



The game's not over yet for the Capital Requirements Directive...

Rym Ayadi*

Following seven years of painstaking and demanding negotiations, European bankers and regulators breathed a sigh of relief when the Capital Requirements Directive (CRD) finally got through the European Parliament on 28 September 2005, and was formally approved by the Council of Ministers of the 25 EU member states on 11 October 2005. The new CRD will finally apply the complex, risk-sensitive Basel II capital adequacy rules to some 8,000 European banks and some 2,000 investment firms in two stages, the first in January 2007 and the second one year later.

Several issues that will determine the successful implementation of the CRD are still on hold, however, and need to be looked at carefully. The future of comitology in the Directive, the impact of the new results of the fifth quantitative impact study for European institutions, the impact of the uneven implementation dates in the EU and the US and the purely European issues that were extensively addressed but only partially resolved pose real challenges for the European regulators and financial institutions.

The latest developments in the CRD since its adoption

The Capital Requirements Directive consists of re-casted versions of the codified banking Directive (2000/12/EC) and the capital adequacy Directive (93/6/EEC) and includes the package of amendments related to the trading book activities.¹ It applies comitology to some provisions in the Directive. Since its adoption,

the European Commission has published the final consolidated text on its website, containing some 800 pages for regulating European credit institutions and investment firms.² Furthermore, it made accessible the conclusions of the impact study of the new operational risk charge for investment firms,³ and formed a new transposition group⁴ for the Directive, whose purpose is to clarify several issues in the new regulation. The new legislative text will be transposed into the national laws of the 25 member states when it is translated into the various national languages.

The new CRD transposes the complex, risk-sensitive Basel II framework designed by the Basel Committee into EU law. All credit institutions and investment firms operating in the 25 member states will have to comply with the new Directive's provisions from January 2007 onwards for the simple approach and from January 2008, for the more advanced approach to measuring credit and operational risks.

The European regulators were determined to push the new regulation ahead, albeit under a cloud of uncertainties that called into question its timely adoption a few weeks before the voting of the Parliament.⁵ The last-minute compromise reached between the three institutions and driven by the will and commitment of the Parliament to win its call-back right under the comitology procedure saved the Directive from further delays in the process. This compromise amends Arts. 150 and 151 in the codified banking Directive (2000/12/EC) and Arts. 42 and 43 in the re-casting of the capital adequacy Directive (93/6/EEC).⁶ It means that the current

* Research Fellow, CEPS. She would like to thank Ole Bus Henriksen and Karel Lannoo for their valuable comments and suggestions.

¹ These rules were finalised by the IOSCO/Basel Committee joint working group on 18 July 2005. By then, the European Commission did not publish the last draft based on the changes agreed in July 2005. The new trading book rules were introduced into the CRD via an amending package adopted in the Plenary session on 28 September 2005.

² See http://europa.eu.int/comm/internal_market/bank/regcapital/index_en.htm#capitalrequire.

³ See http://europa.eu.int/comm/internal_market/bank/regcapital/impact_en.htm#impact.

⁴ See http://europa.eu.int/comm/internal_market/bank/regcapital/transposition_en.htm.

⁵ See Rym Ayadi, The new capital requirements Directive: What pieces are still missing from the puzzle?, CEPS Policy Brief N° 82, September 2005.

⁶ These articles set the rules to allow future amendments in some provisions (related to definitions' adaptation,

2 | Rym Ayadi

comitology system⁷ – which largely excludes the European Parliament – can be used to update and implement the CRD for a maximum of two years following the formal adoption of the new Directive (until 1 April 2008 at latest), after which time these powers may be renewed only with a new agreement of the three institutions. This new agreement will seek to revise the current comitology system used for such implementing provisions to establish the call-back right for the Parliament.

What's next after the last-minute compromise on comitology?

By suspending the comitology provisions in the CRD in July 2005, the European Parliament won the negotiations with the Commission and the Council with respect to the establishment of its call-back right under the comitology framework. That right will be reinstated after the two years following the adoption of the CRD.⁸ Furthermore, by adding the new amendments to the related articles in the new Directive at the last minute, the Parliament put further pressure on the Commission and the Council to re-examine the current inter-institutional agreement – laying down the procedures for the exercise of implementing powers conferred on the Commission – before the end of the two-year sun-set clause following the adoption of the Directive. If a formal agreement between the three institutions that defines and secures the call-back right for the Parliament is not reached within the next two years,⁹

technical adjustments in several articles and annexes) in the new Directive subject to comitology.

