aggressively for reform. On the other hand, suppliers tend to feel safer under the status quo, the only regime where the threat of extinction is minimized. And if suppliers have shareholders that are not market users, their incentive to go down the reform path are even lower.

4.4 Eddy Wymeersch Chairman of CESR

1 Financial integration

The future of the European financial markets, increasingly included in the worldwide capital movements, depends on their integration. Although there will always be a good "niche" justification for the subsistence of local markets, the cost of capital will be the lowest in markets where there is ample supply and demand. Therefore our financial markets have to integrate, what means that all market participants should have access to the same pools of funds on the same conditions. The policy of the EU is intended to pursue this integration, by abolishing the borders that divide the markets, by harmonising the conditions for access to the respective national markets and finally by encouraging market participants to take part in the financial activities in other states. Intra-European integration should go along with integration of EU markets in the worldwide markets: indeed European markets are in many respect the most important markets in the world.

Today, in several fields most of these preliminary conditions have been met: capital flows have been fully liberalised, harmonisation rules have been enacted in most fields, and restrictions on entering into transactions in other states have largely disappeared . But to what extent have all these measures effectively realised an internal market in financial products? Are markets still split along national lines? Is access sometimes barred to unwelcome candidates e.g. for takeovers? And do some authorities not consider protective mechanisms to avoid parties from other member states to enter their markets, up to setting up national sovereign wealth funds?

Looking at the overall picture of financial services, in some important segments the integration is fully realised: these are the market segments that are part of the international capital movements, such as the foreign exchange markets, the interbank markets, and even the markets for many publicly traded securities, including derivatives. But other activities or financial products continue to be predominantly national: the area of payments, although the holding of bank accounts abroad is expected to be opened as a consequence of SEPA while tax advantages attached to certain savings accounts may limit the cross border flows. In the area of real estate financing, business has remained essentially local, what is probably due to the local character of the real estate guarantee that is inherent to this type of financing. Cross border clearing and settlement of securities continues to be segmented, at least among different clearing or settlements organisations, leading to a considerable additional cost for cross border settlement in comparison to domestic settlement. In some fields the apparently important cross border business is in fact a delocalisation of business: so are many investment funds being offered out of Luxembourg or Ireland, but this low is essentially U-turn activity, the distribution of funds being mainly in the hand of local banks, that have set up business in the mentioned jurisdictions. And some of the same applies to financial insurance products.

The segmentation of the markets are only partly due to regulation: in several respects, it is a structural phenomenon, linked especially to the overwhelmingly domestic structure of the banking system. Although increasingly operating on a cross border basis, the banking system continues to be strongly linked to its original, national home base and therefore mainly sells "in house" products. Language, culture, taxes also contribute to keep consumers within the boundaries of their local market. This also means that integration of the markets cannot be decreed by government act: regulation can only put in place the environment within which more cross border activity, and hence integration will flourish.

The European Commission regularly publishes a report on the financial market integration. The latest is based on the end of 2006 figures[1].The recent crisis illustrates that public markets in equities and in bonds are largely integrated, creating instant "contagion transmission" effects, as we have now clearly experienced. The same applies to liquidity. But the report also indicates or analyses some of the areas where integration still has remained weak. In the banking field, most common banking products, such as current accounts, remain local, and conditions and fees differ substantially among the Member States. But it states that price convergence can be noticed for i.a. home loans. It further points to the integrative effects of the distance selling techniques, for which some worldwide operators are active out of the EU markets. On insurance, most products are reported to remain local due to the low level of standardisation. But competition seems to exercise pressure on the premiums. In the field of Post-trade for securities transactions (clearing and settlement), the disparities between domestic and cross border clearing and settlement remain very considerable: the Commission has taken specific initiatives to alleviate this concern by organising, on the basis of a voluntary code of conduct, a platform for opening up access and interoperability to infrastructure provider, along with the ambitious project of the ECB to organise a central platform between settlement organisations ("T 2 S") directly linked to the payment platform (Target 2). Industry is working on the abolition of the remaining private barriers (the so-called "Giovannini barriers") , but public initiatives lag behind.

The effects of the ongoing crisis on the financial integration is still unclear: the public markets have proved their resilience in terms of price discovery and clearing and settlement of the traditional products. Concerns persist on the derivative markets and the absence of an effective post trade environment. But the dust will first have to settle to reassess the effects of the crisis on the state of integration. One would not be astonished that integration would have weakened since the beginning of 2007, as state intervention in the banking and insurance sector has be taking place along the national lines exclusively, although some high profile cross border consolidation have occurred. At the moment of writing, with the crisis still deepening, it would be premature to draw conclusions. At the political level however, strong announcements have been made indicating the need for stronger common action, and agreements have been concluded avoiding national actions to disturb competition between the systems.

