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**I

R E P O R T

of the Committee on Legal Affairs and Citizen's Rights

on the proposal from the Commission to the Council for a directive on capital adequacy of investment firms and credit institutions
(COM(90)0141 final - C3-0184/90 - SYN 257)

Rapporteur : Mr Georgios ZAVVOS

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A Series: Reports - B series: Motions for Resolutions, Oral Questions, - C Series: Documents received from other Institutions (e.g. Consultations)

*	= Consultation procedure requiring a single reading	**II	= Cooperation procedure (second reading) which requires the votes of the majority of the Members of Parliament
**I	= Cooperation procedure (first reading)	***	= Parliamentary assent which requires the votes of the majority of the current Members of Parliament

C O N T E N T S

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By letter of 19 Juny 1990 the Council consulted the European Parliament, pursuant to Article 57 (2) first and third sentences, of the EEC Treaty, on the proposal from the Commission to the Council for a directive on capital adequacy of investment firms and credit institutions.

At the sitting of 9 July 1990, the President of Parliament announced that he had referred this proposal to the Committee on Legal Affairs and Citizen's Rights as the committee responsible and to the Committee on Economic and Monetary Affairs and Industrial Policy for its opinion.

At its meeting of 28 Juny 1990, the Committee on Legal Affairs and Citizen's Rights had appointed Mr Zavvos rapporteur.

At its meeting of 8 january 1991, the Committee on Legal Affairs and Citizen's Rights considered a working document drawn up by the rapporteur and held a hearing with experts on that matter.

At its meeting(s) of 29, 30 and 31 May 1991, it considered the Commission proposal and at its meetings of 18, 19 and 20 June 1991 and 15 and 16 October 1991, it considererd the draft report.

At the meeting of 29, 30 and 31 October 1991, the Committee on Legal Affairs and Citizen's Rights adopted the draft legislative resolution by 19 votes with 1 abstention.

The following took part in the vote: Graf Stauffenberg, chairman; Vayssade and Simeoni, vice-chairmen; Zavvos, rapporteur ; Casini, Elliott, Falconer, Garcia Amigo, Grund, Hadjigeorgiou (for M. Anastassopoulos), Lord Inglewood, Janssen van Raay, Marinho, Mebrak-Zaïdi, Medina Ortega, Oddy, Salema, Saridakis (for M. Cooney), Simpson and Van Outrive.

The opinion of the Committee on Economic and Monetary Affairs and Industrial Policy is attached to the present report.

The report was tabled on 5 November 1991.

The deadline for tabling amendments will appears on the draft agenda for the part-session at which the report is to be considered.

A

AMENDMENTS

Proposal for a Council Directive on capital adequacy of investment firms and credit institutions

Commission text (1)	Amendments
DEFINITIONS	
	(Amendment n° 1) Article 2 (Second Indent)
- the "trading book" of a credit institution shall include its proprietary positions in transferable securities of derivative instruments, which are taken on by the credit institution in order to benefit from actual or expected differences between their buying and selling prices, or in order to hedge other elements of the trading book;	- the "trading book" of a credit institution shall include its proprietary positions in transferable securities or derivative instruments, <u>which are held for resale or</u> which are taken on by the credit institutions <u>with the intention of benefitting</u> from actual or expected differences between their buying and selling prices or in order to hedge other elements of the trading book <u>including the activities related to these positions as mentioned in Annex 2</u>. <u>Inclusion or exclusion of items in or from the trading book shall be in accordance with relevant procedures including, where appropriate, accounting standards in the institution concerned, such procedures and their consistent implementation being subject to review by the competent authority.</u>
	(Amendment n°2) New indent <u>"Zone A, "Zone B", "Zone A credit institutions", "Zone B credit institutions", "non bank sector" and "multilateral development banks" shall be defined in accordance with Article 2 of Directive 89/647/EEC.</u>

(1) COM(90) 0141 final - OJ No C152, 21.6.1990, p. 6.

(Amendment n° 3)

(3d indent)

- exchange-traded instruments" means instruments which are traded on, or under the rules of, a stock exchange, or financial futures or options exchange established and officially recognized in the relevant Member State, or established in a third country and recognized by the competent authorities of the relevant Member State. Instruments which are traded on such exchanges and markets shall be classified as equities, debt instruments, futures, options, convertibles and warrants, in the Directive.

(4th indent)

- "over-the-counter (OTC) instruments" means all other instruments;

(4th indent)

- "over-the-counter (OTC) derivative instruments" shall mean interest-rate and foreign-exchange contracts as set out in Annex 3 of Directive 89/647/EEC and off-balance sheet contracts based on equities, providing that (i) all such contracts are not traded on recognized exchanges where they are subject to daily margin requirements, and (ii), in the case of foreigh-exchange contracts, that they have an original maturity of more than 14 calendar days.

(Amendment n° 4)
(5th indent)

- "qualifying issuer" means a credit institution, or a firm whose securities are listed on a stock exchange in a Member State, or in a stock exchange in a third country when this exchange is recognized by the competend authorities of the relevant Member State;

- "A qualifying issuer is a credit institution or a firm whose securities are listed on a stock exchange in a Member State or listed on a stock exchange in a third country if the listing requirements in that country, as well as the requirements concerning the "status" of a listed issuer, comply with - or are equivalent to - the Directive 79/279/EEC and its modifications".

(Amendment n° 5)
(6th indent)

- "central government" refers to the central government or central bank of Member States and all other countries which are members of the Organization for Economic Cooperation and Development (OECD) and any country which has concluded special lending arrangements with the international Monetary Fund (IMF) associated with the IMF General Arrangements to Borrow (GAB);

- "central government items" shall mean long and short positions in the assets referred to in 1. to 4. of Article 6 (1) (a), and those assigned a weight of 0 % in Article 7, of Directive 89/647/EEC;

(Amendment n° 6)
(10th indent)

- "repurchase agreement" means an agreement in which a firm sells securities subject to a commitment to repurchase them (or substituted securities of the same description) at a specified future time and price, according to the provisions of Article 12 (2) of the Council Directive 86/635/EEC (OJ n° L 372 31.12.1986, p. 1)

- "repruchase agreement" and "reverse repurchase agreement" means an agreement in which a firm transfers securities subject to a commitment to repurchase them (or substituted securities of the same description) at a specified price and a future date specified, or to be specified, by the transferor, shall be a "repruchase agreement" for the firm selling the securities, and a "reverse repruchase agreement" for the firm buying them;

(11th indent)

- "reverse repruchase agreement" means an agreement in which a firm buys securities from a counterparty and agrees to sell them (or substituted securities of the same description) back to that counterparty at a specified future time and price, according to the provisions of Article 12 (2) of Directive 86/635/EEC;

(Amendment n° 7)

(17th indent)	(16th indent)
- "Initial capital" means capital as defined in points (1) and (2) of Article 2 (1) of Directive 89/299/EEC. The paldup share capital component of this shall comprise all amounts regardless of their actual designations, which, in accordance with the legal structure of the institution concerned, are regarded under national law as equity capital subscribed and paid by the shareholders or other proprietors.	- "Initial capital" means capital as defined in Points 1 and 2 of Article 2 (1) of Directive 89/299/EEC. (delete the rest).

INITIAL CAPITAL AND DEROGATIONS FROM CAPITAL REQUIREMENTS

(Amendment n° 8)
Article 3

2. Investment firms shall have initial capital of at least ECU 500.000	2. Investment firms shall have initial capital of at least ECU 600.000

(Amendment n° 9)

3. Member States may reduce this amount to ECU 50.000 where a firm is neither authorised to hold customers'monies of securities, nor to act as a market maker, nor to underwrite except where the firm is involved only in the distribution of issues on a best efforts basis.	3. Member States may reduce this amount to ECU 60.000 where a firm is neither authorised to hold customers' monies or securities, nor to act as a market maker, nor to underwrite except where the firm is involved only in the distribution of issues on a best efforts basis.

(Amendment n° 10)

4. Member States may reduce the amount in paragraph 2 to ECU 100.000 in the case of firms who hold clients'monies or securities in acting as agents or portfolio managers, but who do not hold trading positions of their own.	4. Member States may reduce the amount in paragraph 2 to ECU 150.000 in the case of firms who hold client's monies or securities in acting as agents or portfolio managers, but who do not hold trading positions of their own.

(Amendment n° 11)

5. Notwithstanding paragraphs 2, 3 and 4, Member States may continue the authorisation of investment firms in existence before this Directive is implemented, whose own funds are less than the initial capital levels specified in those paragraphs. The own funds of such firms shall not fall below the highest level recorded <u>after</u> the date of notification of this Directive	5. Notwithstanding paragraphs 2, 3 and 4, Member States may continue the authorisation of investment firms in existence before this Directive is implemented, whose own funds are less than the initial capital levels specified in those paragraphs. The own funds of such firms shall not fall below the highest level recorded <u>at</u> the date of notification of this Directive.

