

EU Risk Based Capital Directive CAD 3 – The Future EU Capital Adequacy Framework

October 2003

In July the European Commission issued its third consultative document on the future regulatory capital framework for the EU. This framework will implement the new Basel Accord in the EU. Unlike Basel, it will apply to all banks in the EU and to investment firms authorised under the Investment Services Directive (ISD). The Basel Accord focuses on internationally active banks.

The framework will be set by a new Directive, the Risk Based Capital Directive (RBCD), which some have dubbed CAD 3. This general consultation follows a period of Structured Dialogue initiated by the publication of an advance draft of the Directive in November 2002. The Commission is looking to receive comments by 22 October 2003, with the aim of presenting a formal legislative proposal to the European Parliament and the Council of Ministers early in 2004 so that the new framework can be implemented at the end of 2006 in parallel with the Basel timetable. This timetable is very tight but the Commission is confident of getting the directive through in time to allow implementation in 2006, and is relaxed – at least in public – about the impact of recent manoeuvres in the US on the Basel process.

The EU approach is founded on the assertion that the Basel Accord forms a suitable basis for the new EU regime for both banks and investment firms – of whatever size. The Commission founded this on the Basel Quantitative Impact Study and has conducted some additional quantitative analysis, in particular for investment firms. This analysis has also highlighted the need to make some changes. Many of these are relatively minor, although there are some important departures from Basel, particularly in the area of operational risk and in relation to investment firms.

Just Basel revisited?

Banks and investment firms should not be lulled into thinking that most of the EU document is a reheated version of Basel, and can safely be ignored in order to focus on the “main event”. For firms within the EU, this is the main event. Even where the intention of the EU is simply to implement Basel, the fact that this is a legislative instrument means that more coercive language is necessary. Firms need to be alert to this as it brings with it the potential for inflexible interpretations to be hard-coded into EU law. This means that the Directive could operate in a manner different to that anticipated by regulators in Basel. The law of unintended consequences is likely to operate. In addition, while retaining the basic Basel architecture, the Commission has tightened or loosened conditions and added or removed some national discretions in a number of places. The devil is very much in the detail.

The Commission is committed to flexible legislation that will allow the European capital framework to evolve with the market. It believes that it has an approach that will deliver this, with core principles contained in the body of the directive, and technical details in a series of annexes that will be able to be modified by speedier means than passing a full directive. While this is as flexible as the Commission can be, given the constitutional constraints, making and changing EU law is and will remain time consuming. Institutions would be wise to factor this both into their lobbying on the directive and into any longer-term planning.

Consolidation

One possible example of the law of unintended consequences is consolidation. This concerns banks as well as investment firms. The Commission proposes a strict approach where institutions will have to meet capital requirements at solo, sub-group and consolidated levels. The existing waivers from consolidated supervision will be greatly restricted to low risk investment firm groups that are active in only a single member state. The objective is to eliminate double gearing and combat excessive leverage.

This at the very least promises a major increase in the number of sub-group consolidations that will be required. It will also diminish supervisors’ flexibility to focus on group level capital rather than solo ratios in order to take account of integrated or solo-consolidated group structures. Institutions have naturally focused – along with Basel and the EU – on how risk weighted assets should be calculated. They should also be alive to the potential effect of the consolidation provisions on their solo capital base. While the EU is largely following the precepts of the Basel Accord, the fact that the Directive has legal force allows none of the wriggle room that supervisors can find – or simply take – in the Basel Accord.

One Accord for all

The Commission believes that the Basel proposals, as adapted by the EU, form a sound basis for capital requirements for banks of all sizes and for investment firms. It sees the Foundation Internal Ratings Based (IRB) approach as fundamental in delivering this wide applicability, with minimal damage to competitive equality. It expects a high take-up of the Foundation IRB – unlike the US, which has stated that it will only offer the Advanced approach to those banks covered by Basel II or opting voluntarily for it.