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1 http://ec.europa.eu/internal_market/finances/docs/cross-sector/fin-integration/efir_report_2007_en.pdf; see also the ECB convergence report 2008 http://www.ecb.int/pub/pdf/conrep/cr200805en.pdf.

2 Supervisory approaches

The present credit crisis constitutes a fundamental challenge to Europe's multi-state supervisory model. Voices are heard to remodel the supervisory framework, and a Committee has been constituted under the chairmanship of Mr. Jacques Delarosière, the former IMF director- general.

Before looking further into the future, it is useful to recall some aspects of the present supervisory system, and the related debate that has been going on for many years.

It should be reminded that financial supervision in Europe is based on the supervisory systems in the 27 sovereign member states, with each of them their own concepts, structure, traditions and philosophies. The present attempt consists of finding a way of putting into place an efficient supervisory structure for the increasingly integrated market, while taking into account some of the specificities of the national approaches.

According to the present rules, the supervisory system is based on nationally organised systems, applied by national supervisory bodies, but applying increasingly harmonised rules. These rules apply first and foremost to the institutions established in and active within that jurisdiction. Due to the increasing integration of the markets the cross-border aspect is becoming more and more important: on the basis of the treaty rules of freedom of establishment and free provision of services, financial institutions are free to offer their services in all other EU states, whether by establishing branches or subsidiaries, or mere offering of services. These firms or products offered will not be subject to additional requirements, a few excepted[2]. This system prohibits member states to be able to close their borders to foreign firms even to "protect" their own citizens[3], as in all states a more or less similar regime will be applicable. Technically the regime leads to mutual recognition, recognizing the home country regime to be applicable even for activities abroad. This system is applicable to services offered by branches or on a remote basis, in both cases as being undertaken by the same legal person. It is not applicable to services offered by subsidiaries, as these are separate legal entities, chartered under the law of another state, and falling under the supervision of the state where the subsidiary has its registered office. The system is based on fargoing trust among the supervisors: the host supervisor will abstain from any supervisory activity because he relies on the supervision of the home state. Exceptionally, if it would appear that the firms is acting against local law, the host state could invite the home state to take corrective action, and in exceptional cases the host state could act itself.

This regime applies in the field of banking and insurance supervision, and with some modifications in the securities field as well.

3 Cooperation in the securities field

With respect to securities transactions, mutual recognition and home country competence regime are followed more strictly, as due to the nature of the subject, supervision mostly relates to a transaction rather than to a firm or institution. Important European measures as the prospectus directive, the transparency directive

2 e.g. on liquidity; or on local marketing conditions.

3 Thereby obviating the general good exception.

or the directive on take over are all based on a home state regime, being the state where the entity engaging in the transaction is located: this is the issuer of securities for all disclosure aspects[4], the registered office of the investment fund, the bidder in a take-over bid. The rule explains why prospectuses are approved in one state and can be freely used all over Europe without any additional approval, ("the so-called "European passport"). The phenomenon is particularly striking for investment funds issues: as most of these are registered in two jurisdictions (Luxembourg and Ireland), supervision has been largely concentrated in these two states, while the other states did retain competence for a smaller number of funds registered in their jurisdictions (about 20% of the total).

But the principle also knows some important exceptions: for the public issue of bonds, the transactions can be placed under the jurisdiction of the place where the bonds will be listed on a regulated market[5]. This lead to a strong concentration in a limited number of jurisdictions of transactions as issues or listings of corporate bonds, notes or certificates, structured products, and similar instruments[6].

The conduct of business rules applicable to securities dealers are in part organisational rules, and hence of the competence of the supervisor of the firm, wherever active in the Union. But once the firm engages in activities abroad, some of these will affect the position of the local investors acting with the firm: hence for specific aspects, local rules have to be applied as well. This creates diversity in the distribution of supervisory competence: firms prefer to have one regime applicable to all of their business, wherever located, while investors should be able to enjoy the protection of the state where they are located. The same applies to supervisors: when home supervisors and host supervisors have competing competences, this would lead to double supervision. In order to avoid additional costs and burden for the firms, agreements have been concluded among supervisors, distributing the work among them. In order to work out a practical solution, a protocol among the supervisors has been initiated within CESR, laying down the schemes along which cooperation can be organised. Several agreements among supervisors have already been concluded whereby one supervisor – especially, but not necessarily, the home supervisor – charges the host supervisor to undertake all supervisory actions necessary for ensuring the result pursued by the directive as far as conduct of business rules in the host's jurisdiction by firms subject to the home supervisor is concerned. But the system remains optional as far some matters- e.g. those with a potential systemic impact, both supervisors may prefer to be equally involved. Similar schemes of competence sharing will have to be developed in the framework of the future supervision of Credit rating Agencies, and in the system of passporting the management company services for UCITS, where the management company may be located in another state than that where the investment fund has been registered. The Commission is envisaging to publish proposals on both subjects later in 2008.

