

**REVIEW OF CAPITAL REQUIREMENTS**

**Response on Commission Services'  
Third Consultation Paper  
LIBA/ISDA**

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**LIBA**

LONDON INVESTMENT BANKING ASSOCIATION  
6 Frederick's Place  
London, EC2R 8BT  
Telephone: 44 (20) 7796 3606  
e-mail: [liba@liba.org.uk](mailto:liba@liba.org.uk)

**ISDA**

International Swaps and Derivatives Association, Inc  
One New Change  
London, EC4M 9QQ  
Telephone: 44 (20) 7330 3550  
website: [www.isda.org](http://www.isda.org)

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### **Introduction**

LIBA and ISDA (The Associations) welcome the opportunity to comment on the Commission's Third Public Consultation on the proposals to review the capital adequacy framework for credit institutions and investment firms.

The degree of consultation on this set of proposals over time is unprecedented and we appreciate the Commission's continued commitment to such an open process. We very much hope that this latest phase of consultation will facilitate further progress and refinement.

In our response, as in our earlier responses to the Commission's Consultative Papers, we focus on the issues of most concern to our Members. In the introductory section we highlight general themes and principles, while in the body of the response we comment in detail on the substance of the Commission's proposals.

### **Consistency with Basel - Implications for the trading book and capital markets**

From the outset LIBA and ISDA have supported the need for reform of the Capital Framework. Consistency of the EU legislative framework with the international Basel Accord is a primary objective, provided that the EU fully and appropriately accommodates features specific to the EU that are not shared by the Basel template.

It is well understood that the EU must ensure that its capital adequacy framework is suitable for investment firms as well as banks, whereas Basel addresses itself solely to the banking community. LIBA and ISDA from the outset have supported the principle that the same risk should be subject to the same approach if the rules are appropriately calibrated for all affected types of firm. However, in the EU, particular emphasis must be paid to the impact on capital markets via both direct amendments (e.g. new definitions of the trading book) or indirect amendments (i.e. the application of credit risk mitigation approaches and the impact of changes to the assessment of counterparty risk).

To date, no meaningful pan EU impact study has been conducted on the effects of changes to the trading book environment on the capital markets and on the firms (both banks and investment firms) who are most active in them. We believe it is essential that an effort is made to review and analyse the impact and incentives that will be created by the new framework. The many changes that affect the trading book environment and hence the capital markets have a cumulative effect that as yet is not fully understood. In addition the proposals on unsettled transactions and the future treatment of Collective Investment Undertakings are of particular importance and concern.

We fully support the contribution that the Basel Accord and EU Directive will make to enhance financial stability on the global, regional and local levels. This is wholly desirable. Nevertheless, the EU framework will also shape the Single Market in terms of its competitiveness internally and also in its ability to compete with the rest of the globe. In the context of global capital markets that are heavily inter-connected, we ask the Commission to reflect carefully on the implications of the trading book proposals for the stability and competitive strength of the EU capital markets.

In order that our detailed response on Trading Book items is understood in its proper context we should clarify that we do not include any discussion of items that we understand either to be a continuing subject of debate in Basel, or where we believe that Basel will shortly be turning its attention. The list of issues includes in particular:

- Maturity Adjustment for very short term transactions under the IRB approach
- Revision of treatment for OTC Derivatives/Repo style transactions (e.g. consideration of the proposals for Expected Positive Exposure)
- VaR treatment of counterparty exposure for repo and securities financing transactions (specifically details concerning backtest and multiplier)
- Further revisions to treatment of credit derivatives: namely specific risk offset and treatment of add-ons.

Although our response does not discuss these items it is critical that these issues are reconsidered by Basel as obtaining the correct treatment for these areas is vital to the ongoing efficiency of capital markets by ensuring capital is aligned to risk. We are hopeful that the delay to finalisation of the Accord, which was recently announced, will provide an opportunity for these items to be reconsidered by the Basel Committee and changes made to the Basel Accord. We urge the Commission to lend its support to the urgency and attention with which Basel should address these issues. We would also ask that the Commission encourage national regulators to think about these issues.

## **Timing**

As the Commission is aware from our previous submissions, LIBA and ISDA have supported parallelism of timing and content with the new Basel Accord. We continue to do so, subject to our comments on the need to take due account of EU specificities, which we know the Commission itself is anxious to achieve.

Despite time pressures, however, we urge the Commission very strongly to present its proposal for a directive only when the Revised Accord has been signed. It will be difficult to achieve parallel timing of implementation but it is vital since a significant gap between the implementation dates for Basel and the EU will lead to considerable competitive and cost of compliance burdens. We recognise also that there is only a very short time available to permit the European processes to be completed if the implementation date of 2007 is to be met notwithstanding the recent Basel press release that the Accord will not be finalised until 2004.

However, if the Accord is not signed at the time the proposal for a directive is adopted, we are gravely concerned that it will be difficult or impossible to shape the directive proposal in such a way as to allow for the appropriate changes to be introduced during negotiation. Some key elements of the directive proposal will need to be amended very swiftly to take account of new technical developments as they emerge from Basel (notably in the derivatives/repo field). We understand that some late changes of this nature can be accommodated in the negotiation process and very much welcome and rely upon this crucial ability.

Nevertheless if late developments in Basel were to prove more far reaching than imagined at the outset of the EU negotiation, these amendments may be perceived as being conceptually too ambitious, or too wide ranging to be acceptable. In such a scenario, the Basel and EU frameworks would be divergent until the EU process were able to re-consider the new material, leading to a substantial delay before the EU regulations and Basel could be brought into consistency.

### **Flexibility, structural change and looking to the future**

Flexibility is a key theme in the Commission proposals. The European Parliament noted in its 2002 report on the implementation of the Own Funds Directive that it was important that Europe did not legislate for yesterday's market. The Basel Accord is intended to be evolutionary and it is essential to mirror this capability in the EU. To this end LIBA and ISDA wholly support the Commission's approach of separating core provisions from technical annexes. In broad terms we believe that the Commission has applied extremely good instincts in distinguishing between the core text and annexes.

The capacity to be flexible is not enough, however. It is vital that there is a clear, transparent and accessible process created in order to:

- (a) Identify those technical issues that require amendment/evolution
- (b) Consult upon the structure and content of technical changes – it is imperative that interested parties from both the banking and securities industry are able to shape the proposals.

If such a two fold process is missing, or fails to involve all relevant industry participants then critical issues will be over looked, priorities mis-allocated and poor or incomplete solutions put forward.

The structure of the EU processes will, of course, shortly be based on the Lamfalussy style model. This is welcome in terms of enhanced ability to review and amend aspects of legislation. Nevertheless, the new committees segregate banking, securities, insurance and conglomerates and as we understand it will devolve the prudential framework for banks and investment firms to the banking committees. We have already seen through the Basel process that a bank centric analysis and model is not wholly suited for the EU single market. The EU structures could therefore restrict or exclude the result in the

perspective of investment firms and the interests of banks when undertaking investment services being restricted or excluded.

The majority of the comments contained in our response to the Commission now express the fact that trading and capital markets issues have been marginalised in the current Basel process. In this context we urgently seek a more inclusive approach within the EU to ensure that all relevant views are taken fully into account when future changes are considered. In practical terms this means greater integration and not segregation and this process must begin with transparency and consultation on future amendments to the Risk Based Capital Directive.

### **Consistency of Implementation**

Due to the complexity of the Risk Based Capital Directive and its greater emphasis on qualitative standards, consistency of application will be as hard to achieve as it is desirable. Different national jurisdictions need to interpret the new and complex framework in the context of their own history, experience and circumstances. This is fully appropriate as the principle of subsidiarity is well understood in the EU.

However, the scope for considerable divergence in practice is too high and will have far reaching implications. The first round effect will fall on firms operating across the Single Market but ultimately the costs and the risks of inconsistent prudential application will fall upon the individual depositors and investors. More encouragingly, there is scope for enhanced mutual understanding by regulators and industry as a result of the new framework, via intelligent operation of the Supervisory Review Process. The Associations have worked together with the European Banking Federation to prepare comments on the Supervisory Review Process which forms a part of this response. For both stability and competitive reasons there must be structure and incentives to encourage consistency of approach. Consistency will be achieved best over time, ideally via a process of convergence rather than coercion. Crucially, consistency of approach does not mean “identical approach” as this would violate the principles of subsidiarity and proportionality.

