

**Response on Commission Working Document on CAD3
LIBA/ISDA**

JANUARY 2003

EXECUTIVE SUMMARY

General Principles

The Associations continue to support consistency with the Basel Accord. So far as possible, parallelism of content and of principle should be maintained, or the position of firms active in the EU will be damaged. Yet the EU capital adequacy regime is applied to a wider set of institutions and affects a wider field of activity than the Basel Accord can do. We welcome, strongly, therefore the Commission's stance that EU specificities must be taken into account. This is an imperative.

We welcome also in the strongest terms, the Commission's desire to create a capital adequacy architecture that can be updated flexibly and efficiently. We are neutral as to the means by which this is achieved, we ask only that the EU institutions continue to work to reaching this goal.

Consistency of application of the new capital regime is essential and will depend ultimately on the content and delivery of the Supervisory Review Process. The first steps outlined in the Working Document are extremely positive. Greater convergence and transparency of supervisory practices is crucial to achieving an effective, fair and consistent capital regime, however, and we ask the Commission to support further efforts towards achieving this.

Consolidation

Consolidation is the cornerstone of capital adequacy. We support rigour in this area, but are highly concerned that too great a level of complexity and duplication of effort by firms and authorities could be introduced. The Associations believe that further analysis is required to ensure that appropriate and meaningful data is yielded from the process. The ability to interpret data and to have reliance on what it means is more important than to have "more" data per se. We are concerned that the Commission's preference for a high degree of sub-consolidation may demonstrate a reluctance to rely on supervisors' judgement and ability to co-operate effectively.

Trading book

The Associations welcome the parallelism maintained by the Commission between the draft Capital Accord and the text of the proposed CAD3. It is essential to limit discrepancies between the two documents to a minimum in order to preserve the competitiveness of firms engaged in trading book activities both inside and outside of the EU.

The Associations have however noted a number of seemingly involuntary instances where the draft CAD text departs from the QIS3 Technical Guidance: the hedging criterion for trading book eligibility for instance is not mentioned in the text; cross product netting is explicitly prohibited, in contradiction with both the Technical Guidance and current regulatory practice in a number of

EU countries; the definition of what constitutes a “qualifying item” is far more restrictive than that proposed by the Basel Committee, etc. Such discrepancies between the Basel Accord and the CAD can have serious commercial and risk management consequences for firms. Where these divergences represent a conscious policy decision we ask that the Commission set out the rationale for this. Bearing in mind, however, that the Draft text is very much work in progress, we recognise that these points may be merely technicalities that the Commission is seeking to iron out, and we hope our response will be helpful in tracking them down.

In a number of further instances, the Commission has exceeded the scope of the proposed Basel rules, e.g. on the treatment of unsettled transactions or investments in CIUs. Although the Associations applaud the Commission’s initiative, we are doubtful that the conclusions reached will achieve the goals that the Commission set itself. Deleting Annex II of the CAD, for instance, could lead to double counting of credit and operational risk for unsettled transactions. Similarly, the proposed approach to treating CIUs should be substantially streamlined to be applicable in practice.

Finally, on Large Exposures, the Associations would strongly recommend that most of the exemptions and reduced risk weights available under Article 49 remain available for firms treated under the Comprehensive Approach.

Operational Risk

The Commission has, as part of its proposals on operational risk, put forward EU-specific approaches on some issues. The Associations have analysed these in the context of some broader concerns about the functioning of the charge overall, especially the role of the Standardised Approach (TSA). This has led the Associations to conclude that further work would be merited on (i) the “beta” factors that are to apply under TSA and (ii) the means of and rationale for possible recognition of insurance. This work is proposed in order to ensure that TSA truly acts as a transitional phase between the Basic Indicator and Advanced Measurement Approaches.

Supervisory Review Process

The Associations support the core principles of Supervisory Review Process and welcome the minimum harmonisation of supervisory powers. We agree that qualitative standards are the best safeguard against a “one size fits all” regime, but equally, consistency of approach must be ensured. Supervisory convergence and transparency of approach are the two foundations we believe necessary to prevent the distortion of minimum standards and an inconsistent application of capital adequacy between jurisdictions. Supervisory convergence itself will require a framework and we firmly believe that the process of convergence should be facilitated by the EU institutions.

We also ask that the Commission explore and open debate on the issue of at what level or levels within a group the Supervisory Review Process is intended to apply.

Market Discipline

We welcome the stance set out by the Commission so far and look forward to further iterations in due course. We ask that the Commission retains a clear differentiation between information that is valuable for regulatory purposes and should properly be disclosed to regulators and data that cannot be meaningfully interpreted by non regulators. Where information falls into the latter category care should be taken before public disclosure is made mandatory.

**ISDA / LIBA RESPONSE TO EUROPEAN COMMISSION STRUCTURED
DIALOGUE**

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ANNEX 3: LIBA-BBA response to Basel Committee on QIS3 Technical Guidance

1 GENERAL PRINCIPLES AND STRATEGIC POINTS

1. We welcome the Commission's Working Document on CAD3 and would, in particular like to stress our support for the following principles on which we believe the process of the new capital adequacy regime should be based.

(i) Consistency with Basel.

2. Consistency of the Basel Accord and the EU capital adequacy legislation should be achieved as far as possible, subject to the need to take account of EU specificities. We support the Commission in its continued efforts in this regard. Such consistency will support the aim of a wider international level playing field and will reduce the possibility of firms being subject to multiple and not necessarily fully consistent capital regulations.

(ii) EU specificities.

3. We recognise that the Basel Accord was not designed specifically for the EU and that there are features within Europe of which Basel takes no account. It is essential that the EU institutions scrutinise the appropriateness of the Basel Accord to ensure that any necessary adjustment can be made to ensure that prudential standards and competitive equity is preserved for all those types of institutions within the EU to which the new capital legislation will apply. We welcome the Commission's attitude that there can be a justified divergence from the Basel approach in some instances. We hope, naturally, that overall the need for such divergences will be limited.

4. In particular, we applaud the Commission's willingness to consider the situation of investment firms. This is important because it was the European Union that made the decision to apply the same capital regime to investment firms as to credit institutions. It is therefore the responsibility of the EU institutions, and the Commission in the first instance, to ensure that any evolution of the capital regime is as appropriately suited to investment firms, who are not analysed by the Basel Committee process, as it is to banks. Whilst the optimal solution would be for Basel to produce the "right answer" for all firms, Basel's remit is primarily focused on internationally active banks (and it is clear that Basel will adopt solutions most appropriate for that population), not other institutions. It is imperative therefore that the Commission take account of the issues of these other institutions.

(iii) Flexibility of Legislation

5. Every effort should be made to ensure that the new regulatory framework is sufficiently flexible to be able to adapt to market developments. We fully support the Commission's desire to introduce legislation that can be updated, in its technical aspects, easily and efficiently. We are neutral, at this stage, as to whether a developed comitology approach, much like that employed for the recent Financial Conglomerates Directive (i.e. core provisions amended by Parliamentary and Council co-decision, accompanied by technical annexes that can be amended via comitology committees) or a "Lamfalussy" style structure (i.e. the new legislative structure brought in for the securities market) is used. In either case, we broadly support the

balance struck in the current working document between the content that should belong to the core provisions and that which should belong to technical annexes. There are instances, though, where we believe that the boundary between the “strands” merits re-examination or amendment. These include:

- Article 1(52): The 90 day past due criterion for default may evolve.
 - Article 27(3): Risk Concerning Off Balance Sheet items refers to an area where the relativities of risk may shift over time. We note that this is a cross reference to one of the original annexes in the Solvency Ratio Directive.
 - Article 29: Standard Risk Weights. Although risk weighting categories are currently not subject to any form of comitology, in future it may be highly desirable to create greater “granularity” in the risk weighting categories through a more flexible process.
 - Article 103: Amending aspects of the CAD [93/6/EEC]. In this case as with Article 27(3) and Article 29 we recognise that there may be sensitivities in introducing a wider scope of comitology or flexibility in extant directives.
 - Article 113: The view of those investment services which can validly be eligible for the differentiated capital treatment for operational risk would, we expect, evolve over time. We also note that the ISD [93/22/EEC] itself is currently under revision and that this reference may be outdated by the time the CAD is negotiated.
6. Clarity of legislation is just as essential as adaptability, and it is important that there is not uncontrolled scope for interpretation due to vague, imprecise or ambiguous drafting. It should be possible to frame qualitative standards with lucidity in terms of their intent and their scope whilst avoiding both excessive room for interpretation and, on the other hand, too rigid a regime. Both have great dangers. Too great a latitude in interpretation coupled with an absence of a framework to assess what is and what is not appropriate will inevitably create a multiplicity of standards throughout the EU and do little to foster consistency of application and the sound evolution of best practice standards.