4 Relating to prospectuses on public issue and listing, but also the continuous disclosures (company related disclosures) but also disclosures by directors on the basis of the market abuse directive, etc.

5 see art. 2(m) Prospectus directive.

6 The Luxembourg stock exchange lists 28626 bonds; most of these are not regularly traded, but have, for asset management purpose the legal status of "listed securities".

4 Complexity in the prudential field

In the prudential fields matters are more complex: not only has the present scheme been based on excluding subsidiaries from the coverage of mutual recognition and home state supervision, leading to intricate questions of coordination between home and host supervisors. In addition, most of the large financial services groups are run on an integrated basis, subtracting part of the host banks' internal organisation to the local supervisors' scrutiny. Even more delicate is the presence of systemically significant establishments, both branches and subsidiaries: there is a legitimate concern of the host supervisor about the well functioning of systemically relevant firms in its jurisdiction, as these may create significant damage to its financial system. In case of systemically important banks - but also insurance companies, - the depositors and policyholders have to be protected against the insolvency of these firms, there where deposit guarantee systems are still national - and very diverse - in the banking field, and generally lacking in the insurance field.

Moreover, a banking crisis is likely to exercise a much stronger effect on the overall economy and lead to stronger negative economic and social consequences, than in the other two fields. In order to mitigate these effects, states have put in place several lines of defence: deposit guarantee schemes, liquidity support by central banks as lenders of last resort, and in last instance, financial support from the states as they are the only ones that can engage the state budget and ultimately call on taxpayers to avert even further damage. All these mechanisms are well known and several examples could give a good insight about the consequences of each of the actions mentioned. In a cross border context however, one immediately comes across questions of sovereignty: deposit guarantee systems are very diverse, remain a national matter, and depending on where the bank is registered and supervised, the overall effect will be considerably different; central banks have been able to provide liquidity in a coordinated manner within their own jurisdiction, relying on the collateral available in the system but it is unclear whether that would also apply to foreign subsidiaries, or to collateral composed on foreign securities. The coordination in the field of state intervention has recently been laid down an a Europe wide protocol, but remains limited to the overall principles[7], while the actual support has remained a national one. Only after the crisis has taken on systemic dimensions have rules relating to the state guarantees for interbank relations been drawn up on the basis of which a more harmonised approach, avoiding destructive competition among individual market participants and between the national financial systems. Risk of regulatory arbitrage and grossly unlevel playing fields has been identified in several corners of the market, leading ultimately to extending the state intervention even further, including to firms that objectively spoken, did not need it. All this constitutes a severe test for the European idea: although the challenge may offer the unique opportunity for a considerable improvement for the future, a failure would have very destructive effects for the future of the European construction.

7 A protocol has been concluded in March 2008 outlines the procedures of cooperation of the states, their central banks and the prudential supervisors in case a systemic crisis erupts.

5 How financial supervision is structured in the EU member states

Before entering into the speculation about a future regulatory organisation in Europe, it is useful to give a brief overview of how the supervision is structured in the different EEE states, and in Switzerland. At present, all 27 EU states have an elaborate supervisory system, dealing with banking, insurance (and often including pension funds) and securities. The way the supervision is structured is different: some have three main supervisors (one for banking, one for insurance and a third for securities), others have centralised all lines of supervision under one roof, while intermediate structures with different characteristics are found in the remaining states, amounting sometimes to five agencies (as is the case in Cyprus) . The following table gives an overview of the present status, identifying the main categories:

European supervision models

Single or integrated supervisors			
Austria			
Belgium			
Denmark			
Estonia			
Germany			
Hungary			
Ireland			
Latvia			
Malta			
Sweden			
United Kingdom			
Norway			
Iceland			
Liechtenstein			
Three Pillar System	**Banks**	**Securities**	**Insurance**
Czech Rep.	CB		government
France	CB		
Greece	CB		government
Italy	CB		
Lithuania	CB		
Poland	CB		
Portugal	CB		
Slovenia	CB		
Spain	CB		
Other systems			
Cyprus	CB	S+I	S+I
Finland	B	B	I
Luxembourg	B	B	I
Netherlands	CB	S	CB
Slovak R.	CB	S+I	S+I
Forthcoming changes **Twin Peaks system**			
Italy	CB	S	CB
Portugal	CB	S	CB
Spain	CB	S	CB

CB: central bank

B: banking supervisor

S: securities supervisor

I: Insurance supervisor

This table is likely to change as in some member states, the prudential matters are planned to be centralised in the hands of the central banks, while the securities supervisors will be put in charge of the markets and conduct of business matters. The latter would include review of contract conditions, investor protection and relate not only to securities but to banking and insurance products as well. It is striking that this evolution is most visible in the Eurozone (Spain, Portugal, Italy), what is probably due to the strong position of the ECB.

