Centre for European Policy Studies

CEPS Policy Brief

No. 82/September 2005/ with postscript of 29/09/05

Thinking ahead for Europe

The New Capital Requirements Directive
What pieces are still missing from the puzzle?

Rym Ayadi*

Introduction

After almost seven years of hard work to produce a new substantive piece of legislation updating the current banking regulation for European credit institutions and investment firms – the Capital Requirements Directive (CRD) – it looks like its timely adoption is still uncertain. The main problem is the dissatisfaction of Parliament with its limited role in comitology and in the Lamfalussy process, which has led it to suspend 'temporarily' the comitology provisions of the CRD, casting doubt over the future ability to amend the legislation. The European Constitution addresses Parliament's concern about ensuring democratic accountability in the comitology process in Art. 36. The pause for reflection on the Constitution prompted by the no-votes in the French and Dutch referenda has re-ignited the issue and is forcing EU institutions to seek a new inter-institutional agreement on this issue.

As a result, one undesirable scenario could materialise concerning the adoption of the new Directive. Unless a formal inter-institutional agreement is reached with respect to comitology, there is a high risk that the CRD will be unduly pushed towards a second reading, which in turn puts a question mark over its timely implementation. Adding to the complexity of the puzzle, the treatment of trading-book activities and double-default effects in the new Basel Capital Accord (Basel II) is to be incorporated into the new Directive as an amending package, without the opportunity to renegotiate any of its aspects.

In addition to the heated issue of comitology, the first reading by Parliament gave rise to several other issues including the level of application, the lead supervisor, the intra-group exposure and the disclosure of ratings. During the parliamentary process, several special interest groups persisted in negotiating for their specific aims. Yet the outcome from such lobbying may risk undermining one of the main goals of the Directive, which is to ensure a level playing field.

The objectives of this Policy Brief are threefold: first, it examines the role of the European Commission in the CRD legislative process; second, it identifies the main scenarios expected in the adoption episode; and third, it offers recommendations with respect to some outstanding issues in the key provisions of the forthcoming Directive.

The role of the European Commission in the CRD process

Since the Basel Committee began to revise the capital adequacy framework for internationally active banks in 1999, the European Commission has been deeply involved and committed to updating the current EU banking rules to keep pace with market developments. Following several years of sustained effort and shortly after the issuance of the Basel II text, the Commission finally produced a major legislative proposal.

In June 2004, the Basel Committee produced a fairly advanced version of a broader and more substantive regulatory framework for internationally active banks that aims at underpinning banking solvency. The same framework served as a background document for the Commission to update the current EU banking regulation. In July 2004, a proposal for an updated CRD was published, which has largely retained the same provisions introduced in the Basel II text, but with some variations to accommodate the EU context.

Although Basel II was originally intended to be applied by internationally active banks, the Directive will target – when adopted – all credit institutions and investment firms irrespective of their size, scope of activities or level of sophistication. This scope of application is highly challenging since it should be made appropriate for small, medium-sized and large banks as well as investment firms on the grounds that they carry out similar activities and risks. This approach is laudable, since it encourages all types of EU financial institutions to upgrade their internal systems, resulting in a more risk-sensitive management of their activities in the future. Moreover, it pays close attention to the level-playing-field principle since EU

* Rym Ayadi is a Research Fellow at CEPS. This version takes into account developments occurring in this fast-changing field through 13 September 2005.

banks and investment firms need to be subject to equivalent regulations on the grounds that they bear the same risk.

In order to smooth the transition to the new regulatory framework of such a large population of financial institutions varying in size and sophistication and to make risk-sensitivity achievable by all of them, the Commission introduced some EU-specific solutions by:

- creating 'roll-out' rules for the internal rating-based (IRB) approaches that allow credit institutions to move different business lines and exposure classes to the foundation or the advanced IRB approach (Art. 85);
- allowing small and medium-sized banks to partially use the IRB approaches for some exposures combined with the continued use of the standardised approach for exposures to sovereigns and financial institutions (Art. 89);
- giving preferential treatment (lower capital charges as compared with the original Basel II text) to private equity and venture capital investments when these are considered as "sufficiently diversified" (Annexes VI and VII);
- providing special treatment to covered bonds (Annex VI); and
- exempting small investment firms from the new operational risk charges, reflecting their risk profile and limited systemic importance.

