

## The EU Releases Draft Directive On Capital Requirements

December 2002

### Executive Summary

The Basel Committee and the EU have both taken a major step forward in reforming their risk-based capital frameworks. Both will flow into the FSA's "Prudential Sourcebook" and through this will impact UK banks and investment firms.

The EU has released an advance draft of a new Directive on the EU capital framework (CAD3), which will implement Basel II into EU legislation, and apply Basel-type provisions to investment firms and domestic credit institutions as well as to international banks. This draft and related working papers form part of the EU's "structured dialogue" with firms and national regulators. The EU proposals differ from the Basel proposals mainly on the treatment of operational risks for investment services firms and providers and introduces a new and alternative approach. They also significantly tighten the conditions for a waiver from consolidated supervision for investment firms.

The Basel Committee launched its third "Quantitative Impact Study" (QIS 3) at the beginning of October, accompanied by extensive guidance, which effectively constitutes an advance copy of Consultative Paper 3 (CP3). Some 200 banks have been asked to provide estimates of their capital requirements by the end of December 2002.

These documents have substantially reaffirmed the proposals made by Basel in July 2002, and the timetable that firms will need to work to. Firms should also be aware of and plan for a number of potential divergences between the EU and Basel, especially in the area of operational risk.

These latest developments give banks and investment firms a clear view of the new regulatory proposals. Key aspects are now well within the planning horizon, and, by the end of 2003 all major institutions will need to have carried out impact analyses and begun the necessary systems and risk management projects to ensure compliance by the implementation date in 2006.

## Impacts and Actions

Banks and investment firms need to pay close attention to the recent documents issued by the Basel Committee and by the European Commission. The draft EU directive on the future capital framework (often called CAD 3), the Quantitative Impact Study (QIS 3, with associated explanatory notes) and the working paper on securitisation have tremendous implications. Firms should:

- 1 **Analyse the EU alternative treatment of operational risk**, taking into account the risk management standards that will need to be met, and consider the impact on their Basel implementation plans.
- 2 **Assess the impact of QIS 3** on them, whether or not they have been asked to take part in the study. This will yield valuable information not only about the quantitative impact of the new minimum capital requirements, but also give essential information about the data requirements of the chosen approach to capital and the compliance effort required. This information should be used to update implementation plans.
- 3 **Revisit their gap analyses** in light of the EU proposals and the information yielded by QIS 3, and update implementation plans, budget and project management arrangements as necessary.
- 4 Take full advantage of the QIS and the period of “**structured dialogue**” opened by the EU which runs until the end of January 2003. The QIS is the last realistic opportunity for significantly influencing the Basel process and the structured dialogue will be one of the key opportunities to influence EU decision makers.
- 5 Affected firms should give close consideration to the working paper on **securitisation** and on lobbying on this paper. The consultation on this is real, but short – ending on 20 December 2002.

## Draft EU Directive on the New Capital Framework (CAD3)

On 18 November 2002, the EU released an advance draft of CAD 3, which will be the EU implementation of the Basel proposals.

Unlike Basel, which is addressed to internationally active banks, CAD 3 will be applied to all credit institutions in the EU (including building societies). It will also be applied to non-bank investment firms authorised under the Investment Services Directive (ISD). Firms who are shortly to come within the ISD (e.g firms that are involved in commodity derivatives business or provide investment advice) should take note. It is no surprise that while CAD 3 is based on the Basel proposals, differences exist to take account of this wider constituency.

The most important difference lies in the alternative calculation of the operational risk charge for firms that can only carry out certain very restricted activities and do

not take client money. The rationale is that the provisions on risk management and customer protection in the ISD reduce the operational risks for those firms. Consequently, the EU proposes a lower capital charge for these investment firms.

It also proposes a lower charge for certain “low-risk” investment services, including asset management. The EU is considering allowing banks as well as investment firms to apply these lower charges to such activities. This would be a significant step away from the Basel Accord and may not be applied to banks by all EU regulators. In addition, UK authorised CIS managers should note the implied change in business practice, i.e. investment monies to be paid to the trustee/depositary, not the managers.

The Commission plans to use the QIS to calibrate the operational risk charge. This means that investment firms that do not have banks as parents will be omitted. It is important that such firms give data to the FSA so their specific nature can be taken into account in the calibration exercise.

Investment firms (particularly investment managers) should note that the EU proposes to amend the existing alternative to consolidated capital requirements for investment firm groups (known as the “CAD waiver”). Those firms are supposed to meet new specific and significantly more stringent conditions if they intend to be exempted from consolidated capital requirements. In particular, the CAD waiver will be restricted to firms that are active in only one country.

