

CAD3: IMPLEMENTATION OF THE NEW CAPITAL ACCORD IN THE EU

Summary: As the Basel Committee on Banking Supervision is approaching the final phase of discussion on the New Capital Accord, the Commission Services are initiating the process of transposing the Accord into a new Directive. A first draft of the Directive, commonly known as CAD3 (Capital Adequacy Directive 3), was released on 18 November 2002 to provide a basis for a structured dialogue with representative organisations at both the EU and national levels. A new Working Document, including a revised Directive proposal, is expected to be issued in June.

In the November 2002 document, the Commission wholly endorses the objectives of the Capital Accord reform, in particular the need for modernising the existing capital adequacy framework, developing more risk sensitive capital requirements, and providing a spectrum of approaches suitable for use by institutions of varying sizes and sophistication. The Directive thus aligns closely with the contents of the New Accord.

The Commission however acknowledges that some differentiation might be necessary to take account of EU specificities, notably the wider scope of application of the proposed EU framework (including investment firms, asset managers and other financial institutions) and the legislative nature of the instrument employed to transpose the Basel rules in the Union.

Various representative bodies actively participate in the structured dialogue initiated by the Commission, with a view to ensuring (i) a consistent and parallel implementation of the New Accord; (ii) the flexible future adaptation of the capital rules; and (iii) the appropriate recognition of EU specificities.

The Commission is expected to submit a Directive proposal to Parliament in early 2004. The New Accord is due for implementation by financial institutions at the end of 2006.

Background

The 1988 Capital Accord and its transposition in the EU

The Basel Committee on Banking Supervision was set up in the 1970s to improve capital levels in the international banking system so as to pre-empt a systemic financial crisis. The Committee is comprised of the central banks and banking supervisors of the G10 countries, plus Spain and Luxembourg and based at the Bank for International Settlements in Basel.

The Committee published the first Basel Accord in 1988. The Accord was designed (i) to ensure that internationally active banks had an adequate capital base and (ii) to deliver a level playing field between these banks.

The 1988 Accord introduced a conceptually simple risk based approach. It requires banks to hold minimum capital of 8% of risk-weighted assets as a cushion against credit and market risk.

In addition to being applied by the member countries of the Basel Committee, the Accord is recognised as an international standard by many other nations and has been implemented in well over 100 countries, and applied to smaller financial institutions. The Committee is keen to promote the Accord as a global standard, as financial markets are increasingly becoming integrated.

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, now repealed and replaced by Council Directive

2000/12/EC. The 1993 Capital Adequacy Directive (Council Directive 93/6/EEC) 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 Basel Accord Amendment of 1996, which allowed banks to use internal risk models to set market risk capital requirements was transposed into EU legislation by Council Directive 98/31/EC.

The Capital Accord reform

Although the Accord was a major achievement in its time, it is now 15 years old and in need of reform. 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 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 appropriate differentiation between exposures.

The New Basel Accord is intended to "foster a strong emphasis on risk management and to encourage ongoing improvements in banks' risk assessment capabilities". The industry supports a move to a more risk sensitive framework.

The Committee has issued three consultation papers since the Capital Accord reform started in 1999, one in June 1999, the second in January 2001, and the third and final (CP3) in April 2003. The comment period ends on 31 July, and the Committee remains firmly focussed on publishing the New Accord by the end of the year, for implementation at the end of 2006.

In these papers, the Committee outlines a new framework for banking regulation based on three pillars:

- Pillar 1 - the core capital requirements in the Accord, which should not globally exceed those imposed under the 1988 Accord;
- Pillar 2 - a more qualitative supervisory review, possibly leading to increased regulatory capital where appropriate; and
- Pillar 3 - greater reliance on public disclosure of a bank's activities, leading to enhanced market discipline.

Pillar 1 covers credit risk and market risk and introduces an explicit capital treatment of operational risk.

