



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.02.1998

COM(1998) 90 final

97/0124 (COD)

**AMENDED PROPOSAL FOR A EUROPEAN PARLIAMENT AND COUNCIL
DIRECTIVE AMENDING DIRECTIVE 93/6/EEC ON THE CAPITAL
ADEQUACY OF INVESTMENT FIRMS AND CREDIT INSTITUTIONS**

(COM(97)71 final

(presented by the Commission pursuant to Article 189 a (2)
of the EC-Treaty)

EXPLANATORY MEMORANDUM

I. INTRODUCTION

The proposal for a Directive concerned by this amended proposal was submitted to Parliament and the Council on 17 June 1997 pursuant to Articles 189b(2) and 57(2) of the EC Treaty.

The Economic and Social Committee handed down a favourable opinion at its 349th plenary session on 29 October 1997. Two of its suggestions (regarding the length of the transitional period and back-testing) have been incorporated into the amended proposal, Parliament having adopted an amendment to that effect.

Parliament adopted (first reading) the legislative resolution giving its opinion on the proposal for a Directive (COM(97)71 final) at its sitting on 18 December 1997.

Parliament's opinion comprises 10 amendments; they have been included in this amended proposal.

II. COMMENTS ON THE AMENDMENTS

Parliament called on the Commission to amend nine points in the proposal for a Directive. The Commission considers the amendments to these points to be acceptable.

The **first and second amendments** extend the transitional provisions for the use of alternative spread, carry and outright rates for commodities risk until the end of 2006 (recital 8 and Article. 1, paragraph 5a). The European Parliament has proposed this extension in order to give those institutions intending to use internal models for commodities risk more time to develop appropriate systems and improve their internal control environment. This accords with a suggestion made by the Economic and Social Committee in its opinion. The Commission accepts that this extension is justified because of the difficulties of introducing internal models for some financial institutions trading in commodities.

The **third amendment** (Annex VIII, paragraph 3) provides more detail on how back-testing should be undertaken. The Commission has accepted these specifications

proposed by the European Parliament, because they make the provisions clearer, particularly with regard to the frequency of the back-tests required.

The **fourth and ninth amendments** (Annex VIII, paragraph 4a and Annex VIII 7a & b) introduce additional conditions required to permit the use of internal models for calculating regulatory capital for specific risk as well as additional arrangements regarding the multiplication factor in the context of specific risk. The European Parliament has proposed these provisions following adoption of such rules by an international forum of banking supervisors. The Commission agrees with the inclusion of these provisions in order to avoid competitive disadvantages for EU institutions.

The **fifth amendment** was introduced by Parliament to clarify that institutions whose models do not meet the extra conditions with respect to specific risk as introduced by the fourth amendment must continue to calculate capital requirements for specific risk according to Annex I of the original directive. The Commission agrees that this is a helpful clarification.

Amendments six, seven and eight provide further explanation of how back-testing should operate in relation to the application of the "plus factor". In particular they specify that for the purposes of calculating the "plus factor" back-testing may be done on either actual or hypothetical (assuming unchanged end-of-day positions) results and that the value-at-risk calculated by the model must correspond to a one day holding period for the portfolio. In addition they provide competent authorities with the option to waive the "plus factor" in particular circumstances, they impose sanctions if back-testing shows the model to be inadequate and they specify reporting requirements. These amendments proposed by the Parliament reflect similar recommendations by the Economic and Social Committee in its opinion. The Commission considers that the clarifications are helpful in substance but has made some minor adaptations to the text proposed by the Parliament in order to achieve consistency and notably to avoid duplication with parts of amendment 3.

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(COM(97)71 final

Original Proposal

Amended Proposal

Amendment 1

8th recital

8th recital

Whereas some investment firms dealing primarily in commodities and commodity derivatives may not yet be able to use internal models or to comply with the capital requirements for commodities risk as laid down in this Directive; whereas it is expected that appropriate, cost effective internal models for investment firms on the risk management of commodities and commodities derivatives, in particular for options, will be available shortly; whereas, in order to give those firms sufficient time to upgrade their risk management systems, competent authorities, under certain conditions, should not be obliged to prescribe the capital charges for commodities referred to in Annex VII to Directive 93/6/EEC for investment firms before 1 January 2000.