⁷ Defined in the 1999 Council Decision (1999/468/EC) laying down the procedures for the exercise of implementing powers conferred on the Commission.

⁸ “Without prejudice to the implementing measures already adopted, upon expiry of a two year-period following the adoption of this Directive and on 1 April 2008 at latest, the application of its provisions requiring the adoption of technical rules, amendments and decisions in accordance with paragraph 2 shall be suspended. Acting on a proposal from the Commission, the European Parliament and the Council may renew the provisions concerned in accordance with the procedure laid down in Article 251 of the Treaty and, to that end, they shall review them prior to the expiry of the period or the date referred to above.” *Text introduced by the Parliament amending Art. 151 of recasting Directive 2000/12/EC and Art. 43 of recasting Directive 93/6/ECC.*

⁹ First, there should be an inter-institutional agreement on a clear definition of the ‘call-back right’ enjoyed by the Parliament. The Parliament requires that the call-back right should include a clause of transparency, precisely the right to information when the EU Commission gives a mandate to the level 3 committees

the comitology provisions in the CRD will be again put at risk,¹⁰ and every change in the Directive will follow the lengthy traditional legislative co-decision process.

This scenario is highly undesirable for three reasons: first, owing to the high level of the Directive’s technicality and the resulting importance to delegate some responsibility for the technical details to expert committees subject to oversight by the co-legislators; second, it is important to retain flexibility in the Directive since it has to be able to keep pace with developments in industry practices, markets and supervisory needs; and third, as one of the objectives of the Commission is to ensure enhanced convergence of regulatory and supervisory practices to help develop a single market, the role of the Committee of European Banking Supervisors (CEBS) in this process is crucial. Putting the comitology provisions at risk will put a question mark over the future of CEBS’ role in the CRD.

The fifth Quantitative Impact Study (QIS5) in Europe: A threat or a comfort?

In September 2005, the Basel Committee announced its intention to conduct a QIS5 between October and December 2005, in order to review the calibration of the Basel II framework in spring 2006. The QIS5 will ensure that the envisaged review is based on the most recent, high-quality data and will evaluate the impact of the new proposals for the recognition of double default and trading book-related issues. At EU level, the Committee of European Banking Supervisors (CEBS) will play a key role in the QIS5. The report that will analyse the results at EU level will be submitted to the EU Commission and to the European Banking Committee (EBC) as input for the discussion of possible amendments to the CRD.

Presumably, the QIS5 will consider the changes based on the relative improvement in banks’ data series (more complete and robust default and loss-severity data), and in the capital models as compared to the previous QIS3 conducted in year 2003. Further, the QIS5 will not only consider the impact of the changes relating to the move to unexpected losses

and the detailed work and progress of these committees with regular up-dates. This would help the Parliament to formulate well-founded opinions about matters under investigation. The three months foreseen by the current inter-institutional agreement may not suffice to build an opinion on complex matters in the CRD.

¹⁰ In its new financial services strategy for the next five years; the Commission considered ensuring the right EU regulatory and supervisory structures as one of its main priorities. http://europa.eu.int/comm/internal_market/finances/policy/index_en.htm

treatment, but also will consider assessing the impact of new trading book rules and the specific 'EU measures' on credit institutions and investment firms. However, because of the additional implementation work required until the end of 2006, there is still room for improvements. This would increase the importance of another impact study to take into account these improvements before the final recalibration. The recalibration will define a scaling factor (in the form of a multiplier), which ensures that the new framework will produce overall capital levels approximately equal to the current ones.

The results of the QIS5, which are expected in the spring of 2006, will provide new and very important information that could be split into two possible scenarios. If the results would show an important material reduction in the minimum required capital for the population of EU institutions, with a significant amount of dispersion across institutions and across portfolios types, this should raise serious concerns among the European regulators and sensible solutions will have to be found. However, if the results are as uniform as the previous quantitative impact exercise, this would support the EU regulators' choice to adopt the new banking regulation without further scrutiny.