We believe that consistency and convergence will be best achieved through serious application of supervisory disclosure and transparency of future amendments to the legislative framework. A more developed articulation of lead supervision arrangements should have much to offer in terms of greater consistency and convergence. We believe that there are ideas in the context of lead supervision arrangements that can be debated fruitfully in the context of our increasing experience of lead supervision and coordination approaches under the Financial Groups Directive. We strongly welcome the favourable comments the Commission has made with respect to supervisory disclosure. We comment further on this topic in the body of our submission.

We do not, however, believe that convergence can be legislated for and prescription of approach should not feature in the draft directive text as this is likely to frustrate the ability of supervisors to converge towards each other in a spirit of deeper dialogue and

enhanced mutual understanding of each other's circumstances and local markets. We look forward to imaginative and flexible approaches being developed by supervisors. This can be supported by an expectation expressed in the directive text that greater mutual co-operation is an important objective. We would be disappointed however if the directive were to constrain the supervisors' room for manoeuvre.

## **Disclosure**

At present it is proposed only that individual firms make disclosures and that Member State supervisors exchange information. It will be impractical for private third parties to aggregate the former and it is intended (rightly) that the latter remains confidential. Supervisory disclosure, building on varying degrees of disclosure already in operation in a number of Member States would redress this imbalance.

Supervisory disclosure is a simple, cost efficient policy built upon the same principle as market disclosure: namely that the market can inform and discipline implementation. Consistency of approach in the new and multi faceted capital regime needs to be supported. Supervisory Disclosure is a straightforward, neutral mechanism to adopt.

We suggest that Member State competent authorities publish, in standard format, data in three core areas:

- (i) national standards and rulebooks;
- (ii) the take up of the national discretions;
- (iii) aggregate statistics on the impact of national implementation.

The third element is essential. It is only by these means that the market as a whole can obtain a meaningful overview of the application of the revised capital regime. The identity of eligible ECAIs as well as the spread of the more sophisticated approaches (Credit risk IRB, Internal Model recognition for Market Risk and Operational risk AMA), can only be achieved via this route. If these requirements are built into the foundations of the new regime then data collection can efficiently be made part of the required EU regulatory reporting regime.

This proposal has the merit that it is entirely neutral in respect of national supervisory practice. Its purpose is simply to make transparent the approach of Member States and the impact this approach has in each jurisdiction. This information can then inform debate on any necessary changes to the EU framework and any material divergences in implementation to the extent that they threaten the achievement of a Single Market in EU financial services.

Finally we would point to the very practical benefit of supervisory disclosure to financial institutions and other financial markets participants. For example firms could easily access information on the take up of the various national discretions, enabling a more efficient basis for the transaction of cross border business within the EU.

On a separate issue we strongly support, the position articulated in Article 128(2) that “requirements to hold an amount of own funds higher than that prescribed in Article 3 shall not be published.” Individual capital adequacy requirements are, or should be, the end result of a complex process. They are not intended to be a short hand regulatory “credit rating” which those outside of the regulatory process would be unlikely to interpret effectively or accurately. Mandatory disclosure of such information would be likely to inhibit regulators to the extent that the application of Pillar 2 would become extremely sporadic.

The European Banking Federation has developed some more detailed proposals on the topic of supervisory disclosure which we believe offer some very rich possibilities. We agree with the core tenet that Supervisory Disclosure should become part of the new regime and would welcome the opportunity to contribute to a wider debate on this topic.

### **Scope of Application**

The scope of application at which the new capital requirements should apply is a running theme in our response. The scope of application is not quite the same concept as scope of consolidation. The level at which minimum capital requirements should apply is not the same question as the level at which all qualitative standards for Pillar 1, or the Supervisory Review Process or Market Disclosure standards should apply. We urge the Commission to consider these issues carefully and come to a risk sensitive view of an appropriate level of application of the various elements of the new capital framework.

Our fundamental view is that applying the full weight of the new capital framework in a blanket manner to each individual entity within a group will obscure and obstruct the benefits of the revised Approach. The risk management capabilities that the Supervisory Review Process is designed to foster and the transparency meaningful risk profile that Market Disclosure is meant to achieve will be lost. Furthermore there is a practical impossibility of creating an Advanced Measurement Approach calculation for Operational Risk at each individual entity, although a calculation at a group level coupled with an allocation of capital to an individual firm is well within our grasp. We trust that the Commission will take a risk sensitive and pragmatic approach.

## 2 TECHNICAL AREAS UNDER PILLAR 1

### **I Consolidation**

#### **Context of issues**

In its response to the structured dialogue of November 2002, the Commission has articulated some very positive messages which we welcome.

In the context of the following concerns which were previously identified:

- Different approaches to the advanced approaches for credit and operational risk in different jurisdictions will lead to a group complying with multiple sets of advanced approach approval requirements;
- Differential exercise by member states of national options will place a significant burden on internationally active firms;
- The proposed Directive imposes significant multi-level reporting burdens.

The Commission responded to these issues in its Explanatory Document in the following manner:

1. Differential application of supervisory approaches result from the jurisdictionally based establishment of separate legal entities and the authorisation and supervisory powers of individual member states. The Commission is giving further consideration to alleviating the burdens of differential application, within these constraints. The explanatory document suggests that one approach could be to use the 'co-ordinating supervisor' required under the Financial Conglomerates Directive.
2. Authorisation and Supervision of firms remains the responsibility of the competent authority of each member state. The Commission states that it is committed to ensuring that prudential requirements imposed on groups are not disproportionately burdensome.
3. The Commission remains committed to a group-wide consolidation and sub consolidated capital view of financial services groups to prevent double gearing of capital and down-streaming of debt. It acknowledges that this creates a compliance burden and is open to a potential exemption of the application of capital requirements to all levels in a group in a few, tightly defined cases.

Our response to the Commission's November document also asked that the definition of a group should not be based on the concept of "close links" (as introduced by the Post BCCI directive). Although the Commission has not commented on this item in its recent

release, the definition has been amended (and close links reference removed). This is very welcome as otherwise the concept of “horizontal consolidation” whereby entities that were not necessarily connected via ownership links, but via “influence” would be included in the consolidation.

## **Objective**

In essence, we seek an application of individual and consolidated requirements according to the following ideal outcome:

- Compliance with the Directive and associated reporting should apply at a consolidated level to the ultimate EU parent (whether a parent institution, as defined in the directive, or Financial Holding Company).
- In addition Competent Authorities should have the ability to apply sub-consolidated requirements at the level of any sub group headed by a parent undertaking institution. Such sub-consolidation should not be mandatory but be applied at the discretion of the ultimate Home State Competent Authority, acting on the basis of consultation and co-operation with the appropriate Competent Authorities in any other EU territory in which the sub group has a presence.
- Finally, the directive requirements should apply at individual regulated entity level except where certain robust criteria are met, in which case the Competent Authority should have the discretion to waive unconsolidated capital adequacy requirements.
- The consolidation would be carried out according to pillar 1 implementation standards and national discretion options established by home state regulator after consultation with the appropriate host state(s).

## **Discussion of Commission Proposals - Interpretation of Articles 16-18**

We recognise that the Commission wishes to ensure consistency with the Basel Committee’s requirements set out in Basel CP3 which insist on consolidation at each level at which there is an internationally active bank.

An essential starting place to the dialogue is a common understanding of the consolidation requirements the Commission has set out. Hence, we preface our main comments by offering our understanding of the textual provisions set out in the Commission’s Working Document. Our comments should thus be seen in the light of this interpretation. We realise that the Working Document may have been further refined since the publication in July, and we attach a copy of the relevant articles for ease of reference, in an annex to this document.

**Art 16** requires individual capital requirements on an unconsolidated basis

**Art 17(1)** requires consolidation where there is a parent entity that is itself a credit institution or investment firm.

**Art 17(2)** requires consolidation even where the parent of a group is not itself a credit institution or investment firm. Note that this article falls short of requiring consolidation where there is Mixed Activity Holding Company.

**Art 18 (1)** imposes mandatory sub-consolidation for any sub group within the wider group where a credit institution or investment firm is itself a parent entity and the sub group is not wholly domiciled in the same Member State jurisdiction.

**Art 18(2)** refers to sub groups of an investment firm or credit institution where all entities within the sub group are in the same Member State. In this case 18(2) attempts to offer some flexibility in relation by indicating that the sub-consolidation need only be demanded if it meets specific supervisory needs. It is not intended to be a mandatory requirement.

**Art 18(3)** is an alternative option to 18(1) and states that sub-consolidation is not required for sub groups not wholly within the same jurisdiction, providing that the holdings/investment in the specified subsidiary entities are deducted from the capital of the parent of the sub group.

**18(4)** specifies further requirements concerning the capital deductions set out in 18(3) for the purposes of calculating the individual capital requirements of the parent of the sub group to which this alternative (non consolidated) treatment has been applied.