The cooperation among the national supervisors takes different forms: the traditional technique of cooperation consists of concluding memoranda of understanding, whereby the national supervisors mainly promise to exchange information on their nationally supervised entities. Sometimes the agreements contain provisions on mutual assistance, on joint actions (including joint inspections) and delegation of supervisory tasks. Some of the agreements are concluded at the level of the European Committees of Supervisors (such as the European Committee of Securities Regulators or CESR) and may even predate the constitution of the committee. Some of these agreements are further extended on a worldwide scale within the International Organisation of Securities Commissions (IOSCO), on the basis of which exchange of information and assistance has been agreed. The Multilateral Memorandum of Understanding of IOSCO allows the European supervisors that are signatories to obtain information worldwide, what is particularly important in the context of market abuse enforcement. Within the EU, the obligations deriving from these agreements are however increasingly superseded by the directive's provisions concerning the internal cooperation within the EU. Among the important building stones for a future supervisory system, the directives sometimes mention the possibility to delegate tasks or even decisions among supervisors.

The directives have considerably strengthened the cooperation among supervisors. Apart from a general obligation to cooperate, they usually contain specific provisions as to how supervisors should deal with cross border aspects. In many cases additional protocols, agreements or procedures have been concluded among the 27 supervisors within the framework of the European committees. Although these agreements are largely voluntary they constitute the stepping-stones for a future system of coordinated supervision.

The present financial crisis has illustrated that the European supervisory scheme deserves to be revised, especially as far as the cross border aspects of prudential supervision is concerned. Different suggestions have already been tabled. The following analysis attempts to outline three schemes that might inspire the future supervisory system.

Scheme 1 Extending the role of the group supervisor

In the prudential field, where coordination among the different national supervisors involved in the supervision of a cross border group has become increasingly important, MOUs have been concluded involving the supervisors competent for a specific bank, or group of banks. Recently, one sees a tendency to regroup the supervisors involved in colleges under the general direction of the supervisor of the parent company, called the "coordinator", or "group supervisor". The role of the latter, apart from its own competences on the basis of the localisation of the parent in its own jurisdiction, mainly consists in coordinating the action of the different supervisors concerned. This was the original approach in the Financial Conglomerates directive.

The capital requirements directive went one step further and gives the coordinator the power to take decisions on certain matters that are applicable throughout the group, after having consulted extensively with the other supervisors and tried to reach an agreement with them. The future directive on Insurance supervision – commonly known as "Solvency II" would take this approach a step further step by allowing the group supervisor to decide on a certain number of issues affecting the group as a whole. And more recently the Commission tabled a proposal aimed a modifying the CRD in which more substantial powers would be given to the group supervisor, leaving other matters to be coordinated within the college. However the last two changes in the supervisory pattern are strongly opposed by several, if not a majority of member states.

Basically, this scheme boils down to the centralisation of certain matters in the hand of the group supervisor, while leaving other matters of a more local nature to the host supervisors.

The question therefore arises whether Europe is on the right track, by creating, step by step, a supervisory scheme whereby the group, or "lead" supervisor would be in charge of deciding about most of the group issues hence extending his authority to both branches and subsidiaries, although maintaining certain competences and privileges for the host supervisors.

This option is likely to result in a scheme whereby the most important states in Europe, where the largest groups are located, would exercise the supervisory power on most of Europe's financial system, leaving the smaller jurisdictions in charge of the essentially local players. This scheme would have certain advantages: it would allow for clear decision making by the lead supervisor and hence for his leadership and responsibility in case of need. Further it would allow for concentration and specialisation along with the build-up of the necessary expertise, avoiding the concentration that a fully centralised scheme would entail. It would also mitigate the fear of a high concentration of economic power by maintaining a limited form of competition among the different national lead supervisors. But it might also create distortions in the level playing field among the EU states, as the national jurisdictions may not necessarily apply the same rules in the same sense, while a further differentiation between large and small banks may be feared, putting the latter's survival in danger.

The scheme whereby one would strengthen the lead supervisor would have the advantage of building on the existing systems without revolutionising it. It would avoid the "big policeman" complex and the concerns about the lack of democratic legitimacy, while allowing for variable involvement of the host supervisors according to a gliding scale to be further analysed on the basis of individual agreements, supported by supervisory instruments such as delegation that would allow for sufficient decentralisation.

