

CAPITAL REQUIREMENTS IN THE EU

Summary: *The 1988 Basel Capital Accord, which sets standardised capital requirements for G10 banks and is regarded as the cornerstone of the global financial system, is currently under review. As anticipated in the Commission's Financial Services Action Plan, changes to the European Directives on Solvency will be necessary to implement the new G10 standards in the EU. The Basel Committee on Banking Supervision released a consultation paper in June 1999 and a Commission consultation paper was issued in November 1999.*

Background:

The Basel Committee on Banking Supervision was set up in the 1970s to improve the standards of the international banking system and to minimise the chances of a systemic financial crisis. Comprised of the central banks and banking supervisors of the G10 countries (France, Germany, Italy, Switzerland, the Netherlands, Belgium, Sweden, the UK, the US, Canada and Japan) and Luxembourg and based at the BIS in Basel, the Committee published an Accord in 1988 which required internationally active banks to hold minimum capital of 8% of risk weighted assets as a cushion to protect them against counterparty and (implicitly) other risks (see www.bis.org). The Accord set five categories of risk weights (0%, 10%, 20%, 50% and 100% per cent). Broadly speaking, a credit exposure to an OECD sovereign is 0% weighted because these sovereigns are unlikely to default, and no capital is required. But a loan to a private company would be 100% weighted, meaning that a bank would have to hold 8 Euro in capital for every 100 Euro of exposure.

The Basel Accord was implemented in the European Union, and applied to banks in all Member States, by the 1989 Solvency Ratio and Own Funds Directives. The Second Banking Directive granted banks subject to those common capital requirements a passport to operate across the single market. The 1993 Capital Adequacy Directive subsequently applied additional capital requirements for market risk (the risk that the value or price of a tradable asset might fall) to EU investment firms and banks. The Investment Services Directive granted the passport for investment business. The Basel Accord Amendment of 1996, which allowed banks to use internal risk models to set capital requirements to cover market risk in the trading book was transposed into EU legislation in the Amendment to the Capital Adequacy Directive agreed by the Council and European Parliament last year.

In addition to being applied in the sponsoring G10 States, the Basel Accord is recognised as an international standard by many other nations and has been implemented in well over 100 countries, some of which also extend it to smaller

financial institutions. The G10 are keen to promote the Accord as a global standard, as financial markets are increasingly becoming global.

What's going on now in Basel

Although the Accord was a major achievement in its time, it is now more than 10 years old and its basic credit or counterparty risk requirements are in need of reforms. In particular, both industry and banking supervisors agree that greater differentiation of the risk weights is needed. It is, for example, odd that exposure to a AAA rated (excellent credit quality, as assessed by leading rating agencies, such as Moody's or Standard and Poor's) company should have the same risk weight, i.e. 100%, as that to a lowly rated high risk company and significantly higher than an exposure to say a Mexican bank (20%) or indeed even to Mexico itself (0%). The Basel Committee has therefore been considering how to allow greater differentiation between exposures and its consultation paper of June 1999 suggests allowing banks to use either external rating agencies assessments or their own internal rating systems to set the risk weightings that underpin the capital requirements. The paper also proposes recognising that banks have developed techniques for mitigating credit risk, notably by means of netting and collateralising their exposures. The Committee is, however, keen to see overall capital levels remain constant in order to protect banks in economic downturns. Its consultation paper therefore proposes that a new capital requirement be introduced to cover "other" risks so as to offset any fall in credit risk capital requirements that might result from a more sophisticated approach in this area.

Finally, it is worth noting that the Committee proposes basing banking regulation on three pillars – pillar one being the core capital requirements in the Accord, as amended; pillar two being a more qualitative regulatory review by supervisors, possibly leading to increased regulatory capital requirements where appropriate; and the third pillar being greater reliance on public disclosure of a bank's activities, leading to greater market discipline. The second and third pillars are seen by some as controversial, since they mean that supervisors may apply different capital requirements to different institutions (as happens now in the UK for example), and as an essential step forward by others, since they allow supervisors to concentrate on the overall quality of risk management in each firm, rather than on the details of individual capital requirements.

The deadline for submitting comments to the Basel Committee on the consultation paper was 31 March 2000. The Committee has received more than 200 responses, which, along with input gathered from the industry on more narrowly defined issues (e.g. internal ratings, use of credit risk mitigation) they are now considering as they refine their proposals.

The Committee has already moved a long way from their original approach in a number of fields:

- Flexibility, where it recognises the need for a dynamic framework to keep pace with further developments and to allow for differences in approach between financial institutions without the loss of consistency.
- Internal ratings, where it accepts that most, as opposed to only a few sophisticated, banks should be allowed to use their systems for regulatory purposes.
- Credit risk mitigation, where regulators envisage the possibility of significantly expanding the scope of eligible collateral.
- Other risks, where through closer work with the industry, supervisors are trying to refine their definition of operational risk and to structure requirements that incentivise good risk management.

There seems to be broad agreement between the Committee and the industry on these key issues.

European developments

The proposals in the European Commission's consultation document are broadly consistent with the Basel Committee's. Both papers rely not just on minimum capital requirements, but on a supervisory review process and market discipline.

The two papers differ in the detail, although some of these differences are precisely what makes a separate Commission's paper necessary :

- The Commission is concerned with drafting legislation;
- The scope of application is much wider in the EU : the directives under review apply not only to large internationally active banks, but also to smaller domestic credit institutions and securities firms.
- The Commission's paper is slightly more precise than the Basel Committee's on the use of ratings, the treatment of credit risk mitigation, and interest rate risk in the banking book.

The European Commission, like the Basel Committee, is currently taking stock of the responses they have received to their paper. The two review processes are being closely co-ordinated in order to ensure consistency of approach. Discussions are held in the Banking Advisory Committee, where all EEA countries are represented by Ministry of Finance and regulatory bodies' officials, under Claes Norgren's chairmanship.

The Commission is understandably keen to issue its proposals as quickly as possible to ensure that European banks are not put at a serious competitive disadvantage internationally once the new G10 standards have been agreed. These plans feature in the Commission Action Plan under Strategic Objective 3, maintaining a state of the art EU prudential regime.

• **Key dates and events:**

- Final proposals from the Basel Committee expected early 2001, possibly issued for (short) consultation.
- European Commission proposals for legislation expected early 2001, the possibility of a (short) consultation period is under consideration.

References:

- Basle Committee on Banking Supervision (1999), A New Capital Adequacy Framework, Consultative Paper, June (see www.bis.org).
- European Commission (1999), A Review of Regulatory Capital Requirements for EU Credit Institutions and Investment Firms, Consultative Document, November (see <http://europa.eu.int/comm/dg15/en/finances>).
- Draft Report by Theresa Villiers MEP on the implementation of the Own Funds Directive, 26 June 2000.

Briefing notes are prepared by the Industry Advisory Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman of the Advisory Committee.

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