Brussels, 28th September 2005

# European Parliament votes to accept Commission proposal for a Capital Requirements Directive for credit institutions and investment firms - frequently asked questions

## What is the purpose of EU capital requirements rules?

Capital requirements rules stipulate the minimum amounts of own financial resources that credit institutions and investment firms must have in order to cover the risks to which they are exposed. The aim is to ensure the financial soundness of these institutions – in particular to ensure that they can weather difficult periods. This is aimed at protecting depositors and clients and the stability of the financial system. In the EU harmonised capital requirements are a key component in the single market in financial services: mutual recognition of requirements is the basis for credit institutions' and investment firms' "single market passport", which basically means that they can operate throughout the EU on the basis of approval by the appropriate regulatory authority in their own Member State.

## What is new about this proposal (as compared with the existing legislation)?

Capital requirements will become much more risk-sensitive, be far less crude than in the past and better cover the real risks run by the institution. This will enhance consumer protection and financial stability and lead to more efficient capital allocation.

Capital requirements will be more comprehensive than in the past. In particular they will cover 'operational risk' (such as the risk of systems breaking down or people doing the wrong things). This is an increasingly important risk for financial institutions.

The new rules include requirements for an 'internal capital assessment' by financial institutions, where they will need to assess their capital needs considering all the risks they face, and a 'supervisory review process' for supervisors to evaluate institutions' overall risk profile to ensure that they hold adequate capital.

The new rules also require credit institutions to disclose certain information publicly in order to increase the levels of 'market discipline' supporting the soundness and stability of financial institutions.

Finally, the new framework enhances the role of the 'consolidating supervisor' responsible for the top-level of supervision of an EU cross-border group, i.e., the national supervisory authority in the Member State where the group's parent institution is authorised.

This role now includes new responsibility and powers in coordinating the supervision of cross-border financial services groups. This includes coordinating the treatment of an application by such a group for approval to use the more sophisticated capital calculation rules. All supervisors concerned in such an application should reach an agreed decision on the application within six months. In the case of failure to do so, the consolidating supervisor would be empowered to make a decision. This is a major step forward in recognising that dealing with multiple supervisors can impose inappropriate burdens on financial institutions operating in several Member States.

## What is the 'Standardised Approach'?

This approach is similar to the existing rules: it is straightforward to use and does not require institutions to provide their own estimates of risks. It incorporates enhanced risk-sensitivity by permitting the use of, for example, external ratings of rating agencies and export credit agencies. It also permits the recognition of a considerably expanded range of collateral, guarantees and other 'risk mitigants'. It includes reduced capital charges for retail lending (6% as compared with 8% previously) and residential mortgage lending (2.8% as compared with 4% previously).

## What is the 'Internal Ratings Based (IRB) Approach'?

A significant step forward in prudential regulation, it allows institutions to provide their own 'risk inputs' – such as probability of default, loss estimates – in the calculation of capital requirements. The calculation of these inputs is subject to a strict set of operational requirements to ensure that they are robust and reliable. They are incorporated into a formula which produces a capital charge for each loan or other exposure that the institution has. The formula is designed to achieve a high level of soundness of the institution in the event of economic difficulties.

The IRB approach comes in two modes. The 'Advanced' mode allows institutions to use their own estimates of all relevant risk inputs, and is likely to be chosen by the biggest and most sophisticated institutions. The 'Foundation' mode requires institutions only to provide the 'probability of default' risk input. This will enable a large number of less complex credit institutions to reap the benefits of the risk-sensitivity provided by the IRB approach.

## What is operational risk?

Operational risk is the risk that financial institutions suffer losses due to problems with their systems or processes or due to human error or as a result of external events. This is an important area of risk for financial institutions. The proposals introduce capital requirements to ensure that institutions are resilient to such risks.

In the proposal, three methods of calculating the capital requirements for such risks are made available: the simplest, based on a percentage of total gross income; an intermediate approach which requires activities to be ascribed to eight different business lines; and an advanced approach which relies on institutions' own calculations of operational risk.

### Who will be covered by the new rules?

The new framework – like the current rules – applies to all credit institutions and investment firms in the EU.

### How will investment firms be affected by the proposals?

The EU Single Market in financial services requires that the same activities giving rise to the same risks should be subject to the same capital charge. The rules should cover both credit institutions and investment firms, because often these businesses are competing, and do face the same risks. However, the new framework contains a number of different treatments to reflect the fact that investment firms do not always face exactly the same risks as credit institutions.

### Is the new EU framework a disadvantage or burden for smaller firms?

The proposal is designed for financial institutions of all sizes and complexities. It provides approaches of different sophistication and obliges Member States to apply the rules in a proportionate manner, taking account of the size of the institution.

To make the new rules only available to internationally active credit institutions would put all other credit institutions at a considerable competitive disadvantage. They would not benefit from lower capital requirements for core banking business (e.g., SME lending, mortgages) and they would be seen by the market as 'second tier credit institutions' operating under outdated rules, with matching funding costs. This would expedite consolidation of small credit institutions in the EU rather than protect their present position.