Further, it called for enhanced convergence of regulatory and supervisory practices aimed at creating a single EU financial market. To this end, some actions have already been taken to prepare the ground for the successful implementation of the new CRD in the EU. The creation of the Committee of European Banking Supervisors (CEBS) under the comitology structure specified by Commission Decision 2004/5/EC of 5 November 2003 is intended not only to enhance the cooperation and the exchange of information between national supervisors to increase the effectiveness of supervision in a cross-border context, but also to help incorporate updates and technical changes more easily under the comitology procedure.

Hence, the role of the CEBS is crucial in promoting supervisory convergence and disclosure, given the enhanced supervisory discretion introduced by pillar 2 of the new Basel Capital Accord. The CEBS is also responsible for providing criteria for national supervisors to validate the IRB models for credit risk and the advanced measurement (AM) models for operational risk, along with the requirements of the statistical data to be provided by the banks. This ongoing task is certainly burdensome and demanding, because it will have to seek a theoretical and probably non-existent balance between diversity and convergence. Diversity is a result of cultural and legal differences between the member states, while the drive for convergence through new legislation relates to the major opportunity to promote a level playing field among credit institutions and investment firms across the EU and ultimately to achieve an integrated financial market. Therefore, the key success factor for the EU in its implementation of the CRD is to construct a solid, cooperative system in banking supervision to spread supervisory best practices throughout the member states.

At the same time, the Commission proposal is being expanded to incorporate additions to the Basel II framework (finalised in June 2004) that have been proposed by the joint Working Group of the Basel Committee and the International Organisation of Securities Commission (IOSCO) under its review of trading book[2] issues and the treatment of double-default[3] effects. Because the time frame for the adoption of the Directive is tight, the Commission is seeking to introduce the new Basel rules on trading activities and the treatment of double-default effects as a package of amendments in a European Parliament plenary session in September 2005, which is a very unusual measure. This was inevitable, however, since the final rules were only finalised by the international regulators as recently as 18 July 2005 and time is running out.

Since the beginning of the process to revise the capital requirement rules, the Commission has followed a very flexible approach and has ensured public consultation at every step of the way. Nevertheless, in this author's view, its role in the process has suffered from several weaknesses.

First, the Commission has produced a substantive EU legislative text by reference to the Basel II framework but at no time has it explicitly indicated the main differences

---

[2] The definition of 'trading book' is given in para. 685 of the revised framework (June 2004): "A trading book consists of positions in financial instruments and commodities held either with *trading intent* or in order to hedge other elements of the trading book. To be eligible for trading book capital treatment, financial instruments must either be free of any restrictive covenants on their tradability or able to be hedged completely. In addition, positions should be frequently and accurately valued, and the portfolio should be actively managed" (italics added for emphasis). In the CRD proposal, this is defined in Art. 11 of the re-cast version of Directive 93/6/EEC. The definition of trading intent criteria is more precisely given in para. 687 of the revised framework: "Positions held with trading intent are those held intentionally for short-term resale and/or with the intent of benefiting from actual or expected short-term price movements or to lock in arbitrage profits, and may include for example proprietary positions, positions arising from client servicing (e.g. matched principal broking) and market making." In the CRD proposal, the trading intent criteria are defined in Annex VII, part A.

[3] Double-default stems from the risk of both the borrower and the guarantor defaulting on the same obligation; see the report on revised rules to trading activities and double-default effects by the Bank for International Settlements (2005b).

between the Basel text and the EU one[4]. Such a comparison would have eased the task of Parliament, industry representatives and other observers in understanding the two sets of rules. As yet, the exact differences are not thoroughly identified and the deviations from the original text are not sufficiently explained.

Cost-benefit analyses or targeted impact studies could have been provided to gauge the impact of the proposed specific 'EU' measures on financial institutions and across business lines.

The fact that the drafters of the EU text have relied on the results of the Basel Committee's and the European Commission's third Qualitative Impact Studies (QIS-3) published in year 2003 should not necessarily inspire confidence since the results of the QIS-3 have proven to be insufficiently reliable to enable final conclusions to be drawn.[5] Moreover, these results do not take into account the impact that the new trading book rules has on the required levels of capital for banks and investment firms. Additional impact studies will be required to gauge the effects of the new rules on credit institutions and investment firms on the one hand and on financial stability on the other.

Second, among the three alternatives for updating the existing banking legislation (amending, re-casting or developing a new directive), the Commission has preferred the re-cast technique,[6] since it not only retains the previously adopted provisions (which may not be subject to further negotiation or adaptation) but also preserves the consolidated version of the legislation. Obviously, in light of the length and complexity of the original Basel II framework, the resulting EU version is a highly burdensome piece of legislation (half of which is contained in the annexes), with no fewer than 146 articles.