Nevertheless, the Commission is concerned that the extent of national discretion available to regulators could subvert both competitive equality and the single market. On the other hand, it acknowledges that supervisors need discretion to deal with different market structures and with specific circumstances. In order to promote supervisory convergence, the Commission has taken up the idea of supervisory transparency suggested by a number of bankers’ associations. This would involve a forum of European supervisors to promote convergence in the application of the

regulatory framework, and the disclosure of regulatory policies, how options under the RBCD are exercised and the publication of statistics on how the Accord and the Directive are implemented. As this is likely to be resisted by some regulators, institutions that want this sort of transparency need to show their support for the Commission.

Reducing the burden for Groups

The Commission recognises the potential for Groups to be subject to multiple interpretations of the same Directive. It shares the approach being developed by Basel of placing the prime responsibility for institutions with the supervisor of the country of incorporation. This is, of course, very much in keeping with the home country approach that forms one of the cornerstones of the EU approach to supervision. The Commission is interested in exploring whether this can develop in the direction of lead supervision, where the home supervisor of the parent of a group would effectively co-ordinate the supervision of the whole group. This would appear to offer a way of at least mitigating potential conflicts of regulators in relation to a single group, and the Commission is especially interested in institutions' views on this concept.

Key differences between the EU and Basel and open issues

Most of the focus is on Pillar 1 (minimum capital requirements). There have been relatively few significant developments in respect of Pillars 2 and 3 (supervisory review and disclosure).

The standardised approach

The EU essentially follows Basel. However, there are some departures from Basel that are more than just points of detail or emphasis.

- *Definition of retail loans*: the draft RBCD does not limit retail loans to 0.2% of the overall retail portfolio, as in Basel II, on the grounds that it is unduly rigid.
- *Claims secured on residential real estate*: the Commission has introduced eligibility criteria, for example that the value of the property does not materially depend on the credit quality of the obligor, and other minimum requirements that do not exist in Basel II.
- *Claims secured on commercial real estate*: the Commission offers a reduced weighting, whereas Basel regards a 100% weighting as the norm, with the possibility of a 50% weighting as an exception. The conditions for the use of the preferential 50% risk weighting differ from Basel, and as with claims secured on residential real estate, the Commission introduces eligibility criteria and minimum requirements that do not exist in Basel II.
- *Covered Bonds (e.g. Pfandbriefe)*: the Commission has developed weights that are one notch above that of the issuer with a floor of 10%. A 20% issuer gets a 10% risk weight, a 50% issuer gets a 20% risk weight, etc. Banks in countries that apply Option 1, where all banks are weighted at one notch lower than the sovereign, should benefit more than those in countries where the risk weight will depend on the credit rating of the bank (i.e. Option 2).

Internal Ratings Based (IRB) approach

Again, the Commission essentially takes the Basel approach. The approach to permanent partial use is both a sensible and significant departure from Basel, which continues to insist that a bank that adopts the IRB approach should apply it to all portfolios subject to materiality. This should make it easier for smaller institutions to apply the Foundation IRB.

- *Permanent partial use:* the Commission will allow permanent partial use of the IRB, so that institutions which are able to apply IRB to corporate and retail exposures will not necessarily have to develop ratings systems for exposures to banks and investment firms and sovereigns. This is intended to apply to institutions that have only a limited number of exposures to such counterparties. It is also intended for “smaller institutions”, and requires explicit supervisory approval. There is no proposed limit on the size of institution that can apply for permission for permanent partial use.
- *Covered bonds (e.g. Pfandbriefe):* an LGD of 20% can be applied under the Foundation IRB – this compares with a 45% LGD for unsecured bonds.

Credit risk mitigation

- *Unrated Bonds issued by banks and investment firms:* the EU will treat unrated and unlisted bonds as eligible credit risk mitigants where they will be repurchased by the issuer on request, providing a guarantee-type treatment of such instruments.
- *Minimum requirements for guarantees:* the Commission may be prepared to recognise principal-only guarantees and is looking for views on this. Sovereign counter guarantees will be accepted as eligible guarantees, subject to conditions. The Commission seeks views on permitting the recognition of guarantees where the protection provider covers a portion of the loss after the institution has realised other credit mitigation such as collateral. It is also proposed to relax the requirement that guarantees should be entirely unconditional, provided any conditions do not compromise the protection provided.