(Amendment n° 12)

Article 3(6)	Article 3(6)
If control of an investment firm falling within paragraph 5 is taken, other than through inheritance, by a natural or legal person other than the person who controlled it previously, attain at least the appropriate level prescribed for initial capital in paragraph 2, 3 and 4.	If control of an investment firm falling within paragraph 5 is taken, other than through inheritance, by a natural or legal person other than the person who controlled it previously, attain at least the appropriate level prescribed for initial capital in paragraph 2, 3 and 4, <u>save that, in the case where paragraph 3 applies, if the business is sold during a period of 5 years following the implementation of this directive, paragraph 5 applies</u>.

(Amendment n° 13)

7. However, in certain specific circumstances and with the consent of the competent authorities, where there is a merger of two or more investment firms, the own funds of the firm resulting from the merger need not attain the level of initial capital referred to in paragraphs 2, 3 and 4. However the own funds of the new investment firm may not fall below the total own funds of the merged firms at the time of the merger, as long as the appropriate levels pursuant to paragraphs 2, 3 and 4 have not been attained.	7. However, in certain specific circumstances and with the consent of the competent authorities, where there is a merger of two or more investment firms, the own funds of the firm resulting from the merger need not attain the level of initial capital referred to in paragraphs 2, 3 and 4. <u>However, during a period when the levels referred to in paragraphs 2, 3 and 4 have not been attained, the own funds of the new investment firm may not fall below the total own funds of the merged firms at the time of the merger.</u>

PROVISION AGAINST RISKS

(Amendment n° 14)

Article 4

2. Credit institutions shall provide, in addition to the requirements set in Directive 89/647/EEC and any set in paragraphs 4 and 5 below, own funds to cover their foreign exchange risk; this amount shall be calculated in accordance with the method outlined in Annex 4. Pending further harmonisation however, Member States may waive the application of this requirement in relation to credit institutions whose business is limited as follows : their overall net foreign exchange position, calculated in accordance with Annex 4, must not exceed the equivalent of 10 % of own funds.	2. Credit institutions shall provide, in addition to the requirements set out in Directive 89/647/EEC and any set out in paragraphs 4 and 5 below, own funds to cover their foreign exchange risk; this amount shall be calculated in accordance with the method outlined <u>in Annex 3</u>. Pending further harmonisation however, Member States may waive the application of this requirement in relation to credit institutions whose business is limited as follows : their overall net foreign exchange position, calculated in accordance with <u>Annex 3</u>, must not exceed the equivalent of <u>2 %</u> of own funds.

(Amendment n° 15)
Article 4

	Intermediaries investing money on behalf of a client with investment companies must be covered by professsional indemnity.

EVALUATION OF POSITIONS FOR REPORTING PURPOSES

(Amendment n° 16)
Article 5

1. Positions shall be marked to market daily by investment firms and credit institutions unless Annexes 2, 3 and 5 hereto do not apply to them.	1. Positions in instruments in Section B of the Annex of the Investment Services Directive which are held by investment firms which are not credit institutions, and the trading books of those credit institutions which are subject to Annexes 1, 2 and 3 below, shall be marked to market daily.

REPORTING REQUIREMENTS

(Amendment n° 17)
Article 6

2. Investment firms which are not credit institutions shall be obliged to report to the competent authorities in the manner specified by the latter at least once every month in the case of firms which are authorised to deal as principal, at least once every three months in the case of those firms described in Article 3 (4), and at least once a year in the case of those firms covered by Article 3 (3). Such reports must be received by the competent authorities within two weeks of the end of the reporting period.	2. Investment firms which are not credit institutions shall be obliged to report to the competent authorities in the manner specified by the latter at least once every month in the case of firms which are authorised to deal as principal, at least once every three months in the case of those firms covered by Article 3 (4), and at least once a year in the case of those firms covered by Article 3 (4), and at least once a year in the case of those firms covered by article 3 (3). (Delete the rest)

(Amendment n° 18)

3. Credit institutions shall be obliged to report in the manner specified by the competent authorities at the same time as they are obliged to report under Directive 89/647/EEC, and at more frequent intervals if the competent authorities so request.	3. Credit institutions shall be obliged to report in the manner specified by the competent authorities at the same time as they are obliged to report under Directive 89/647/EEC, and at more frequent intervals if the competent authorities so request. Credit institutions shall notify separately to the competent authority the buying and selling of the securities excluded from their trading book.

COMPETENT AUTHORITIES

(Amendment n° 19)
Article 7

4. The competent authorities of different Member States shall collaborate closely to carry out the duties provided for in this Directive, particularly when investment services are provided on a services basis or by the establishment of branches in one or more Member States. They shall supply one another on request with all information likely to facilitate the supervision of the capital adequacy of investment firms and credit institutions and particularly the verification of their compliance to the rules laid down in this Directive. Any exchange of information between competent authorities which is provided for in this Directive in respect of investment firms shall be subject to the obligation of professional secrecy as set out in Article 20 of Directive .../.../EEC (relating to investment services) and, in respect of credit institutions, subject to the obligation set out in Article 12 of Council Directive 77/780/EEC.	4. The competent authorities of different Member States shall collaborate closely to carry out the duties provided for in this Directive, particularly when investment services are provided on a services basis or by the establishment of branches in one or more Member States. They shall supply one another on request with all information likely to facilitate the supervision of the capital adequacy of investment firms and credit institutions and particularly the verification of their compliance to the rules laid down in this Directive. Any exchange of information between competent authorities which is provided for in this Directive in respect of investment firms shall be subject to the obligation of professional secrecy as set out in Article 20 of Directive .../.../EEC (relating to investment services) and, in respect of credit institutions, subject to the obligation set out in Article 12 of Council Directive 77/780/EEC, as modified by Council Directive 89/646/EEC.

(Amendment n° 20)
ANNEX 1
(substituting entirely Annex 1 and Annex 2 of the Commission proposal)

Position risk

Equity and debt instruments

Netting

(Corresponds to paragraph 1 of Annex 1)

1. The excess of the firm's long (short) positions over its short (long) positions in the same equity, debt and convertible issues, and identical financial futures, options and warrants, contracts shall be its net position in each of the different instruments. In calculating the net position the competent authorities shall allow positions in derivative instruments to be treated, in the manner specified in paragraphs 4 to 6 below, as positions in the underlying (or notional) security/securities.

(Corresponds to paragraph 4 of Annex 1)

2. No netting shall be allowed between a convertible and an offsetting position in the instrument underlying it, unless the competent authorities adopt an approach under which the likelihood of a particular convertible being converted is taken into account, or have a capital requirement to cover any potential loss which could be incurred on conversion.

A firm shall split a stock index future into its various constituent positions and treat them as it would its underlying positions in the same equities.

However, the competent authorities may deem that the components of a stock index future may not be netted off against opposite positions in the underlying equities.

3. All net positions, irrespective of their sign, must be converted on a daily basis into the firm's reporting currency at the prevailing spot exchange rate before their aggregation.

Particular instruments

(Corresponds to paragraph 5 of Annex 1)

4. Interest rate futures and forward rate agreements (FRAs) will be treated as combinations of long and short positions. Thus a long futures position will be treated as a combination of a borrowing maturing on the delivery date of the futures contract and a holding of an asset maturing on the expiration date of the future. The opposite holds for a short position. Both the borrowing and asset holding will be included in the central government column of Table 1 in paragraph 10. The competent authorities may allow the capital requirement for an exchange-traded future to be equal to the margin held at the exchange if they are fully satisfied that it provides an accurate measure of the risk associated with the future.

(Corresponds to paragraph 6 of Annex 1)

5. Options on interest rates, debt instruments, equities, financial futures, swaps and foreign currencies, shall be treated as if they were positions in the amount of the underlying instrument to which the option refers, multiplied by its delta. The delta used shall be that of the exchange concerned, or, where this is not available or for OTC options, that calculated by the firm itself, subject to the competent authorities being satisfied that the model used by the firm is reasonable. However the competent authorities may also prescribe that investment firms may, or must, calculate their deltas using a methodology specified by the competent authorities instead of following the two preceding methods. The competent authorities shall require that the other risks, apart from the delta risk, associated with options are safeguarded against. The competent authorities may allow the requirement against a written exchange-traded option to be equal to the margin held at the exchange if they are fully satisfied that it provides an accurate measure of the risk associated with the option, and for the requirement on a bought, exchange-traded or OTC option to be the same as that for the instrument underlying it, subject to the constraint that the resulting requirement does not exceed the market value of the option. The requirement against a written OTC option will be set in relation to the instrument underlying it.

(Corresponds to paragraph 8 of Annex 1)

6. Warrants shall be treated in the same way that options are treated in paragraph 5.

(Corresponds to paragraph 7 of Annex 1)

7. Swaps will be treated for interest rate risk purposes on the same basis as on-balance sheet instruments. Thus an interest rate swap under which a firm receives floating rate interest and pays fixed rate interest will be treated as equivalent to a long position in a floating rate instrument of maturity equivalent to the period until the next interest fixing, and a short position in a fixed rate instrument with the same maturity as the swap itself. Competent authorities may however set alternative requirements to these for firms using swap models which provide, to the satisfaction of the competent authorities, a more accurate measure of the risks in swaps.