(iv) Parallel implementation

7. We support all efforts that will deliver the revised capital adequacy legislation in time to permit parallel implementation of an appropriate new EU regime and the revised Basel Accord. The competitive implications for EU banks compared with banks from outside the Single Market, as well as infrastructure costs that will be incurred by firms with presences within and outside the EU due to a staggered implementation of the new capital adequacy regime are severe. We ask that the EU institutions do all that they can to progress the scrutiny and passage of the new legislation to ensure that competitive issues do not arise and that implementation costs may be kept to a prudent minimum.

(v) Transitional Provisions: Ceiling and Floor

8. The Commission, like the Basel Committee, proposes that institutions adopting the Foundation and/or Advanced IRB Approach shall calculate their minimum capital requirements in parallel with the existing approach for the first two years following the date of implementation of the new Directive. If a floor does continue to apply on the overall capital charge, we would recommend that it be strictly limited to two years and we are hopeful that the Commission's present drafting indicates that this is their view also.
9. Additionally, it would be logical to apply a parallel ceiling on the new charge. A number of firms will see their regulatory capital increase as a result of the new rules; a ceiling would assist their transition to the new Directive. If there is insistence on retaining a floor, then the application of a ceiling is justified by applying the same standards and will serve to ensure a symmetrical application of the new capital regime. At the very least, those firms that can demonstrate an initial increase in regulatory capital as a result of the new regulations should be excluded from the need to maintain parallel calculations.

I Consolidation

10. **Solo consolidation:** We regret the apparent loss of flexibility to supervisors and industry in with the removal of the waiver allowing solo consolidation (formerly provided for by Article 52(7) of Directive 2000/12/EC). We believe that this supervisory technique can be retained in prudent fashion providing that minimum requirements are set out to assure supervisors of the integrity of the management and risk control processes and the mobility of capital within the sub consolidated group.
11. **Sub Consolidation:** We note that the requirement implied by the definition set out in Article 1(18) has the potential to lead to a considerable number of sub groups. In the case of large financial groups, the number of sub groups could run into dozens. The benefit to supervisors of multiple sub-consolidations will in many cases be negligible. Significant burdens that fail any cost benefit analysis are therefore potentially created by this new requirement.
12. We understand and fully support the Commission's concerns that capital should be readily available to support risks incurred by an institution within a group, but we are unsure whether there has been an in-depth analysis to clarify whether meaningful information will be gathered and analysed by authorities as a result of the new requirement. We recognise that the Commission has aimed to offer some flexibility through the provisions of Article 18(1). The option to require sub consolidation(s) is reasonable but it should not be compulsory. Regulators should have the ability to require sub-consolidation(s), but also the flexibility not to require it in every circumstance. We are concerned by the implication that the Commission is not willing to rely on supervisory judgement in this field. Existing directives create powerful gateways to enable effective communication between competent authorities so exchange of information should be no obstacle. Furthermore, we note that the supervisory climate that is informed by the new Directive on Financial Conglomerates, that places strong emphasis on co-operation and collaborative regulatory solutions, fits well with the possibility of allowing supervisory discretion on the appropriate degree of sub consolidation within a wider group. It is important to recognise that the provisions of the new legislation, where unduly onerous and not obviously meeting a prudential need will lead to pressure to restructure groups. This, in turn, may in fact reduce the overall capital available within the group as individual entities become branches of a merged entity: hence, zealously in sub consolidation may create perverse effects.
13. **“Horizontal” consolidation:** We are unclear what the Commission intends, in practical terms, by introducing close links into the definition of “groups” (i.e. such that capital requirements will bite on groups including entities with whom an

institution has no direct ownership or participation link). The effect of this could be misleading. The increase of burden on firms is likely to be considerable and undesirable and alternative sensible proposals need to be offered by the Commission. We believe that this kind of horizontal consolidation across EU entities is unnecessary, provided that each entity is meeting its capital requirements on a solo basis, and that such entities are included within a consolidated capital adequacy test at some level in the group (which may be within or outside the EU). The new EU Financial Conglomerates Directive establishes principles to ensure that EU supervisors do not have to take further action provided that equivalent consolidated supervision is being undertaken by the supervisor of a non-EU parent. We believe that the Commission proposals in this field appear inconsistent with the approach taken in the Conglomerates Directive.

14. In fact, we are unclear as to why the Commission would want to consolidate the capital/assets of an entity that is only “horizontally” related to another firm in the group? Such consolidation could serve to obscure the exposure of funding (since it would vanish upon consolidation) and there would not be access to the capital of the horizontally linked entity – so the relationship of the capital to assets would in fact be more obscured rather than less.
15. Close links yield important information from the supervisory perspective, but are not appropriate as a basis for capital adequacy calculations. We recognise that the definition of “group” in the draft text incorporates the definition used in the recent directive on Financial Conglomerates (FCD), but the definition is wider than in FCD because it is dependent on entities which are “closely linked”. Furthermore the definition of “close links” appears to us to be wider than that employed either by the FCD or by the Consolidated Banking Directive [2000/12/EC].¹ Indeed in the analysis of the Common Position on the FCD, we note that the commentary on close links states, *“The definition of “close links” is used in the common position purely to define intra-group transactions (see below), and does not bear upon the determination of a group.”* In this context we are surprised to see a definition of close links being used here as the basis for determining a group for solvency purposes at the very least without more discussion.

¹ Article 2(12) of the Financial Conglomerates Directive (FCD) sets out four key features by which to identify a group – parent relationship, subsidiary relationship, participation relationship (as defined in the 4th Council Directive) and as entities linked as defined in the 7th Company Law Directive. Article 1(16) of the draft CAD3 bases the definition of group upon “close links.” CAD3 definition of “close links” [Art 1(17)] includes the same definition used for “close links” as in FCD and in 2000/12/EC. It also includes the same concept of participation and linked entities as the FCD does in its definition of “group.” However the CAD3 definition of “close links” also includes the concept of “dominant influence.”

II Trading Book Issues

16. The Associations are providing below a detailed set of comments on the proposed Trading Book and Credit Risk Mitigation Annexes, as well as the relevant articles in the body of the draft Directive. We clearly emphasise where our comments are not only relevant to EU specific issues, but have also been addressed to the Basel Committee on Banking Supervision itself.

(A) TRADING BOOK: SCOPE

(i) Definition of the trading book:

17. The Associations welcome the proposed streamlining of the eligibility criteria for trading book capital treatment. Eligibility currently depends upon whether the item features in a list of recognised financial instruments, which, because it was designed a number of years ago and carved into legislation, has hampered the inclusion of new instruments within the regulatory perimeter of the trading book. Examples of traded products not or only partly qualifying for trading book treatment under the current standard include traded loans and credit derivatives written on loans. The approach that the Commission is contemplating in the draft CAD text is principle-based rather than list-based, hence inclusive rather than exclusive. The Associations fully support this methodological change, as well as the suggested use of trading intent as the main determining factor for trading book eligibility.

18. We note however that a second definitional criterion is mentioned in the QIS3 Technical Guidance, which curiously does not appear in the draft CAD text. Para 620 of the Technical Guidance defines the trading book as including “positions held in order to hedge other elements of the trading book”. Given the nature of trading book exposures and their dynamic hedging by regulated firms, it is essential for hedges to be included in the regulatory definition of the trading book. Article 96 of the draft CAD3 should be amended accordingly.

19. On a more technical note, Annex G-1 of the draft CAD should clarify that for loans, the transferability test can be passed even where borrower consent must be sought, provided that such consent cannot be unreasonably withheld. Similarly, deposits held on the asset side of the balance sheet should be eligible for trading book treatment provided that the trading intent test is passed. It would be useful if the Commission could clarify the capital treatment of such deposits. It should be equally clear that deposits are eligible for trading book treatment where they hedge existing trading book positions. We note that Annex E-3, 3.1.6.1. treats deposits with third party institutions as guarantees. The Associations believe that such deposits where used as hedges in essence constitute pledged cash collateral and should hence, provided any legal requirements attaching to the pledge are met, receive funded credit risk protection treatment. This would appear to us to be consistent with the treatment they

would receive under the current Basel Committee proposals. If the pledge was unenforceable, then the existence of mitigation could be questioned and the deposit would not warrant a guarantee treatment in any case.