Introducing such a system of European financial supervision would only solve the simplest part of the problem. Further work has also to be undertaken with respect to the coordination of the cross border action of the central banks, separately in their lender of last resort capacity and in their macro-supervisory activity, while pursuing further coordination of the national treasuries, by agreeing common criteria, standards, guidelines relating to their intervention, without of course committing to earmark a certain amount of funds. With respect to the latter issue, any formula or commitment has been strongly resisted by the states: an intermediate solution might

be found in the support, out of the EU budget, for a certain amount of means that would allow the ECB to search for solutions beyond its lender of last resort function and before the state steps in. Resistance to this idea is likely to be considerable.

Scheme 2 Extending the role of the group supervisor and strengthening the existing coordination role of the Level 3 committees

An intermediate solution between a rather soft form of coordination of strong national supervisors (scheme 1) and a full European centralised supervisor (scheme 3) could be found in strengthening the present Level 3 committees and give them a stronger role of coordinating the supervisory process of the national supervisors. The reasoning is based on the hypothesis that the role of group supervisors should be defined as mentioned in scheme 1.

As strong national supervisors are not always willing to act along the same lines, creating the risk of regulatory arbitrage, a coordination body is needed: in Solvency II this was considered to be the task of the Level 3 Committee, by allowing it to exercise strengthened mediation powers. The present voluntary mediation procedure would however be insufficient to attain that goal, as mediation today is of a non binding nature. The function of the level 3 committee should be upgraded to an arbitration function, be based on clear binding rules and open for judicial review before the ECJ.

What should be the role of this central body of supervisors? Is it to take decisions in lieu of the national supervisor? Will it exercise actual supervisory powers, engaging with the individual institutions, up to the imposition of sanctions? My answer would be certainly negative: I do see no good arguments for having all prospectuses for securities issues, or for takeover offering documents, approved by CESR. This would be highly inefficient, dilute responsibility for essentially local transactions and create a top heavy bureaucracy.

The remit of a future European coordination body should therefore be clarified. The level 3 Committees are already today engaged in an active process of issuing standards, recommendations, guidance etc, leading to an increasingly – although still not satisfactory – process of convergence through harmonisation and coordination. The process is slow and often painstaking, although the recent rule change according to which matters can be decided by Qualified Majority (QMV) is likely to speed it up. But all this Level 3 work is voluntary: member competent authorities are not bound by the decision, and may refuse to implement provided they state on what grounds their refusal is based ("comply or explain"). And even implementation of common standards or recommendations remain diverse: implementation is followed up by the Review Panel, but is case of non implementation, the Panel can only state its finding. According to scheme 2, the Committee would essentially be involved in developing coordinating rules and interpretations, of the type that is at present developed by the level 3 committees, but then on a binding basis. The scheme would not be fundamentally different from what the L3 committees do today, except that the decisions approved by members, might be declared binding on all members. Non complying members could be obliged by the Committee to comply, and in case of refusal the matter could be brought before the Commission, within its level 4 powers. External effect of the Committee 's decision could be considered, allowing market participants to avail themselves of the decisions of the level 3 committee in

their relationship with a national supervisor[8].

The scheme 2 would certainly constitute an improvement on the present situation, and will facilitate integration of the regulatory system. It would not however insure the same integration as far as actual supervision is concerned, as national supervisors would still be master of their procedures and approaches in dealing with market participants. Giving markets participants the right to complain to the Committee, and possibly also to have the national decisions reviewed by the Committee would constitute an answer to these questions. It might however be objectionable to national supervisors that might consider that there is no justification for having their individual decisions or actions revised by their colleagues.

Additional convergence activity of the committees could consists of the intervention in conflicts between jurisdictions, including cases of non implementation of lack of convergence submitted to the committee by market participants. Here the committee would act as a mediator, or in case to be specified as an arbitrator.

Extending the powers of the committees would also mean that the governance of the committees has to be adapted to that new reality and their financial and human resource means have to strengthened.

The advantages of this scheme mainly flow from the stronger coordination of the supervisor's action, while allowing the national supervisors to take account of the specificities of the local situations. Decisions within the committees should continue to be supported by a vast majority of members, allowing for "democratic" guarantees. Moreover, the regulatory functions at the three levels would become even more important: the committees would act a rule maker and preliminary enforces of their own rules, ultimate legal enforcement remaining the competence of the Commission.

Scheme 3 A European supervisor

Several other schemes have been advanced whereby for full centralisation at the European level is the key common feature. None of these schemes obviously has raised the issue whether both banking and insurance supervision have to dealt with under one roof, as is now the case in the majority of EU states; and further whether securities or conduct of business supervision has to be included.