Regulated entities are offered a range of approaches for capitalising these risks, broadly calibrated to encourage them to move over time to more sophisticated and risk sensitive approaches. For example, the standardised approach to credit risk establishes fixed weights (as in the current Accord) and makes use of external credit assessments, whereas under the so called Internal Ratings Based approach, firms capable of producing internal ratings are allowed to use them to calculate their credit risk charges. In the field of operational risk, the most sophisticated institutions will be able to rely on their own modelling of operational losses, subject to supervisory review.

The Committee has furthermore recognised the need to review certain issues that have not so far been and will not completely be resolved during the Capital Accord reform process. For instance, the capital treatment of securitisation will be adapted to reflect market developments. The Committee also intends to consider a revised, more risk-sensitive, treatment of potential exposures associated with OTC derivatives.

The industry is strongly supportive of these initiatives and views it as important that changes in this area are implemented at the same time as the Accord itself.

Finally, the Committee has established the Accord Implementation Group for national supervisors to exchange information on practical Accord implementation issues.

Implementation of the New Accord in the EU

Unlike the Basel Accord itself, which takes the form of an agreement amongst national supervisors, the capital adequacy framework in the EU is legislative in nature and binding for all EU member states and their banks and credit institutions.

The European Commission consultation process has paralleled the Basel process. The Commission is expected to issue a further consultation document in June. The two review processes are being closely coordinated 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.

The Commission Services issued a working document in November 2002, which included a first draft of a new capital adequacy directive and outlined three *key objectives* for the EU capital adequacy framework:

- 1) The Directive must be adopted swiftly, to allow for *parallel implementation* of the New Accord with non-EU countries.
- 2) The new Directive must be *flexible* to be capable of speedy updating to respond to changes in market practice and regulatory approaches. On various occasions in the past, non EU regulators have departed from the 1988 Accord to upgrade the capital treatment of products or techniques, and by so doing have created competitive distortions with EU firms, constrained by the 1988 Accord wording via its legislative transposition in the Union. To avoid such discrepancies reappearing in the future, the Commission has divided the Directive proposal into two parts: the articles [referred to as Strand 1] embodying the key principles of the Accord, the update of which will require a full legislative procedure; and the annexes [Strand 2], containing the technical requirements, subject to amendments by comitology.
- 3) Finally, there must be a process in place ensuring *consistency of implementation* of the new Directive across the EU to avoid competitive distortion and regulatory arbitrage within the EU. The Commission refers to this supervisory convergence process as "Strand 3" of their work and are proposing to establish a forum of EU banking supervisors to promote the consistency of interpretation and convergence of application of the new framework.

The Commission is supportive of the overall design of the New Accord, and believes that the spectrum of approaches for the calculation of capital ensures the continued suitability of the Accord for banks of all sizes and levels of complexity. The Commission is also supportive of the specific treatment of SME lending in the New Accord.

Scope of application of the proposed EU framework

In accordance with the principle that capital requirements should be proportionate to the risks of activities carried on regardless of the legal nature or level of complexity of the institution, the new capital adequacy directive will, like the directives it modifies, apply to all credit institutions and investment firms within the Union. The Commission notes that this also underpins the competitive level playing field in the EU. In non-EU countries, the Accord affects only the banking sector, and in some cases (e.g. the US), only a subset of banks.

Policy issues

The Commission outlined preliminary thinking on a number of policy issues, some of which are likely to be developed further in the Commission's forthcoming consultation document. These include:

- the treatment of mortgages and covered bonds;
- the possible use of insurance as an operational risk mitigant in all three approaches for calculating the operational risk charge set out in the New Accord;

- a possible lower calibration of the operational risk charge applied to investment business;
- some trading book issues, including the treatment of unsettled transactions and holdings in Collective Investment Units;
- the application of the Pillar 2 supervisory review process.

Mortgages and covered bonds

The Commission issued a working document in April which set out draft rules for the treatment of loans secured by real estate and proposed draft minimum requirements for the management of real estate collateral and prudent valuation of mortgage property. The Commission also issued a working document outlining its current thinking on capital requirements for covered bonds held in the banking book. The Commission noted that its analysis had been hampered by an extreme scarcity of empirical data. Both issues are expected to be explored further in the Commission's forthcoming consultation document.