(ii) Material holdings in the trading book

20. The draft directive would benefit from clarification in relation to material holdings in the trading book. There is a clear distinction in principle between trading book holdings and banking book holdings in the securities of other financial institutions. We believe that holdings of items in the trading book do not necessarily give rise to double gearing and that the new CAD text should clarify that such holdings should not be subject to the deductions required under the material holdings provisions. Such items are held with trading and not strategic intent, are marked-to-market and will generally not give rise to the same contagion risk as banking book holdings, and should therefore not be subject to deduction. We believe that this was the intention of the original EC legislation and would welcome greater legislative clarity. Annex C-1 6.7.1 should be amended accordingly.

(iii) Equity Holdings in the Banking Book

21. In addition, the definition of equity provided in article 47(6) is ambiguous. It should be clarified that it is restricted to equity holdings in the banking book, and not trading book. Similarly, in Annex C-1, paragraph 11.1.5., the mention of a possible deduction of equity holdings presumably only applies in the banking book. Finally it is unclear whether Annex C-1, 6.7.1 regarding the treatment of investments in regulatory capital instruments, applies to trading book positions.

B CREDIT RISK MITIGATION IN THE TRADING BOOK

22. The Commission closely follows the credit risk mitigation treatment proposed by the Basel Committee in the QIS3 Technical Guidance. The Associations support this approach, which will ensure that a common treatment applies to firms engaged in dealing in credit derivatives and securities financing transactions on the main financial markets both inside and outside the European Union.
23. One issue, and arguably the only one, where the Commission has rightly diverged from the Basel Committee, is with respect to the treatment of buyers of first to default credit protection. Article 103 of the draft CAD text grants the protection buyer the option to select the asset in the pool against which to record a short position for regulatory purposes. This treatment is consistent with the parallel treatment of protection sellers, itself predicated upon independence in default across the pool, i.e. a worst statistical case. By contrast, the capital charge proposed in the Basel Technical Guidance is overly conservative and inconsistent with the underlying statistical assumptions. We have submitted comments in this respect to the Basel Committee

and hope that their approach will evolve towards alignment with the Commission's proposal.

24. In terms of "stranding," the current article 103 is too detailed for inclusion in the body of the directive and should be transferred to Annex G-4, paragraph 9. The wording of G-4 paragraph 9, as well as that of paragraph 5 of Annex G-5, is surprisingly at odds with Article 103 and should be brought into consistency with the principle currently embedded in this article irrespective of any other amendments.
25. We recognise that Article 103 amends provisions that are not subject to comitology in an existing directive (CAD, 93/6/EEC). Ideally however we would wish this article to be drafted according to the same principles as those upon which the other provisions of the draft CAD3 have been based. We recognise that splitting Article 103 between core provisions and annexes is a theoretical possibility. We realise that objections may be raised to this approach because it would have the effect of widening the scope of comitology in the CAD without a more thorough debate on the CAD itself. However, this point draws attention to the wider issue that we might, as a result of the current capital review, have a situation where some capital regulations in future will be subject to flexibility and others will not. Although a longer term issue, we ask the Commission to consider taking steps to ensure all capital adequacy regulation can be subject to appropriate and flexible amendment.
26. Both ISDA and LIBA have submitted extensive comments to the Basel Committee regarding the capital treatment of credit risk mitigation in the trading book (see Appendix). These are briefly summarised below.
 - (a) Credit derivatives: The Associations are seeking amendment to the proposed rules in relation to (i) *credit default swap add-ons*, where we suggest the application of a more appropriate add-on for qualifying underlyings; (ii) *specific risk hedges*, where we advocate the adoption of a more risk sensitive measure of the hedge, as well as (iii) the *operational requirements applying to credit default swaps* for obtaining capital relief, which should exclude the need for systematically hedging restructuring risk.
 - (b) Securities financing transactions: The Associations welcome the recognition by the Committee of the use of VaR modelling for measuring exposure on portfolios of repo-style transactions. We however remain concerned that the *multipliers* which the Committee intends to apply where the allowable number of backtesting exceptions is exceeded, is unduly high, and so much so that it might discourage the development of the VaR models themselves. We have advocated the adoption of a more reasonable set of ex post multipliers.
 - (c) Margin lending: The Associations have furthermore argued that margin lending, where subject to daily remargining, should be treated like repurchase agreements in all respects.
 - (d) Potential exposure for OTC derivatives: It is worth noting that the Associations are in continuing discussions with the Basel Committee on allowing a modelled measure of potential exposure on OTC derivatives, in place of the cruder

notional-based add-ons approach. We would hope that the Commission will be able to take into account any future developments in Basel on this subject.

- (e) Legal Enforceability. In its response to CP2, the industry raised concerns in relation to some of the legal and operational requirements for recognition of Credit Risk Mitigation techniques, and these concerns remain valid.

27. In addition to the views summarised above, and turning more specifically to the Commission's draft, the Associations would like to offer the following technical comments:

(i) Funded credit risk mitigation:

28. We are concerned by the illustration of the way the comprehensive approach under the IRB Foundation Approach allows the offset of collateral. The EU methodology, like that developed by the Basel Committee, shows collateral being offset against LGD to reduce the risk weight (Annex E3 3.1.3.2 c(ii)). We believe that the capital regime should instead allow firms to offset collateral against exposures. Whilst both methods yield the same result, firms manage exposures by offsetting collateral against the exposure, and indeed this provides an exposure figure which may then be used in the large exposures regime, and enables reconciliation of data across various areas of the firm. It is unclear what the added complexity of calculating LGD* offers – you have to calculate E* anyway to get to LGD*, so it is simpler to just risk weight E* (which de facto offsets collateral against exposure), rather than use it to scale down LGD.

29. In the same vein, a further concern is the rule in Article 70 stating that notwithstanding the use of credit risk mitigation, firms need to demonstrate that they continue to undertake *full* credit risk assessment of the underlying exposure. This prudential test must still be set at a reasonable and meaningful level. In certain markets such as repo/securities lending it is not business risk management practice to monitor the gross exposure pre-“collateral” offset. This is because knowledge of the gross exposure in such a product is not useful given the intrinsic link between the exposure and collateral legs of the transaction (this is echoed below in our comments on the Large Exposures reporting requirements). It is good business risk management to have scrutiny of the counterparty risk (i.e. the credit risk element of the transaction). Therefore we believe that best practice in the repo market will satisfy the core test of Article 70. However, if “full credit risk assessment of the underlying exposure” is interpreted as meaning that the firm has to demonstrate continuous assessment of the gross exposure, then a fundamental shift in market practice with all the related systems changes and costs, but without any clear prudential benefit would be created.

30. Finally, the treatment of collateralised OTC derivative positions (Annex E-3, 3.1.3.2) should be clarified. The Associations understand that the Basel Committee is now satisfied that applying factor H_E to collateralised OTC derivatives would duplicate with the derivative add-on already imposed for the calculation of Credit Equivalent

Exposures. The draft CAD3 should reflect this understanding. Furthermore, we believe that factor H_E should also be disapplied for collateralised banking book exposures accounted for on an accruals basis. We would appreciate it if the Commission were to clarify that, as stated in the Basel Technical Guidance, collateral posted on OTC derivative transactions will receive a haircut.

(ii) Unfunded credit risk mitigation

31. It would be useful on a more general note if CAD3 could explicitly state that it will be possible to hedge counterparty risk arising in the trading book by buying protection in the form of a guarantee/credit derivative, without incurring any rebate on the amount of offset obtained.
32. Whilst this is not a specifically trading book issue, it would be useful if the Commission could clarify whether the maturity mismatch formula also applies to on balance sheet netting, as per the Basel Committee's proposals.

C IRB APPROACHES IN THE TRADING BOOK:

(i) Specific risk

33. There has, however, been one highly significant change which is to the definition of qualifying items for the purpose of setting specific risk charges in the trading book: namely raising the threshold for an item to be deemed as "qualifying" to a AA-standard from investment grade (BBB or equivalent). Given the magnitude of the effect that this change would have, it is disappointing that the Commission did not highlight this point as a major policy issue and present a discussion of this important item in its cover document. We note that the Commission (paragraph 234 of its commentary, in the section acting as a guide to the working document) states that it wishes to "link" the treatment of specific risk with credit risk in the non trading book. The phrase "link" is ambiguous in its usage here and a number of issues are raised.
34. We are aware, of course, that this "link" has always existed in the CAD in the sense that the definition of qualifying items is referenced to the 20% risk weighting category of the (former) Solvency Ratio Directive, although greater discretion is permitted to institutions subject to the scrutiny of their competent authorities to include items not explicitly identified in the 20% risk weighting category.² Although we have not contacted all EU competent authorities, we would note in passing that the supervisory regulations for the Netherlands, Ireland and the UK³ at the very least, set the threshold at investment grade (BBB or equivalent) level.