Whereas some investment firms dealing primarily in commodities and commodity derivatives may not yet be able to use internal models or to comply with the capital requirements for commodities risk as laid down in this Directive; whereas it is expected that appropriate, cost effective internal models for investment firms on the risk management of commodities and commodities derivatives, in particular for options, will be available shortly; whereas, in order to give those firms sufficient time to upgrade their risk management systems, competent authorities, under certain conditions, should not be obliged to prescribe the capital charges for commodities referred to in Annex VII to Directive 93/6/EEC for investment firms until after 31 December 2006.

Amendment 2

Article 1, paragraph 5a (new)

Article 11a is inserted:

“Article 11a

Up to 31 December 2006, Member States may authorize their institutions to use the minimum spread, carry and outright rates indicated in the following table rather than those indicated in Annex VII.13, 13.a, 16 and 16.a, provided that those institutions, in the opinion of the competent authorities:

- carry out a significant volume of transactions in commodities;

- have a diversified portfolio of commodities;

- are not yet in a position to employ internal models as part of their risk management system for the calculation of the capital requirements in relation to their commodities position in accordance with Annex VIII.

Minimum spread, carry and outright rates

	<u>Precious</u> <u>metals</u> <u>(except</u> <u>gold)</u>	<u>Base</u> <u>metals</u>	<u>Perishable</u> <u>goods</u> <u>(agricultural</u> <u>products)</u>	<u>Other</u> <u>goods</u> <u>inc.</u> <u>energy</u> <u>products</u>
<u>Spread</u> <u>Rate (%)</u>	<u>1.0</u>	<u>1.2</u>	<u>1.5</u>	<u>1.5</u>
<u>Carry rate</u> <u>(%)</u>	<u>0.3</u>	<u>0.5</u>	<u>0.6</u>	<u>0.6</u>
<u>Outright</u> <u>Rate (%)</u>	<u>8</u>	<u>10</u>	<u>12</u>	<u>15</u>

Member States applying this Article shall provide the Commission with the necessary information.”

Original Proposal

Annex VIII, paragraph 3

3. The competent authorities shall also be satisfied that the institution's models continue to be reasonably accurate, as evidenced by a regular back-testing programme to be conducted by the institution.

Amended Proposal

Amendment 3

Annex VIII, paragraph 3

3. The institution shall monitor the accuracy and performance of its model by conducting a back-testing programme. The back-testing has to provide for each business day a comparison of the one day value-at-risk measure generated by the institution's model for the portfolio's end-of-day positions with the one day change of the portfolio's value by the end of the subsequent business day. Competent authorities shall monitor the development by institutions of the capability to perform back-testing on both actual and hypothetical changes in the portfolio's value. Back-testing on hypothetical changes in the portfolio's value is based upon a comparison between the portfolio's end-of-day value and, assuming unchanged positions, its value at the end of the subsequent day.

Amendment 4

Annex VIII, paragraph 4a (new)

4a. For the purpose of calculating capital requirements for specific risk associated with traded debt and equity positions the competent authorities may recognise the use of an institution's internal model if in addition to compliance with the conditions in the remainder of this Annex the model:

- explains the historical price variation in the portfolio,

- captures concentration in terms of magnitude and changes of composition of the portfolio,

- is robust to an adverse environment, and

- is validated through back-testing aimed at assessing whether specific risk is being accurately captured. If competent authorities allow this back-testing to be performed on the basis of relevant sub-portfolios these must be chosen in a consistent manner.

Original Proposal

Annex VIII, paragraph 5

5. Notwithstanding paragraph 1, institutions using models shall be subject to a separate capital charge to cover the specific risk of traded debt instruments and equities as described in Annex I to the extent that the competent authorities consider that this risk is not incorporated sufficiently into their models. The competent authorities shall in any case set a minimum specific risk charge of 50% of the charge as calculated according to Annex I for institutions using models.