Further, it has proven difficult to keep the clear-cut structure of the original framework and to translate highly technical rules into a purely legal text. Given the growing level of complexity, implementing the new Directive will be a challenging exercise not only for banks but also for national supervisors. It would thus help them to have separate guidelines (which are not necessarily legislative texts), including rules by type of bank (standard versus IRB banks) and by type of business (retail, corporate, mortgage or trading, etc). In this respect, the CEBS has a key role in ensuring comprehensive rules are developed and consistently implemented across jurisdictions.

Third, the Commission has not been explicit as to whether the CRD is a 'Lamfalussy directive'[7] in a strict sense. On the one hand it has pushed for the creation of the Lamfalussy committees: the European Banking Committee (EBC) (level 2) established by Commission Decision 2004/10/EC and the CEBS (level 3) established by Commission Decision 2004/5/EC. On the other hand it has been very vague about what it considered to be either the principles or the detailed technical measures. Intuitively, one might think that the CRD is a kind of Lamfalussy directive and consider the articles as the principles, with the central rules governing the new provisions introduced by the new regulation and the annexes being the detailed, technical implementing measures. Therefore, in theory one could have expected that only the principles contained in the articles would be passed under co-decision procedures and all the provisions contained in the annexes would be the task of the committees.

Yet in reality, the revision of the CRD has not followed the typical Lamfalussy procedure given that the full document (articles and annexes) has been driven through the co-decision legislative process. The CRD only applies the delegation of powers of some implementing measures to the EBC (level 2) and the CEBS (level 3) under the comitology procedure. These measures are referred to explicitly in Arts. 150 and 42 of the Directive proposal. The further evolution of the more risk-selective capital adequacy rules will be handled by the CEBS, whose main task is to advise on the implementing measures of the CRD and then to report their findings to the EBC, which will in turn decide whether or not to adopt them.

In this process, only the Council can block proposals to be adopted under the comitology procedure. Indeed, according to the 1999 Council Decision (1999/468/EC) laying down the procedures for the exercise of implementing powers conferred on the Commission, only the Council has the right to act by qualified majority in a period that does not exceed three months on the proposal of measures agreed at level 2. The European Parliament; however, does not enjoy the same right. In fact, its limited role in the Lamfalussy process and in the comitology provisions in the CRD is the source of some discontent among MEPs. Although the European Constitution addresses Parliament's concern about ensuring democratic accountability in the comitology procedure in Art. 36, the pause for reflection on the Constitution after

[4] An explanatory memorandum of less than 10 pages as compared to the lengthy legislation of some 400 pages points the "specific" EU measures but it does not provide a thorough explanation.

[5] Most importantly, these results do not take into account the endorsement of the new treatment of expected and unexpected losses, See Ayadi & Resti (2004).

[6] The recasting technique (Interinstitutional Agreement 2002/C 77/01 allows the addition of new provisions to the existing legislation in grey. These sections should be negotiated and amended under the co-decision procedure, whereas the pre-existing white text is not amendable. Any text that is no longer valid is simply deleted.

[7] In theory, the Lamfalussy procedure means that legislative measures are drafted by subdividing the measures into principles (level 1) and technical implementing measures (level 2). The principles are adapted using the co-decision procedure (between the European Council and Parliament) and the implementing measures are adapted using the comitology process (between the EBC and the CEBS).

the French and Dutch referenda has placed the issue in abeyance.

In response, the European Parliament temporarily suspended the comitology provisions in the CRD[8] until a new inter-institutional agreement can be reached that establishes its call-back right.

What are the scenarios for CRD adoption?

Throughout the process, the European Parliament has generally been supportive of the CRD and it seems that the majority of its members do not want to see further delays in its implementation despite the short time allocated to them to review this large and far-reaching piece of legislation.[9] Nevertheless, in the legislative battle to win the call-back right, Parliament has held the CRD comitology provisions hostage. In these circumstances, delays appear inevitable if the adoption of the Commission's proposal requires a second reading.

Further, this situation has created broader uncertainties that go beyond the CRD adoption. Parliament is strongly committed to obtaining its call-back right and is using the CRD as a critical bargaining chip in the negotiations.

The ideal solution would be to reach a horizontal inter-institutional agreement, before the plenary session meets late in September, which would extend the powers of the European Parliament in line with the powers granted in the Constitution in the context of comitology. If this agreement materialises, the comitology provisions in the CRD will not be at risk and the adoption process will not be pushed towards a second reading. This agreement should aim at amending the 1999 Council agreement. Against this background, meeting the September date[10] is unlikely given that the negotiations would have to start within the UK presidency with an objective of finding an agreement in the course of 2006.