Different schemes have been circulated. Some propose to create a structure similar to the ECB, whereby the local authorities will act as delegated or executing agents for the central body that sets the criteria ("hub-and-spoke system"). This would create a level-playing field, as all national supervisors would act according to the same rules and the coordination is ensured by the hub that would supervise the decisions of the "spokes". It would also strengthen supervision considerably as more expertise and resources could be put at work at the central level. Policy decisions would be made and declared applicable at a Europe wide basis. Market participants would, per hypothesis, be confronted with one set of rules.

Some consider that this approach should only be applicable to the Euro zone, probably hoping that the political will can be found to make use of article 105(6) of the Treaty and allow the ECB to exercise prudential supervision. It would allow strengthening supervision even if non-Euro states would not be willing to take part.

8 This would be some type of direct effect.

Another proposal, supported by the EU Parliament and the ECB, would introduce this type of organisation for the largest cross border banking groups that are about 45 and which represent the real systemic risk.

According to another tendency, the Union should set up a specialised agency, comparable to the other agencies in the field e.g. of aviation, or food control. The agency would have individual decision-making power, e.g. on deciding on risk models, or registering rating agencies, but have no regulatory power. Some have advanced the idea that the agency would check whether a certain financial product is fit for "consumption", comparable to the review by the EU Food Safety Authority or the US Food and Drug Administration. Banks, at least deposit banks and retail investors would not be allowed to acquire products that have not been declared fit for "consumption".

In a previous version, it was proposed to organise a pan European type of supervision for products that are distributed all over the Union (the so-called "twenty sixth regime") . These would than be the simplest, most widely distributed financial products(e.g. automobile insurance), what would ensure at least for these a stronger degree of market integration. Obviously the prudential issues would not be dealt with.

The creation of a unified European supervisory organisation is opposed by many member states that are unwilling to abandon their sovereignty in these delicate matters, especially as there may be considerable financial risks involved in case of a systemic crisis. Without a clear arrangement on burden sharing and fiscal authority, the question is indeed: who will support emergency action, as no state will be willing – or even be legitimate – to support the financial system of another state with its own taxpayers' money? The same reservation applies to the ECB acting as a prudential supervisor: differently from the national central banks, as long as there is no state, no taxpayer behind the ECB to provide for funds in case of rescue of a bank, one does not see how the ECB could become a credible player in this field. The question may therefore be: how to create this state support to the ECB , by organising a common fund, or having the states committing themselves? This line of reasoning might be further discussed.

Others fear that a big, super bureaucracy might be created, without clear democratic legitimacy. They also point to the diversity in legal, regulatory, social or linguistic regimes that would stand in the way of one single supervisory system. Lack of proximity and understanding of local situations is also mentioned, creating the fear of an oppressive regime. Furthermore, it is not clear whether the creation of a Europe wide supervisory body, implying considerable transfer of sovereign power, could be achieved without a change of the Treaty. Reference if made to the European agencies, but most of these are mainly consultative bodies, without regulatory power, and only for the most recent agencies some decision making competences e.g. in the case of the EAA, the European aviation agency.

The needs are likely to be different in the prudential field as opposed to the supervision of securities business: in the former detailed rulemaking – as already undertaken by the Committees CEBS and CEIOPS – is needed to allow for more efficiency of supervision to take account of the rapidly increasing integration of the banking and insurance markets. Developing common reporting requirements, mapping supervisory procedures, etc. are the fields where most progress is needed: it is not sure that this objective could easily be achieved except within a strong

decision making process, centralised at the European level. Individual supervisory action however, is rarely a matter in which all or most supervisors would be involved, as today's banking or insurance groups are active only in a few markets but not in all member states. Therefore it seems reasonable to state that supervision can best be dealt with at the level of the competent college of supervisors, and not in a pan-European body where decisions would be made by parties that are not directly concerned. Of course, this would presume that the colleges work in an efficient way, have the necessary powers and that decisions can effectively be implemented.

A future European body would further have a monitoring role with respect to the supervisory action developed at the national level to ensure that in each of the jurisdictions concerned, prudential supervision is of sufficient quality and reaches the same level of effectiveness. Although in an integrated body one may expect decisions to be identical, irrespective of where they have been taken, there is likely to be a need for adaptation to the local requirements and customs without loosing out of sight the respect of the overall standards, as determined at the European level.

The creation of a new European body might trigger delicate discussions about the relationship with the central banks, and more specifically the ECB. These discussions will have to be carried on in any case, as the need of a more thorough coordination of banking supervision with the central banks has clearly been illustrated during the present crisis. Two models seem possible: according to the first one, prudential supervision would be absorbed by the central bank, in which case the problem is likely to disappear. In a second model, a bridge has to be built between the central bank and the prudential supervisor, whereby apart from mutual information and procedures, a clear agreement on the respective powers has to be reached.