Specific, and general, risks

8. The position risk on a traded debt instrument or equity (or equity derivative) shall be divided into two components in order to calculate the capital required against it. The first shall be its specific risk component - this is the risk of a price change in the instrument concerned due to factors related to its issuer (in the case of a cash instrument) or (in the case of a derivative) the issuer of the underlying instrument. The second component will cover its general risk - this is the risk of a price change in the instrument due (in the case of a traded debt instrument) to a change in the level of interest rates, or (in the case of an equity or equity derivative) a broad equity market movement unrelated to any specific attributes of individual securities.

Traded debt instruments

9. The firm shall classify its net positions according to the currency in which they are denominated and shall calculate the capital requirement for general and specific risk in each individual currency separately.

Specific risk

10. The firm shall assign its net positions, as calculated in paragraph 1, to the appropriate categories in the first row of Table 1 on the basis of their residual maturities and then multiply them by the weights shown in the second row. It shall sum its weighted positions (regardless of whether they are long or short) in order to calculate its capital requirement against specific risk.

Table 1

Central government	Qualifying			Other
	0-6m	6-24m	24m	
0.00%	0.25%	1.00%	1.60%	8.00%

General risk

11. The procedure for calculating capital requirements against general risk will involve two basic steps. First, all positions shall be weighted according to maturity (as explained in paragraph 12), in order to compute the amount of capital required against them. Second, allowance will be made for this requirement to be reduced when a weighted position is held alongside an opposite weighted position within the same maturity band. A reduction in the requirement will also be allowed when the opposite weighted positions fall into different maturity bands, with the size of this reduction depending both on whether the two positions fall into the same zone, or not, and the particular zones they fall into. There are three zones (groups of maturity bands) altogether.

12. The firm shall assign its net positions to the appropriate maturity bands in the second, or third, column, as appropriate, in Table 2. It will do so on the basis of residual maturity in the case of fixed-rate instruments, and on the basis of the period until the interest rate is next set in the case of instruments on which the interest rate is variable before final maturity. It will also distinguish between debt instruments with a coupon of 3% or more, and those with a coupon of less than 3%, and thus allocate them to either the second or third columns in Table 2. It will then multiply each of them by the weight presented for the maturity band in question in the fourth column of Table 2.

13. It shall then work out the sum of the weighted long positions, and the sum of the weighted short positions, in each maturity band. The amount of the former which are matched by the latter in a given maturity band will be the weighted matched position in that band, while the residual long or short position will be the weighted unmatched position for the same band. The total of the weighted matched positions in all bands will then be calculated.

14. The firm shall compute the totals of the weighted unmatched long positions, for the bands included in each of the zones in Table 2, in order to derive the weighted unmatched long position for each zone. Similarly, the sum of the weighted unmatched short positions for each band in a particular zone will be summed to compute the weighted unmatched short position for that zone. That part of the weighted unmatched long position for a given zone that is matched by the weighted unmatched short position for the same zone will be the weighted matched position for that zone. That part of the weighted unmatched long, or weighted unmatched short, position for a zone, that cannot be thus matched, shall be the weighted unmatched position for that zone.

Table 2

1	2	3	4	5
Zones	Maturity bands		Weights (%)	Assumed Interest rate change (%)
	Coupon of 3% or more	Coupon of less than 3%[1] modified duration[2]		
One	0-1m	0-1m	0.00	---
	1-3m	1-3m	0.20	1.00
	3-6m	3-6m	0.40	1.00
	6-12m	6-12m	0.70	1.00
Two	1-2y	1.0-1.9y	1.25	0.90
	2-3y	1.9-2.8y	1.75	0.80
	3-4y	2.8-3.6y	2.25	0.75
Three	4-5y	3.6-4.3y	2.75	0.75
	5-7y	4.3-5.7y	3.25	0.70
	7-10y	5.7-7.3y	3.75	0.65
	10-15y	7.3-9.3y	4.50	0.60
	15-20y	9.3-10.6y	5.25	0.60
	20y	10.6-12.0y	6.00	0.60
		12.0-20.0y	8.40	0.60
		20y	13.0	0.60

15. The amount of the weighted unmatched long (short) position in Zone One which is matched by the weighted unmatched short (long) position in Zone Two shall then be computed. This shall be referred to in paragraph 19 as the weighted matched position between Zones One and Two. The same calculation will then be undertaken with regard to that part of the weighted unmatched position in Zone Two which is left over, and the weighted unmatched position in Zone Three, in order to calculate the weighted matched position between Zones Two and Three.

16. The firm may, if it wishes, reverse the order in paragraph 15 so as to calculate the weighted matched position between Zones Two and Three, before working out that between Zones One and Two.

17. The remainder of the weighted unmatched position in Zone One shall then be matched with what remains of that for Zone Three after this zone's matching with Zone Two, in order to derive the weighted matched position between Zones One and Three.

18. Residual positions, following the three separate matching calculations in paragraphs 15 to 17 above, will be summed.

19. The firm's capital requirement shall be calculated as the sum of:

a) 10% of the sum of the weighted matched positions in all maturity bands;
b) 30% of the weighted matched position in Zone One;
c) 20% of the weighted matched position in Zone Two;
d) 20% of the weighted matched position in Zone Three;
e) 30% of the weighted matched position between Zones One and Two, and between Zones Two and Three (see paragraph 16);
f) 100% of the weighted matched position between Zones One and Three;
g) 100% of the residual weighted unmatched positions.

Duration

(Corresponds to paragraph 4 of Annex 2)

20. Competent authorities in a Member State may use a system for calculating the capital requirement for the general risk on their firms' (fixed-rate), traded debt instruments, which reflects duration, instead of the system set out in paragraphs 11 to 19 above.

21. Under such a system the investment firm shall first work out which residual maturity zone each of its debt instruments (e.g. bonds) fall into. It shall do this on the basis of the second column of Table 2.

22. It shall then take the market value of the bond (or other instrument) and calculate its yield-to-maturity, which is the implied discount rate for the bond.

23. The firm shall then calculate its "modified duration" on the basis of the following formula:

$$\text{modified duration} = \frac{\text{duration (D)}}{(1+r)} \quad \text{where}$$

$$D = \frac{\sum_{t=1}^{m} \frac{tC_t}{(1+r)^t}}{\sum_{t=1}^{m} \frac{C_t}{(1+r)^t}}$$

and

r = yield to maturity

C_t = cash payment in time t

24. The firm will then determine the interest change that must be covered against for a bond of that particular modified duration. It shall refer to the third column of Table 2 in order to arrive at this amount.

25. If the interest rate change is equal to 1% it will multiply the market price of the bond by its modified duration in order to calculate the duration-weighted position in that bond. If however the interest rate change is not 1%, the market price of the bond must be multiplied by both its modified duration and the percentage change in question, in order to compute the duration-weighted position in that bond.

26. The investment firm will work out its duration-weighted long, and its duration-weighted short, positions within each zone, on the basis of the residual maturities of such positions. The amount of the former which are matched by the latter within each zone shall be the weighted duration-matched position for that zone. The firm shall then calculate the duration-weighted unmatched positions for each zone. It shall then follow the procedures laid down for weighted unmatched positions in paragraph 15 to 18 above.

27. The firm's capital requirement shall then be calculated as the sum of:

a) 10% of the sum of the weighted duration-matched position in each zone;

b) 30% of the weighted duration-matched positions between Zones One and Two, and between Zones Two and Three;

c) 100% of the weighted duration-matched positions between Zones One and Three;

d) 100% of the residual weighted duration-unmatched positions.

28. Competent authorities which choose to use the system described in paragraphs 21 to 27 above shall make details of it publicly available.

Equities

(Corresponds to paragraphs 5 and 6 of Annex 2)

29. The firm shall sum all its net - according to paragraph 1 - long positions, and all its net short positions. The sum of the two figures will be its overall gross position. The excess of one over the other shall be its overall net position.

30. It will multiply its overall gross position by 4% in order to calculate its capital requirement against specific risk. Its capital requirement against general risk shall be its overall net position multiplied by 8%.

31. The competent authorities may allow the capital requirement against specific risk to be 2%, and not 4%, of the overall gross requirement, for those portfolios of equities that a firm holds that meet the following conditions. First, the equities therein shall all be those of issuers which have issued traded debt instruments which are qualifying items and which are outstanding. Second, they must be adjusted highly liquid by the competent authorities concerned. Third, no individual position within such a portfolio shall comprise more than 5% of the value of the overall gross position of the portfolio.

32. The competent authorities shall ensure that firms which have netted off their positions in one or more of the equities constituting a stock index future against opposite position(s) in the stock index future itself have adequate capital to cover the risk of loss arising from the value of the future not moving fully in line with that of its constituent equities.

(Amendment n° 21)
ANNEX 2

(substituting entirely Annex 3 of the Commission proposal)

Counterparty/settlement risk

1. In the case of transactions in which bonds and equities (excluding repurchase and reverse repurchase agreements) are unsettled after their due delivery dates, a firm must calculate the price difference to which it is exposed. This is the difference between the agreed settlement price for the bond or equity in question, and its current market value,where the difference could involve a loss for the firm. It must multiply this difference by the appropriate factor in Column A of Table 1 in order to calculate its capital requirement.