In the first-case scenario, international regulators may consider recalibrating the Accord with a high scaling factor necessary to lift the minimum capital requirements to the level that has historically ensured the safety of the financial system. Also, it could offer the means to correct Basel II limits since they do not account for interest rate and liquidity risks. Further, Basel II capital standards are based partly on the banks' own data series and models. Data are based on estimates, and models are based on assumptions – both of which are subject to errors. However, such a crude correction might draw severe criticism from the industry because it will partially diminish the scope of a risk-based regulatory capital system and may be viewed as penalising adequately-capitalised and well-managed banks. Building upon the emerging concepts of better and more risk-sensitive regulation, the minimum Basel I capital level that was historically required could be challenged. Undoubtedly, while introducing a regulation that is more risk sensitive, it is hard to continue advocating the minimum capital level that is roughly determined. Herein lies a serious dilemma for international regulators: is it safe for the financial system to give up the minimum required capital level that served its purpose historically for the new levels that will be produced by the new risk-based regulation?

What is the impact of staggered EU and US implementation schedules on European banks and supervisors?

In light of Basel II developments in Europe, it is important to examine the US decision that delays the publication and the implementation of the Notice of Proposed Rulemaking (NPR). The latter transposes Basel II rules into US legislation and ought to be applied to some 20 of the largest internationally active banks in the US. This cautious decision was the result of the worrying findings of the fourth quantitative impact study (QIS4), which showed an overall drop of regulatory capital requirements for the participating, internationally active US banks, with a high level of dispersion.¹¹ This drop was not anticipated by US supervisory agencies. As a response, they delayed the issuance of the NPR and introduced additional prudential safeguards in the legislation, while retaining the Prompt Corrective Action and leverage ratio requirements, to address concerns identified in the analysis of the results of QIS4. The implementation of the NPR is expected to be gradual, with the first opportunity for internationally active US banking institutions to conduct parallel runs in January 2008 and then being subject to a minimum three-year transition starting from January 2009 to January 2011. During this period, the agencies would apply limits or floors on the amounts, by which time each institution's risk-based capital could decline with the application of Basel II.¹² These floors are more conservative than those in the Basel II framework.

The rest of the US banking system, composed of some 8,900 or more regional and community banks, will operate under the Basel IA proposals that would upgrade the current Basel I capital rules.¹³ The

¹¹ These results were not explained by differences in risks, but were rather attributed to the fact that internal banking systems are not all developing at the same pace, partly due to the lack of definitive rules and guidance. Consequently, it was not clear whether QIS4 results understate or overstate the minimum capital requirements.

¹² FDIC, "Banking agencies announce revised plan for implementation of Basel II framework", press release, September 2005.

¹³ Basel IA is an improved version of Basel I, and could be seen as the standardised approach of Basel II. Indeed, Basel IA allows: more granularity by increasing the number of risk weights, an expanded use of external risk ratings as indicators of credit risk, wider list of guarantees and collateral eligible, modified risk weights for residential mortgages and lower risk weights for certain small business loans. Also, Basel IA foresees a capital charge for certain securitisations with early amortisation provisions, higher risk weights for past due

4 | Rym Ayadi

revision of the rules for these banks aims at reducing the material distortions that would occur while applying different rules. Also, it aims at maintaining a reasonable balance between risk sensitivity and operational feasibility.

Because of staggered implementation dates, some commentators believed that European banks will benefit from a competitive advantage of implementing CRD in advance of their US counterparts. However, this is hard to believe since this competitive advantage is only temporary and is likely to be counterbalanced by the threat of additional compliance costs due to different implementation dates in the EU and the US. Moreover, the ambiguity of supervision on a solo basis versus a consolidated basis and the role of the lead supervisor for European banks operating in the US and US banks operating in the EU will be ever stronger. In practice, at least for one year, large European banks with substantial operations in the US will have to comply with Basel II rules in Europe and the current Basel I rules in the US and the reverse would hold for US banks with European operations, which will have to comply with Basel II in Europe and Basel I in the US. Internationally active banks represented by the Institute of International Finance have voiced their concern over the increased risk of competitive inequities and costly inefficiencies resulting from the uneven implementation of Basel II.

In addition to these developments, internationally active banks will have to identify the problems arising from the uneven implementation of Basel II. To solve these problems and advance multilateral¹⁴ and bilateral¹⁵ discussions, international regulators will have to cooperate and coordinate their efforts and actions in order to provide tangible, quick, pragmatic, efficient and workable solutions, particularly for complex banking groups.