To meet the target date of the plenary session, another informal agreement will have to be explored to give Parliament the call-back right. Yet this solution depends greatly on the will, commitment and comfort-level of the majority of MEPs, as well as on an accurate and convincing message being transmitted by the Commission and the Council.

Consequently, several different scenarios are plausible. If no formal agreement is reached by the September plenary but the Commission and Council reach an informal agreement with Parliament to extend its powers in the comitology context, then the likelihood that the CRD with the comitology provisions will be adopted at the first reading is very high.

If Parliament is not satisfied with an informal agreement, however, then two other possibilities can be foreseen – either the CRD will be adopted at the first reading without the comitology provisions or the CRD will be pushed towards a second reading while a new inter-institutional agreement is sought in the course of 2006. If the CRD is adopted without comitology, then the relevance of the CEBS and the EBC in the CRD process is questionable. Moreover, if any changes (recalibration and updates, etc.) to the Directive are required after the fifth Quantitative Impact Study (QIS-5) – due to be initiated by the Basel Committee and the Commission Services in the second half of 2005 – then short amending directives will follow the traditional, lengthy, legislative co-decision process.

In short, the CRD cannot be dispossessed of the comitology provisions for three reasons:

- First, given the high level of the Directive's technicality, it is advisable to delegate some responsibility for the details to an expert committee 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.
- 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 CEBS in this process is crucial. As noted above, the suspension of the comitology provisions will put a question mark over the future of CEBS' role in the CRD.

The new trading book rules: Adding to the complexity of the puzzle…

Since the beginning of the revision process, the Basel Committee has insisted that the new framework should keep pace with ongoing developments in industry practices and build on an active public consultation. When the revised framework for credit and operational risks was finalised in June 2004, the Basel Committee had already set up a joint Working Group with IOSCO in January 2004, aiming at revising the treatment of counterparty credit risk (CCR),[11] a number of trading

[8] When voting upon the amendments on 13 July 2005 in the plenary session of the European Parliament Committee on Economic and Monetary Affairs (ECON), a majority of the members voted for the suspension of the comitology provisions introduced in the CRD proposal.

[9] On 24 May 2005, Rapporteur Alexander Radwan presented the final report containing some 887 amendments (based on the European Commission's proposal and after the Council's political agreement in December 2004), of which 288 were his own. Prior to the 13 July vote on the amendments by the ECON Committee, some compromise amendments were presented aiming at decreasing the original number of amendments and hence easing the voting process. The majority of the amendments were passed.

[10] The plenary session is scheduled for the end of September 2005.

[11] CCR is the risk that the counterparty to a transaction could default before the final settlement of the transaction cash flows (see Bank for International Settlements, 2005b).

book-related issues as well as the treatment of double-default.

The resulting framework, which was based on extensive industry contributions and consultations,[12] was finalised on 18 July 2005.

In parallel, the Commission consulted with the Working Group on the Basel/IOSCO review, strongly stressing that they would not diverge from the text agreed by the international regulators. The Commission Services are now preparing a set of amendments to the current CRD proposal for the purpose of incorporating the Working Group's review into the legislation and enabling its implementation at the same time as the rest of the Directive. The amendments are mainly expected to modify the annexes of the CRD.

The Basel II/IOSCO Working Group set up three subgroups that looked at amending the regulatory treatment of:

1) counterparty credit risk for over-the-counter (OTC) derivatives and securities financing transactions (SFTs)[13] (strand 1 of the review);
2) double-default effects of hedged transactions in the banking and the trading books and short-term maturity adjustments in the IRB approach (strand 2); and
3) unsettled and failed transactions along with the boundary between trading and banking books and specific risk (strand 3).

Importantly, the review seeks to deliver a consistent regulatory treatment of economically similar products (derivatives and SFTs), enabling cross-product netting[14] of current and future exposures and ensuring a level playing field for all dealers in these products, whether banks or investment firms.

Overall, the review is a step forward towards a modern and more economically viable treatment for these complex products.

In the field of counterparty risk, the changes put forward better reflect market practices. Indeed, the use of expected positive exposure (EPE) [15] was considered to be an adequate measure to estimate the exposure at default (EAD), [16] despite the amendments[17] brought to the concept by the regulators to account for the roll-over[18] of positions.