**Art 19** includes ancillary services undertakings within the consolidation or sub consolidation of Articles 17-18.

**Art 20(1)** For the purposes of calculating the individual capital requirements, where an entity is a parent of a sub group that is subject to sub consolidated capital requirements, it need not make certain capital deductions in respect of the entities in the sub group.

**Art 20(2)** For the purposes of calculating the individual capital requirements, where an entity is a parent of a group and is subject to consolidated capital requirements, it need not make certain capital deductions in respect of the entities in the group.

**Art 21(1) and (2)** Sets out the requirements for disapplying consolidated requirements for investment firm groups. A key criterion is that there may be no credit institutions within this group in order for this concessionary treatment to apply. Moreover the group must be entirely within a single jurisdiction, not undertake principal positions nor hold client monies. Systems and controls must be in place to monitor the capital and funding within the wider group.

## **Individual requirements**

We recognise that the supervisor, who grants authorisations to credit institutions and investment firms will want the power to apply capital requirements to all credit institutions and investment firms individually. This has always been a central tenet of supervision in order to ensure that capital is - in place to protect depositors and investors.

This issue runs deeply through the entire capital framework because the level of application of the minimum capital requirements as well as the scope of application of more qualitative issues and the Supervisory Review Process and Market Disclosure must also be considered. In other words, there is a need for there to be a careful consideration of the scope of application of all the three “Pillars” of the new capital framework..

Discussing the scope of consolidation and the quantitative minimum capital requirements from “Pillar 1” in the current legislation, however, there is an option to disapply individual requirements. This option is not presented in the EC Working Paper, but we hope the EC will be sympathetic to the concept of re-introducing this layer of flexibility, subject to robust criteria being established to ensure the location of capital to support the risk of the business.

In essence, there are certain structures where two firms (where one or both is a regulated entity) are managed on a sufficiently integrated basis that we believe the “unconsolidated” information for the regulated firm would be less meaningful than the two firms treated on a consolidated basis with each other.

We appreciate that the conditions under which this option could be offered will be of vital importance and we have reviewed the criteria set out in Article 19 of the Consolidated Banking Directive [2000/12/EC] as a departure point for assessing the standards that would be an appropriate basis for permitting a waiver.

Article 19 sets out the conditions applied to financial institutions as a basis for permitting the use of the passport within the EU. As these conditions apply to firms which are not themselves regulated, but are to be offered the latitude of a passport, we believe that these conditions may act as a point of departure for establishing conditions under which a “waiver” from individual requirements may be provided to regulated firms. We summarise and comment on the conditions from Article 19 that we believe are the most relevant below.

We believe that the following three points, taken together, demonstrate that the capital, the management and control for the firms in question would be subject to the most integrated and stringent standards and would ensure the access to and mobility of capital that will be essential to any waiver permission. These standards do not represent any diminution of the high prudential requirements that any regulated firm should meet on an individual basis.

- **Ownership and voting rights:** “the parent undertaking or undertakings must hold 90% or more of the voting rights attaching to shares in the capital of the subsidiary”.

The precise percentage may not be 90%, however the central point is that the parent can exercise unfettered control over the subsidiary.

- **Subsidiary must be subject to prudent management standards and its commitments guaranteed by its parent:** The core principle is that the parent assumes unambiguous responsibility for the liabilities of its subsidiary. A guarantee mechanism may not be the most appropriate way of achieving this degree of certainty of parental support (i.e. tax or other reasons may make this an inefficient solution), but the principle is not in doubt.
- **Subsidiary to be included in the consolidated supervision of its parent:** This point is so central it may not need to be made.
- **Home Member State responsibility:** “Compliance with these conditions must be verified by the competent authorities of the home Member State and the latter must supply the subsidiary with a certificate of compliance.” AND “The competent authorities of the home Member State shall ensure the supervision of the subsidiary.” This criterion emphasises the centrality of regulatory co-operation and we hope will build on the lead regulation model.
- **Reporting Requirement:** There would also be an obligation to be able to report the amount of own funds, but not the unconsolidated capital ratio of the subsidiary. This standard, importantly confirms the location of the capital within the “waived entity” but does not require supplementary capital adequacy reporting, that should be redundant in the context of the integrated management, ownership and control of the two institutions.

## **Sub Consolidation**

We strongly welcome Commission’s signals supporting flexibility in the treatment for sub-consolidation that it has proposed. The potential to disapply sub-consolidated requirements where the sub group is completely located in a single Member State ensures that supervisors and financial groups can conclude on the most meaningful provision of data to the authorities within a single jurisdiction.

Nevertheless, we believe that this same flexibility can and should be extended to groups active in more than one territory, but within the EU single market. This necessary extension of flexibility can be offered prudently and can do much to underpin enhanced regulatory dialogue at the international level, between Member States, building as it will upon a lead regulator model and relying upon supervisory co-operation.

We therefore recommend that the directive should require the regulator to assess the overall composition and condition of the group and then take decisions, in co-operation with fellow affected regulators, on the appropriate degrees of sub-consolidation that should be most meaningfully required from the group.

We note that should this greater flexibility in respect of sub-groups located in more than one jurisdiction not be available, then groups will necessarily have to re-assess the most efficient basis on which to locate their business across the EU. In some instances, firms would thus look to the “deduction” alternative outlined in Article 18. Alternatively firms will be likely to re-consider the balance of factors when making their decisions on subsidiarisation, branching and use of passport.

### **Other Issues - Large Exposures**

Certain Large Exposures issues arise in connection with consolidation. We refer the Commission to our remarks in the section concerning Trading Book issues.

## II Capital treatment of trading book items

### General comments

#### *Parallelism with the Accord reform process*

The Basel Committee acknowledges that to date the New Accord only partially and imperfectly answers industry concerns in a number of fields, notably the treatment of credit risk mitigation and the measurement of counterparty risk exposures.

On both fronts, ISDA and LIBA have advocated a review of the current proposals<sup>1</sup>, ideally before the New Accord is finalised, and failing this, immediately after its adoption. We understand that any delay in the finalisation of the Accord may permit the re-assessment of, at least, some of these issues. If this is the case, it is essential that the Commission structures the Directive in a manner flexible enough to allow the simultaneous implementation of any amended proposals in both EU and non-EU countries.

It would furthermore be extremely helpful if the Commission would support and press for a reassessment of remaining credit risk mitigation and trading book issues, including counterparty risk, in the Basel Committee itself.

Finally, any delay in the adoption of the new capital standards should entail a reassessment of implementation deadlines, taking due account of the time necessary for the transposition of the Accord in the EU. The primary objective should remain parallel implementation of the New Accord in all G-10 countries.

#### *Amendments to the first RBCD draft*

The Associations welcome the growing convergence between the Basel Committee's and the Commission's definition of "qualifying items", as well as the recognition by the Commission of valuation adjustments and cross product netting. We also applaud the extension of existing Large Exposures exemptions and reduced risk weights to firms using the Comprehensive Approach to measuring collateralised exposures.

We understand that the Commission is reviewing the capital treatment of unsettled transactions and trading book holdings of collective investment undertakings. Both of these issues relate to businesses which are material for our member firms; hence, depending on the approach adopted by the Commission, the amount of capital required against these activities could increase very significantly. Any capital increase should be evaluated against the costs and benefits that it will entail, for both firms and supervisory bodies. We focus on these areas in Section (a) and provide some elements of cost benefit analysis.

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<sup>1</sup> ISDA/TBMA commentary on Basel CP3, 31 July 2003, attached as Annex 2.  
LIBA/BBA response to Basel CP3, attached as Annex 3.

In Section (b), we offer additional comments on the definition of the trading book, material holdings, credit risk mitigation and the proposed amendments to the Large Exposures provisions of Directive 2000/12/EC.

### **Detailed Commentary**

We continue to have significant concerns on some areas of the Basel proposals. In the ISDA-TBMA response to CP3, which we append for your information, we noted a number of issues remaining in the treatment of counterparty risk. Two key issues are:

- The measurement of potential exposure on OTC derivatives is risk insensitive and inconsistent with the advances in risk sensitivity made in other areas of the Accord. We have urged the Basel Committee to address this area alongside a review of the treatment of securities financing transactions<sup>2</sup>. The Committee have agreed to address the issues although the timing of such a review is uncertain. We continue to press for a firm undertaking on this issue.
- The treatment of maturity is inappropriate. Inadequate recognition is given to the lower risk associated with very short-term transactions. ISDA-TBMA have put forward proposals for an alternative treatment of maturity. This area requires vital reconsideration particularly given the current discussions on settling and unsettled transactions, which are typically very short-term in nature.