European issues extensively addressed but further scrutiny is needed to be fully solved...

During the adoption process of the CRD, several issues have stimulated extensive debate between different interest groups. Although the related articles were adopted, these issues should be subject to further scrutiny in the future. These include:

loans, and high volatility commercial real estate and increased credit conversion factors for certain short-term commitments.

¹⁴ Those are fostered by the Accord Implementation Group (AIG).

¹⁵ Bilateral discussions are considered to be an effective means to address cross-border issues.

- the level at which supervision is to apply – solo entity versus consolidated application (Art. 69 re-casting 2000/12/CE);
- intra-group exposure (Art. 80(7) (re-casting 2000/12/EC);
- the role of the lead supervisor (Art. 129 re-casting 2000/12/EC); and
- the disclosure of ratings to loan applicants (Art. 145 (3) re-casting 2000/12/EC).

With regard to the level of application, changes made by Parliament and agreed upon by the Council allow under very strict conditions the supervision of national subsidiaries on a consolidated basis. These changes also allow, under similarly strict conditions and with additional disclosure requirements, supervisors to waive the solo requirement for parent undertakings. Waiving the solo requirement for subsidiaries and parent undertaking in the same member state will certainly favour credit institutions operating nationally as opposed to those operating across borders. Indeed, if all conditions are satisfied, the former will be supervised on a consolidated basis, whereas the latter will have to comply with all requirements on an individual and a consolidated basis.

Also, thanks to the backing of the Parliament and the Council, it was made possible to extend the zero risk-weighting for intra-group exposures to banks operating within an institutional protection scheme (Art. 87 (7a)) under more lenient conditions as compared to the requirements originally imposed by the Commission on the other types of banks. These conditions may not be sufficient to qualify as a single unit for prudential purposes.

In view of these two developments, if one of the main objectives of the new Directive is presumably to ensure the level playing field between institutions performing the same activities and bearing the same risks, it is expected that they are treated equivalently.

Further, Parliament backed a partial role of the lead supervisor usually based in the home country of the bank, with respect to the validation and final shape of internal rating-based and advanced measurement models for credit and operational risks. This is only one step forward towards a full lead supervisor regime and would risk undesirable inconsistencies in implementation since this concept is not extended to pillar 2 and pillar 3. It would also risk the creation of asymmetries with respect to the responsibilities and burdens borne by home and host country supervisors. In this context, the question is how to solve a situation where a home and a host do not agree on the model's validation within the six-month period foreseen by the Directive and during which time the host has to be accountable to local taxpayers when a

given subsidiary is in distress. At the same time, a full lead supervisor regime may not be sustainable unless there is a binding agreement between the home and the host supervisors with respect to the issues of deposit guarantee schemes, lender of last resort and reorganisation and winding up.

Finally, banks will have to explain their rating decisions to SMEs and other corporate applicants for loans if they so request. Art. 145 (3a) in the final text suggests, in a rather threatening tone, that if a “voluntary undertaking” fails to achieve an adequate level of transparency between loan applicants and banks regarding the rating decision, national measures should be taken. However, nothing is said about the format and the content of the rating decision, the criteria to define the adequacy of the voluntary undertaking of the sector or what national measures would be taken if these undertakings prove inadequate.

Key factors to ensure successful implementation in Europe

To ensure a successful implementation in the 25 member states, the new Directive should benefit from the comitology provisions during the two-year sunset clause foreseen by the Parliament. These provisions must be extended in light of a formal inter-institutional agreement that reforms the current one in the next two years to define and establish the call-back right for the Parliament. This is crucial for allowing flexible updates and changes related to the continuous development in market practices. The related role of the Committee of European Banking Supervisors (CEBS) is key to ensuring a consistent and coherent implementation and application of EU banking regulation in all member states.