² It would be useful if the Commission could clarify that "RSA" in table 1, Annex G-4, refers to the "Revised Standardised Approach."

³ Standardized Method for Debt Instruments 4025-05.1 of the De Nederlandsche Bank Solvency Supervision Directives; Section 4.3.1 and Appendix 3 of BSD S 2/00 of the Central Bank of Ireland; Chapter TI, Section 5.2 of Interim Prudential Sourcebook (Banks).

35. It is possible, though, that by “linking” specific risk and credit risk the Commission means to imply that it believes the two risks are fully analogous. Credit risk in the banking book and specific risk in the trading book are not, however, identical in nature. Specific risk represents the risk of loss arising from variations in credit spreads, themselves reflective of default, downgrade and market liquidity risks, typically analysed over a much shorter horizon than credit risk. This definitional difference justified adopting a distinct approach to specific risk when the Market Risk Amendment to the Capital Accord was negotiated. The same difference exists today and merits a differential regulatory approach.
36. If the Commission were to raise the threshold for qualifying items, the EU would be significantly divergent, i.e. super-equivalent to Basel. We note that the Basel Committee retains the qualifying threshold at the BBB investment grade level. Indeed, in our view, the wording of paragraphs 642-645 of the QIS3 Technical Guidance emphasises that Basel intends the BBB threshold to remain in place.
37. It is of particular concern that the Commission has not argued that there is a need for “EU specificity” in the area of the treatment of Specific Risk as the basis for proposing divergence from Basel. We are surprised that the Commission does not indicate whether or not it has assessed or considered the potential impact on the existing EU jurisdictions by increasing the capital charge when the international standard will remain constant.
38. The Associations believe that the 80% specific risk offset on credit derivatives is arbitrary and risk insensitive and urge the Commission and Basel Committee to review their proposals in this area. ISDA has proposed a more risk sensitive approach to calculating the degree of offset to the Basel Committee.
39. Finally, the wording of the proposed rules regarding specific risk offsets in the trading book should be revised, to acknowledge the fact that credit derivatives generally reference several rather than just one obligation issued by the underlying issuer.

(ii) Counterparty risk

40. With respect to counterparty risk, we would like to draw the Commission’s attention to the need to recognise valuation adjustments: these have the characteristics of a credit risk provision, as they are built to reflect the impact on each exposure’s mark-to-market of a change in the credit quality of the counterparty. They should therefore count as a valid form of capital against counterparty risk charges in the trading book. The Associations have raised this issue separately with the Basel Committee.
41. Furthermore, from Annex D-3 1.3.11, it appears that the Commission plans to bring unsettled transactions within the remit of IRB. We support this, but note that the list of transactions for which a maturity of under 1 year is allowable should be extended
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to cover fails. In this way, the maturity adjusted risk weight would perform a similar function to the maturity scale used for unsettled transactions today. Regulated firms currently benefit from a 4 days window during which they can resolve unsettled transactions without receiving a capital charge. Considering that a vast majority of unsettled transactions are resolved in the first few days following settlement failure⁴, the Associations strongly recommend that the same allowance as under the current CAD be introduced in the draft. Absent this change, a credit risk charge will apply on transactions for which failed settlement is generally reflective of operational failings, and charged separately under the new operational risk framework. The Associations strongly encourage the Commission to avoid double counting of settlement risk.

42. Finally, Annex G5 (2c) on Settlement/counterparty risk states explicitly that “cross-product netting (i.e. between repos and OTC transactions both booked in the trading book) will not be allowed.” We are deeply concerned by this statement. This is inconsistent with developments in risk management and industry master netting agreements, and indeed with recognised practice in some EU jurisdictions. We see no justification for this kind of restriction, provided that the institution has met all of the relevant legal and operational requirements with respect to netting. If the legal documentation and supporting legal opinions are sufficient to permit netting in the first place, why should this be any different for cross-product netting, provided that there is the same level of assurance?
43. Not recognising cross product netting will act as a disincentive for industry to move its own standards forward – as the expectation will be that the regulators do not wish to consider or reward them. For example, work is currently under way to develop the legal basis of cross-product, cross-affiliate netting arrangements. This project has the potential to reduce risk and increase market efficiency. The primary purpose of this work is not to achieve regulatory capital economies. However, if CAD3 were to signal that such developments would not be recognised in regulatory terms, this potentially promising initiative could be frustrated. If this work, or similar projects, delivers legal certainty in its arrangements and demonstrable risk reduction benefits, it is not clear why the CAD3 should prohibit its recognition. In fact this attitude sits strangely with the Commission’s generally encouraging approach towards enhancing best market practices. It would be very helpful to know if there are regulatory concerns with the concept of cross product netting, which interestingly the Basel Committee does not prohibit.

⁴ ISDA’s Operations Benchmarking Survey, run on an annual basis, shows that 65% of respondents resolve payment failures on OTC derivatives trades within 5 days, while payment break resolution takes less than 5 days for 87% of firms.

D LARGE EXPOSURES

(i) Overall impact on Large Exposures capital requirements

44. We are concerned that the consequence of the changes in the credit/counterparty risk capital treatment, will lead to considerably higher large exposure capital requirements for firms when compared to the existing calculation methodology, and believe that this is an unintended consequence of the proposed changes to the capital adequacy framework. There has been no suggestion that the level of regulatory capital set aside against trading book large exposures is currently inadequate.

(ii) Definition of exposure and purpose of Large Exposures (LE) rules

45. For Large Exposures purposes, the Associations support, in principle, the use of a measure of exposure identical to that defined under the new solvency standards. This has the benefit of ensuring consistency between the Large Exposures provisions and the CAD and accordingly reducing the reporting burden placed on firms. We recognise that there might be technical issues relating to the calculation of exposure that may not be easy to resolve in practice. Consistency in measurement reflects the purpose of the LE regime, which is to discourage the build up of concentrated credit risk on single or connected names. Concentration risk is just one of the risk categories for which capital is assigned internally by firms; measures of exposure used for this purpose are identical to those employed for determining credit risk capital. However, as noted above, the Commission need to consider the implications of this on the overall level of capital set aside on large exposures.

(iii) Availability of existing LE exemptions and reduced weights:

46. The Commission notes that for firms treated under the Simple Approach for collateral, the LE exemptions and reduced risk weights provided for at Article 49 of 2000/12/EC, amended as necessary to reflect the new CAD, will continue to apply. The Associations strongly recommend that such exemptions and weights, excluding that provided under article 49(7)(o), continue to benefit all firms, including those treated under the Comprehensive Approach. They are justified, as they target exposures to or collateralised by low risk entities/cash. If they ceased to be available to firms treated under the Comprehensive Approach, the capital impact on such firms could be punitive in comparison with the impact on other institutions, particularly where the large exposures arise from repo-style transactions in the trading book. Given that the Simple Approach is not open to transactions booked in the trading book this is another field in which the impact on active trading firms could be disproportionate and unintentional.

47. The Associations recognise that for firms using portfolio VaR measures of counterparty exposure, the exemptions provided for at article 49(7) will become impractical to apply, but strongly support the possibility to use the reduced weights mentioned at articles 49(8), 49(9) and 49(10).

(iv) Reporting requirements

48. Finally, the Associations fail to perceive the rationale for requiring that not only net, but also gross exposures and exposures to the collateral issuers be reported on an ongoing basis. The Commission, like the Basel Committee, imposes a number of detailed operational requirements on collateral agreements to ensure that these agreements are legally enforceable and kept up-to-date. Firms' collateral practice will be reviewed as part of the Supervisory process, based on these requirements. Where a firm is found to receive reduced capital charges without satisfying the operational test, we would expect the supervisor to envisage, amongst other actions, disallowing

the effect of the hedge. At this point, it would be necessary for the firm to report gross exposures. Most firms are however expected to meet the operational requirements mentioned above, which renders reporting gross exposures meaningless, and only results in considerably increased reporting costs.