We believe the optimal outcome for these issues is resolution at the Basel level and we would welcome support from the Commission on any review of these areas in Basel. Any resulting changes should be adequately incorporated into the European Directive. It is also essential that flexibility be introduced around implementation deadlines in areas where the Basel Committee is likely to amend the Accord post adoption but before the end of 2006.

#### ***(a) Capital treatment of Unsettled Transactions and CIU holdings in the trading book***

These exposures share a number of characteristics from a regulatory standpoint : they are treated differently across the G-10 and have come into focus relatively late in the Accord reform process. Partly for this reason, their proposed regulatory capital treatment has not been finalised, or even discussed fully in the relevant Committee or Commission working groups. It is also worth emphasising that therefore these areas have been excluded from or only partially included in the scope of past quantitative impact studies.

### **Unsettled Transactions**

Unsettled transactions currently give rise to a capital charge under Annex II of the Directive 93/6/EEC (the CAD).

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<sup>2</sup> See in particular ISDA-TBMA-LIBA recommendations in “Counterparty Risk Treatment of OTC Derivatives and Securities Financing Transactions”, June 2003 ([www.isda.org](http://www.isda.org))

The CAD requirement for unsettled transactions is limited to purchases and sales of securities [i.e. does not apply to repo, OTC derivative or spot FX transactions] and is levied purely on a failed settlement basis, after a grace period of 4 days has elapsed.

In reviewing the provisions of the CAD, the Commission is considering adopting one of the two following options: either maintaining the current treatment (while charging capital from trade date for transactions with deferred settlement) or charging capital on both pre-settlement and failed settlement risk. It is unclear how the Commission ultimately intends to choose between these very different alternatives.

The Associations would like to suggest the following way forward :

- (i) We recommend that the Commission maintains the current treatment. To amend the approach to unsettled transactions, or to charge capital from trade date has, in our view, the potential for significant impact on the functioning of the capital market, which could by far outweigh any improvement to the structure of the trading book treatment. We recognise, however, that time is limited for the Commission to undertake analysis and to study the likely effects of changes to its regulatory framework. In this context we believe that the most appropriate way forward is to retain the existing treatment.
- (ii) It is desirable that settlement risk be addressed on a consistent basis across the G-10. In practical terms this means that the issue should ideally be resolved at Basel Committee level, rather than EU level. However, if Basel itself is unable to undertake the requisite analysis of any proposed changes, then we maintain our view that changes to the trading book in this field are unwarranted, and could be damaging.
- (iii) The third consultation paper (CP3) issued by the Basel Committee on the New Capital Accord only indirectly mentions unsettled transactions, in paragraph 292, leaving national regulators free to disapply the one year maturity floor for short term exposures such as : “exposures arising from settling securities purchases and sales” and “exposures to banks arising from foreign exchange settlements”. The implication of this paragraph is in fact ambiguous. One reading is of course that these very short dated exposures would normally attract a credit risk charge, but how this charge is calculated and whether it would apply from trade date, settlement date or settlement date plus a grace period was not made explicit. An alternative reading is that paragraph 292 does not imply the need to introduce a charge if the national jurisdiction did not already have one in place. The revision of the Capital Accord, has after all, not been addressed primarily to the Trading Book except insofar as changes to the banking book have “read across.”
- (iv) ISDA and LIBA requested clarification of the treatment intended by the Basel Committee for counterparty risk arising (i) on a pre-settlement basis and (ii) from failed settlements, in their responses to CP3. The issue was also discussed at a meeting organised between the trade associations and the Credit Risk Mitigation

Sub-group of the Basel Committee in early September. Regulators noticeably disagreed amongst themselves as to the interpretation of paragraph 292. It quickly became apparent that the divergences of view originated from the diversity of regulatory approaches employed at present.

The only point of agreement amongst regulators and industry was the need to consider the treatment of unsettled and settling exposures as a subset of the broader “counterparty risk” topic, which the Basel Committee has tabled for review in 2004. In the meantime, regulators may continue with their current treatment or seek to converge towards a single standard, which may involve charging capital on pre-settlement profits, measured as the positive MTM differential between the two legs of a trade [with no haircuts or add-ons applied]. No firm conclusion was reached at the meeting, but we understand from further contacts that a position might have been agreed in the Capital Task Force or the Basel Committee.

- (v) The elements which we believe should be considered in determining a revised capital treatment for unsettled and settling exposures are the following:

*On the one hand*

- the introduction of a new operational risk charge that explicitly covers the operational risk of failing transactions;
- the impact of charging pre-settlement risk on firms’ capital ;
- the cost of building risk management systems tracking settling exposures;
- the scarcity of settlement losses due to default of the counterparty; this notably reflects mitigating factors and improvements in market practice - e.g. exchange settlement terms falling from T+3;
- the inadequacy of the current IRB capital function for capturing credit risk arising over extremely short periods of time. There is clearly a need for an appropriate treatment of maturity in the risk weight formula. If the maturity adjustment is not amended, capital requirements will be completely disproportionate to the risks involved

*And, on the other hand*

- the conceptual case for applying a credit risk charge, founded on the recording of profits from trade date and the similarity between settling cash transactions and repo transactions.

Although the Associations accept that there is a conceptual case for capitalising pre-settlement risk (an exposure is created from trade date, which in essence is similar to a repo exposure), the vast majority of trades settle without issue. Where there is a settlement loss, it is mostly due to operational reasons, and will be captured and capitalised as such under the New Capital Accord. We are also concerned that for firms to build systems capable of collecting the data required to calculate a pre-settlement charge would be extremely costly. Thorough testing of impact on banks’ and investment

firms' regulatory capital needs should be performed before a significant change of approach is agreed.

The Commission should in particular ensure that investment firms are included within the scope of an impact study, since a rigorous interpretation of paragraph 292 will affect trading institutions proportionately more than commercial banks. The Commission should also bear in mind that changes of the nature discussed above could adversely impact the community of small investment firms, for whom the costs implied might be disproportionately high. Finally, transactions settled on exchange or by Clearing Houses should continue to be exempt from a counterparty risk capital charge.

It may be difficult to run the cost benefit analysis and impact study mentioned above in the time remaining to finalise the Accord, although it may prove possible within the current delay. ISDA and LIBA stand ready to assist the Committee and the Commission in this respect.

### **Treatment of Collective Investment Undertakings (CIUs) in the trading book**

The Associations welcome the proposed application of the look through approaches to collective investment schemes (CIS) not authorised as UCITS. As stated in our letter dated February 3rd, 2003, the key to deriving appropriate market risk capital charges for these products is that the composition of each fund is transparent. We believe that the transparency and liquidity criteria identified by the Commission serve this objective.

We however remain deeply concerned that (i) the fall back 100% capital charge is unjustifiably onerous; (ii) the eligibility criteria for the full look-through approach may restrict it to a few firms, and maybe just to a few positions; (iii) the treatment of leverage and FX risks in the partial look-through approach must be reconsidered.

- (i) The fall back 100% capital charge is unjustifiably onerous

In view of the practical difficulties associated with the look-through entry requirements, a substantial proportion of firms' CIU holdings will attract a one for one capital charge. The fall back capital treatment is material, and must not be set at levels divorced from the true level of risk embedded in the CIU.

Conceptually, charging a Euro for Euro capital charge on all units falling outside the scope of the look-through approaches is, in our view, unjustified. We ask that the Commission articulate why these positions should routinely be subject to the same penal treatment as, for example, the concentrated default risk that exists in first loss credit enhancements in securitisation transactions when the risks associated with CIUs are much lower. As the Commission is proposing an increase in capital charge from 8%, under the current framework, to full deduction from capital, we would like to understand better the rationale behind such a significant change. It seems to us that the Commission is calibrating this charge on an extreme outcome, which is not consistent with the calibration of the rest of the capital framework.

Applying a 100% capital charge to CIU holdings in the trading book is furthermore inconsistent with the approach adopted in the banking book, where similar investments are subject to a considerably lower charge (depending on the underlying investments and the credit risk treatment elected by the firm, the charge would broadly be comprised between 8% and 32%), in spite of the considerably longer horizon of investment presumed in the banking book. In addition, under the Basel Committee's capital proposals, collateral provided in the form of UCITS or mutual funds is recognised and certainly does not attract a 100% haircut.

A Euro for Euro capital charge can only be predicated upon the belief that CIU structures are significantly leveraged. This is however not verified in practice. For instance, fund managers do not normally use derivatives to create naked exposures to market risk factors, but rather to hedge market risk arising from previous investments. Furthermore, identifying and setting capital against leverage risk for holdings in CIUs is conceptually debatable, as explained at 2 (iii) below.

