

## CAPITAL REQUIREMENTS – GLOBAL OR EUROPEAN?

**Executive summary:** The successful transposition of the Basel II framework into Community law through the Capital Requirements Directive should improve financial institutions' risk management practices and foster financial stability in the EU. Since the Directive helps to protect deposits and investments, applying it widely is in the interest of European depositors, borrowers and investors. However, some challenges remain before the legislative process can be successfully completed. Ensuring a level playing field with non-EU institutions, incorporating updated trading book calibrations, maintaining sufficient flexibility to adapt the body of law to changes in financial services markets and ensuring even implementation in the EU are key steps towards a successful outcome.

### From Basel I to Basel II

The Capital Accord (Basel I), adopted by the Basel Committee on Banking Supervision in 1988, introduced minimum capital requirements for all internationally active banks for the first time. The subsequent development of more sophisticated risk management techniques by banks highlighted the crudeness of the supervisory requirements and their inconsistency with firms' internal assessment of their capital adequacy. The increasing use of credit risk transfer instruments, such as securitisation and credit derivatives, also pointed to the need for a more risk-sensitive approach to be adopted. The new Capital Accord (Basel II) seeks to address these failings, in order to further enhance risk management and financial stability.

### The European follow-up: Capital Requirements Directive

In order to give legal effect to Basel II within the EU, the European Commission proposed a directive on capital requirements on 14 July 2004. The proposed Capital Requirements Directive (CRD) will be applicable to all banks and investment firms in the European Union, and hence has a wider scope of application than Basel II. It also allows smaller institutions to implement less complex approaches with incentives to move to the more advanced approaches over time. The Commission has aimed to transpose Basel II as faithfully as possible while at the same time taking European specificities into consideration. However, the question remains of whether the applicability of some of the requirements to investment firms can be justified. It is essential that derogations are made for the various types of investment firms in order to avoid them being put at a competitive disadvantage to banks. The Commission has also recognised the need for flexibility to allow technical updates, in response to market and supervisory innovation.

The CRD mirrors the three pillar structure of Basel II. Pillar 1 sets out minimum capital requirements. These include new capital charges for operational risk – essentially, risk related to inadequate or failed internal processes, people and systems. Pillar 2 covers the 'supervisory review process' carried out by national authorities to evaluate institutions' overall risk and capital adequacy. Pillar 3 requires institutions to disclose information regarding risk assessment publicly, in order to increase levels of 'market discipline', thus enhancing transparency in the financial system. One key element of the CRD is the enhanced, though still limited, role for the 'consolidated supervisor' who will coordinate the validation of the advanced risk measurement models for groups active on a cross-border basis.

### Legislative Process

On 7 December, the Council reached a general compromise on the proposed Directive under the Dutch Presidency. The proposal is being studied in parallel by the European Parliament.

### Issues for consideration:

#### Scope and Level of application

The Directive's primary objective is to ensure the robustness of financial institutions' risk management systems and processes and the adequacy of their capital, thus protecting the deposits and investments of consumers. The application to all banks and investment firms in the EU should ensure a high level of financial stability within the Single Market and will encourage continuing convergence towards best risk management practices. However, since investment firms carry a significantly different risk

structure to banks, it has been necessary to question the relevance of some of the detailed requirements to investment firms.

### **Need for a level Playing Field**

Alignment between the **EU Member States and other G10 countries** both in terms of implementation and content of legislation or regulations implementing Basel II is necessary to ensure competitiveness of European markets in line with the Lisbon agenda. Alignment is also important to avoid unnecessary implementation costs. The Commission has proposed a high level of parallelism with the Basel framework. However, it is inevitable that there will be divergences in implementation between jurisdictions. The US for instance will implement Basel II including the Trading Book Review from 1<sup>st</sup> January 2008. This provides time for further Quantitative Impact Studies which will provide the basis on which the framework will be recalibrated in the US and certain other jurisdictions. This could lead to enhancements in some supervisory regimes that EU Member States will not enjoy given that the Commission is proposing a staggered approach to implementing Basel II with two implementation dates, 1<sup>st</sup> January 2007 and 1<sup>st</sup> January 2008. The difference in implementation dates between the EU and other countries is therefore not just a pure timing issue but also has consequences for the quality of the framework. One single EU implementation date would be more cost efficient, and avoid legal uncertainty for cross-border groups during the transition period. It would also allow the EU framework to be updated to include any changes arising from QIS4 and QIS5.