2. Notwithstanding paragraph 1, a firm can , at the discretion of its competent authorities, calculate its capital requirements by multiplying the agreed settlement price of every transaction which is unsettled between 5 and 45 days after its due date, by the appropriate factor in Column B of Table 1. From 45 or more days after the due date it shall take the requirement to be 100% of the price difference to which it is exposed, as in Column A.

Table 1

Number of days after due settlement date	Column A %	Column B %
5-15	8	0.5
16-30	50	4.0
31-45	75	9.0
46 + more	100	see para. 2

Repurchase agreements

(Corresponds to paragraph 3 of Annex 3)

3. In the case of repurchase and securities lending agreements the firm's capital requirement shall be the difference between the market value of the securities, and the amount borrowed by the firm or the collateral including the margin received or the market value of the collateral, where this difference is positive. In the case of reverse repurchase and securities borrowing agreements it shall be the difference between the amount the firm has lent or the collateral or the market value of the collateral given and the market value of the securities it has received, where this difference is positive. Accrued interest shall be included in calculating the market value of amounts lent or borrowed and collateral.

OTC derivative instruments

4. Where there is a separate bilateral contract for novation, recognized by the national supervisory authorities, between a firm and its counterparty under which any obligation to each other to deliver payments in their common currency on a given date are automatically amalgamated with other similar obligations due on the same date, the single net amount fixed by such novation is weighted, rather than the gross amounts involved.

(Corresponds to Paragraph 4 of Annex 3)

The requirement shall be calculated as follows: first the firm will sum (i) the total replacement cost (obtained by marking to market) of all its contracts, including bought equity option contracts, with positive values and (ii), in the case of interest rate and exchange rate contracts, an amount for potential future credit exposure, calculated by multiplying the total notional principal amount of its contracts by the following weights, as appropriate:

Residual maturity	Interest rate contracts	Exchange rate contracts
less than one year	-	1.0%
one year and over	0.5%	5.0%

The capital requirement will be
4% of the sum of (i) and (ii) where the counterparty is in the private sector, but not a credit institution, or an investment firm,
1.6% of the sum where it is a credit institution, an investment firm, or in the public sector, and
zero if it is the central government.

5. A firm shall be required to hold capital against counterparty risk if:

i) it has paid for securities before receiving them or if it has delivered securities before receiving them or if it has delivered securities before receiving payment for them, and

ii) three days or more have elapsed since it made this payment or delivery. Thereafter an investment firm which is a credit institution shall be required to hold 8% of the value of the securities or cash owed it as capital where the counterparty is in the private sector, but not a credit institution, or an investment firm, and 1.6% of the sum where it is a credit institution, an investment firm, or in the other public sector, and zero if it is the central government. An investment firm which is not a credit institution shall treat it as an illiquid asset in Annex 5.

(Amendment n° 22)
ANNEX 3
(substituting entirely Annex 4 of the Commission proposal)

Foreign exchange risk

1. The overall net foreign exchange position, calculated in accordance with the procedures set out below, shall be assigned an 8% capital requirement only to the extent that this position exceeds 2% of total own funds.

2. A two-stage calculation shall be used.

3. First, the firm's net open currency position in each currency (including the reporting currency) shall be calculated. This position shall consist of the addition of the following elements (positive or negative):

   - the net spot position (i.e. all asset items less all liability items, including accrued interest, in the currency in question);

   - the net forward position (i.e. all amounts to be received less all amounts to be paid under forward exchange transactions, including currency futures and the principal on currency swaps not included in the spot position);

   - guarantees (and similar instruments) that are certain to be called and are irrevocable;

   - net future income/expenses not yet accrued but already fully hedged (at the discretion of the reporting institutions and with the prior consent of the competent authorities, those next future income/expenses which have not yet been registered in the accounting records, but which have already been fully hedged by forward foreign exchange transactions may be included here. Such discretion must be based on a consistent basis);

   - the net delta (or delta-based) equivalent of the total book of foreign currency options;

   - any positions which a credit institution or investment firm has deliberately taken in order to hedge against the adverse effect of the exchange rate on its capital, may be excluded from the calculation of net open currency positions. Such positions should be of a non-trading or structural nature, and their exclusion, and any variation of the terms of their exclusion, shall require the consent of the competent authorities. The same treatment subject to the same conditions as above may be applied to positions which a credit institution or investment firm has which relate to items that are already deducted in the calculation of own funds;

(Amendment n° 23)
ANNEX 4
(substituting entirely Annex 5 of the Commission proposal)

Other risks

Investment firms, excluding credit institutions, shall be required to hold own funds equivalent to one quarter of their previous year's fixed overheads. The competent authorities may adjust this requirement in the event of a material change to a firm's business since the previous year. When the firm has not completed a year's business, including on the day it starts up, the requirement will be a quarter of the fixed overheads' figure projected in its business plan, unless an adjustment to this plan is required by the authorities. For firms that are starting up, own funds shall be greater than or equal to this amount, and initial capital at least equal to the requirements laid down in Article 3.	Investment firms, excluding credit institutions, shall be required to hold own funds equivalent to one quarter of their previous year's fixed overheads. The competent authorities may adjust this requirement in the event of a material change to a firm's business since the previous year. When the firm has not completed a year's business, including on the day it starts up, the requirement will be a quarter of the fixed overheads' figure projected in its business plan, unless an adjustment to this plan is required by the authorities. (The rest deleted)

(Amendment n° 24)
ANNEX 5
(Corresponds to Annex 6 of the Commission proposal: points 1 to 5(1) unchanged

(2) The subordinated loan capital referred to in 4(5) shall have an initial maturity of at least two years. It shall be fully paid-up and the loan agreement shall not include any clause providing that, in specified circumstances, other than the winding-up of the investment firm, the debt will become repayable before the agreed repayment date, unless the supervisory authorities agree to it having been given two days' notice. Subordinated debt may not be repaid if such repayment would mean that the own funds of the firm 120% of the firm's overall requirement.	(2) The subordinated loan capital referred to in 4(5) shall have an initial maturity of at least two years. It shall be fully paid-up and the loan agreement shall not include any clause providing that, in specified circumstances, other than the winding-up of the investment firm, the debt will become repayable before the agreed repayment date, subject to the approval of the competent authorities. Subordinated debt may not be repaid if such repayment would mean that the own funds of the firm 100% of the firm's overall requirement.

(3) The subordinated loan capital referred to in 4(5) may not exceed a maximum of 250% of the sum total of items 4(2) plus 4(4) less 4(3) and should only approach this maximum in particular circumstances acceptable to the relevant competent authorities.	(3) The subordinated loan capital referred to in 4(5) may not exceed a maximum of 250% of the sum total of items 4(2) plus 4(4) less 4(3) and should only approach this maximum in particular circumstances acceptable to the relevant competent authorities.
(4) Illiquid assets include: - fixed assets (except to the extent that land and buildings are allowed to count against secured loans);	(4) Illiquid assets include: - fixed assets (except to the extent that land and buildings may be allowed to count against the loans which they are securing);

(Amendment n° 25)
Annex 6 - Own funds
para 4 (7)

	(7) plus any unencumbered property or equity within the business.

DRAFT LEGISLATIVE RESOLUTION
(Cooperation procedure: first reading)

embodying the opinion of the European Parliament on the proposal from the Commission to the Council for a directive on capital adequacy of investment firms and credit institutions

The European Parliament

- having regard to the Commission proposal to the Council (COM(90)0141 final - SYN 257)(1) ,

- having been consulted by the Council pursuant to Article 57(2) of the EEC Treaty (C3-0184/90),

- having regard to the report of the Committee on Legal Affairs and Citizens' Rights and the opinion of the Committee on Economic and Monetary Affairs and Industrial Policy (A3-0298/91),

- having regard to the Commission position on the amendments adopted by Parliament,

1. Approves the Commission proposal in accordance with the vote thereon;

2. Calls on the Commission to amend its proposal accordingly, pursuant to Article 149(3) of the EEC Treaty;

3. Calls for the conciliation procedure to be opened if the Council should intend to depart from the text approved by Parliament;

4. Asks to be consulted again should the Council intend to make substantial modifications to the Commission proposal;

5. Calls on the Council to incorporate Parliament's amendments in the common position that it adopts in accordance with Article 149(2) (a) of the EEC Treaty;

6. Instructs its President to forward this opinion to the Council and Commission.

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(1) OJ No C152, 21.6.1990, p. 6

EXPLANATORY MEMORANDUM

I. INTRODUCTION

The European Community's 1992 programme for the creation of a single European market has been an unqualified success. A key component of this endeavour is financial integration including the liberalisation of securities markets.

The momentum achieved by developments in financial services until now place Europe in a position to overcome the fragmentation of financial markets that has for so long deprived the consumer of high-quality services and industry of competitive financing. The EC urgently needs a unified securities market since it is the only entity capable of ensuring cheap financing for European industry in times of capital scarcity and increasing international competition.

The proposed Council Directive on the Adequacy of Own Funds of Investment Firms and Credit Establishments[1] is the companion measure to the Amended Proposal for a Council Directive on Investment Services in the Securities Field[2]. Together, these two measures create a regime of regulatory prudence whose object is the protection of the soundness of the financial system as a whole and of the individual investor in particular.