Large exposures

This is a major difference with Basel – which does not have a specific regime covering risk concentrations. While this is not a complete overhaul of the large exposures provisions of the Banking Directive, the RBCD will amend the Banking Directive so that the calculation of the amount of an exposure will be consistent with the proposed credit risk mitigation framework. This will mean that – subject to supervisory discretion – different approaches to capital adequacy and to credit risk mitigation will have differing impacts on the large exposures calculation at individual institutions.

- *Institutions using the simple method for financial collateral:* no change to the current regime.
- *Institutions using the comprehensive method for financial collateral:* supervisors will have the option to allow firms that use this method employing the calculation for the amount of an exposure where funded protection is obtained. This will carry with it a Pillar 2 requirement to stress test realisable value of collateral taken against large exposures. Unfunded protection, such as guarantees and credit derivatives, will be recognised as under the current large exposures regime.

- *Institutions on the advanced IRB*: will, subject to supervisory agreement, be able to use their estimates of the effects of collateral on their large exposures. Unfunded protection will be recognised as under the current regime.

Trading book

Again, the EU proposals are largely in line with the Basel Committee, and many of the changes in respect of previous proposals bring the EU more closely into line with Basel, for example in respect of the definition of qualifying items. The treatment of unsettled transactions remains an open issue. The Commission continues to consider two options. The first would be to subject unsettled transactions to the general credit risk rules of the banking book. The other would essentially retain the current approach of the CAD, irrespective of Basel.

Operational risk

While the EU adopts the basic Basel approach to operational risk, there are a number of points to consider.

- *Qualifying criteria for the Standardised Approach and Advanced Measurement Approaches (AMA)*: these are fewer, different and apparently less demanding (especially in respect of the Standardised Approach) than those specified by Basel.
- *Alternative Standardised Approach*: the Commission will make the Alternative Standardised Approach available with supervisory consent, but subject it to strict conditions – and only offer the main variant. It will be available to firms in which retail and commercial banking account for over 90% of income, and there should be evidence of double counting if the Standardised Approach was used. Institutions must still map to the standardised business lines and meet the qualifying criteria.
- *Partial use*: partial use of the Basic Indicator and Standardised Approaches will only be allowed in exceptional circumstances, e.g. new acquisitions and, for a limited period only. Partial use of AMA and other methods will be allowed, subject to the overall credibility of the approach and rolling out AMA to a material part of group legal entities within an agreed time frame. The Commission is not adopting the Basel requirement to rollout AMA to all material legal entities and business lines *in order to encourage smaller firms to apply AMA to part of their business*.
- *Recognition of insurance*: having previously stuck its neck out in suggesting that insurance should count as a risk mitigant in all approaches to operational risk, the Commission has come back into line with Basel in recognising insurance only in AMA.

Investment firms and operational risk capital

This is an area where the Commission's thinking has undergone considerable refinement, especially in relation to investment firms that do not take principal positions, following the consultation of the Structured Dialogue, and major concessions have now been made.

- *Limited licence firms*: the Commission's impact analysis suggested that the operational risk charge would increase capital requirements for investment firms significantly. The Commission proposes that certain low risk firms (asset managers, receivers and transmitters, executors of orders, placers of orders with no firm commitment and advisors) should remain subject to the current expenditure based requirement set out in the CAD. At the consolidated level, this could also be applied to groups that do not contain banks or full licence investment firms. **Groups that do contain banks and full licence**

investment firms will still have to calculate RBCD operational risk capital requirements based on gross income at the consolidated level. Limited licence investment firms using AMA could be exempted from the expenditure based requirement, subject to supervisory discretion.