Based on the above, we would suggest that CIUs should not in principle receive a charge higher than the highest market risk requirement applied to their main economic underlying (equity/debt/commodity). We had encapsulated these requirements in a table featuring in our February 2003 response on the first RBCD draft. We reproduce this table below for convenience.

Fund category	Capital Charge
Equity	16%
Broad based	8%
Money market fund	8%
Long term debt:	
-investment grade	14.1%
-non investment grade	20.5%

- (ii) The eligibility criteria for the full look-through approach may restrict it to a few firms, and maybe just to a few positions.

We understand the rationale for restricting the scope of the full look through approach [redemption in specie, minimum correlation] to be directed by the need to minimise basis risk between the value of the CIU and the value of the underlying portfolio. No charge would apply for basis risk provided that the correlation between the CIU and the underlying index was high. We appreciate the motivation for this policy, but would object that it creates a cliff effect around the threshold value for the correlation parameter, which can and should be avoided by setting capital against basis risk appropriately.

At the very least, some flexibility should be provided around the correlation test. We strongly believe that the requirement to measure correlation should be conducted using weekly, rather than daily prices. This would lessen the compliance burden on firms while providing a reliable measure of correlation, to an acceptable degree of accuracy.

- (iii) The treatment of leverage and FX risks in the partial look-through approach must be revised.

The Associations view these risks as akin to those a financial institution is exposed to where investing in debt issued by a corporate. The corporate's activities might be highly dependent on a currency distinct from that in which debt is issued, or indeed significantly leveraged. For the purpose of regulatory foreign exchange requirements however, only the currency of denomination of the debt item is relevant for determining its capital treatment, not any underlying currency exposure within the activities of the bond issuer. Similarly, leverage is only assessed implicitly via the credit rating of the corporate, where one exists.

We believe that an equally pragmatic treatment should prevail under the partial look-through approach to CIU holdings. For this reason, we argued in our commentary on the first RBCD draft that the relevant currency for establishing the existence of an FX risk charge should be that of the CIU itself.

As far as leverage risk is concerned, we do not see a rationale for capitalising it separately, at least on a systematic basis. Leverage risk is adequately addressed by the worst market risk charge approach adopted by the Commission, whilst unusual levels of leverage can be addressed as part of the supervisory review of the firm, by the supervisor possibly requiring a higher capital charge.

We understand that the Commission continues to review the prudential treatment of CIU investments and stand ready to assist in this process in any way the Commission would deem useful. We would in particular value any opportunity to meet with the specific working group addressing this issue.

### ***(b) Additional comments***

#### **Trading book definitions**

The Associations noted during the structured dialogue that loans should be eligible for trading book treatment, if transferable. In a number of instances, the borrower's acceptance of a transfer is needed for the transfer to become effective. The Associations do not however view borrower consent as a limitation on a loan's transferability, provided that such consent cannot be unreasonably withheld. We continue to recommend, for clarity and consistency, that the Commission formally include this definition of transferability in Annex G-1 of the Directive. Absent this degree of specification, we are concerned that regulators might adopt diverging definitions across the EU.

## **Material Holdings**

The EU regulatory capital regime has, since the introduction of the Own Funds provisions (in force since 1992), required the deduction of Material Holdings, namely holdings in the equity and subordinated debt of other regulated entities that exceed 10%. These provisions were slightly amended by the Financial Conglomerates Directive [2002/87/EC] which has expanded the scope of such deductions to holdings in insurance, reinsurance and insurance holding companies.

There are deep concerns related to the liquidity of the capital markets and the international level playing field which were raised at the time of the Financial Conglomerates Directive and which we understood could be addressed in the context of the Risk Based Capital Directive.

We urge that the directive be amended to distinguish clearly between structural investment positions that should be subject to material holdings provisions and trading positions which should be exempt. At present flexibility is only permitted in instances where financial assistance designed to reorganise and save the entity is required. If this amendment is made, we believe the adverse consequences noted below can be avoided.

### *Double gearing and the liquidity of the capital markets*

Provisions of Article 34(2), points (12), (13), (14), (15) and (16) of the Consolidated Banking Directive (as amended by the Financial Conglomerates Directive) are drafted on the presumption that such holding will give rise to double gearing. Where positions are held in the trading book and are marked to market they will generally not give rise to the same double gearing and contagion risks since they are typically not deliberate reciprocal cross holdings. Trading book holdings tend to arise when firms are underwriting or making a market in bank's securities or engaging in arbitrage or hedging activities.

It is important for financial stability reasons that the market in financial sector entities' capital instruments should be deep and liquid. We seek clarity in order to ensure that there is no unnecessary inhibition restricting firms' willingness and ability to invest and trade in such instruments and the consequent impact on the liquidity of the market.

### *International level playing field*

A significant concern raised during the negotiation of the Financial Conglomerates Directive was the new requirement for holdings in insurance companies to be deducted. It creates an un-level playing field at the expense of European institutions and is super-equivalent, in our view, to the Basel Committee's intention to deduct only reciprocal cross-holdings. This disparity between the EU and the rest of the world puts European credit institutions and investment firms at a competitive disadvantage. We do not believe that the recommendation to distinguish between investment and trading positions would lead to the structural cross holdings that the Committee has identified as a prudential concern.

## **Credit risk mitigation (CRM)**

The Associations continue to question fundamental aspects of the treatment of credit risk mitigation by the Basel Committee- see joint ISDA-TBMA comment letter on CP3, appended. Issues under discussion notably include the treatment of double default risk, the specific risk offset rule, as well as the suitability of credit default swap add-ons. We have also commented at length on the size of the proposed repo VaR multipliers, which we find highly questionable. We expect substantial progress to be achieved in the coming months by the CRM Sub-group on these topics.

We accept that the Commission is purely reflecting the contents of the New Accord in the RBCD provisions addressing CRM. On these grounds, greater consistency should be introduced between RBCD and Basel II regarding the treatment of collateralised derivatives transactions. The text at Appendix G-3, section 3.1.3.2 (top of page 28) is unclear, as it references an Article 27(4) that we have not been able to locate. We would strongly recommend that the Commission use the same wording as the Basel Committee, specifically paragraphs 157 and 158 of CP3.

The minimum requirements for legal certainty introduced in Annex E.2 are also inconsistent with Basel wording. Examples of this are Annex E.2 2.1.1 (2) which states that a netting agreement must give the non-defaulting party the “unfettered, legally enforceable right to immediately close out all transactions...” This has been revised in CP3 paragraph 144(a). Similarly the Commission paper requires at E-2 2.1.3.1 that “institutions must have appropriate legal opinions confirming the enforceability of collateral arrangements.” The Basel wording has been revised to note, “banks must have conducted sufficient legal review to verify this (enforceability) and have a well founded legal basis to reach this conclusion...” (paragraph 89 of CP3). Finally, the Commission also needs to update Annex E2 for changes made by the Basel Committee to the requirements imposed on credit default swaps with regard to restructuring events.

We note that any reference to the Advanced IRB approach has totally disappeared from the credit risk mitigation section of RBCD. The CRM treatment seems applicable to firms treated under the Standardised approach and Foundation IRB only. Although this is seemingly an editorial oversight, we would be grateful if it could be remedied.

The treatment of specific risk offsets in the body of the Directive has been brought into consistency with the Annex. However, we believe that most of article 103 should be transferred to Annex G-4, with only the application of a market risk charge to credit derivatives in the trading book mentioned in the body of the Directive.

We continue to find the representation of collateral [offset against LGD, in Annex E-3, 3.1.3.2. c(ii)] unhelpful. We believe that the capital regime should present collateral as being offset against exposures. The net exposure could then directly be used in the large exposures regime.

Finally, Article 70 states: “notwithstanding the existence of credit risk mitigation techniques that have attracted regulatory capital relief, institutions shall continue to undertake full credit risk assessment of the underlying exposure”. For repo-style transactions, the Associations continue to feel that this requirement is inappropriate and would be fundamentally inconsistent with firms’ internal practices, as the collateral and exposure pieces are completely interdependent. Monitoring the gross exposure on a repo-style transaction would not reflect its economic risk and would lead to considerable systems changes and costs for firms if introduced. The Associations nevertheless accept that there will be a need to monitor the credit quality of the underlying exposure, including for repo transactions. Clarifying the wording of Article 70 in this respect would be helpful.