E CAPITAL TREATMENT OF CIU INVESTMENTS

49. The Associations welcome the initiative taken by the Commission to offer a market risk treatment for trading book investments in Collective Investment Units. Holdings of CIUs give rise to both general and specific market risks and should be treated accordingly.
50. We acknowledge the attempt made by the Commission to provide, through a spectrum of approaches, a risk sensitive treatment for these holdings, ensuring that risk measured for regulatory purposes is aligned with risk arising from investments made by the Schemes. We accept that the degree of alignment will depend on the transparency of the Scheme manager in relation to the Scheme investments, and the redeemability of the shares/units.
51. Having reviewed the practical means by which the Commission proposes to achieve its dual objective of promoting risk sensitivity and rewarding Scheme investment transparency, we have identified four main concerns with respect to the current draft of the proposals:

1. Distinction between CIU investments and economically similar holdings

Clarity should be provided in Annex G3 as to how the regulators are proposing to distinguish between CIU investments and other economically similar holdings, such as investments in Asset or Mortgage Backed Securities. The industry would suggest that a clearer boundary be established between the two by explicitly limiting the scope of the CIU requirements to open ended funds.

2. There is an unnecessary dependency on UCITS authorisation

52. For a market risk capital regime, what matters most is transparency regarding the risk in the fund (and conditions of redemption), not whether it is UCITS-authorized or not. The Commission appears to be using UCITS authorisation as a proxy for lower market risk, due we assume to the existence of regulation and its harmonised minimum standards. However, there are UCITS-authorized funds that have considerably higher levels of market risk than non-UCITS-authorized funds. The key to deriving appropriate market risk capital charges for these products is that the market risk and composition of each fund are transparent. Where this is the case, that risk should be subjected to the existing market risk regulatory capital requirements.

53. On a more technical note, the Associations would suggest that point 3.d in Annex G-3 be merged with point 3.c, as it effectively relates to the management of the fund and is not referred to as a qualifying condition for access to the look through approaches in the opening part of paragraph 3.

3. The spectrum of approaches suggested is highly complex and in places unworkable

Full look-through approach

54. We welcome the ability to use a full look-through approach. One of the main advantages of this approach stems from the ability to offset positions acquired indirectly via Scheme investments against existing positions in the investing institution's trading book.
55. We understand the rationale for limiting the benefit of a full look-through approach to funds whose unit holders have the right to redeem the units/shares in exchange for the underlying assets. Exchange traded funds clearly meet this requirement. It should however also be possible for the investing institution to avail itself of full look-through provided that the composition of the fund is disclosed on a daily basis, and where redemption is provided for in cash form. In addition, whether the fund is index linked, and what degree of correlation is achieved also appears irrelevant in this respect.
56. Furthermore, whilst the ability to apply a full look-through treatment is welcomed, we would suggest the following amendment to the proposals where the fund is index linked. In keeping with other areas of the market risk rules, firms should have the choice between breaking positions down into their underlying component parts (as proposed) and treating them as one single position in the fund. The single position would be subject to the relevant general and specific market risk capital charges under the existing rules for indices or baskets. A firm might choose to do this for instance, if it had a position in a future that offset the position in the fund – rather than having to decompose both positions into the underlying securities, a firm should be able to offset the respective overall positions. This would always result in a capital charge of the same amount, or higher, as calculated if both positions were decomposed.
57. Finally, on a technical note, should the correlation requirement remain for index linked funds, we would contend that weekly, as opposed to daily, returns are appropriate to calculate correlations.

Capital look-through approach

58. The Associations believe that if the scope of the full look-through approach is broadened as suggested above, there will be little benefit for firms in being able to use a capital look-through approach, as this precludes the offsetting of the fund's positions against the firms' own portfolios.

Partial look-through approach

59. The Associations recognise the need for a partial look-through approach where the composition of the Scheme is not disclosed on a daily basis. We would suggest that rather than founding the approach upon the riskiest possible investment under the Mandate, it should be possible to base it upon the riskiest asset effectively held by the Scheme. Our proposal would only require disclosure of this investment at the establishment of the Scheme, subject to updates as appropriate. The industry strongly welcomes the recognition by the Commission of the ability to net long against short positions in CIUs before calculating the partial look-through charge. Derivative hedges acquired on CIU positions should be taken into account in deriving the net CIU exposure for market risk purposes.

FX risk charge

60. Under both the partial look-through and fall back (“100% capital charge”) treatments, where positions in a scheme are not being decomposed into the underlying positions, we would suggest that an FX charge only applies where the units themselves are denominated in a currency distinct from the investing institution’s base currency. Where full look-through is used, then the FX charge would be applied against the underlying positions as this is consistent with the way in which the market risk is being assessed.

Leverage Related Risk

61. It should be clarified that the proposed treatment does not apply to positions being treated under the full look-through approach since, given the requirements on transparency, any leverage within the fund will have been identified when the fund is broken down, and will have been treated accordingly. We believe that this is the intention of the Commission, but clarity would be helpful.
62. With regard to how leverage impacts on the partial look-through approach, rather than assume that the ability to leverage to maximum levels will be used systematically, it would be more reasonable to treat leverage as an undrawn commitment.
63. Finally, under the fall-back treatment, since no hard and fast rule can be applied for capturing leverage, the Associations would suggest that the supervisors assess the significance of leverage before applying any simple capital charges on CIUs. Our specific capital treatment proposals are outlined at point 4 below.

4. The fall-back treatment for schemes not meeting the transparency/redeemability conditions set out by the Commission for eligibility under the look-through approaches is too onerous.

64. The Associations accept that a simple treatment should be available for funds not meeting the disclosure requirements imposed for eligibility under the look-through approaches. Applying a 1 for 1 capital charge has the merit of simplicity but is considerably too onerous: a 1 for 1 hit systematically exceeds the worst case standardised market risk charge that would apply on direct investments by financial institutions in the assets acquired by the funds. To express the concern in even more simple terms, what is the Commission’s rationale for applying a capital charge that is equivalent to that of the highest risk item that a firm could invest in directly? This is inconsistent with an overall capital framework premised on adequate levels of capital being set aside under reasonable circumstances.
65. The Associations would propose that the fall-back treatment consist of applying appropriate worst case standardised market risk charges, distinguishing by fund category:

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%

66. The capital charges above are predicated on the absence of FX risk and leverage risk. Where significant leverage risk exists in the structure, supervisors should discuss the appropriateness of the charges above directly with the investing institution as part of the supervisory review process. Pillar 2 should also be used for funds not directly matching any of the broad categories identified in the table. Additionally, as already suggested, FX risk would be charged only if a discrepancy exists between the currency in which the units are denominated and the investing institution’s base currency. Finally, netting between short and long positions in the CIU should be recognised before applying the charges.
67. In addition to our comments on the Commission’s proposals per se, we would find it useful if the CAD text could clarify the treatment of (i) options on CIUs and (ii) investments in Collective Investment Schemes indirectly invested in equity.

(i) Options on CIUs should be treated consistently with both the above proposals and the current standardised treatment of options on equity index futures as set out in Annex I of the CAD. Firms should also be able to include options on CIUs within the scope of recognised CAD1 and CAD2 models.

68. In addition, swaps and futures on CIUs should be reallocated to a CIU-equivalent amount and, again provided that the criteria for the Full Look-Through approach are met, decomposed into the underlying securities or treated as a single position, consistent with the current market risk treatment of swaps and futures.

(ii) It is unclear how investments in Collective Investment Schemes which are not directly invested in equity would be treated under the new rules. For instance, a CIU investing in high quality bonds and entering into an equity swap on a basket of shares, will have a value correlated to the value of the share basket. In this instance, we would recommend that the regulators look through to the economic nature of the investment and consider the fund invested in equity.

III Operational Risk

69. As regards the treatment of Operational Risk, the Associations have focused primarily on issues on which the Commission has diverged from the Basel Committee proposals. In particular, we have looked most closely at:
- (a) the proposed differentiation of beta levels, and the Standardised Approach in general;
 - (b) the treatment of insurance.

