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Mr John F. Mogg
Director-General
European Commission
Internal Market DG
Rue de la Loi 200
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29 March 2000,

Dear Mr Mogg,

ISDA RESPONSE TO CONSULTATIVE PAPER ‘ A REVIEW OF REGULATORY CAPITAL REQUIREMENTS FOR EU CREDIT INSTITUTIONS AND INVESTMENT FIRMS’

ISDA is pleased to have the opportunity to comment on the Commission services’ paper ‘A review of regulatory capital requirements for EU credit institutions and investment firms’. This paper explores a vast array of issues, a number of which also feature prominently in the Basel Committee’s consultation document ‘A new capital adequacy framework’. Our views on these common topics are laid out in the attached submission to the Basel Committee.

In addition, ISDA has identified two issues of particular concern to its members in the EU context : (i) the treatment of “small” (i.e. mostly domestic) versus large internationally active credit institutions and (ii) the appropriateness of mandating horizontal consolidation for EU financial firms whose parent is a non-EU company.

(i) Small versus large credit institutions :

The relative treatment of small versus large credit institutions is not addressed per se in the consultation document published by the Commission services, but was felt of significance by the ISDA membership, notably in relation to how EU regulators may develop their supervisory review function.

Each credit institution, regardless of its 'size' (however this might be defined), runs credit, market and operational risks. As capital requirements become risk-based, they will automatically adjust to the risk run independently from the 'size' of the credit institution in question. It follows that small credit institutions arguably deserve the same treatment as large internationally active ones under the new capital adequacy framework.

ISDA believes that the framework outlined in its Basel response for addressing the various risks run by banks can validly apply to small credit institutions.

To maximise the efficiency of supervision, and taking account of the fact that failure by a small institution will not in principle entail the same consequences for the banking system as failure by a major firm, ISDA would suggest that the intensity of supervisory reviews (in both frequency and amount of resources invested on a review) might be a function of institution size, mitigated by the complexity of the risks run by the firm concerned.

Size would hence primarily impact on the implementation of Pillar II (as defined in the Basel Committee's consultation paper), not on how minimum capital requirements are set (Pillar I).

(ii) Horizontal consolidation

The Commission services' paper suggests that for financial institutions whose parent is outside the EU, horizontal consolidation should be mandated. The purpose of horizontal consolidation would be to enhance the supervision of the intra-EU activities of the group and, arguably, to mitigate contagion risk.

ISDA does not agree that this is the right way of approaching these issues. It is, in fact, unclear whether mandating horizontal consolidation in the way proposed would provide significant additional supervisory benefits. In particular, to the extent that consolidation is intended to address risks of contagion of the locally authorised institution by other members of the group, horizontal consolidation is likely to be of limited benefit where the activities of the world-wide group of which the EU authorised institutions form part are conducted mainly outside the EU.

In view of the above, imposing an additional layer in the structure of financial groups, with all the costs entailed, would not be justified by the supervisory benefits obtained.

Horizontal consolidation of part of a group should therefore at most be imposed in exceptional cases, and then only with the agreement of all the EU regulators concerned.

ISDA nevertheless recognises the legitimacy of EU regulators' concerns regarding the financial health of non-EU parents of EU incorporated financial institutions. In the specific case of securities firm parent companies, ISDA believes that these concerns may be allayed by establishing proper means of exchanging supervisory information between the EU regulators concerned and the relevant home country regulator. Such Memoranda of Understanding already exist between a number of EU regulators and their counterparts outside the EU. Legislative developments at national level in some countries might further facilitate the integration of supervision of financial groups headquartered outside the EU.

Finally, ISDA views the current Capital Accord review process as a unique opportunity to introduce a capital adequacy framework that is better suited to the risks being run by financial institutions and to their management of those risks. This principle has influenced our response throughout. More than 40 major institutions in over a dozen countries participated actively in the detailed formulation of this response, supported by specialist working groups in each of the key areas of the Conceptual Framework, Internal Ratings (with groups working on both the measurement and the mitigation of credit risk) and Operational Risk. We would be pleased to elaborate further should this be deemed useful.

Yours sincerely,

Mark Harding
ISDA Vice Chairman and
Chairman of European Regulatory Committee