### **Amendments to large exposures provisions (Articles 48-50) of Directive 2000/12/EC**

We have concerns regarding one of the proposed changes to Directive 2000/12/EC. Article 48(3) introduces a discrepancy in reporting requirements between firms using the simple approach to collateral, and those subject to the comprehensive approach. The Associations question the rationale for requesting that the latter report exempt exposures, where the former do not. Firms using the comprehensive approach have invested resources into decomposing collateralised transactions and estimating the volatility of financial collateral values. We fail to understand why reporting costs should be added to this investment, whilst less sophisticated firms are exempt. Regulators need to provide firms with an incentive to move to the more refined regulatory approaches, and adding reporting burdens on the more advanced firms runs contrary to this objective.

In addition, it would be useful to clarify if existing exemptions in the large exposures requirements (LER) will apply to the reporting of concentrated exposures to issuers of collateral. For example, a large part of derivatives collateral will consist of government bonds attracting a 0% risk weight. Such government exposures are exempt from LER reporting. It would be useful to know if government bonds collateral will be similarly exempt.

### **Credit valuation adjustments**

We welcome the Commission’s willingness to work on the area of credit valuation adjustments (CVAs) but note that this area may be impacted by the latest discussions from Basel on expected and unexpected loss. Alongside the outcome of such discussions we ask that the Commission consider how CVAs can be included within such a framework as this will be of importance to member firms.

### **III Operational Risk**

Members of ISDA and LIBA ('the associations') have set out their views on current Basel Committee proposals for operational risk in responses to the Committee and its Risk Management Group. Given that the current EU Commission proposals for operational risk largely mirror those of the Basel Committee, we attach the ISDA responses to the April 2003 Basel consultation.<sup>3</sup> Most of these are also briefly summarised below.

#### **AMA capital calculation**

We do, however, take this opportunity to underline our single most important point: our strong belief that the rules should allow firms to calculate capital under the Advanced Measurement Approach ("AMA") at group level and then allocate it, using internal methodologies based on internal indicators, to individual jurisdictions or legal entities. We are firmly of the view that the AMA will be impractical and therefore redundant if this ability is not explicitly included in the rules. At the same time, the rules need to factor in the possibility that methodologies could evolve, in ways that cannot yet be determined, beyond the current focus on gross income as an indicator.

In connection with this approach to the AMA, we note that Article 16 of the July 2003 Working Document applies capital requirements to "institutions on an individual basis". It should, however, be recalled that the 'Market Risk Amendment' (98/31/EEC), in our view appropriately, adopts a pragmatic approach to the level at which calculation of market risk should be made, referring broadly to "institutions".

In addition to this key point, we highlight here our comment on those aspects of the rules where the EU has attempted to take into account EU-specific factors.

#### **Beta factors**

As regards the impact of the proposals on investment firms, particularly the beta factors specified for use under the Standardised Approach, we note that the process by which these have been generated has been unsatisfactory. They are meant to deliver a charge equal to an average 12%-of-existing-minimum-capital-requirement, yet this average amount was calculated exclusively in relation to firms other than investment firms. At the same time, the system of betas inherently assumes a) a spread of business lines broader than that conducted by investment firms, with b) relatively little emphasis in that business mix of investment-firm business lines. Moreover, the betas were generated only from data collected from firms other than investment firms. This has resulted in a Standardised Approach which will increase the capital requirement for the typical investment firm relative to the Basic Indicator Approach, but will not have the same effect for other types of firm. By the same token, investment firms will face a greater pressure to move on to the Advanced Measurement Approach than other types of firm.

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<sup>3</sup> ISDA/TBMA commentary on Basel CP3, 31 July 2003, attached as Annex 2.

If firms have a genuine choice as to the approach to adopt, based on the risk management benefit it brings, this situation matters less. In practice, however, firms will be likely to experience pressure from various sources to move on from the Basic Indicator Approach, leaving the Standardised Approach as a de facto benchmark and unsatisfactory alternative. We believe strongly that further study needs to be made on the impact of the Standardised Approach on the whole universe of firms potentially subject to it.

### **Expenditure-Based Requirement**

The associations believe that the intentions with regards to the Expenditure-Based Requirement (EBR) need to be more clearly set out. The current draft does not provide a clear overview as to whom the requirement is expected to apply to or who may be exempted. In particular, we are concerned that the EBR appears to continue to apply to '730K' firms who calculate an operational risk capital charge under any approach other than the AMA.

We believe these problems with the workings of the EBR primarily to be a drafting issue but reserve the right to comment further as necessary. In particular we do not understand it to be the Commission's intention that the EBR should be an additive charge (coupled with the Operational Risk charge) and would warmly urge the Commission to clarify this fully. Retaining the EBR as an additive charge clearly results in an inflated capital requirement, disadvantaging European firms, and this should at the very least be the subject of further consultation.

### **Unsettled transactions**

Please note that we comment elsewhere in this response on the proposals to charge firms for unsettled transactions. As stated above in the section on Unsettled Transactions in the part of our response discussing Capital Treatment of Trading Book Transactions, we believe these proposals require further thought and consultation, which should be carried out in the context of a thorough review of trading book issues and counterparty risk management. Generally speaking, settlement losses are captured through the operational risk capital charge and this should not be duplicated. It is important to bear in mind that, as the Commission is considering the impact on investment firms of the proposed new regime, unsettled transactions could – depending on the definition and scope of this – be a notable factor for such firms.

### **International co-ordination**

With regards to the need to co-ordinate across jurisdictions the implementation and operation by supervisors of the framework for operational risk, we note that, in order to properly reflect developing industry practice, this must respect the flexibility built into the rules. Neither within jurisdictions nor internationally should implementation be used to introduce a greater degree of prescription. At the same time, co-ordination among supervisors can be a force for good, by promoting helpful developments and consistency of application of the rules.

## **Risk mitigation**

The associations continue to believe that the capital rules should – but as drafted do not – offer meaningful recognition of techniques such as insurance. This absence appears particularly anomalous where “funded” protection is concerned, given that protection provided in this form pre-empts any issue around certainty of payment.

In drafting terms, we note that the 'Joint Forum' of banking, securities and insurance supervisors recently concluded that the market for transfer of operational risk has clear potential to develop significantly ("Operational risk transfer across financial sectors", August 2003, [www.bis.org](http://www.bis.org)). As such, we believe that the relevant article of the Directive (arguably Article 107) should set out only the principle of recognising risk mitigation, while any more specific considerations (that may conceivably require amendment in future, e.g., recognition under the Standardised and Basic Indicator Approaches) should be dealt with in the relevant part of annex H.

## **Timetable**

Finally, it is the associations' view that the current delay in the finalisation of the Basel Accord should be used to ensure that issues such as the above are dealt with appropriately and that it would in any case be unhelpful for the EU to press on with legislation that risked inconsistency with other, non-EU G-10 jurisdictions.

## **2 An Industry Framework for Pillar 2: Supervisory Review**

This section of our response comprises the discussion paper on Pillar 2, prepared jointly by the European Banking Federation (FBE), the International Swaps and Derivatives Association (ISDA) and the London Investment Banking Association (LIBA).

### **1 Introduction**

The new Basel Capital Accord and the proposed new Capital Adequacy Directive (CAD 3) contain many new ideas. Perhaps the idea that will have the biggest impact over time is the proposal for Pillar 2: Supervisory Review. It is strange therefore that this is the least debated element of the new proposals and, perhaps, the least clear. To address the balance, and to examine concerns that the industry has, the FBE, ISDA and LIBA have combined to produce a paper that raises serious questions in respect of the current proposals and sets out a proposed industry framework and process for Pillar 2: Supervisory Review.

### **2 The importance of Pillar 2: Supervisory Review**

We share the view of the Basel Committee and the European Commission that the Supervisory Review process will be critical in determining the impact of the new regime for individual firms and the global banking industry.

The success of Pillar 2 is important not only to supervisors but to all participants in the financial community. The value in Pillar 2 is that it is addressed more directly towards the individual circumstances of the institutions than is possible under Pillar 1 and takes an inclusive view of a firm's strength against its risk profile. Therefore, in common with internal risk management practice, the process itself has a value that exceeds the outcome. Our objective is to preserve the integrity and value of this process.

### **3 The Basel Committee proposals**

In its original form, the purpose and scope of the Supervisory Review process was clear. It provided a framework which affirmed that it was the responsibility of a firm to assess its own risk profile and the supervisor's role was to review and challenge this process, review and challenge the outcome and, if necessary, intervene promptly, including being able to set higher minimum capital standards for an individual firm. We broadly supported this process and understood its value.

Nevertheless, from the outset the industry has had concerns about the effectiveness of the Supervisory Review framework. These concerns focused on the potential for differing application of the rules by supervisors. The industry therefore made proposals to improve the prospects for consistency in application.