Yet further refinements ought to be brought to the operational requirements for EPE modelling, some of which are viewed as too prescriptive,[19] particularly the floor imposed on own alpha estimates (which is now set equal to 1.2).[20] Further, the imposition of regulatory

---

[12] The industry was very active in the revision process and responded to the consultations launched by the Basel/IOSCO Working Group and the European Commission on 27 May 2005. A joint industry response was prepared for the Basel/IOSCO Working Group by the International Swaps and Derivatives Association (ISDA), the Institute of International Finance (IIF), the London Investment Banking Association (LIBA), the Bond Market Association (TBMA), the Futures and Options Association (FOA), the International Banking Federation (IBFed) and the British Banking Association (BBA). Further, LIBA, ISDA and FBE (Fédération Bancaire Européenne) commented separately on the Commission's consultation.

[13] SFTs are transactions such as re-purchase agreements, reverse re-purchase agreements, security lending and borrowing and margin-lending transactions, where the value of the transactions depends on market valuations and the transactions are often subject to margin agreements (see Bank for International Settlements, 2005b).

[14] Cross-product netting refers to the inclusion of transactions of different product categories within the same 'netting set'. A netting set is a group of transactions with a single counterparty that are subject to a legally-enforceable bilateral netting arrangement and for which netting is recognised for regulatory capital purposes (Bank for International Settlements, 2005b).

[15] EPE is the weighted average over time of expected exposures in which the weights are the proportion that an individual expected exposure represents over the entire time interval. When calculating the minimum capital requirements, the average is taken over the first year or over the time period of the longest maturity contract on the netting set. This concept was originally worked out by the industry (ISDA, LIBA and TBMA, 2004).

[16] EPE has two limitations: it does not account for the concentration of the portfolio or the correlation between the exposures to different counterparties. Wilde (2001) shows that for a perfectly diversified portfolio of counterparty exposures, EPE is a correct measure of EAD. But reality is different and portfolios are not perfectly diversified since they have credit and market risk granularities. To correct this concept and account for the granularity risk, Picoult (2002) defined an alpha multiplier, which is a ratio between the economic capital under market and credit uncertainty and economic capital calculated based on EPE.

[17] The solution proposed by the regulators is to use the effective EPE defined as the weighted average over time of effective expected exposure over the first year, or over the time period of the longest maturity contract in the netting set where the weights are the proportion that an individual expected exposure represents over the entire time interval: effective EPE_t = Max (eff EPE_{t-1}, EPE).

[18] The rollover risk is the amount by which the EPE is understated when future transactions with a counterpart are expected to be conducted on an ongoing basis, but the additional exposure generated by those future transactions is not included in the calculation of EPE.

[19] When calculating the alpha multiplier, several issues remain to be worked out such as accounting for the market characteristics, the differentiation between counterparty exposures, the floor of the internally calculated alpha and the default value for banks that choose not to calculate the alpha multiplier (α).

[20] Canabarro (2002) developed a quantitative model to represent a portfolio of market-driven counterparty exposures with parameters defining various characteristics of

treatment (usually applied to transactions considered with a maturity of over one year) on short-dated transactions (SFTs such as repo and securities lending transactions, which are collateralised transactions with a liquidation period broadly equal to five days), needs to be revisited since these transactions do not generally reach a maturity of one year. Also, the conditional recognition[21] of cross-product netting has been criticised by the industry in view of recent changes in the US bankruptcy law and of the long-recognised enforceability of cross-product netting in other key jurisdictions.

With respect to the treatment of double-default, there have been efforts to improve the current regulatory treatment of credit mitigation through the purchase of credit derivatives or guarantees, a process that is based on the substitution approach. This approach is deemed to be overly conservative since the double-default of both the reference entity (obligor) and the protection provider must occur within a short time interval and it ignores double recovery. A new approach based on the asymptotic single risk factor (ASRF) model was put forward by the international regulators. This approach introduces a separate risk factor that affects the reference entity and the protection provider.

Because of this extra factor, hedged exposures are sensitive to three correlation parameters: $\rho_{0S,}$ the correlation between the reference name and the systematic factor (this factor is already calibrated within the revised framework of June 2004); ρ_{gs}, the correlation between the guarantor and the systematic factor; and the pair-wise correlation ρ_{og}. The final calibrations were set at $\rho_{gs} = 0.7$ and $\rho_{og} = 0.5$. These values correspond to the median values observed in the empirical studies.

Since these values only represent average values, it is important to consider revising them when the new rules are due to be tested in the future. Further, it is important to reconsider the short-term maturity[22] (of less than one year) benefits at a later date when more reliable evidence is gathered. At this stage, it is imperative to maintain a constructive dialogue between regulators and industry representatives, which should continue beyond the adoption of the review measures, to ensure that the rules are updated and adapted to keep pace with market developments and evolving risk-management practices.