(a) Beta levels and the Standardised Approach

70. The Associations consider the Standardised Approach (TSA) somewhat anomalous, and have set out in responses to the Basel Committee, serious reservations on this area of the proposals. It requires firms to meet criteria much closer to those required of an AMA firm than a BIA firm, though irrelevant to the allocation of capital by business line. Yet it will demand regulatory capital in line with (or, for some firms, significantly higher than) that which applies under the Basic Approach.
71. There are reasons, however, why TSA remains a real prospect for individual firms. The exact cost-versus-benefit of their implementing the AMA remains uncertain; as does its accessibility for them in practice. Yet, because of the standards that apply under TSA, firms may come under considerable pressure – whether from regulators or ‘market discipline’ – to avoid remaining on the BIA. This means that, while many firms have no great enthusiasm for the Standardised Approach, they are loath to reject it entirely, and can still subscribe to the original concept of an intermediate stage designed to encourage progress towards the AMA by offering some capital relief in return for advances in risk management standards.
72. In that context (and assuming that the mechanism for generating individual betas does not change), it would seem appropriate to ensure that the capital incentive for moving to the Standardised Approach should be set such that no ‘beta’ factor should have to be higher than the ‘alpha’. This will ensure that, even if some firms will still have no capital incentive to move to TSA, no firms will face higher regulatory capital charges under TSA than BIA i.e. are effectively punished for improving their risk management.
73. The objective stated by the Basel Committee of not raising aggregate capital in the system – but reallocating it – will not be achievable in an EU context if the Operational Risk rules are applied to all firms that must follow CAD rules. In particular, the betas proposed by the Basel Committee were derived from a narrower universe of firms (namely internationally active banks) than the wider population of types of institutions falling under the CAD. As a matter of principle, the Associations believe it appropriate that the same multiplication factor should apply to the same business, whatever form of legal entity carries it out, though these factors should logically be representative of all types of institutions and not just Basel banks. At the

same time, care may have to be taken that the playing field does not tilt significantly against Basel banks whose supervisors may, having contributed to their development, be honour-bound to implement the Basel Committee beta factors. Such banks believe that consistency between the Accord and the Directive is paramount. The Associations believe it would be helpful for the Basel Committee and the European Commission to confer further on this, and produce proposals that are consistent in the treatment of each business line while being appropriate for all types of financial firms.

74. A fundamental point underlying these considerations on the Standardised Approach, in the Associations' view, is that there should be the flexibility to recalibrate both the overall approach and the individual beta factors in future, as more data on and understanding of operational risk becomes available. What will be relevant to this calibration is the capital impact of Advanced Measurement Approaches and the implications this has for a progressive capital treatment – together with a risk management 'glide-path' – from Basic Indicator to AMA, as concerns both individual betas and overall calibration.
75. On this issue of recalibration, there is a further, technical consideration, relating to gross income and accounting standards. There are currently proposals to move to fuller use of fair value accounting in the EU. This creates the potential for significant change in firms' stated financial results, including gross income. (Such change could be one-off, following the introduction of fuller use of fair value; but the new accounting standards could also affect the way asset valuation is recorded over a market/economic cycle). In light of this potential outcome, there is a further incentive to plan for recalibration. More generally, the Associations believe it would be beneficial to pursue greater alignment between the capital regime and accounting standards.

(b) Insurance

76. The Commission has carefully highlighted the challenges with regards to incorporating recognition of insurance into the Basic and Standardised Approaches, which are essentially risk-insensitive. At the same time, there may be merits in allowing some formulaic recognition of insurance other than only under the AMA, given the potential systemic benefit.
77. The debate on insurance is complicated by the fact that the market for operational-risk insurance remains relatively undeveloped. However, a capital regime that prudently rewarded use of insurance could only encourage more substantive development of such techniques.
78. Insurance has, ostensibly, been taken into account in Basel's calibration of the two more basic approaches. However, the Standardised Approach is calibrated at exactly the same level as the BIA (while, as discussed above, entailing standards akin to the AMA's). A logical way to ensure that the Standardised Approach constituted a genuine staging post en route to the AMA would be to at least offer recognition of

insurance effects under TSA. This would have the advantage of giving a firm and its supervisors a meaningful understanding of the effectiveness of insurance, providing the basis for a more accurate determination of the appropriate degree of recognition that could later apply under the AMA for that firm.

Premium-based approaches

79. An approach based on premium does, as the Commission notes, run the risk of offering a greater reward (i.e., a reduced capital requirement) for a more poorly run firm (whose premiums would logically be higher). This problem could be exacerbated by any instance of premium reflecting extraneous factors that were not specific to the risk profile of the protection-buyer (for example, generic insurance-industry pricing cycles).
80. It may, in theory, be possible to overcome this latter problem by basing recognition on the expected-loss element of premium, which should logically reflect actual loss experience. To investigate the feasibility of this approach (including a suitable multiplier) would, of course, require more data on premiums and how they are built up than is currently readily available.
81. As regards the first problem, of unjustified incentives, the solution would be the policing by supervisors of such recognition (reinforced by market discipline effects). Such policing must naturally occur under AMA, in any case. It should, moreover, be remembered that the potential for greater reward in the face of a poorer risk profile would be relative and marginal. In combination with the policing of recognition, limits on the recognition afforded, both in aggregate and in relation to individual contracts, would counter the marginal effects associated with recognition based on (the EL portion of) premium.

Limit-based approaches

82. The Commission states that, from a conceptual point of view, 'limit-based' approaches – i.e., the recognition of (some set portion of) the pay-out that a contract affords – is closer to the spirit and mechanics of the AMA, by dint of being more focused on specific risks. This is undoubtedly true. Why this necessarily means rejecting such recognition of insurance under simpler approaches is not, however, apparent. Recognition of credit-risk mitigation is, after all, afforded under simpler approaches to credit-risk capital.
83. If necessary, limits can easily be set on the recognition of insurance under such an approach, whether fixed or temporary and reviewable. As discussed above, an approach that was consistent with that available under the AMA (albeit offering a lesser degree of recognition) would make the overall framework for operational risk more coherent, as well as ensuring a more logical capital gradation.

(c) Further points

84. Segregation rules proposed in Annex H-7. We have specific detailed comments to make on the content of this annex, which are contained in Annex 1 to this response document.
85. Expenditure Based Capital Requirement (Annex IV of 93/6/EEC). We acknowledge that the Commission retains for the present an open view on whether or not to retain the Expenditure Based Capital Requirement (EBR). Our preference would be for this option to be maintained in future legislation, but there should be complete clarity that the EBR is a “fall back” capital charge and that it is not designed to be additive to any credit, market or operational risk charge to which an institution is already subject.
86. In Annex H-3(2), “Prime Brokerage” is included under Trading & Sales, yet “Margin Lending” is included under Commercial and Retail Banking (in the footnotes). Given that these terms are often used interchangeably, the Associations believe some sort of clarification will be necessary.
87. Annex H-4, section 1.1(d) sets out a requirement for regulator review of operational risk management processes and measurement systems, to be “performed [by] internal and external auditors.” Specifically, the requirement to involve external auditors on a routine basis is burdensome and costly and should, in the Associations’ view, be amended , such that use of external auditors apply where necessary or relevant.
88. Paragraph 114 of the Cover Document implies that Dealing on own account and Underwriting on a firm-commitment basis are inherently more risky activities. This determination appears subjective and it would seem prudent at the very least to ensure that there is scope to review this assumption in future.
89. Paragraph 89 of the same document refers to a set of “basic risk management standards applicable to every institution”. It should be specified which standards are envisaged here (though the details would, we presume, properly be spelled out in an Annex).
90. Finally, it will be necessary to spell out the mechanics of calculating capital requirements under the BIA/TSA, specifically the frequency and timing of such calculations.

(i) Support for core principles of Supervisory Review Process

91. The core concepts of the Supervisory Review Process (SRP) are that firms themselves should first and foremost be responsible for their own capital adequacy. Secondly supervisors should be satisfied that the capital adequacy of the firms is indeed appropriate to the nature and scale of the risks of the institutions in question. This means that a firm cannot rely merely on compliance with the basic minimum standards set out in regulations, but instead must actively assess, manage and provide against the risks to which the institution is exposed. We support this approach.

(ii) Support for minimum harmonisation of supervisory powers

92. The SRP goes further still and states that supervisors should be able to intervene with firms in certain circumstances. We support this approach also and in particular welcome the minimum harmonisation of supervisory powers indicated in the working document.

93. Balance is necessary, however. We note that there is no framework within which these powers are intended to be used. This leads to concern that the practical exercise of these powers will be extremely divergent between jurisdictions and will thus impair the level playing field.

(iii) Support for qualitative standards as best safeguard against “one size fits all”

94. We note and accept that the introduction of SRP represents the most far reaching application of a qualitative regime in the context of capital adequacy to date. It is, of course, not the first time that qualitative standards have been set out in regulatory capital legislation, but the scope has increased considerably. We believe that this is an appropriate development as qualitative standards do not, of themselves, lack objectivity. Further, such standards are the best way to avoid a “one size fits all” which we believe leads to imprudent and unjust outcomes in very many cases. Nevertheless the SRP **must** be introduced with suitable safeguards. Where qualitative standards are used poorly they lead to grave inconsistency of approach.