We are now concerned that much of the original purpose of the Supervisory Review process has been lost. The primary industry concerns in respect of Pillar 2: Supervisory Review are:

- Consistency of application. The absence of a clear framework of set objectives on how Supervisory Review should be structured and a lack of supervisory consensus is likely to produce inconsistent application.
- Intrusiveness. Pillar 2 has become more prescriptive in how firms are to measure risk. This development encourages a “box ticking” approach which we believe erodes the value of the process in that it fails to encourage diversity of approach or innovation.
- Unclear boundary between Pillar 1 and Pillar 2. A general blurring of the boundary between Pillar 1 and Pillar 2 has taken place, most specifically in the introduction of the Section C specific risk factors but also in elements such as the stress testing proposals. This has led to the concern that a Pillar 2 “add-on” would be automatic for every firm, which undermines the advances made in Pillar 1 of the Accord.
- Separation of risk assessment process and economic capital process. The requirements on firms suggest a separation of the risk and economic capital assessment process and make the latter a qualifying criteria. This separation and requirement does not reflect industry practice.

In summary, the Supervisory Review process has moved away from a bank driven and bank focused review of all risks as the basis of a dialogue with supervisors and agreement on remedial actions. It is now a more rule driven process, more prescriptive in outcome and more confused in purpose.

#### **4 The European Commission’s proposals**

The European Commission’s proposed framework for the implementation of Pillar 2 superficially mirrors the Basel proposals but adds an additional layer of prescription. It would represent a significant backward step. Of most concern are the following points:

- Dual risk assessment process: CAD 3 articulates parallel firm and supervisory risk assessment processes. The supervisory assessment process takes precedence, the role of the firm assessment is marginal.
- Prescription in risk assessment. The CAD 3 process is more prescriptive in determining how firms and supervisors undertake risk assessment (see Annex J-1 and J-2) of the Commission’s July 2003 Working Document.

- Scope of application. The scope of the supervisory risk assessment process has been expanded beyond the Basel requirement and now resembles the format for a check-list rather than the basis of a dialogue.
- Level of application. Supervisory review is to be applied in full by each institution in a group and to each institution in a group. There is no mechanism for developing a group view, in stark contrast to how risk in many groups is managed.

A substantial review of policy and drafting is required if the original vision is to be re-captured and the original value revived. This would include Articles 2 to 6 of the Commission’s Working Document, the totality of Title III and Annexes I and J.

## **5 An industry framework for Pillar 2: Supervisory Review**

We believe that the Supervisory Review process has the potential to add value for firms and supervisors. We have therefore developed an industry framework which clarifies and deepens the original conceptual model to maximise the value of the process.

### ***5.1 Objective***

The overarching objective of a separate Pillar 2: Supervisory Review process is to:

- enhance understanding on the part of the group, and its supervisor, of a groups whole risk profile, including its programme of mitigation or capital planning, thereby reducing the probability of prudential failure in a cost efficient manner;

This objective directly implies a process and dialogue that has as its central dynamic a firm driven risk assessment process and that fundamentally Pillar 2: Supervisory Review is the responsibility of the firm.

We would note that Pillar 2 is different, and should be different from Pillar 1. Pillar 2 offers the opportunity to take a different and inclusive perspective not to focus narrowly on the output and to reinforce the conclusions of Pillar 1. The test is very different; it is more flexible in process and outcome as it is tailored to the individual needs and circumstance of the firm. Pillar 2 should be a challenge process and not a compliance exercise.

### ***5.2 Consistency in application***

Consistency in Pillar 2 can only be achieved by ensuring that each firm is treated appropriately according to its unique profile and is not simply subjected to a “consistent” (one size fits all) capital charge that is inappropriate to its true risk structure. Consistency can in fact only be achieved where there is a true mutual understanding between industry and supervisors and amongst supervisors themselves on how to assess and respond to the almost infinite variations of risk profiles that will be encountered in the industry. That is

consistency, in the “good” sense of consistent standards of assessment and dialogue, which our principles noted below are explicitly designed to foster. Such understanding can only be reached via a closer engagement and dialogue between the interested parties. Consultation is essential. Some mechanisms are already in place that can be built upon, whether the new Committee Structures and working groups at the EU, or the AIG within the Basel process. To date such groupings have been remote and relatively uncommunicative. We have to move beyond this stage to active dialogue. Industry is ready and anxious to play its role.

### ***5.3 Principles***

Underpinning the proposed industry framework are a number of important base assumptions and high-level principles. As follows:

**Principle 1: Pillar 2: Supervisory Review is a firm driven process and responsibility.** The Pillar 2 process is first and foremost the responsibility of the firm management and shall be integral to the management of the firm. The onus is and will always remain upon the firm to assess and manage its risks. Pillar 2 should be based upon, and create incentives, for a process of internal risk self-assessment and management. The process should be given force through the following rule:

*Firms should have a robust process for assessing their own capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.<sup>4</sup>*

The regulator should not take a prescriptive view of the process a firm might adopt. Indeed there are dangers inherent in the regulator encouraging too great a degree of uniformity of practice. Pillar 2 should have a systematic value in allowing institutions to exercise a diverse range of measures and management techniques.

**Principle 2: The scope of risk assessment should be the responsibility of the firm.** The scope of firm risk assessment should be comprehensive but not prescriptive. The scope of this assessment cannot be mandated without a material risk of the distraction or mis-direction of firm efforts. It is not desirable that legislation should lay a burden on firms to manage risks to which they may not be exposed. Further the strategies for mitigating the risks identified by the Pillar 2 process should not be confined to the risk mitigation strategies that are outlined as eligible in Pillar 1.

**Principle 3: Pillar 2: Supervisory Review should be a dialogue between firm and supervisor.** Pillar 2 should be an ongoing, dynamic and open dialogue between firms and their supervisors. The responsibility rests with the firm to explain its processes, analysis and actions to the regulator and to satisfy the regulator that its actions are appropriate for its business. The supervisor’s role is to challenge the firms risk assessment.

**Principle 4: Supervisory action should be the exception.** Supervisory action requires the substitution of the judgement of the supervisor for the judgement of the firm,

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<sup>4</sup> Basel Committee, CP2, 1<sup>st</sup> Key Principle of Supervisory Review Process

although the firm retains full responsibility for the consequences. Therefore action should be the exception and needs to be explicitly justified by the supervisor. Especially as Pillar 1 will on average deliver an adequate capital charge and require firms to meet high qualitative and quantitative standards. Supervisory action under Pillar 2 should therefore be the exception not the rule.

**Principle 5: Supervisory action must be justified.** There should be an onus on the supervisor to be able to demonstrate that all relevant factors have been taken into account in recommending or requiring further action by the firm. In particular the supervisor must demonstrate that it has understood the reasons for which a firm chooses to hold its specific level of capital. If the firm disputes, or wishes to dispute the supervisory action demanded, the supervisor must ensure that there is an appeal process available to the firm.

**Principle 6: Capital is not the only answer.** Pillar 2 is about the strength of banks, this is delivered not just through additional capital but through the quality of thinking, management and reputation. It follows that threats to the financial soundness of an institution are not always best addressed with greater financial resources, but systems, controls, management and mitigation strategies. Capital should only be required where there is a clear case that it will provide effective and efficient mitigation of risk.

**Principle 7: Pillar 2: Supervisory Review should be applied at the level of the group.** In order to align with the group risk structure operating within most firms Pillar 2: Supervisory Review should only be applied at the consolidated group level and the dialogue should be with the lead supervisor.

**Principle 8: Pillar 2: Supervisory Review is a confidential process.** The output of the Supervisory Review process, and especially any required supervisory actions, should be confidential to the firm and its lead supervisor.

#### ***5.4 Process***

These principles translate into a Supervisory Review process. The first step of the process would be an assessment by the firm of its' whole risk profile and any consequent mitigation action. This assessment and action plan would then be challenged by the firms' lead supervisor. In exceptional circumstance the firm might be required to take action by its' supervisor, this could include a requirement to hold additional capital, transfer or mitigate risks or improve controls. In this instance full reasoning would be provided to the firm and an opportunity given to appeal. Once an issue has been addressed any supervisory requirement will be removed.

## **6 What needs to be done?**

The concerns expressed by the industry in respect of Pillar 2 are not peripheral but fundamental.