6 Conclusion

The discussion on the way forward in field of the integration of the European financial markets should be addressed very soon. Many lessons from the crisis have to be drawn. In this paper only the issues relating to the supervisory structure were developed. Three main models could be devised, whereby the second model seems to be preferable, as responding the best to the present and future objectives without revolutionizing the system. It also is the system that allows all member states, whether belonging to the Euro-zone or not, to be involved, which is likely not to be the case under the third model. It would be detrimental to the credibility of the Union's supervisory system that one of the major financial centres in the world would not be involved, extending a two speed system to the field of financial regulation and supervision.

The third scheme is less adapted to securities supervision which is mainly a home state business and where the application of the third scheme would call for very considerable, nor commensurate efforts. For securities matters, the first, or preferably the second scheme offer the right answers. For prudential matters the differences between the second and the third schemes are more formal than functional, and are mainly related to questions of decision making and power. But the first objective of any reform should be to have a more efficient supervisory system offering a better protection to the savers and investors in our states.

5 Challeges of financial supervision in Spain

Pedro Solbes

Second Vice-President of the Spanish Government and Minister of Economy and Finance

It is a pleasure to participate in this conference celebrating the 20th anniversary of the Comisión Nacional del Mercado de Valores.

In view of the growing importance of capital markets in intermediating the flow of savings and investment, and the notable role of financial shocks in shaping the current economic situation, it is particularly appropriate to discuss the prospects for the securities markets and their regulation and supervision, and those for the financial system as a whole, since it is increasingly clear that there is a strong interconnection between traditional banking and the securities markets.

This debate is all the more opportune as we observe that, far from remitting, the tensions in the financial markets are scaling new heights; this week, we have seen the collapse of Lehman Brothers, the fourth-largest investment bank in the US, the acquisition of Merrill Lynch by Bank of America, and the government's intervention in AIG, one of the world's largest insurers, to avoid a messy collapse.

And events in the financial world are coming thick and fast: the acquisition of Halifax, the UK's largest mortgage lender, by Lloyds, which will thus become the UK's largest retail bank and Morgan Stanley's search for a merger partner; we will undoubtedly see more deals in this vein. In short, we are witnessing a profound restructuring of the sector. In this situation, Europe's economic authorities are taking the necessary steps to ensure that the markets function properly; at last weekend's informal ECOFIN meeting in Nice, we strengthened our strategy to provide a coordinated response to the crisis.

In this context of great instability, we all (public and private sector) must make an effort to keep calm and contribute to restoring the necessary confidence that will enable the system to return to normal and bring investors gradually back into the securities markets.

However, in times of uncertainty, it is more important than ever not to lose the long-term view. If we compare the current situation with 1988, when the Comisión Nacional del Mercado de Valores was founded, we observe an intense transformation not only in the financial markets but also in our economies in general. Specifically, the Spanish economy has changed deeply as a result of notable modernisation and intense integration into the world economy. During this time, the economy has

expanded steadily, converging notably with the most advanced countries in Europe in terms of income per capita.

The financial system has played a key role in this process by efficiently mobilising savings to finance investment opportunities and by distributing risks, performing very dynamically, growing non-stop and developing a range of novel instruments. The CNMV has done a great job during this time by ensuring the securities markets' transparency and safeguarding investors' interests.

Spain may be one of the economies that has benefited most in recent years, particularly since the euro was introduced, from the possibility of using other countries' savings to finance the major investment efforts that have characterised the last phase of economic growth.

Overall, this process should be viewed as positive, although it has suffered from weaknesses that have come to light in recent months as the crisis that originated in the US has spread rapidly through the international credit markets.

The current dislocation being suffered by the financial markets should not prevent us from acknowledging this sector's outstanding contribution to economic development. In fact, as corrective measures are adopted to address the current financial turbulence, both the public and private sectors should draw lessons from this crisis in order to strengthen the financial markets going forward. The turbulence has brought to light a number of deficiencies in the way the markets work—concentrated in some financial systems more than in others—and, consequently, has highlighted the advisability of improving supervision and regulation systems, which need to adapt to the rapid pace of financial innovation and the growing financial integration worldwide.