(iv) Concern regarding Scope of application of SRP

95. The provisions concerning the Supervisory Review Process indicate that the requirements are to apply at the level of each individual institution. No account is taken of the fact that the capital adequacy processes are likely in the majority of cases to be operated at a group level where capital adequacy requirements, of course, also apply. At present there appears to be an absence of mechanisms to ensure (as opposed to facilitate) the co-operation of competent authorities responsible for regulated firms at different levels of consolidation within a group. It is important, for example, for the supervisor of a consolidated or sub-consolidated group to understand the SRP regime applied to individual firms within the consolidation, particularly when additional capital has been required by the local supervisor. Without this knowledge a

supervisor cannot truly assess the adequacy of the capitalisation at the group/sub-group level.

96. The inter-relation between the individual institution and the group level thus requires further analysis to prevent the imposition of unrealistic burdens upon institutions. The caveat that processes should be proportionate to the nature and scale of the institution in question will not avoid unnecessary and unfruitful duplication of effort within group structures, if the requirements apply rigidly at individual firm level. As a minor technical point, in this context, we wonder what the phrase “whole organisation” is intended to mean in Annex I1(5)(1). It is important that the application of SRP underpins capital adequacy within financial groups in the EU, and does not increase bureaucracy at the expenses of genuinely meaningful and rigorous processes.

(v) Supervisory Convergence is essential

97. The consistency and quality of the new capital regime will depend crucially on supervisory practice. The industry believes that convergence and transparency of supervisory practice are essential to the success of the new regime.

a) *Need for a framework to avoid distorting minimum standards*

98. We are gravely concerned that certain discretions will lead to too great a distortion of the minimum standards. Therefore we believe that the qualitative nature of the SRP requirements needs to be placed within a more structured framework. We do not suggest that the process of supervision (concerning how supervision is conducted) should be prescribed but fear that too great a divergence of approach towards the aims of SRP could lead to widely different standards being applied in different jurisdictions.

b) *Need to assess consistency of approach*

99. The need for a framework can be seen in a number of places. The factors set out in Annex J-2(2) which the competent authorities should use in their evaluation of the capital adequacy processes of firms have no framework or context in which they can be interpreted. We appreciate that the fullest articulation of these standards does not belong in a legislative text. However, the minimalist approach taken in this Annex is too abbreviated and the thinking behind the choice of factors is not entirely clear.

100. Furthermore we note that of the range of factors set out in Annex J-2(2) some are subject to clear legislative minimum requirements and others are not. For example, the structure and amount of own funds is governed by Own Funds provisions in the consolidated banking directive and there are also directive requirements for shareholder controllers to be fit and proper. Other factors such as “objectives and articulation of strategy” and “legal structure and ownership” are not subject to any existing minimum standards, much less any internationally agreed benchmarks or converged standards of assessment.

101. Of even more concern is that some of the Annex J-2 factors appear to move considerably beyond the field of capital adequacy. Competent authorities are asked to

assess firms' capital adequacy processes in the light of factors in Annex I 1 and 2, but to intervene with the institution to remedy weaknesses detected in the factors listed in Annex J-2(2). It would be reasonable to expect, therefore, that the factors in Annex J-2(2) had a clear and unambiguous bearing on the soundness of the firms' capital adequacy. It is not at all clear, though, that the legal structure and ownership, structure of current and planned business or the objectives and articulation of strategy are wholly within the field of capital adequacy assessment. These issues are at the core of a firm's entire corporate governance rather than capital adequacy per se. We are glad that the Annexes I and J avoid a mechanistic approach towards risk, but it is essential that both annexes retain a clear relevance and focus in their relationship towards the capital adequacy of firms, rather than seeking to become too generic and too wide.

c) EU institutions to facilitate process

102. We call upon the Commission and the other European Institutions to facilitate and support greater consistency and convergence of supervisory practice. We do not suggest that there is a single effective or appropriate model for supervision within the EU, rather steady convergence based on an enhanced understanding of the evolving financial industry would be a welcome aim.

d) Need for more supervisory infrastructure

103. There is at present little infrastructure supporting the exchange of information and best practice particularly in the evolving approach towards the assessment of capital adequacy by firms and the authorities themselves. The Groupe de Contact is a notable exception to this, but it is an informal and confidential committee whose mandate can productively sit alongside any additional structures established to probe the issues surrounding the Supervisory Review Process. Supplementary committees, ideally mandated to publish papers, and peer group review structures would do much to foster industry confidence as well as a confident evolution by the supervisors themselves.

e) Legislation should support a concept of "upwards convergence"

104. Legislation can and should be used to emphasise the fact that industry and regulator alike need to concentrate on enhanced risk management practices. Regulators should create incentives for improvements in this field. Industry is dynamic and it is vital the regulators keep pace with and reward emerging best practices. Failure of the regulatory process to evolve will ultimately lead to perverse incentives that will be damaging for the firms and the financial system as a whole.

(vi) Transparency and public disclosure by supervisors is also essential to ensure consistency of application

105. A general interest exists in monitoring the impact of the new EU capital adequacy regime regulations in terms of systemic stability but also to ensure competitive equality. It is not possible to anticipate every aspect of the impact of the regulations partly because they are complex and dynamic in nature but also because of the

necessary flexibility built into the regime. In reality , the impact could differ substantially across Member States.

106. Those with an interest in monitoring this impact include of course supervisors, but also government, legislators, industry and consumers. Currently it is proposed that only supervisors and government will have access to such information. We firmly believe that all those with an interest have a right to understand the impact of the new regime upon the EU financial system and any material differences driven by Member State interpretations. This is only possible in an environment in which the necessary data is readily available, and so we propose that a policy of supervisory disclosure is built into the new EU capital adequacy regime. At present it is proposed only that individual firms make disclosures and that Member State supervisors exchange information. It will be impractic al for private third parties to aggregate the former and it is intended (rightly) that the latter remains confidential. Supervisory disclosure would redress this imbalance.
107. Supervisory disclosure is a simple, cost efficient and potentially effective policy built upon the accepted observation that the market can inform and discipline implementation. We would propose 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.
108. We would stress that the third element is essential. For example, it would be useful to understand what proportion of firms have achieved the more sophisticated approaches (Credit risk IRB, Internal Model recognition for Market Risk and Operational risk AMA), the average capital required under SRP and recognised ECAIs in any jurisdiction. 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.
109. 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.
110. 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.

111. On a separate issue we support, however, 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. We have grave fears that if there were mandatory disclosure of this information the regulators would be inhibited to the extent that the application of Pillar 2 would become extremely sporadic.

(vii) Balance of flexibility struck in working document is very encouraging

112. We applaud the fact that the drafting of the working document concentrates on identifying those elements that supervisors should concentrate upon, rather than attempting to specify the manner in which the supervisors should carry out their reviews and appraisals. The first section of Annex I2 encapsulates the degree of detail without prescription that we believe to be most appropriate: a clear identification of the requirements placed on an institution, but no specification of the way in which the firm must satisfy the requirements.

(viii) Capital Assessment

a) *Institution’s Capital Adequacy Assessment Process*

113. The language of Annex I2(1) suggests that the firm’s own assessment will always be higher than the regulatory capital minimum requirements, but this may not necessarily be the case. We should note in this context that the 100% risk weight under the existing standardised approach, which led to an over statement of risk of a number of asset items was a prime driver both of the structured finance market and also of the current capital adequacy review. Although the new regime will have much reduced “over statement” of required capital, there will be areas in which this is still likely to be the case. There should be explicit acknowledgement that the amount of additional capital calculated under Pillar 2 could be zero, provided that the firm can justify that.

b) *Increased capital is not always the right response.*

114. If a firm were to have a legal structure that rendered the interests of depositors unsafe, or if there were an incoherent or unsafe business strategy then arguably the authorities should intervene as the right of a firm to retain its authorisation may well be called into question – but it is by no means clear that these concerns are an expression of deficient capital adequacy (or capital “inadequacy”). Increased capital is not always the right answer for business, systems and control risks, e.g., an inadequate business plan. Yet the Annex J2(2) factors – which are all presented in the wider context of capital adequacy (i.e. a directive governing capital adequacy) may lead regulators to the conclusion that increased capital is always and everywhere a safe or neutral option. This is not the case, not least as some firms might be forced to move their business higher up the risk-return curve to generate returns on the new increased levels of capital that the regulator demands.

c) *Economic capital*

115. There are references to the use of economic capital measures in the commission paper (e.g. Annex D-5 100). We would note that “Economic Capital” means different things to different people, and it would be better to refer to the concept that is meant, rather than to this phrase (or to clearly defined Economic Capital). In addition not all institutions have models that would be regarded as economic capital models and would ask for references to economic capital to be modified to ensure that a rigid legalistic approach does not accidentally prohibit the use of valid models by institutions.

d) *Nature of risks against which capital can be applied*

116. The working draft refers in Article 127(2) to the need for institutions to have an appropriate treatment of “all risks, including non measurable ones.” Annex F1(1) states that institutions shall design policies and procedures to identify, *measure*, monitor and control risks as well as establishing limits. Hence, the present drafting may make the annex requirement unworkable. However, if the annex referred to “*assess*” rather than “measure” and clarified that limits should be set for quantifiable risks, then the language would set a practical task that could be achieved.