The framework we have outlined addresses the majority of these concerns whilst retaining, we believe in fact improving, the delivery of supervisory objectives. We note with considerable concern that debate amongst supervisors on Pillar 2: Supervisory Review is focused almost entirely on the issues surrounding implementation. We do not believe that implementation can solve issues created by a flawed framework. Before moving forward supervisors, and the global banking industry, needs urgently to reflect on the objectives, process and outcome of Pillar 2: Supervisory Review.

### 3 MARKET DISCIPLINE

#### **Disclosure by Firms**

We are conscious that in the light of the very recent Basel Press Notice, there will be implications for the detailed substance of Pillar 3 at the Basel level and that this will have to be considered also at the EU level.

The central principle to any consideration of disclosure requirements is that the information disclosed should be meaningful. Disclosure requirements that are too onerous, too granular or that are in conflict with or are overlapping with other requirements will fail this principle.

We continue to encourage the Commission in the strongest terms to retain and refine its focus on differentiation between information that is useful and meaningful to disclose to the regulator and information that is genuinely helpful in achieving the objectives of market discipline.

In this context we note that the criteria on disclosure in Annex L1 are basically sound, but believe that more could be done to ensure differentiation.

We very much welcome the Commission's willingness to recognise compliance under relevant accounting standards for the purposes of complying with the capital standards. (Article 140). This factor does much to ensure the limitation of overlap with other international standards. We must stress, however, that it will be essential for there to be maximum consistency with the International Financial Reporting Standards and encourage the Commission to continue its dialogue with the International Accounting Standards Board.

Disappointingly, on the scope of disclosure the Commission has proposed that disclosure should be required at the level of each individual firm within a group: Article 137 (3) requires parent undertakings to disclose information about their subsidiaries and sub-groups on an individual entity basis. We understand the consistency the Commission may be wishing to achieve between the Pillar 1 and Pillar 2 regime, but for Pillars 2 and 3 in particular, a failure to permit reliance on group information and management will drive up costs considerably as well as generating a multiplicity of information that could obscure rather than illuminate the real risk profile of the institutions in question.

Hence, we recommend that Article 137(3) be deleted. Annex L2 should therefore be applied at the level of the group and not of the individual entity. Annex L2 should also be reviewed to remove the duplication that is currently contained within it. For example, the requirements in Annex L2 Paragraph 4(d) overlap with Paragraphs 8 and 9. Such duplication is not necessary and will lead to confused disclosure.

**Article 16** Individual Capital Requirements

**16** The capital requirements prescribed in this Directive shall apply to all institutions<sup>5</sup> on an individual basis in accordance with the methods laid down in this Directive.

**Article 17** Consolidated Capital Requirements

**17(1)** Without prejudice to the provisions contained in Article 16 of the Directive, the parent undertaking institution<sup>6</sup> within a group of institutions shall be subject to capital requirements on a consolidated basis in accordance with the methods laid down in this Directive, in Directive 2000/12/EC and in Directive 86/635/EEC.

**17(2)** Without prejudice to the provisions contained in Article 16 of this Directive institutions whose parent undertaking is a financial holding company<sup>7</sup> shall be subject to capital requirements applied on the basis of the consolidated financial situation of that financial holding company in accordance with the methods laid down in this Directive, in Directive 2000/12/EC and in Directive 86/635/EEC.

**Article 18** Sub-consolidated capital requirements

**18(1)** Without prejudice to the provisions contained in Article 16 of the Directive, the parent undertaking institution within any sub-group of institutions shall be subject to capital requirements on a sub-consolidated basis in accordance with the methods laid down in this Directive, in Directive 2000/12/EC and in Directive 86/635/EEC when not all institutions within the sub-group are authorised and supervised by the competent authorities of the same member state.

**18(2)** Without prejudice to the provisions contained in Article 16 of the present Directive, competent authorities may impose the application of capital requirements on a sub-consolidated basis to the parent undertaking

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<sup>5</sup> Institution means a credit institution or an investment firm

<sup>6</sup> parent undertaking institution means a parent undertaking ( see 83/349/EEC) which exercises a dominant influence and which is also an institution.

<sup>7</sup> *Financial holding company* means the *financial institution* the subsidiary undertakings of which are mainly institutions or financial institutions. A *financial institution* is an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities subject to mutual recognition (except acceptance of deposits, credit reference services, safe custody services). (RBCD uses the definition of 2000/12/EC).

**institution within any sub-group of institutions when such requirements are considered to be relevant for the purposes of supervision.**

- 18(3) In the case in which paragraph 1 of this Article applies, as an alternative to the application of capital requirements on a sub-consolidated basis to the institution which is the parent undertaking within a sub-group of institutions, Member States' competent authorities may apply capital requirements to such an institution on an individual basis in accordance with provisions laid down in this Directive or in Directive 2000/12/EC, except that the book value of any holdings, subordinated claims, and instruments referred to in Article 35 of Directive 2000/12/EC held in respect of institutions, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated in accordance with the provisions of Articles 52 to 56 of Directive 2000/12/EC is deducted in full from the capital of that institution.**
- 18(4) Institutions to which paragraph 3 of this Article applies must deduct, for the calculation of their individual capital requirements referred to in that same paragraph, the items referred to in points 12 to 16 of Article 34(2) of the Directive 2000/12/EC held in institutions, financial institutions, asset management companies and ancillary services undertakings, as well as in insurance undertaking, reinsurance undertakings, and insurance holding companies, except for the following:**
- Where shares in another institution, financial institution, asset management companies and ancillary services undertakings, as well as in insurance or, reinsurance undertakings, and insurance holding companies, are held temporarily for the purpose of a financial assistance operation designed to reorganise and save that entity, the competent authority may waive the provisions on deductions referred to in points 12 to 16 of Article 34(2) of Directive 2000/12/EC.**
  - As an alternative to the deduction of 15 and 16 of Article 34(2) of the Directive 2000/12/EC, Member States may allow their institutions to apply mutatis mutandis methods 1, 2 or 3 of Annexe I to Directive 2002/87/EC. Method 1 (Accounting consolidation) shall only be applied if the competent authority is confident about the level of integrated management and internal controls regarding the entities which would be included in the scope of the consolidation. The method chosen shall be applied in a consistent manner over time**

**Article 19** Ancillary services undertakings

**When capital requirements apply on a consolidated or sub-consolidated basis in accordance with Articles 17 or 18 of this Directive, ancillary services undertakings shall be included in the consolidation or in the sub-consolidation.**

**Article 20** Individual capital requirements for parent undertaking institutions within a sub-group of institutions or within a group of institutions

**20(1) Competent authorities may provide that, for the calculation of individual capital requirements, the parent undertaking institution within a sub-group of institutions subject to capital requirements on a sub-consolidated basis need not deduct from their own funds and in accordance with Articles 34 to 39 of the Directive 2000/12/EC their holdings in institutions, financial institutions, asset management companies and ancillary services undertakings which are included in the sub-consolidation.**

**20(2) Competent authorities may provide that, for the calculation of individual capital requirements, the parent undertaking institution within a group subject to capital requirements on a consolidated basis need not deduct from their own funds and in accordance with the methods laid down in Articles 34 to 39 of the Directive 2000/12/EC their holdings in institutions, financial institutions, asset management companies and ancillary services undertakings which are included in the consolidation.**

**Article 21** Exemption from consolidated capital requirements for investment firms groups

**21(1) The competent authorities may waive on a case by case basis, the application of capital requirements on a consolidated basis provided that :**

- a. All institutions with in the group of institutions are investment firms;**
- b. All institutions within the group of institutions use the definition of own funds given in paragraph 9 of Annex V of Directive 93/6/EEC;**
- c. All institutions within the group of institutions are authorised and supervised by the competent authorities of the same member state;**
- d. No investment firm with in the group of institutions is authorised to provide the services listed in point 2 and point 4 of Section A of the Annexe of Directive 93/22/EEC when provided on a firm commitment basis;**
- e. No investment firm within the group of institutions holds client money or securities;**
- f. The funds of the group of institutions comply with the capital requirements applied on a consolidated basis to the parent undertaking within the group;**

- g. Any financial holding company within the group of institutions holds as much capital as the full book value of any holding, subordinated claims and instruments referred to in Article 35 of Directive 2000/12/Ec in investment firms, financial institutions and ancillary services undertakings in accordance with Articles 52 to 56 of Directive 2000/12/EC;**
- h. Financial institutions and ancillary services undertakings hold letter of credits for an amount equal to or greater than the capital required to fulfil the capital requirements as provided for in paragraph 1 of Article 16 of this Directive.**

**21(2) In cases where paragraph 1 of this Article applies, each institution within the group of institutions has in place systems to monitor and control the sources of capital and funding of all other financial holding company, financial institutions and ancillary services undertakings within the group.**