The EU further diverges from the Basel proposals on other specific issues, such as:

- **The use of insurance as an operational risk mitigant:** the EU is considering whether institutions applying the basic indicator or the standardised approaches for operational risk might use insurance as a risk mitigant. So far, the Basel Committee recognises insurance as a risk mitigation technique only for banks intending to use the Advanced Measurement Approaches.
- **The process of adopting internal ratings approaches for credit risk across asset classes:** in the CAD3 cover document, the EU is considering how to facilitate the adoption of internal ratings by smaller firms, for example by giving permanent dispensation to “small institutions with a limited number of exposures towards sovereigns or institutions” from developing rating systems for those asset classes, even if those exposures are material. Yet, in article 51 supporting the cover document, the EU seems to allow this permanent partial use to all institutions, subject to approval by the national competent authorities. In the technical notes supporting the QIS3, Basel only allows banks “with some exposures in non-significant business units as well as asset classes that are immaterial in terms of sizes and perceived risk profile” to apply the standardised approach (while using the IRB method for other exposures). Neither the EU nor Basel provide for a definition of materiality of exposures or size of institutions.

In other areas (e.g. the treatment of exposures to small and medium-sized enterprises or of mortgage lending), CAD3 is consistent with the Basel proposals. That said, a number of issues remain open. It is important firms take full advantage of the lobbying opportunities to press for the most appropriate policy options to be selected.

## Quantitative Impact Study 3 (QIS 3)

On 1 October 2002, the Basel Committee on Banking Supervision issued the documentation supporting the third Quantitative Impact Study. The aim of the exercise, as before, is to evaluate the impact of the Basel Committee's latest proposals across a wide range of banks in the G10 and beyond.

Along with instructions and spreadsheets to be completed by banks before 20 December 2002, the Basel Committee also published technical guidance notes to be followed by the banks when calculating their capital requirements in accordance with the latest Basel proposals. These give a clear insight into the approaches to minimum capital requirements, although there is no further detail on the approaches to supervisory review or disclosure (Pillars 2 and 3).

Basel II is becoming a much clearer target and key policy issues are no longer up for grabs. They were settled in July 2002. The main features arising from the QIS and their implications for financial institutions are as follows:

### **What has been reaffirmed by Basel through the QIS 3?**

### **What are the implications for financial institutions?**

#### **Roll out process through transitional provisions**

The Basel Committee allows banking groups to implement IRB approaches for credit risk throughout their different asset classes based on a phased rollout process.

Rollout will be significantly easier than under CP2. However, Basel still envisages an "exacting, yet realistic" timetable and rollout that will cover the entire banking group, subject to the possible exclusion of immaterial business units or asset classes.

#### **Data used for the corporate, sovereign, banks and retail exposures**

Between 2006 and 2008, some of the minimum data requirements will be relaxed. Banks transitioning in 2006 must have a minimum of two years' data on default probabilities (reaching 5 years at 2009 year-end).

In order to be ready for the 2006 calculation, banks intending to apply IRB methods will need to build databases by end 2003. This implies that all methodologies and frameworks deemed necessary are defined before this date for each relevant asset class.

#### **Parallel run and introduction of new transitional floors:**

Between 2006 and 2008, banks using the IRB approaches for credit risk or the advanced measurement methods for operational risks will have a floor set on their minimum capital requirements, which amounts to 90% of the capital charge calculated based on the rules of the existing Accord for the first year of the new Accord and 80% for the second year.

Firms will have to perform parallel calculations of their capital requirements between 2006 and 2008. They must assess the impact of this parallel run on their reporting systems and the surrounding controls, and on their budgets.

#### **Retail Exposures**

New IRB risk-weight retail curves have been introduced. Three different sets of curves are to be used depending on the type of exposure:

Banks with significant retail exposures should assess the impact of the changes on their different portfolios. They should also assess the impact of the definitions of the different types of exposure to see in particular

1. Qualifying revolving exposures (e. g

**What has been reaffirmed by Basel through the QIS 3?**

- credit cards) – subject to certain entry requirements;
- 2. Residential mortgages; and
- 3. “Other retail” lending.

The standardised risk weights for retail lending have also been reduced. The risk weight for mortgage lending has been reduced from 50% to 40%, and a new retail lending risk weight of 75% has been introduced.

**SME business**

SME exposures of up to a total of €1m can be treated as retail exposures (subject to certain conditions).