4 MARKET DISCIPLINE

117. We support the general approach taken by the Commission in this document. We appreciate the sensitivity to the appropriate frequency and level of disclosure, whether on individual basis or on the basis of different levels of consolidation.
118. We encourage the Commission 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.

ANNEX 1 re Modified Capital Requirements for Operational Risk

Modified Capital Requirements for Operational Risk: compliance with segregation rules proposed in Annex H-7, section C⁵

We support the general principle that higher risk management standards warrant in many cases, a lower regulatory capital charge. We further agree that identifying the segregation of customers assets, including in particular, the segregation of client money is a reasonable feature to focus on for these purposes. A firm which segregates client money clearly poses a lower level of risk in terms of customer protection than a firm undertaking the same business which does not. However, we believe that additional work is needed to establish how the modified capital charge should be calculated. We are mindful that the concept of a differential treatment on operational risk generally is not wholly supported and our comments should be read in that context.

Our understanding is that the Commission are proposing a regime under which the specified requirements on segregation that are proposed in section C to Annex H-7 would have to be met *only* by those firms wishing to benefit from the reduced operational risk charge and *not* by firms more generally. However, the drafting of the proposals needs to make this clear. In addition, in order for the proposed regime for modified operational risk capital requirements to be effective in practice, the segregation standards will need to be proportionate for their purpose and our comments below explain why in a number of important areas the draft provisions in section C fail to satisfy this criterion.

Our central concern is that the Commission's current proposals do not track industry good practice and, in particular, diverge from the arrangements that Member States already have in place in implementing the requirements for safeguarding investors' instruments and funds under Article 10 of the Investment Services Directive. As a result, we believe that few firms, if any, will be able to benefit from the special regime proposed unless significant changes are made.

We have identified fourteen areas of concern/issues to be resolved at this stage.

1. Paragraph H-7C.1 provides that institutions "must ensure that clients' assets are segregated at any time from those belonging to *other clients* or to the institution itself" (although both paragraphs (i) and (ii) appear to envisage global client accounts). It must be understood that to require every clients' funds/instruments to be segregated from every other clients' would be prohibitively expensive and that segregation *can* be achieved by pooling, which is the approach adopted in the great

⁵ Our Members are still considering the need to comment on the proposals contained in Annex H-7, section B for firms with limited licence.

majority of cases by firms. The proposed standards must confirm explicitly, therefore, that the efficacy of global accounts is recognised.

2. There is no apparent carve-out for delivery versus payment transactions through commercial settlement systems. This is fundamental to the cost-effectiveness – and, indeed, practicality – of the Client Asset rules in the UK, for example, where money due in a DVP transaction is not treated immediately as client money and where investments do not have to be immediately segregated (for convenience, copies of the Financial Services Authority’s rules on this aspect are attached).
3. Firms can transfer client money to another undertaking without discharging the fiduciary duty owed to the client: for example, payments to an exchange or clearing house, or initial or variation margin payments made to an intermediate broker. It is not apparent that such payments would be recognised under the regime proposed.
4. The proposed rules as drafted do not seem to recognise that there are overseas jurisdictions where different settlement, legal and regulatory requirements prevail: section C must be amended to allow customer’s assets to be held in such jurisdictions – provided that the customer is notified – without the firm being held to be in contravention of the requirements.
5. In some EU countries market counterparties and categories of sophisticated client are allowed to “opt out” of client money segregation, and in some areas notification/consent requirements differ also (for example, and as noted above, in the case where it may be necessary to hold money other than with an approved bank because of the applicable law or market practice in certain overseas jurisdictions). It is not apparent that these arrangements could be maintained under the proposals (although it may be that such clients would not be regarded as “investors”).
6. There are cases where it is not necessary to apply the full range of the custody rules to all business or to all firms given that they may be subject to the general law with regard to the appropriate treatment of clients’ investments as well as to the provisions of the relevant trust instrument/scheme constitution in the case where a firm is acting as a custodian for a trust or collective investment scheme: it would be wrong for such firms to be ineligible for the proposed regime just because *part* of their business is not conducted in compliance with the proposed rules in section C.
7. In a similar vein, particular issues arise as regards the custody of unquoted securities where custodians can decline to provide safe custody services because their systems are not tailored for the business concerned. In such cases, firms have to make arrangements for safeguarding customers’ assets in other ways and, again, it would be wrong for firms in this position for part of their business to be ineligible for the proposed regime.
8. Paragraphs C1(i) and (ii) refer to funds and instruments being held by “[third parties] supervised institutions”, and it seems that a bank affiliated to an investment firm

might not fall within this description. This would be unnecessary as regards to customer protection and is at odds with arrangements under which firms are able currently to use banking affiliates to hold safe custody assets provided that appropriate disclosure is made to the client.

9. In a number of areas the proposals envisage the imposition of *specific requirements* rather than setting out the *characteristics* of the fundamental protections which should be achieved. This creates the risk that current arrangements which operate successfully would not be recognised. For example, for firms subject to the Financial Services Authority's rules, daily calculations and 25 business day reconciliations are required – and it is not clear that the proposed requirements recognise this arrangement (see below). The FSA also allows for two different methods for segregating client money – one of which (the “alternative approach”) allows a multi-product and multi-currency firm initially to receive client money into its own bank accounts – and for calculating whether the appropriate amount of client money has been segregated. It would make no sense for the modified EU capital regime to exclude firms complying with such equivalent, alternative arrangements.
10. There are two concerns about over-detailed requirements at this stage. First, the reference in C1(iv) to the establishment of *accounting systems* capable of identifying *each client's* position at any time whereas, in fact, it is likely that this information will be held in other systems which feed in to a firm's accounting system: the provision should require simply that the firm must have systems that can identify the client's position at any time. Second, the final part of C.1 – the unnumbered paragraph at the end – which would require at least quarterly compliance reports (or monthly reports in the case of 730K firms) which could cut across the different but equivalent arrangements which regulators have introduced. The rule should be amended, therefore, to refer just to the need to report at intervals to be determined by the relevant competent authority. (It is also not clear what is meant by “compliance reports” in this context [; and the proposed requirement, as drafted, seems to apply equally to both clients' funds and instruments whereas normally the focus of such reporting is the segregation of client money].)
11. There are provisions where the proposed requirements are unclear and/or appear to envisage excessive reporting by firms: in the final unnumbered paragraph dealing with reporting and notifications, it is not clear what is meant by “deficiency” in this context – does this mean non-compliance with a rule, or a shortfall in the amount of client funds/assets? – and there should be an exemption from the requirement to report when a deficiency is not material.
12. In a similar vein, perhaps, C.1(vi) refers to the provision of *periodic* statements to clients: it is not clear that *annual* reports would suffice for this purpose although this is the requirement in the UK, for example.
13. In addition, and on the drafting, it needs to be clear that assets received or held in connection with an arrangement to secure the obligation of a client in the course of, or

in connection with, a firm's investment business – i.e. collateral – are not covered by the proposed requirements.

14. Finally, under the Investment Services Directive, credit institutions are not prevented from using investors' funds for own account (see Article 10): it seems, therefore, that credit institutions benefiting from this ISD provision would be *unable* to benefit from the modified capital regime that is envisaged.

EXTRACT FROM FSA CONDUCT OF BUSINESS RULES

Chapter 9: CLIENT ASSETS

Section 1: CUSTODY

9.1.13 R

Delivery versus payment transactions

A designated investment need not be treated as a safe custody investment in respect of a delivery versus payment transaction through a commercial settlement system if it is intended that the designated investment is either to be:

- (1) In respect of a client's purchase, due to the client within one business day following the client's fulfilment of a payment obligation; or
- (2) In respect of a client's sale, due to the firm within one business day following the fulfilment of a payment obligation;

unless the delivery or payment by the firm does not occur by the close of business on the third business day following the date of payment or delivery of the designated investment by the client.

9.1.15 G

Modification of scope

It is not necessary to apply the full range of the custody rules to all types of firm. For example, certain firms already have extensive obligations imposed on them under the general law with regard to the correct treatment of client's safe custody investments. Likewise the full range of the rules is not appropriate for a firm that only arranges safe custody services for its clients. Consequently, the rules provide for appropriate differentiation of scope and application of the rules.