### What are the Trading Book rules?

Further work has been carried out by the Basel Committee and IOSCO – the Trading Book review. There are new rules which introduce more state of the art rules for trading activities. These will be introduced into EU legislation – they are important for all firms who are active in trading activities and important for the international level-playing field.

### How does the proposal benefit small-and-medium size enterprises (SMEs)?

Capital requirements are one of the factors that can affect the availability and cost of lending to (and other forms of financing of) SMEs. The risk-sensitivity of the new framework means that it is possible to reflect the fact that it is less risky to have a large number of small loans than a small number of large loans. This results in lower capital requirements for lending to SMEs.

The proposal also recognises that for certain forms of equity financing (venture capital) carried out as part of a sufficiently diversified portfolio the risks are lower than in the case of individual equity exposures. Accordingly a preferential capital charge is provided for this kind of financing.

A report prepared by PriceWaterhouseCoopers at the request of the European Council indicates an overall beneficial outcome for SMEs (see http://europa.eu.int/comm/internal_market/regcapital/index_en.htm)

### What is the implementation date for the proposed Directive?

The implementation date will be 1 January 2007. In order to allow reasonable transition arrangements, institutions will be able to continue to use the existing rules as an alternative until the end of 2007. And the most sophisticated approaches to credit risk and operational risk will be available at the start of 2008.

### Why doesn't the Directive go further in moving to a lead supervisor?

The new rules ensure that EU financial groups do not have to make multiple applications to different supervisors in order to use the most sophisticated capital approaches. It also ensures that a decision is taken in a timely manner - within six months. We regard this provision as one of the most important provisions in the proposal. But before moving any further in discussing the allocation of supervisory responsibilities, we need to answer the question of who will ultimately pay the bill if financial institutions get into difficulties.

### How will coherent implementation of the new framework be ensured?

The new framework incorporates harmonised state-of-the-art prudential rules and means that the opportunities for regulatory arbitrage will be very significantly reduced. This will have significant beneficial effects in enhancing the level playing field within the Single Market.

The rules incorporate important requirements for supervisory authorities to work together so as to ensure an efficient and proportionate regulatory environment for cross-border groups. The Directive will also oblige supervisors themselves to publicly disclose how they implement and apply its rules in practice.

The Committee of European Banking Supervisors (CEBS) will play an essential role in ensuring consistency and convergence in the application of the new framework. Such a role forms a key part of its mandate and of the reason for its establishment.

### What is the Basel Committee?

The Basel Committee on Banking Supervision ('the Basel Committee') consists of central bank and supervisory authority representatives from the thirteen 'G10' countries. Nine EU Member States are represented – Belgium, France, Germany, Italy, Luxembourg, the Netherlands, Spain, Sweden, and the UK. The other countries represented are Canada, Japan, Switzerland and the US. The European Commission, along with the European Central Bank, participates as an observer in the Committee itself and in its many working groups.

### What is the Basel Accord?

The 'Basel Accord' is an agreement on capital requirements amongst the members of the Basel Committee. 'Basel I' was agreed in 1988.

Although strictly speaking it only applies to internationally active banks in the G10, the Accord has been applied to most banks in 100 countries throughout the world.

While it has made a significant contribution to financial stability and consumer protection, Basel I is now viewed as outdated. Accordingly since 1998 an intensive exercise has been conducted to revise the Accord ('Basel II) and, in parallel, the EU capital requirements legislation. Final proposals were made by the Basel Committee in June 2004 and, for the Trading Book Review, in July 2005.

## What is the link between the Basel Accord and EU legislation?

The existing European legislation, the Codified Banking Directive of 2000 (originally the Solvency Ratio Directive of 1989) and the Directive on the capital adequacy of investment firms and credit institutions of 1993) was based on the Basel I Accord of 1988 and the Basel market risk amendment of 1996. It applies to all credit institutions and investment firms in the EU.

In order to maximise consistency between the EU legislation and the international framework, the European Commission and EU members of the Basel Committee have had as a primary objective ensuring the suitability of Basel II for application in the EU Single Market.

Accordingly, the new Basel agreement represents the appropriate basis for the proposed EU Directive on a new capital requirements framework. At the same time the EU legislative proposal has been designed to fully reflect the specific features of the European context – in particular its application to the full range of financial institutions including credit institutions of all sizes and levels of complexity and investment firms.

Examples of such "EU adaptations" in the proposed Directive include:

- more detailed rules on partial use which would allow less complex institutions to make use of the more sophisticated methodologies for some of their portfolios while using the simpler methodologies for others
- tailoring of the new operational risk requirements in their application to low- and medium-risk investment firms. Such firms may be permitted to continue to use the existing 'expenditure-based requirement'
- specific rules on how the applications of cross-border groups for approval to use the more sophisticated methodologies should be handled. There would be only one application process which would be channelled through the 'consolidating supervisor'. A decision should be made within six months by the different supervisors acting together
- lower capital requirements for credit institutions' 'venture capital' business, which is key for the financing of small start-up companies in some Member States and to achieving the Lisbon growth and competitiveness target.