For SMEs with total exposure in excess of €1Mn, discounts of up to 20% to the capital requirements for corporate exposures are available based on a size-based adjustment to the risk-weight function

**What are the implications for financial institutions?**

whether they are able to meet the requirements for revolving exposures where the reduction in capital charge is especially beneficial.

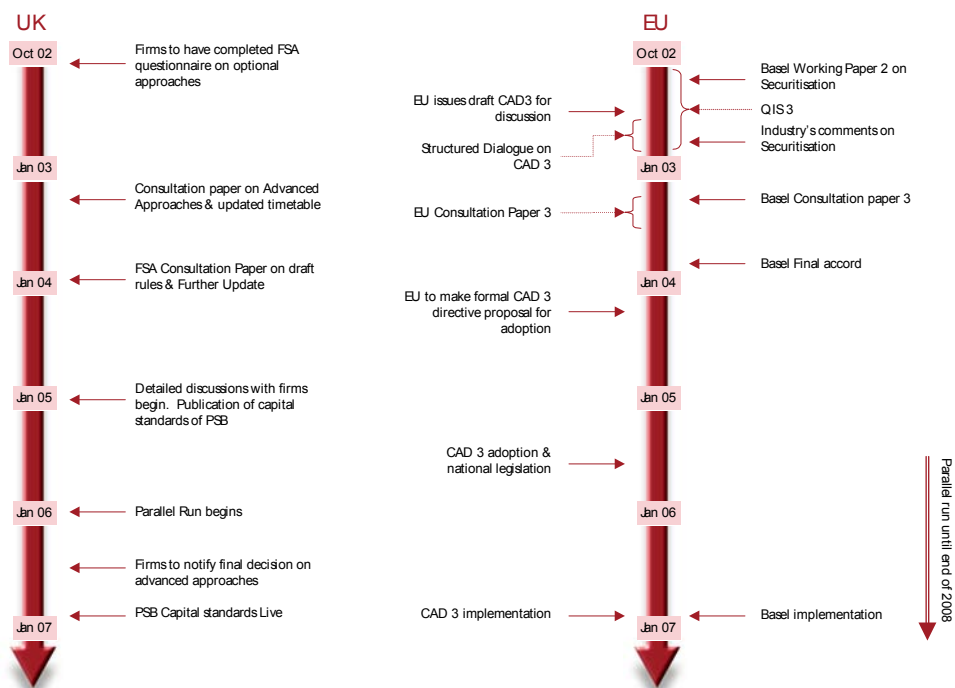
Firms need to evaluate how much of their SME business they can fit into the retail approach

Banks will also need to assess the systems implications in order to be able to identify SMEs separately from other corporate exposures and take advantage of the potential capital reductions

Other points to note are:

- **National discretion** - There are some 40 areas of the QIS technical guidance where supervisors are asked to exercise national discretion. While there will be a review by the Accord Implementation Group of how national discretion has been used, the results are not likely to be published. It does raise significant questions about how level the playing field will be after the introduction of the Accord.
- **Securitisation** - A specific section on securitisation has been enclosed in the technical guidance notes issued on 1 October 2002 for the QIS 3. A consultative working paper on securitisation has also been released. The approach is claimed to be less punitive than under previous proposals, but could still result in banks having to hold more capital against securitised assets than against the underlying in certain circumstances. Comments are required by 20 December 2002.

## Timelines



### Basel & EU timetables

Basel has reaffirmed its timetable. The next important step will be the release of the third (and final) consultative paper, in the spring/early summer of 2003. This last consultation period is expected to be very short and organisations wishing to lobby need to do so on the basis of QIS 3 to have any realistic hope of success.

The EU timeline is largely concurrent with the one issued by the Basel Committee. It is subject to some uncertainty surrounding the legislative process, but the intention is that the EU Directive should be passed by the end of 2005. This will allow a year for national implementation before parallel running commences in 2006. EU firms seeking changes to the EU proposals now have a final chance to persuade the Commission to make material changes, or to support the divergences proposed from the Basel proposals themselves.

### UK timetable

For UK headquartered banks and investment firms, the Basel and EU requirements will be implemented through the new Integrated Prudential Sourcebook. This will apply an integrated capital and risk management framework across the whole financial sector. For banks and investment firms, systems and controls requirements will apply from 2004, new liquidity control requirements from 2005 and credit and operational risk requirements from 2006. The timetable for the capital-related elements in the diagram above.

By the end of 2003, all major institutions will need to have carried out impact analyses, and begun the necessary systems and risk management projects to ensure compliance by the implementation date in 2006.

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