I will focus my comments on the European financial sector, although my arguments will be generally applicable. The institutional framework of the European Union's financial sector has undergone a sweeping revision in the last ten years. Despite the instability in the markets, I believe that the reforms have moved in the right direction and that we should continue along this path. The current situation is evidently testing the world's financial systems; I think those of the European Union are withstanding the financial tensions relatively well. This is not mere chance; rather, it is the result of a European framework which, compared with that of other economies, is proving to be more coherent and predictable and has been better able to address market failures. Nevertheless, some major weaknesses have been exposed and we must correct them in order to reduce the risk of similar crises in the future.

In this context, I believe the European Union should centre its efforts on the following objectives:

Continue implementing the roadmap approved by ECOFIN in October 2007 to address the financial instability. However, we are still far from restoring normality in the markets, which continue to be severely affected by a decline in confidence. For that reason, it is necessary to continue working in accordance with the roadmap: increase transparency, perfect asset valuation systems, strengthen the prudential framework, and improve market functioning.

In the present situation, the best way to avoid a potential downward spiral of self-reinforcing weak credit and weak growth is to have a solid, efficient financial system. We have sound financial institutions in Europe, but it is necessary to restore confidence and, with it, liquidity to enable investors to take advantage of the

opportunities that arise.

There is also an urgent need to advance in creating an appropriate framework for preventing and managing crises at a European level. I consider that the existing informal cooperation mechanisms need to be reinforced with a number of harmonised legal instruments, particularly with regard to deposit insurance and intervention in the event of a crisis. I consider that these are the two most important and most urgent areas, and they should strengthen Europe's capacity to prevent crises and minimise their social costs.

It is very important to properly understand and analyse the lessons to be learnt from this period of financial instability. It is vital to assess how we need to reform the system so as to smoothen the sharp cyclical fluctuations in liquidity, credit and asset prices. Work has been done in this field for some time.

Important theoretical work has been done by the Bank for International Settlements, which is promoting the inclusion of stabilising elements in regulation and supervision systems throughout the world. And on the practical front, I would like to mention the introduction in Spain in 2000 of a dynamic provision requiring credit institutions to book additional provisions during the cycle upswing for use in the downswing, with stabilising effects. Other major issues requiring additional work are the search for mechanisms to neutralise the procyclical impact of capital requirements and fair value accounting.

Moreover, I believe that one of the European Union's priorities should be to continue promoting financial integration. In these times of great instability and uncertainty, it is inevitable that voices less disposed to integration should gain in importance, not just in the financial world but also outside the sphere of economics.

Although such a position is understandable, it would be a mistake to use it as a basis for policy. The progress made with financial integration in Europe in recent years is helping us to weather the turbulence. In fact, if the private bond markets had been less fragmented and more liquid, they would have helped soften the blow of financial spillover. For that reason, it is important to make efforts to remove the persisting barriers to integration in some markets.

Faced with growing financial integration, there is a debate on how to make the supervisory system more efficient in a context in which transnational groups are growing in importance. In this vein, there are plans to implement mechanisms to foster convergence in between countries supervisory practices, and work is continuing on improving supervision of transnational financial groups.

I believe it is important, in this context, to define a system involving a balanced distribution of powers between supervisors, and effective mechanisms for exchanging information and ensuring equal treatment of clients and shareholders in the event of a crisis.

Fortunately, in Spain we have a financial system comprised of solvent banks and a framework of regulation and supervision that is recognised internationally for its quality and rigour. This has undoubtedly placed us in a better position to withstand the financial tensions of recent months. However, the system needs to be adapted to the changes that have taken place in the last few years. We have been working on this adaptation for some time; this reform is not something that has been put together hurriedly in the face of the crisis.

The trends in the financial sector make it advisable to revisit the traditional partitions between the supervision of banks, insurance and securities markets. We believe that the role of supervisors should be redefined and their functions should be redistributed more reasonably to take advantage of each supervisor's strengths to the benefit of the system's general efficacy and for the protection of savers.

The planned reform will be structured around two core institutions:

- the Bank of Spain, which will be tasked with the prudential supervision of risks and solvency of all financial institutions (banks, insurers and investment firms)
- and a new National Financial Services Commission, whose job will be to oversee proper functioning and transparency of the financial markets through supervision of intermediaries in their relations with investors, savers, insured and generally all consumers of financial services.

I would like to continue to count on the assistance of Julio Segura for this purpose, and I will ask the Cabinet to approve his appointment.

Discussions with the sectors involved will begin shortly in order to ensure that the reform process is rigorous and unhurried, that our country has a supervision system that is adapted to the rapid pace of change in the financial sector and helps us to maintain our position among the countries with the most effective supervision systems.

In short, we are entering a very demanding phase for both private managers and for government authorities, one that will require an attitude of responsibility on the part of all concerned, plus leadership and the ability to react on the part of the financial authorities in order to restore lost confidence, reduce uncertainty and re-establish the normal functioning of the world's financial system.