Further improvements have been proposed to the trading book regime including the clarification of the types of exposures that qualify for the trading book (such as securitisation pipelines and investment in non-financial assets). The ultimate intention, however, is to achieve a risk-sensitive treatment of the items included in the trading book. In this regard, the Working Group introduced some changes that relate to the specific risk modelling. These changes are designed to update the rules in line with the developments in industry practices and the growth of complex and less liquid positions in the institutions' trading books. Changes include a specific requirement under pillar 1 to incorporate the results of a firm's stress test into their pillar 2 internal capital assessment. Further, firms will be required to capture default and event risk if they want to receive specific risk-model recognition. Finally, with respect to the failed trades and non-DvP[23] (delivery versus payment) transactions, the new measures aim at setting out a uniform treatment for various types of unsettled transactions as current global standards differ. The measures also distinguish between DvP and non-DvP transactions as well as those with normal and longer settlement periods, and set the corresponding risk multipliers based on the settlement period. Obviously, capital requirements for these types of transactions are expected to increase, which is not necessarily pleasant for the industry players. At the same time, the measures encourage institutions to develop, implement and improve systems for tracking and monitoring credit-risk exposures arising from unsettled transactions.

Overall, the changes brought by the trading book review are a significant step forward to better management of the risks stemming from these complex and growing activities. Therefore, the framework has allowed for the degree of flexibility necessary for further improvement in the future. Indeed, to continue the process of evolutionary adaptation of the regulatory framework, it is important for the rules to provide firms with the flexibility needed to improve their risk-management practices. As markets develop for offloading new forms of risk, it will be possible for the regulators and industry to recalibrate the regulatory model based on new, more extensive and better quality data.

In this respect, it is vital to give firms the time necessary to undertake further reliable research in cooperation with the regulators, to ensure a sensible regulatory treatment overall. Too much prescription at this stage would not be advisable, as it would stifle risk-management innovation and hinder the emergence of better practices.

From the perspective of the EU process, these new rules are being updated by the Commission Services based on the changes implemented in the final draft published on

---

the portfolio. With that model, Canabarro calculated α's by using Monte Carlo simulations. Wilde (2002) derived the analytical expressions for α for the model. Fleck & Wilde (2004) extended the model to incorporate systematic, wrong-way risk. The results of the model were validated with calculations of α in real portfolios of major derivatives dealers. These results showed that α converges to 1.1. ISDA proposed setting its value to 1.2. The use of credit derivative swaps may lead to the increase of the value of α.

[21] The cross-border netting recognition is subject to a consensus among international regulators.

[22] Basel II sets out the scope of transactions eligible for short-term maturity in paras. 321 and 322, both of which are subject to national discretion.

[23] These deliverables are delivered without receipt of the corresponding cash payment.

18 July. There will not be a final EU proposal per se, but the amending text (of approximately 42 pages) is expected to be included in the CRD (mainly in the annexes) as a package. This would mean that neither renegotiation nor further text amendments would be sought. And in the event that some market participants were to seek further amendments in the plenary, the package will simply not be adopted and the review would need to be transposed through a separate directive.

All this obviously creates an even greater challenge to overcome the deadlock resulting from the 'temporary' suspension in July of the comitology provisions in the CRD.

The need to keep the comitology provisions is underscored by the high level of complexity and technicality of the new trading book rules together with the banking book rules. They are also necessary in light of the expected frequency of recalibration and updates to keep pace with the development of industry practices. And the inclusion of the new trading book rules in the CRD is essential, since these rules are an integral part of the Basel II package and vital are in ensuring that trading book instruments are subject to appropriately risk-sensitive capital treatments. As previously discussed, however, uncertainty is clouding the timely adoption of the Directive. Given that a second reading scenario is not excluded, a word of caution is needed: any delay in implementation could put EU financial institutions at a disadvantage *vis-à-vis* their non-EU competitors. It is therefore crucial that the new trading book rules are adopted together with the remainder of the CRD to protect the level playing field between EU firms and the rest of the world, and to ensure that the CRD is appropriate for application to both banking book and trading book exposures.