Amended Proposal

Amendment 5

Annex VIII, paragraph 5

5. Institutions using internal models which are not in accordance with paragraph 4a shall be subject to the separate capital charge in respect of the specific risk calculated according to Annex I.

Original Proposal

Annex VIII, paragraph 7 – second sub-paragraph

The value-at-risk number calculated by means of the model shall be compared with the actual change in value of the portfolio. Back-testing shall be carried out daily on the basis of both effective and, assuming unchanged end-of-day positions, hypothetical changes in the portfolio value.

Amended Proposal

Amendment 6

Annex VIII, paragraph 7– second sub-paragraph

The value-at-risk number calculated by means of the model shall be compared with the actual change in value of the portfolio. Back-testing shall be carried out daily on the basis of actual or, assuming unchanged end-of-day positions, hypothetical changes in the portfolio value. The value-at-risk number subject to the backtesting must correspond to a holding period of one day. Before using an internal model to determine its own funds, the institution shall also obtain the approval of the competent authorities, inter alia, for the type of changes (actual or hypothetical) to be used in its backtesting. The institution must also apply the method selected consistently.

Original Proposal

Amended Proposal

Amendment 7

Annex VIII, paragraph 7 – second sub-paragraph

Annex VIII, paragraph 7– third sub-paragraph

If the change in portfolio value exceeds the value-at-risk calculated using the model, the target has been overshoot. The number of overshootings, as set out in table 5, shall be based on a spot check of 250 values.

If the change in portfolio value exceeds the value-at-risk calculated using the model, the target has been overshoot. The number of overshootings, as set out in Table 5, shall be based on a statistical sample of daily values covering the 250 most recent working days.

For the purpose of determining the ‘plus’ factor, the number of overshootings shall be determined at least quarterly

Original Proposal

Annex VIII, paragraph 7 – last three sub-paragraphs

The competent authorities can, in individual cases, waive the requirement to add a plus factor if, owing to an exceptional situation, an increase in the multiplication factor would be unjustified and the model is basically sound. In this context, the institution has to prove that an increase would be unjustified.

In the event of numerous overshootings, the competent authority shall revoke the model's recognition or impose appropriate measures to ensure that the model is improved promptly.

The institution is to record all overshootings ascertained by back-testing, together with the reasons for them, and to notify the competent authorities immediately of the extent of the overshootings and the reasons for them.

Amended Proposal

Amendment 8

Annex VIII, paragraph 7– last three sub-paragraphs

“The competent authorities can, in individual cases, waive the requirement to increase the multiplication factor by the “plus”-factor in accordance with Table 5 if the institution has demonstrated to the satisfaction of the competent authorities that such an increase is unjustified and that the model is basically sound.”

If numerous overshootings indicate that the model is not sufficiently accurate, the competent authorities shall revoke the model's recognition or impose appropriate measures to ensure that the model is improved promptly.

The institution is to record all overshootings ascertained by back-testing, together with the reasons for them, and to notify the competent authorities, without undue delay, and in any case no later than 5 working days after the day on which the error was noted.

Amendment 9

Annex VIII, paragraph 7a & b (new)

7a. If for the purpose of calculating capital requirements for specific risk the institution's model is recognised by the competent authorities in accordance with paragraph 4a, the multiplication factor to be applied to the specific risk portion of the institution's value-at-risk measure shall be increased to 4. If the institution's back-testing indicates that the model does not sufficiently accurately capture specific risk the competent authorities shall revoke the model's recognition for the purpose of calculating capital requirements for specific risk or impose appropriate measures to ensure that the model is improved promptly.

7b. The competent authorities may waive the requirement pursuant to paragraph 7a. for an increase of the multiplication factor to 4 if the institution demonstrates that in line with agreed international standards its model adequately captures also, inter alia, the event and default risk for its traded debt and equity positions.

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