The aim of these two Directives is to permit investment firms licensed in one Member States to enjoy free access to the financial markets of every other Member State, whether it be for the issuance of securities or with a view to the provision of investment services. This "single license" for investment firms is to be created on the basis of settled conditions parallel to those provided for credit institutions (banks) by the Second Banking Coordination Directive.

The division of functions between the Investment Services Directive and the Capital Adequacy Directive is parallel to that between the Second Banking Coordination Directive on the one hand and the Own Funds and Solvency Ratio Directives on the other. The proposed Investment Services Directive would provide an investment firm licensed in one of the Member States a single license to provide its services in every other Member State. The Capital Adequacy Directive, on the other hand, would effect the minimum harmonization of supervisory standards governing the provision against the risk an investment firm assumes sufficient to allow the Member States to

1 (COM(90)141 - SYN 257) [Hereinafter the Capital Adequacy Directive].

2 (COM(89)629 final - SYN 176) [Hereinafter, the Investment Services Directive].

mutually recognize each others' regulatory and supervisory regimes.

It is essential to see these two Directives as a single part of a larger package, including the three Directives on credit institutions mentioned above. The single license to be conferred by the Investment Services Directive cannot operate without the harmonisation the Capital Adequacy Directive is to achieve. And the single license given to credit institutions by the Second Banking Coordination Directive and its accompanying measures would actually disrupt the competitive structure of the Community's financial services industry if similar freedom were not given to investment services firms. Without the Investment Services and Capital Adequacy Directives, Community credit institutions would be able to operate freely in every Member State, while the non-bank investment firms against which they compete would not. Thus, the coherence of the Community's regulatory regime for the entire financial services industry turns upon the timely promulgation of these two pieces of legislation.

Equally important, these measures are the means by which financial services firms, whether bank or non-bank, are to enjoy the benefits of a single European Market. Only by removing the regulatory barriers between the markets of the several Member States can the Community's financial services industry achieve the economies of scale and geographical diversification that other sectors enjoy by virtue of the single market programme.

The legislative programme comprising these two directives must operate within two constraints. First, they ought to put on an equal footing investment firms which are banks and those which are not. The rules provided for by the Directives should not influence a firm's decision to choose one institutional structure over another. On the contrary they should create a level playing field between the two banking structures prevalent in the Community: Germany's universal banking and the UK's bifurcated structure. Second, the Directives ought to enhance, or at least ought not to impair, the competitiveness of Europe as a financial centre.

II. THE REGULATION SECURITIES FIRMS IN THE EUROPEAN COMMUNITY

A. Regulatory Aims

1. Investor Protection

It is generally accepted that investors should be free to assume what risks they wish and suffer the losses thereon, provided that they are informed of the nature and extent of such risks. There is an exception to this general rule, however, in that investors should not have to bear the risk of loss caused by the default of the securities firm through which they transact their business. To relieve the investor of this risk, many countries demand that investment firms participate in investor protection schemes which will compensate investors for losses incurred as a result of a firm's default. The Proposed Investment Services Directive adopts this approach in its Article 11(1). To further insulate the investor, the same provision requires that the cash and securities of the firm and those of its customers be held separately.

2. Protection of Those with Whom the Firm Does Business.

It is often thought that regulation is essential to reassure other firms of the safety of an investment firm. Without regulation, it is argued, other market participants will be unwilling to deal with an investment firm because they will be unable to monitor the firm's financial condition. One may doubt that this is in fact the case, but this argument is nonetheless very frequently put forward as a rationale for regulating securities firms.

3. Protection of the Financial System

A third rationale for the regulation of investment firms argues that a failure by one could potentially destabilise the entire financial system, including under that rubric investor confidence in the securities markets and the smooth functioning of the clearing and settlement systems. It is this theory that underlies much of the recent efforts, both in the European Community and elsewhere, toward shoring up the stability of investment firms through regulation.

B. The Regulation of Banks and Securities Firms.

Banks and securities firms face different types of risks, which require separate regulation. Banks generally hold assets (loans) until they mature. Securities firms, on the other hand, rapidly turn over their holdings in the course of their everyday activities. In other words, banks assets are less liquid than those of securities firms. The two types of institutions are therefore exposed to different risks. Banks face credit risk, the risk that the debtor will not pay. This is much less important to securities firms for they can simply sell the debts owing to them on the market. More important for them is market risk, the risk that they will have to sell at a lower price than they bought. This difference between the two sorts of institutions is reflected in their valuation. Whereas securities firms are evaluated on the basis of their liquidation value, banks are assessed as going concerns.

This reflects the ability of a securities firm to change its risk exposure rapidly by selling its assets. The risk profile of a bank, whose assets are much less liquid, is much more resistant to change.

These different risks mandate different regulatory techniques. In financial straits, a securities firms is expected to shrink, which it may do so long as its assets are in liquid form. The regulator must, therefore, ensure that these assets remain liquid. The same avenue of escape is unavailable to banks, for the illiquid nature of their assets means that they can be sold rapidly only at a substantial loss, thus compounding the institution's problems rather than solving them. A bank regulator's aim, then, is to keep the bank afloat by giving it time to restore its impaired capital. To this end, a bank's capital must be permanent in nature. A securities firm's can be more flexible, if only because it has the option of shrinking its way out of danger. As a result, securities firms are usually able to rely more heavily on subordinated debt as capital. The Proposed Directive on Capital Adequacy contains just such a provision.

C. Different Member States Maintain Different Financial Structures.

Community Member States now maintain widely different structures in their financial industries. Germany, for example, permits universal banking. A financial institution may undertake both commercial and investment banking activities within the same corporate entity. In the United Kingdom, on the other hand, supervisory authorities prefer that the same entity not transact both kinds of business. Instead it is more common for securities business to be performed through a subsidiary enjoying a separate legal personality from the parent.

The Proposed Directive on Capital Adequacy would maintain a level playing field between the universal banks and bifurcated financial institutions by permitting Member States to choose between the definition of capital set forth in the Banking Directives and new rules specially tailored to the needs of the securities industry. Banks active on the securities markets may, at the option of their Member State, continue to apply the banking definition of capital to all their business, or they may separate their securities business out into a "trading book", to which the alternative capital definition applies.

III. THE CAPITAL ADEQUACY DIRECTIVE

A. Aims of Capital Adequacy.

Capital adequacy describes the system of rules supervisory authorities apply to assure that the financial institutions under their supervision have adequate reserves to cover the risks they assume in the course of their business. The aim is always a delicate balance. On the one hand, the greater the reserves required, the safer is the institution, its depositors, and, to that extent, the financial system as a whole. Yet capital requirements are a burden upon such firms. Funds held in reserve could usefully be invested. If too much in the way of reserves is required, a firm will be placed at a competitive disadvantage vis à vis firms facing lower requirements, who can put a greater percentage of their resources to work. Thus, the task of the regulator is to ensure the safety of the firms under its control while not putting them out of business. The Directive seeks to harmonise the rules by which the Member State supervisors are to accomplish this task.

The Directive applies to investment firms and to credit institutions. It fixes two different capital requirements for investment firms and for certain portions of the business of credit institutions.

B. <u>Initial Capital</u>

Article 3 contains the initial capital requirements an investment firm which is not a credit institution must satisfy in order to be granted a license in any of the Member States. Certain reductions are provided with respect to firms that do not handle client' moneys and certain other firms. These reductions in capital requirements reflect the lesser risk to which these firms are exposed. Moreover, existing firms are grandfathered and will not have to meet the Directive's initial funds requirement in order to retain their licenses. They will, however, have to meet these requirements if they wish to expand into Member States other than the ones in which they currently operate.

As drafted, Article 3 requires lower initial capital for investment firms than is required for banks. This constitutes an inequality between the two sorts of institutions. But this inequality is justified: banks by their nature are eligible for a wider range of activities than are investment institutions. Accordingly, banks need rather more initial capital to go into business in the first place. One may argue that diversification should lead to lower capital requirements, but this consideration is already taken into account in the calculation of operating capital requirements. To make the same concession in initial capital requirements would accord diversification double weight. Given the recent crises in the international securities markets and the situation in the majority of the Member States the Rapporteur suggested a slight increase over the proposal's initial capital requirement.

Second, the Directive provides rules on the capital an investment firm must retain against the risks it assumes.

C. The Trading Book Option

The key provision of the Directive is found in Article 4(4): the trading book option. This provision is the means by which competitive equality is to be maintained between financial service firms which are banks and those which are not. By way of background, investment firms which are credit institutions will be required to meet the requirements of the Solvency Ratio Directive when that measure comes into force. The Solvency Ratio Directive will not apply to investment firms that are not credit institutions. To prevent such firms from being subjected to different capital requirements, article 4(4) of the Capital Adequacy Directive would permit Member States the option to subject their credit institutions, on general or individual bases, to substitute the requirements of the Capital Adequacy Directive for those of the Solvency Ratio Directive with respect to certain types of risks they incur in their "trading book". Thus, at the option of the Member State, credit institutions and other financial services firms can be subjected to the same capital requirements with respect to the same risks.