Towards the adoption and implementation of the new CRD: Outstanding issues

During Parliament's reading process, specific issues have provoked strong lobbying from several interest groups to put forward certain changes. The outcome entailed, as noted earlier, some 288 amendments in April 2005, which were extended to 887 amendments in May 2005 proposed by the members of the Committee on Economic and Monetary Affairs (ECON)[24]. Thanks to the compromise amendments proposed by the Rapporteur, Alexander Radwan, these were reduced in July 2005. The remaining amendments were voted upon on 13 July 2005.[25]

Besides the heated comitology issue, several other issues were voted upon by the ECON Committee and reacted upon to seek for agreement by the Council.[26]

The main issues, which require careful assessment now along with continuous revision in the future, are:

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

Each of these is considered in detail below.

The level at which supervision is to apply – Solo entity versus consolidated application

Art. 68(1) of the Commission's proposal (the solo entity rule) stipulates that every credit institution (the parent undertaking[27] and each subsidiary[28]) shall comply with the application of capital requirements on an individual basis. This solo requirement also applies to pillar 2 and for significant subsidiaries to pillar 3.

Art. 69 allows, under very strict conditions and with the approval of the supervisors, the waiver of the solo requirement. This implies that for national subsidiaries it is possible to supervise them on a consolidated basis (for adequate capital allocation and application of the supervisory review and disclosure requirements at a group level). Art. 69 also allows, under similarly strict conditions and with additional disclosure requirements, supervisors to waive the solo requirement for parent undertakings.

In compromise amendment B, part 2,[29] it was proposed that the application of the waiver be extended to the national parent undertaking, together with the national subsidiaries, which allows for the supervision of national subsidiaries and the parent undertaking at a consolidated level. This treatment clearly disadvantages banks operating through subsidiaries across borders and benefits banks operating nationally.

The industry has been pushing for supervision at a consolidated level. For the time being, this is deemed to be very unlikely since there are still legal impediments to the application of such supervision: fragmented legal structures for prudential supervision, different deposit

[24] European Parliament (2005b).

[25] See European Parliament (2005c).

[26] Some of the 150 amendments voted upon in the ECON in July have not necessarily been agreed by the Council. An agreement between the two institutions is to be reached before the new Directive is voted upon in the plenary session in late September.

[27] A parent undertaking is defined in Arts. 1 and 2 of Directive 83/349/EEC.

[28] A subsidiary undertaking is defined in Arts. 1 and 2 of Directive 83/349/EEC. National subsidiaries are those that are established in the home country of the bank. EU subsidiaries are those that are established in countries other than the home country of the bank.

[29] See European Parliament (2005c).

guarantee schemes, the role of lender of last resort and liquidity management, etc.

A transitional alternative could be the application of supervision at a consolidated level (national, EU subsidiaries and parent undertakings) at the discretion of the national authorities and with the consent of the host authorities during a transitional period and for specific cases.

Consequently, the review clause already voted upon under the compromise amendment L in July[30] is certainly highly welcomed.

The role of the lead supervisor

Art. 129 of the CRD empowers the consolidating (or lead) supervisor, which is usually based in the home country of the bank, to have a decisive role in model authorisation at a group level (with respect to the validation and final shape of the IRB and AM models for credit and operational risks). This is only a first step towards a lead supervisor regime; this partial application risks inconsistencies in implementation since this concept is not extended to pillars 2 and 3 of the CRD. For this reason, the industry has strongly advocated the extension of the provisions of Art. 129 to pillars 2 and 3, to reduce the multiplicity of the regulatory requirements in the different jurisdictions where the financial groups operate.

This move would give more powers to home supervisors over the host in the supervisory review and evaluation process. It may, however, raise some asymmetries with respect to the involvement of the host supervisor, as the latter has responsibility for financial stability and liquidity management issues in its own country and is accountable to local taxpayers if a banking failure occurs. From a financial stability standpoint, a complete lead supervisory regime may not be acceptable unless there is a binding agreement between the home and host supervisors with respect to the issues of deposit guarantee schemes, lender of last resort and reorganisation and winding-up.

In this respect, the follow-up recommendations of the European Financial Services Roundtable (EFR) in June 2005 support the lead-supervisor concept if it is complemented by the establishment of a so-called ‘college of supervisors’, which would include, at a minimum, representatives of the supervisory authorities of those countries where the institution has substantial operations.[31] In parallel, the EFR recommendations gave sensible solutions for supervisory cooperation in situations of crisis and the issues of lender of last resort, deposit insurance / insurance guarantees in an environment in which there is a lead supervisor. These recommendations should be further explored to ensure an efficient supervisory cooperation and coordination. The role of the CEBS was also considered as paramount for a higher degree of cooperation and transparency between the home and host supervisors and for fostering a consistent and coherent implementation and application of EU banking regulation in all member states.