### **Importance of flexibility**

The Basel framework is work in progress. It is important that the directive remains flexible enough to reflect changes necessary both before and after its implementation. In particular, the results of the Trading Book Review currently being undertaken by the Basel Committee and IOSCO need to be incorporated into the CRD as soon as possible. This is particularly urgent in respect of the work streams focused on counterparty risk, short-term maturity (which has further important implications for trade finance and leasing) and double default. Proposals are expected in March that should provide a more efficient and risk-based approach for globally migratory instruments such as repos and OTC derivatives. Failure to achieve timely application of these proposals together with the rest of the revised capital framework could significantly impair the efficiency of Europe's capital markets compared with other jurisdictions.

It is important that the new Directive should take a principles-based approach to allow financial institutions necessary flexibility in their risk management. This is particularly key for the application of the Supervisory Review Process under Pillar 2 and it is vital in this regard that CEBS works towards an increasingly high level of cooperation and consistent application.

### **Need for convergence in the EU**

CEBS plays an essential role in ensuring consistency in practices and interpretation of the rules by national supervisors. Divergence in application of the rules in the different Member States could constitute a serious obstacle to a level playing field. The inclusion in the CRD of a requirement for supervisors to disclose their policies is a positive step in this regard.

The draft CRD still contains 143 national discretions that could give rise to an uneven implementation of the new capital requirement framework. There are strong arguments that national discretions should be removed over time and should be included in the annexes of the Directive so that they can be revisited at a later date. CEBS is working on identifying discretions which can be removed. Industry is also carrying out parallel work on national discretions, two of which are of particular concern.

The first one relates to the level of application of the rules. In the current Commission proposal, calculation of capital requirements takes place at the level of each entity within the group. Member States are given an option to waive the solo level application and apply the rules at a consolidated level but only within their national borders. The national discretion has no prudential justification and is directly contrary to the objectives of the Single Market. One could argue that the principle of

**consolidated supervision** versus solo supervision should apply for the entirety of the new CRD (pillars 1, 2 and 3). Solo application should always be the exception rather than the rule and, in such cases, should apply on a transitional basis with respect to Pillar 1 only.

**The second national discretion which is of major concern relates to the treatment of intra-group exposures.** Under the current proposals competent authorities may exempt intra-group exposures from credit risk capital charges when the exposure is to a group entity included in the same consolidation as the credit institution and incorporated in the same Member State as the credit institution. This option should be available on a non discretionary basis to all intra-group exposures within consolidated and centrally managed banking groups in the EU.

### **Consolidated supervisor**

The enhanced role for the consolidating supervisor model in the Directive proposal is a positive development. However, the role of the consolidated supervisor is limited to the validation of the advanced models. The acceptance of Member States of Article 129 in the general approach indicates that the proposal could go further towards delivering true consolidated supervision in Europe. Business practice today shows that banks increasingly manage risk using a group-wide model based on business lines and removed from the traditional country-based model. Matching this business reality with an extension of the model to the application of the Supervisory Review Process under Pillar 2 is necessary if the objective of reflecting the entire risk profile of financial groups is to be achieved and inconsistent treatment is to be avoided. CEBS is working in this respect on advancing supervisory cooperation and convergence. The benefits of this approach should be extended to third-country supervisors.

### **A Global framework**

It is apparent that although Basel II was initially targeted at internationally active banks, the adoption of its principles is much more widespread. Bank supervisors and leading practitioners in non-Basel member countries are actively considering how to build safer and sounder local banking systems. Also, non-regulated financial intermediaries and corporate clients are showing increasing interest: they will not only be affected but also want to improve their own risk disciplines. It is clear that there will be continuous developments towards frameworks integrating market and regulatory innovations resulting in even more sound and stable financial systems. In line with the Lisbon Agenda, Europe must place itself at the forefront of these developments.

Briefing notes are prepared by the Financial Industry 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 Financial Industry Committee.

**Chairman Financial Industry Members**

Rainer W. Boden  
Deutsche Bank, EU-Representation  
17, Avenue Marnix, B – 1000 Brussels  
Tel: 0032 2 551 60 06 / Fax: 0032 2 551 61 08  
E-mail: [rainer-w.boden@db.com](mailto:rainer-w.boden@db.com)

**Secretary**

John Houston  
EPFSF Secretariat  
Av. de la Joyeuse Entrée, 1-5, B – 1040 Brussels  
Tel: 0032 2 504 80 40/ Fax: 0032 2 504 80 50  
E-mail: [secretariat@epfsf.org](mailto:secretariat@epfsf.org)

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