It has been suggested that the option be given to the institutions themselves rather than to the regulators of the Member States. The argument is that, if either the Solvency Ratio or Capital Adequacy approaches are sound and will satisfy Community law, the firms themselves should have the choice. However this argument cannot stand because it presumes de facto harmonization of Member State supervisory regimes. The reality is harmonization to the degree envisioned by the argument granting firm's the option does not currently exist. Therefore the Member States cannot depend on firms themselves to ensure the soundness of the firms under their control. Member States should be allowed to retain the option for themselves.

D. The Mechanism of Capital Adequacy

Risks are identified in the Annexes of the Directive. Article 4(1) provides that the total capital investment firms are required to hold is the sum of the requirements against the specific risks listed in these Annexes. Thus Annex 2 contains the rules applicable to Position Risk, Annex 3 those for Counterparty/Settlement Risks, Annex 4 Foreign Exchange Risk, And Annex 5 Other Risks, including Operating Risk. The mechanics of determining the total capital required are thus relatively straightforward. Consult the provisions of Annex 1 to determine the net open position against which capital must be held. Then, consult Annexes 2 through 5 to determine the capital requirements for each of the different types of risk to which the firm is exposed by virtue of this open position. Add these figures. The result is the total capital the firm must have at any given time.

Annex 1 governs the calculation of net open positions. It takes account of the fact that some investments are by nature more risky than others. Less risky investments need less capital to back them up. Several commentators have noted, however, that the Directive as drafted paints with too broad a brush in classifying "safe" and "risky" instruments. The Rapporteur has proposed technical amendments to refine the Directive's treatment.

There is also the question as to whether Annex 1 sufficiently rewards reduction of risk through hedging. By this practice, a firm would take offsetting positions whose risk profiles cancel each other out. The Directive would grant some relief for hedged positions, but not to the full extent that risk is reduced. Hedging is a sophisticated financial technique; its use should be rewarded in the form of reduced capital requirements. It is also, however, highly complex and the Directive would have to be substantially augmented to provide for all possible permutations. This question can perhaps be resolved in connection with the building block approach described below.

Annex 2 sets forth rules on Position Risk applicable to all non-bank investment firms. In addition, it mandates that credit institutions institute their own surveillance systems to monitor and control market risk. With respect to these risks, the Member States will have to choose to apply either the requirements of the Solvency Ratio Directive to their credit institutions or the provisions found in this Annex of the Capital Adequacy Directive to those transaction of a credit institution which make up its trading book.

E. <u>The Building Block Approach</u>

As currently drafted, Annex 2 covers two distinct sorts of risk: interest rate risk and credit risk. Some commentators have therefore suggested separate treatment of these risks in different annexes. This is colloquially referred to as "the building block approach". Separate treatment would more accurately reflect economic reality. An uncovered position in a security representing a debt, for instance, carries with it the risk that the issuer will default. Quite apart from questions as to the financial strength of the issuer, a fixed-rate debt instrument also remains susceptible to changes in prevailing interest rates. Such changes affect the discounted present value of the future cash flows that the instrument represents to fluctuate. Different factors bear on these two sorts of risk, so there is at least a theoretical case to be made for treating them separately. The same holds true for equity securities as well.

The Rapporteur therefore proposes the adoption of the building block approach in lieu of that now found in Annex 2 of the proposed Directive. The proposed amendments would also have the advantage of incorporating the provisions of Annex 1, so both old Annex 1 and Annex 2 can be rolled into the single new one. The new Annex would provide separate treatment for general and specific risks. General risk is defined to mean the price risk associated with a security due to broad market movements unrelated to the attributes of the particular security. Specific risk, on the other hand, means the risk of a price change in a security due to factors related to its issuer.

By separating risk into general and specific categories the Building Block Approach presents several advantages as a risk barometer. Under the building block approach the specific risk of the issuer can more easily be integrated into the Solvency Ratio Directive framework for the non-trading book activities of banks. This will insure equal treatment regarding capital requirements between investment firms and credit institutions.

The Building Block Approach sets specific risk requirements on the net position (long or short) in each debt instrument.

The specific risk requirements differ from those under the Solvency Ratio Directive in two ways: classification of issuers and allocation of risk weight. Unlike the Solvency Ratio Directive which allocates the same risk weight to all private sector borrowers, the Building Block Approach distinguishes between qualified (private) borrowers and others. Nor does the Building Block Approach allocate a flat risk weight for qualified issuers (and credit institutions) or other public sector entities.

The Building Block Approach deviations from the Solvency Ratio Directive framework are justified because qualified issues trade on liquid markets where assets can be sold on short notice without adverse impact on price, i.e. positions are not held until maturity.

For fixed interest instruments Building Block Approach provides for a market price risk requirement intended to cover a change in market interest rates. BBA suggests a basic method for setting interest rate risk requirements as well as a more accurate method for more sophisticated firms. Both methods are intended to provide equivalent protection against changes in the market price of bonds and other fixed rate instruments.

The Building Block Approach has three principal advantages. First, the division of risk into two separate components will enable a more precise and accurate treatment of sophisticated financial techniques like hedging, which are becoming ever more important and widespread. Second, the distinction drawn between general and specific risk isolates credit risk from other sorts of risk. This is considered good practice amongst banking regulators. Finally, the version of the building block approach proposed here comports well with the progress of discussions in Basle on this same subject.

Annex 3 establishes capital requirements with respect to transactions that have been entered into but have not yet been concluded. The Directive may be over-cautious in setting capital requirements against such risk. The current rules may significantly affect cross-border transactions, which generally take at least some additional time to clear. As with many of the Directive's provisions, the trade-off is one of simplicity against accuracy: one could provide a separate capital requirement for such transactions, but the result would be a very complex provision indeed. Or one can have a simple, easy-to-apply rule that may overstate capital requirements in some cases.

Annex 4 applies to all non-bank investment firms and to those credit establishment whose net global positions exceed 10% of their own funds. It provides that the figure of eight percent of positions in foreign exchange be held as capital. This copies the provisions of the Solvency Ratio Directive governing credit risk with respect to foreign exchange transactions. In this context, the 8% figure seems excessive as compared with the actual risk, for positions in foreign exchange are to reevaluated on a daily basis. This figure should therefore be reduced. In addition, the 10% threshold figure is excessive. Exemption should be granted only to those credit institutions whose net global positions exceed 2% of own funds.

Moreover, there is a striking omission in that Annex 4 makes no allowance in its capital requirements for the fact that many currencies, most notably those of the EMS, are linked. It is therefore to be expected that foreign exchange position between these currencies are subject to much less risk than those between unlinked currencies. Annex 4 should reduce the capital required to be held against these transactions. It would be ironic for a Community 'Directive enabling European financial institutions to reap the benefits of the Single Market to deny them those stemming from the EMS.

A further issue with respect to foreign-exchange risk is the treatment of what are known as structural positions. A structural position, as opposed to an operating position, may be investment in buildings, facilities or networks in another country, investments in nonfinancial firms in another country or securities held only for investment, that is, until they mature. In each case, the investment is not subject to the full force of exchange rate volatility. Some reflection of this fact ought to be made in the calculation of capital requirements.

Annex 5 requires that non-bank investment firms keep capital equivalent to one-quarter of their previous year's overheads.

Annex 6 provides the types of capital that may be used to satisfy these requirements. As currently drafted, the Directive would allow non-bank investment firms greater latitude to meet their requirements with subordinated debt than credit institutions would enjoy. Subordinated debt is allowed to be considered as capital for the purposes of the Directive to the extent of 2 1/2 times equity capital, provided that such debt has an initial maturity of at least two years. This option would also be available to banks that adopt the trading book option to the extent of their trading book. This freedom is subject to the constraint use of the Directive's alternative definition cannot add more than twenty-five percent to the capital that would have to be held under the bank definition alone. Banks would not, though, be required to deduct illiquid assets from their calculations, as would securities firms.

Article 5 governs the evaluation of open positions. Generally, investment firms and credit institutions are required to mark their portfolios to market daily. Certain Member States retain the use of the historical cost method of evaluation: Consider an asset to be worth what you paid for it. These Member States have argued that they should not be forced to mark-to-market daily, but should be left free to apply their own supervision systems. These pleas must be rejected. Marking to market is a more accurate evaluation of the worth of an asset at any given time. Market prices reflect an issuer's credit rating and the market's expectations about future interest and exchange rates. This more accurate evaluation is better suited to the monitoring and control of trading activity, where liquidity, not solvency, is the aim. And in any event, a bank will not have to mark to market unless its Member State adopts the trading book option.

Article 6 establishes the reporting requirements by which the competent authorities of the Member States are to ensure compliance with the provisions of the Directive. For investment firms, reporting is to be made at least monthly, though there are less stringent requirements for firms that act only as agents or do not hold clients' money or securities. Credit institutions must report in accordance with the provisions of the Solvency Ratio Directive. With respect to both institutions, Member States must ensure that firms under their supervision maintain internal control mechanisms and administrative and accounting procedures sufficient to allow Member State authorities to monitor compliance with the requirements of the Directive.

Article 7 designates the competent authorities who are to implement the Directive's provisions and mandates their collaboration with one another to achieve the aims of the Directive.