- *Firms that do not hold client money or assets and investment advisors:* the Commission is considering exempting such firms from capital requirements altogether. If this happens, they will be required to have professional indemnity insurance cover or comparable coverage against liability for professional negligence.
- *Firms that take principal positions:* the Commission believes that other amendments to the proposed Directive in line with the Basel proposals, such as the revised calibration of the Standardised Approach and the recognition of models in calculating repo and securities lending capital requirements, mean that the capital framework is now applicable to such firms.

Supervisory review

The Commission retains an approach to Pillar 2 that sets requirements for firms and minimum criteria for supervisors to consider, but only empowers supervisors to act, rather than creating a harmonised approach. The Commission is still considering how Supervisory Review should apply at the consolidated level, and whether a consolidated group Pillar 2 capital requirement should be the result of a separate assessment process or the sum of all the individual Pillar 2 assessments. Institutions which believe that Pillar 2 should essentially operate at a group level, or which think that Pillar 2 should be a “top down” assessment of the capital requirements of the whole group may particularly wish to comment on this in their responses to the Commission.

Disclosure

The Commission retains an approach under which disclosure requirements apply at group level, although significant subsidiaries and sub-groups will also be required to disclose certain information. An issue here is that “significant” is not defined in the EU document, although when Basel uses the term “significant” it refers back to accounting standards. Annual disclosure is considered sufficient for most institutions, although large international institutions will need to make more frequent disclosures in line with Basel requirements. That said, the requirements are expressed rather differently as the table below shows.

	Basel II	RBCD
Frequency of disclosure	Half yearly as the norm, with quarterly reports for matters subject to rapid change. Small banks allowed to report annually.	Annual reporting the norm. The authorities have the power to require more frequent reporting.
Medium of disclosure	Management should use its discretion in determining the appropriate medium and location of the disclosure.	The authorities are empowered to mandate the use of specific media and locations for disclosures.
Exemptions	No exemptions, but paragraph 771 of CP3 makes it clear that disclosure is applied at the top consolidated level with individual banks within groups only expected to disclose Total and Tier 1 capital ratios.	The authorities may partially or completely exempt entities from disclosure if they are included within equivalent disclosures provided at a group level by a parent undertaking established outside the EU.

PricewaterhouseCoopers LLP

If you would like to discuss any of the issues arising from the proposals, please speak to your usual contact at PricewaterhouseCoopers, or one of the people listed below.

UK regulation

John Tattersall Regulatory	john.h.tattersall@uk.pwc.com	+44 (0) 20 7212 4689
Richard Smith Credit Risk	richard.r.smith@uk.pwc.com	+44 (0) 20 7213 4705
Andrew Gray Operational Risk	andrew.gray@uk.pwc.com	+44 (0) 20 7804 3431

EU regulation

Charles Ilako EU Regulatory	charles.ilako@uk.pwc.com	+32 (0)2 710 7121
Richard Quinn	richard.quinn@uk.pwc.com	+44 (0) 20 7804 9991
Monika Mars EU Credit Risk	monika.mars@nl.pwc.com	+31 20 568 4537
Benoit Catherine EU Financial Risk	benoit.catherine@fr.pwc.com	+33 1 56 57 12 38

PwC's UK Financial Services Regulatory Consulting Group comprises 100 partners, directors, managers and staff dedicated to providing pro-active regulatory advice to authorised firms and other financial institutions within the UK, Europe and elsewhere. Our team blends the experience of former senior regulators, compliance managers, industry personnel and staff with an assurance/client facing background, to provide clients with an unparalleled knowledge of the regulatory rules, codes of conduct and the prudential supervisory framework.

This bulletin is produced periodically to address important issues affecting the financial services industry. If you wish to receive it by e-mail or if any of your colleagues would like to be added to the mailing list or if you do not wish to receive further editions, please write to:

Jackie Dowsett
PricewaterhouseCoopers
Southwark Towers
32 London Bridge Street
London SE1 9SY

Or send an email to:
jackie.m.dowsett@uk.pwc.com

PricewaterhouseCoopers (www.uk.pwc.com) is the world's largest professional services organisation. Drawing on the knowledge and skills of more than 124,000 people in 142 countries, we build relationships by providing services based on quality and integrity.

("PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.)