Two very important issues arose further in the US supervisory agencies' decision to delay the implementation date of the advanced approach of Basel II in Europe from January 2008 to January 2009. Most importantly, one should give more attention to the likely impact of the new rules on banks and investment firms on the one hand and on financial stability on the other. The results of a new quantitative impact study are keenly anticipated, not only to add comfort and reassurance with respect to the challenging approach taken by European regulators, but also to take the necessary measures on time in the event that similar results occur in the US. Staggered implementation of timetables across the Atlantic are neither welcomed by internationally active banks nor appreciated by national regulators. For the former, this would increase the compliance burden which leads to inefficiencies. For the latter, this would render their tasks more burdensome. Relying only on bilateral and/or multilateral dialogue

to solve the heightened cross-border matters may not suffice to reach a quick and workable solution. Undoubtedly, the implementation of the new rules will be much more difficult to handle in these circumstances; however, the difficulties are not insuperable if both sides of the Atlantic are committed to cooperate in finding quick, pragmatic and workable solutions.

With respect to the purely European issues, owing to the evolving nature of banking regulation and supervision, it is fundamental to prepare the foundation for a more integrated financial market. Ensuring that the lead-supervisor concept functions well in general and in the context of the CRD in particular is vital. Efforts in this direction would also solve the issues related to the levels of application – whether banking supervision can be conducted at a consolidated level nationally or across borders or whether banks and their subsidiaries are to be supervised as solo entities in the medium term while seeking other arrangements in the direction of complete supervision at a consolidated level.

In addition, providing the conditions for a level playing field is one of the chief objectives in the development of new banking regulation. Therefore, it is important to treat entities that perform the same activities in an equivalent way so as not to undermine this principle.

Finally, provisions in the CRD that promote transparency and better communication between SMEs and their lenders are appreciated. This could be achieved through a non-legislative code of conduct, which sets out the main principles governing this growing SME-banking relationship and also the details of the minimum requirements for the disclosed elements in the rating process.

The new CRD is a revolution in prudential supervision, not only for EU financial institutions but also for EU supervisors, and their respective tasks are challenging. Putting all the key elements together – comprehensible legislation, adequate and flexible means for updating it and a continuous impartial dialogue with the interested parties, together with effective cooperation and coordination in the most sensitive matters – will lay a firm cornerstone to successful implementation.

About CEPS

Founded in 1983, the Centre for European Policy Studies is an independent policy research institute dedicated to producing sound policy research leading to constructive solutions to the challenges facing Europe today. Funding is obtained from membership fees, contributions from official institutions (European Commission, other international and multilateral institutions, and national bodies), foundation grants, project research, conferences fees and publication sales.

Goals

- To achieve high standards of academic excellence and maintain unqualified independence.
- To provide a forum for discussion among all stakeholders in the European policy process.
- To build collaborative networks of researchers, policy-makers and business across the whole of Europe.
- To disseminate our findings and views through a regular flow of publications and public events.

Assets and Achievements

- Complete independence to set its own priorities and freedom from any outside influence.
- Authoritative research by an international staff with a demonstrated capability to analyse policy questions and anticipate trends well before they become topics of general public discussion.
- Formation of seven different research networks, comprising some 140 research institutes from throughout Europe and beyond, to complement and consolidate our research expertise and to greatly extend our reach in a wide range of areas from agricultural and security policy to climate change, JHA and economic analysis.
- An extensive network of external collaborators, including some 35 senior associates with extensive working experience in EU affairs.

Programme Structure

CEPS is a place where creative and authoritative specialists reflect and comment on the problems and opportunities facing Europe today. This is evidenced by the depth and originality of its publications and the talent and prescience of its expanding research staff. The CEPS research programme is organised under two major headings:

Economic Policy

Macroeconomic Policy
 European Network of Economic Policy
 Research Institutes (ENEPRI)
 Financial Markets, Company Law & Taxation
 European Credit Research Institute (ECRI)
 Trade Developments & Policy
 Energy, Environment & Climate Change
 Agricultural Policy

Politics, Institutions and Security

The Future of Europe
 Justice and Home Affairs
 The Wider Europe
 South-East Europe
 Caucasus & Black Sea
 EU-Russian/Ukraine Relations
 Mediterranean & Middle East
 CEPS-IISS European Security Forum

In addition to these two sets of research programmes, the Centre organises a variety of activities within the CEPS Policy Forum. These include CEPS task forces, lunchtime membership meetings, network meetings abroad, board-level briefings for CEPS corporate members, conferences, training seminars, major annual events (e.g. the CEPS International Advisory Council) and internet and media relations.