Article 8 establishes a Committee with powers to make certain changes to provision governing capital requirements in accordance with procedures set forth in the Investment Services Directive. This procedure would allow the Commission to approve changes that have been rejected by the Council acting by qualified majority. The appropriate procedure is instead found in Article 22 of the Second Banking Directive, where the Commission's power is more limited.

Finally, the Directive is slated to enter into force 1 January 1993. Thus, the Capital Adequacy, Investment Services, Second Banking Coordination, Own Funds, and Solvency Ratio Directives will all enter into force at the same time. This will assure competitive equality between bank and non-bank investment firms.

IV. CONSOLIDATED SUPERVISION

The goals of the directive should be viewed in relation with the directive on consolidated supervision. The idea of preserving competition between credit institutions and investment firms underlies the supervisory functions of both directives. One cannot regulate an investment company as if it were a bank if that investment company is to remain competitive with other investment companies.

The European banking and financial services industry has seen a tremendous increase in its complexity and integration over the past decade. As more and more relationships are formed between different institutions, regulators face a new and difficult problem, namely, how to ensure that whole groups, rather than individual firms within such groups, retain their financial soundness. Consolidated supervision of credit institutions (banks) is widely accepted. What is more controversial, however, is the issue of whether securities firms within group structures should also be supervised on a consolidated basis.

Banks, and their Member State regulators, argue against the exemption of securities firms from consolidated supervision on the ground that such exemption would unduly penalise the universal banking structure vis a vis the bifurcated structure prevalent in competing markets. The securities firms respond that simple application of banking rules to securities firms, especially in the matter of capital, is unworkable. The Solvency Ratio Directive, which governs banks, protects against credit risk, whereas the securities business needs regulation of market risk. Thus, it is argued, straight application of the Solvency Ratio will not adequately protect against the risks that the different member firms of a group structure actually face.

There is not as yet any agreed method for the consolidated supervision of firms exposed to market risk. Different firms in the same group structure could take offsetting positions, thus reducing the own funds requirement of the groups as a whole. But, should either of the firms become insolvent, there would be no legal duty owing by either firm to the creditors of the other. Indeed, many problems remain to be solved with respect to the interaction of banking and nonbanking supervision to different types of firms within the same corporate group. Significant work remains to be done in this area.

The largest problem confronting consolidated supervision may be the difference between means and results. Some members of the financial community have argued that it is inappropriate to even attempt to separate a bank's securities and conventional banking business and to then apply the same capital rules to each. The question becomes much more complex when the issue is how to separate the securities and conventional banking business of a financial services group for purposes of supervision. Perhaps a more effective tool would be less concerned with the specific rules applied and more focused on the results obtained. At a minimum consolidated supervision should refrain from creating incentives for market participants to structure their business so as to avoid regulation.

Consolidated supervision poses several specific problems. First, the current directive excludes from consolidation financial institutions whose activities expose them to market risks. This omission results in a situation where banks engaged in universal banking will be subject to consolidation while their counterpart financial institutions who follow a bifurcated system will not. This may encourage the diversification of portfolios of credit establishments so as to avoid consolidation.

A further problem of particular relevance to the Capital Adequacy Directive involves the situation where a credit institution parent is not authorized to use the trading book option and therefore subject to the Solvency Ratio Directive, while an investment firm is by definition subject to the requirements of the Capital Adequacy Directive. There is debate on whether under consolidation, the investment firm may be fully subject to Solvency Ratio Directive's capital requirements because the credit institution was not authorized to use the trading-book option. In practice this would substantially increase the capital requirements of the group as a whole without any substantial justification. A similar situation would also happen when a credit institution is not authorized to use the alternative own funds definition under the Capital Adequacy Directive. Consolidation would subject the investment firm to a banking definition of "own funds" where subordinate debt would not qualify as capital.

A final problem faced by regulators seeking to enact consolidated supervision is created by the international context. There is no consensus at the international level on the way to carryout consolidated supervision of market risks. Currently both Japan and the United States contemplate allowing banking organization to engage in securities activities, but only through separate subsidiaries. Neither country plans to apply consolidated capital requirements to affiliated banking and securities firms. However, the US Treasury Proposal would require a bank affiliated with a securities firm to meet a higher capital requirement on a solo basis, than the 8% capital requirement. If EC credit institutions are to be competitive on a global level it is important to address the implications of international developments with respect to the regulation of financial intermediaries.

O P I N I O N

(Rule 120 of the Rules of Procedure)

of the Committee on Economic and Monetary Affairs and Industrial Policy
for the Committee on Legal Affairs and Citizens'Rights

Draftsman : Mr John STEVENS

At its meeting of 20 September 1990 the Committee on Economic and Monetary Affairs and Industrial Policy appointed Mr John STEVENS draftsman.

At its meeting of 25-26 September 1990 - 5-7 November 1990 - 17 September 1991, 15-16 October 1991 it considered the draft opinion.

At the meeting of 15 October 1991 it adopted the conclusions as a whole unanimously.

The following took part in the vote : MM. Beumer (President), Fuchs (Vice-President), de Montesquiou (Vice-President), Stevens (draftsman), Barton, Beazley, Bernard-Raymond, Mrs Catasta (for Mr. De Piccoli), MM. Bofill Abeilhe, Caudron, Christiansen, Donnelly, Mrs Ernst de la Graete, MM. Hoppenstedt, Metten, Mrs Nielsen (for Mr. Risker), Mr. Patterson, Mrs Randzio-Plath (for Mr. Mattina), MM. Ribeiro, Roumeliotis, Siso Cruellas, Smith (for Mr. Rogalla), Speciale, Titley (for Mr. Seal).

I. OUTLINE OF THE COMMISSION'S PROPOSALS

A. The Principles of the Directive

1. This Directive is part of the Commission's programme to achieve a Single Market across the Community in Financial Services. Along with the proposed Investment Services Directive it is designed to provide for the securities business a regulatory framework comparable with that granted to the banking business by the Second Banking Coordination Directive and the Own Funds and Solvency Ratio Directives.

2. Within this context, the Capital Adequacy Directive seeks to protect investors and the securities market system as a whole from the failure of participating investment houses just as the own Funds and Solvency Ratio Directives seek to protect depositors and the credit system as a whole from bank failure.

3. The Capital Adequacy Directive therefore shares with its companion Directives the general philosophy of the Commission towards the achievement of. a Single Market in Financial Services : mutual recognition of home country authorization, regulation and supervision underpinned by commonly agreed minimum standards.

4. This philosophy is derived from a political compromise necessitated by the great disparity in both the structure and sophistication of the financial services industry in the various Member States. Prominent among the tensions to which such disparity gives rise under the pressure of the objective of achieving a European Single Market are disparities :

a) between the interests of the city of London to be the dominant financial services centre for the Community analogous to the Status of New York in the United States and the interests of competing centres such as Frankfurt, Paris or Milan.

b) between national financial services markets dominated by institutions which combine banking and securities operations, such as Germany, and those, such as the UK, where a separation of function is the norm.

5. The Capital Adequacy Directive also shares specifically with the Own Funds and Solvency Ratio Directives the two key elements of the Commission's detailed approach to the protection of clients and the financial services system as a whole from the failure of participating institutions :

a) that security should derive from the constant application by the supervising authorities of a clear regulatory framework for a free market rather than through tolerating cartels or other restrictive practices by investment houses or banks.

b) that the cost burdens of regulation are outweighed by the advantages which superior safety standards provide for the clients of financial services and thus community financial institutions and centres should not be disadvantaged as against less regulated foreign competitors.

6. This approach is, in turn, derived from a political compromise necessitated by three conflicting trends in the current development of the financial services market :

   a) market liberalization, while vastly promoting the efficiency of financial services, has, at the same time, progressively undermined traditional operating practices for participating institutions which previously had been the basis of the business security;

   b) the tremendous growth in the scale and complexity of the trading of financial assets, while in many respects reducing the risk to investors and to the market system, through greater liquidity and the development of hedging techniques in futures and options, has simultaneously increased the volatility of the value of securities and thereby the possibility of failure;

   c) the globalization of the provision in financial services, while, on the one hand, accelarating the concentration of trading by time zone in London, New York and Tokyo and thus the possibility of rationalizing international control of the business, has also created the risk of regulatory competition and the proliferation of off-shore centres seeking to take advantage of the lower costs of inferior structures of supervision and thereby threaten the security of investors and the international system as a whole.

B. <u>The Structure of the Directive</u>

1. In seeking to meet these considerations and fulfil these principles, the Commission has drawn up a Capital Adequacy Directive with the following five key features :

   a) the Treatment of Start Up and Ongoing Capital Requirements;
   b) the Treatment of Banks and Investment Houses in the General Conduct of Securities Business;
   c) the Enumeration and Classification of Risks to be regulated;
   d) Accounting and Reporting Requirements of those engaged in the Securities Business;
   e) the Definition of Regulatory Capital.

2. Start Up and Ongoing Capital

   As the minimum start up capital for credit institutions is already dealt with by the Second Banking Coordination Directive, which requires ECU 5 million, the Directive only applies to non bank investment firms' initial capital.