SMEs

An important aspect of the work in developing the proposed new capital adequacy framework in the European context has been the impact on SMEs. The Commission believes that changes made by the Basel Committee to the capital requirements applied to lending to SMEs ensure a prudentially sound treatment, which is suitable to such borrowers.

Exposures to SMEs can, for example, be included in the retail portfolio, subject to a bank's exposure to one counter party not exceeding Euro 1 million. The Commission proposes to adopt this approach in the New Capital Adequacy Directive but has indicated that it will not include a numerical limit on the exposure to one counter party as a proportion of the overall regulatory retail portfolio (the *granularity criterion*).

Operational risk

In calibrating the operational risk charge, the Basel Committee has not been able to take into account data from investment firms. With regards to the intermediate 'Standardised' Approach, this has led to debate about the appropriate level of multiplier (or 'beta factor', to be applied to gross income) for certain investment-service business lines given that under this approach, a higher charge will be faced for firms specialising in such activities, despite the higher standards that must be met to qualify for it. But the Commission is also proposing lower 'betas' for some investment-service business lines in limited circumstances.

It remains unclear whether all Member States would apply such lower 'betas' to all firms pursuing such business lines, particularly large universal banks (which are the focus of the Basel Committee). The Commission has stressed that the principle of the same risks receiving the same treatment is fundamental.

In terms of legislative process, the calibration of the charge and particularly the levels set for 'beta' factors (and the 'alpha' multiplier under the Basic Indicator Approach) would benefit from being reviewed and, if necessary, reset periodically in future, without having to rework the whole Directive.

The Commission has also proposed greater recognition of insurance effects. It is investigating potential technical obstacles to recognising insurance under the less sophisticated approaches to operational risk (ie, the Basic Indicator and the Standardised Approaches). While the market for insurance against operational risk remains relatively undeveloped, the principle of risk mitigation is broadly welcome.

The flexibility afforded firms under the 'Advanced Measurement Approaches' gives rise to a particularly acute need for supervisory co-ordination, within and between jurisdictions. It also raises questions of supervisory resources, in connection with initial vetting of firms AMAs and their subsequent monitoring.

Trading book

Unlike Basel, the EU intends to apply the new capital framework to firms that specialise in trading book activities, as is the case for many investment firms. However developing a more risk-sensitive approach for these activities has not been focused on by Basel to the same extent as for the banking book. Major issues such as the measure of potential exposure on derivatives remain unresolved. As a result of this, coupled with the new Operational Risk charge, firms with predominantly trading book activities suffer capital increases disproportionate to the underlying risks.

In addition, the Commission has repealed the CAD provisions currently providing firms with a 4-day window during which unsettled transactions can be resolved without requiring a capital charge. This could lead to double capitalisation, as in the vast majority of cases, failed settlement is reflective of operational risk, and charged as such under the Accord.

The Commission is also proposing to develop a market risk treatment for trading book investments in Collective Investment Units, which is a welcome effort, provided it results in reasonable capital requirements.

Supervisory Review

The Pillar 2 supervisory review process will be a major innovation for some banks and also for some supervisors. A key issue in this context is the supervision of institutions with operations in more than one Member State and/or outside of the EU. Enhanced supervisory co-operation will play an important role in this respect.

Transparency of supervisory practice will also be an important element in the process, particularly in the application of national discretions.

Consolidation requirements

The implications of the consolidation requirements proposed in CAD III are also an issue for further consideration. In order to deliver Single Market objectives, it is important that the relationship between an institution's home state and its host state(s) is clear and that multiple disclosures are avoided. This issue was tackled in the Financial Conglomerates Directive by the introduction of the lead supervisor model.

Implications of changes to accounting standards

The European Union will implement the International Accounting Standards by 2005. It is important that conflicting accounting and regulatory requirements, particularly under Pillar 3 of the New Accord, are avoided. The Basel Committee has accepted the need to align the disclosure framework in the Accord with accounting standards.

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, Members or Secretariat of the Advisory Committee.

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