   The minimum start up capital is, as in the Second Banking Coordination Directive, not only a requirement for authorization, but also a condition for maintaining the authorization of an investment firm. Firms already authorized before the date of implementation may, however, at the option of the Member States concerned, remain authorized even if they do not meet the requirement set by the Directive.

Some categories of low risk investment firms, such as locals on financial future markets or firms offering only investment advice, are excluded both from initial and ongoing capital requirements. In principle the minimum start up capital is set at ECU 500 000. However, Member States are given the option of reducing that amount to ECU 100 000 or to 50 000 for firms which do not engage in certain activities.

3. The treatment of banks and investment houses in the general conduct of securities business

The Directive offers supervising authorities several options, including that of allowing them to choose whether they impose a bank's trading book, the capital requirements of this Directive or those emanating from the Solvency Ratio Directive instead.

The trading book is defined in such a way that a bank knows whether to allocate a position to its investment book or to its trading book immediately after it has entered into a position.

Where the trading book option is exercised, banking supervisors can also choose whether they want to apply the definition of own funds, set out in the Own Funds Directive, or the alternative definition for securities firms set out in this Directive. It is possible that, depending on the options exercised by its supervisors, a bank would remain subject to the Solvency Ratio risk weights on its trading book and subject to the Bank Own Funds Directive in respect of its regulatory capital. Even in this situation, however, banks would have to monitor all their risks, and their foreign exchange exposure would either be subject to the Capital Adequacy Directive foreign exchange risk requirement or subject to a ceiling on their foreign exchange exposure.

4. The enumeration and classification of risks to be regulated

The Capital Adequacy Directive proposal covers the following four categories of risks :

- the position risk (subdivided for debt instruments, equities and new issues),
- the counterparty risk,
- the foreign exchange risk,
- other risks (base risk).

The position risk affects only the net long or short positions in each individual instrument.

Different risk weights are set for the interest rate risk on debt instruments, depending on the credit standing of the issuer and on remaining maturity.

The market risk on equity differentiates between listed and unlisted shares. Firms may get a benefit for diversification and hedging, taking into account for example, the delta value of options.

For new issues a window is allowed during the first few weeks after the launching of a new issue, where normal risk weights may be reduced. There is also a penalty for concentrated positions.

The counterparty risk requirement applies to unsettled deals. It starts to apply 5 days after due settlement date. It is based on the difference between the contract, and the market, price and it increases with the length of the time the deal remains unsettled.

The foreign exchange risk requirement is intended to cover the firm's exposure to each foreign currency in which it has a net long or short position. The requirement is lower where the firm's positions are diversified.

The requirement for other risks is intended to cover the risk of a downturn in market activity reducing the firm's current income and preventing it from paying its fixed overheads. It amounts to three months expenses paid in the previous year on fixed overhead.

These various risk requirements are additive.

5. Accounting and reporting requirements of those engaged in the securities business

The Capital Adequacy Directive requires daily marking to market for all positions, except for banks obliged by their supervisors to measure their capital requirements using solely the Solvency Directive yardstick. The firm's regulatory capital needs to be equal to or higher than the sum of the various risk requirements at the close of trading. Firms must report to their authorities at set intervals and the latter must be able to inspect the books at any time.

6. The definition of regulatory capital

In principle, the Capital Adequacy Directive proposal imposes the definition of own funds set by the Banks Own Funds Directive. However, it allows Member States to use an alternative definition, which allows for the inclusion of more short-terms subordinated loans but requires the deduction of all illiquid assets on the grounds that securities business requires both more flexibility and more liquidity than commercial banking.

II. COMMENTARY ON THE COMMISSION'S PROPOSALS

1. In expressing its opinion on this Capital Adequacy Directive, the Economic and Monetary Affairs Committee has resisted the temptation, never, perhaps, very great, to scrutinize in detail the complex analysis of risk which constitutes the main part of the Commission's proposals. Some of us continue to be surprised that, in a matter which demands probably more than most others a significant degree of practical understanding of the current state of the Financial Services Industry, EMAC, which is undoubtedly the best equipped of all the

Parliament's Committees in this respect, should nevertheless have been allocated a subsidiary role in the legislative process. But privilege brings responsibility and the Legal Affairs Committee must ensure that this Directive furthers the considerable interests of the Community in the efficiency and reliability of its financial markets.

2. Where the Committee has been tempted to make specific recommendations for changes in this Directive, such as in some aspects of the initial capital requirement under Article 3, or the counterparty/settlement risk provisions under Annexe 3, it has been apparent that our concern derives from the perception that actual market practice is already developing along lines which tend to undermine the relevance or efficacy of these items.

3. However, it is impossible to separate such specific instances from the general impact on these proposals of the tremendous changes that are under way in the international securities and banking business. Our chosen task, in commenting on the Capital Adequacy Directive is therefore rather to consider it in the wider context of the other Directives which together are designed to create a single European market in financial services and to consider the medium term implications of these changes for this whole supervisory and regulatory structure that is currently being put in place.

4. As has already been pointed out in Section 1.A, this Capital Adequacy Directive, like its companion Directives, is a compromise. It is, broadly speaking and for the time being, probably the best available compromise, and should be implemented to ensure that the single market programme is completed on schedule and in its entirety in this vital field. But it is a compromise that cannot long endure.

5. The essence of this compromise is one that occurs right across the process of European integration : the conflict between centralisation and decentralisation, between uniformity and diversity. The problem is that in no other area of economic activity are the pressures towards centralisation and uniformity stronger than in the provision of financial services.

6. Great questions, such as the future of Paris or Amsterdam as financial centres, the survival of independent securities firms, the disappearance of the distinction between banking and securities operations, let alone the deeper economic policy issues that lie behind these, such as the effective financing of European industry and commerce or the impact of European monetary union, or the protection of vital national or regional interests are being submerged by the incoming tide of the trading revolution which financial market deregulation and the application of new communications and computer technology over the past fifteen years has released.

7. The increasing international form of major financial scandals, not least the current case of the Bank of Credit and Commercial International, must give rise to the gravest doubts as to whether anything less than a single, uniform European supervisory authority and regulatory regime can hope to properly protect the interests of investors and depositors and deal effectively with the other major jurisdictions of the United States and Japan.

8. While none of these concerns can justify not proceeding now with these proposals and setting in place at least a form of Community framework for Europe's financial services industry, they must make us recognize the inadequacy of what we are now undertaking and thus the need to simultaneously initiate a process by which these inadequacies can be progressively made good. To recognize that it is not presently politically possible to resolve all the complex issues involved in reaching even a decision of principle to implement at some point a truly uniform Community level supervisory authority and regulatory regime does not mean that there should not be some procedure for monitoring the workings of these proposals with such a possibility in mind.

9. The Commission has already indicated that it intends to constantly review the operation of the new supervisory and regulatory regime. However, the Economic and Monetary Affairs Committee is not persuaded that the Commission alone is the appropriate body for this task. In the United States it is recognized that the powers of calling evidence and of investigation of both the Senate Banking Committee and the House of Representatives Commerce Committee are a critical element in ensuring the efficacy of the supervisory and regulatory roles of the Federal Reserve and the Securities and Exchange Commission. The Economic and Monetary Affairs Committee believes that it should be granted, in the light of the concerns already outlined, powers to call for a report on a regular basis from the various national supervisory authorities on the working of the legislative framework for the single European market in financial services which we have participated in initiating.

10. The Committee believes this is the minimum that can be done to produce a politically effective forum for ensuring that the great issues which the ongoing process of change in the financial services markets have brought forward can be properly reviewed from a European rather than a purely national point of view and begin the process by which the emergence of a more thoroughgoing and effective European structure of supervision and regulation can come into being.

11. The competent authorities of the Member States and any Community supervisory authority established subsequently shall forward to the European Parliament each year a comprehensive report on the progress and development of the single market in the field of financial services.

    On that occasion, the European Parliament's Committee on Economic and Monetary Affairs and Industrial Policy may request representatives of those authorities to appear in person before it to answer any questions concerning the reports.

Proposed amendment

Article 6 - Reporting requirements

After paragraph 3, add a new paragraph 4 :

4. The competent authorities of the Member States and any Community supervisory authority established subsequently shall forward to the European Parliament each year a comprehensive report on the progress and development of the single market in the field of financial services.

   On that occasion, the European Parliament's Committee on Economic and Monetary Affairs and Industrial Policy may request representatives of those authorities to appear in person before it to answer any question concerning the reports.

CONCLUSIONS

1. The Economic and Monetary Affairs Committee recommends that a provision should be placed in the Capital Adequacy Directive requiring relevant national supervisory and regulatory authorities to submit to the Parliament by way of an annual report to the Economic and Monetary Affairs Committee an outline of their activities and of the development of the Community single market in financial services.

2. The Economic and Monetary Affairs Committee of the Parliament should also have the power to call upon appropriate representatives of those national regulatory or supervisory authorities to answer in person on an annual basis any questions the Committee might have arising from these reports.

3. This requirement should clearly also apply to any Community level successor institution or institutions to these national supervisory and regulatory authorities.

4. That subject to the above and the concerns expressed in this opinion as to its inevitably provisional nature, the Economic and Monetary Affairs Committee supports the Commission's proposals for the Capital Adequacy Directive.