These recommendations have already been considered by the Commission in its recent initiative in July 2005 to revise the Deposit Guarantee Scheme Directive (94/19/EC), with a view to assessing the adequacy of the minimum coverage level of such schemes and to explore whether and to what extent additional features of the schemes should be further harmonised.

Since the lead-supervisor concept has not yet fully materialised, the European Parliament has sensibly backed the non-extension of Art. 129 to pillars 2 and 3 for the time being,[32] but foresees some changes in the direction of strengthening the role of the consolidating supervisor in the future, as it has called for a re-examination of the provisions of this article under the review clause requirement.

In conclusion and in support of the EFR recommendations, the lead supervisor concept complemented by a college of supervisors should be seen as a positive step towards a more efficient and effective prudential supervisory structure in the EU.

The intra-group exposures

Art. 80(7) of the CRD allows banking groups to apply a risk weight of zero to some exposures between the parent and its subsidiaries within a single country and among the individual subsidiaries also located there. But this is only allowed as an exemption at the discretion of the national authorities and if certain stringent conditions are met.

As stipulated in the Commission’s Directive proposal, these conditions are:

a) “the counterparty is an institution or a financial holding company, financial institution, asset management company or ancillary services undertaking subject to appropriate prudential requirements”;

b) “the counterparty is included in the same consolidation as the credit institution on a full basis”;

c) “the counterparty is subject to the same risk evaluation, measurement and control procedure as the credit institution”;

d) “the counterparty is established in the same Member State as the credit institution”;

e) “there is no current or foreseen material or legal impediment to the prompt transfer of own funds

[30] European Parliament (2005c).

[31] In its follow-up recommendations, the EFR (2005) warns: “It is absolutely clear that the lead supervisor concept cannot operate without this interaction; hence this should be considered an essential part of the concept.”

[32] Amendments 57, 487 and 488 (European Parliament (2005a).

> or repayment of liabilities from the counterparty to the credit institution".

Otherwise, these intra-group exposures must be risk-weighted by at least 20% for credit risk.

It is important to note that large banks have generally centralised group risk-management, mostly organised along business lines irrespective of their geography. Requiring a risk weighting for intra-group exposures could be not realistic since the default history among group companies is almost nonexistent – default rarely occurs when lending within the same group. Building upon this approach, it is natural to defend the extension of the zero-risk weighting of intra-group exposures to sister subsidiaries in the same member state and in all member states. Therefore, allowing this extension to cross-border subsidiaries is an important issue to be considered in the future.

In the meanwhile, it is important to ensure the risk quality of these entities at all levels (national or EU), to allow the extension of the zero-risk weighting. In this respect, the Commission was prudent in setting in its proposal a list of requirements a bank must fulfil before it can benefit from this treatment at this stage.

Nevertheless, the diversity of banking markets in Europe shows that conflicting interests can arise.

There has been an active and vociferous debate to extend zero-risk weighting to institutions that are members of the same institutional protection scheme. In Germany, for example, where savings and cooperative banks operate under this scheme, a failing bank is supported by others in the scheme and in particular to ensure their liquidity and solvency. However, some of these institutions are unlikely to meet the requirements set in the Commission's proposal in particular criteria (b) and (c).

It is important to mention the fundamental difference between the zero-risk weighting of intra-group exposures and the zero weighting of lending among institutions covered by protection schemes. The status of being covered by a protection scheme would not by itself suffice to extend the zero-risk weights to intra-group exposures as opposed to banks fulfilling the list of requirements proposed by the Commission's Directive proposal. The ECON Committee's proposal of 13 July[33] concerning the qualification of liability agreements on the protection of institutions and the risk-monitoring requirements has been more lenient on the treatment of such counterparties. Indeed, to qualify for the extension of the zero-risk weighting, the counterparty has to fulfil only three criteria: (a), (d) and (e) out of the five set in the Commission's proposal, plus several other criteria that are related to the institution's part of an institutional protection scheme. If these criteria were to be considered insufficient to qualify as a single unit for prudential purposes, this may cast doubt over the equivalent treatment of other institutions that are not members of these schemes.

The Presidency compromise[34] of Art. 80 (7a) provided further changes to the criteria to be fulfilled by this type of institution as compared to those proposed by the ECON. The main changes concerned the annual reporting and the risk evaluation, measurement and control procedures.

It is important to ensure an equivalent treatment of institutions that are managing the same risks regardless of their different nature. Towards that end, the new criteria to be fulfilled by the institutions as part of any protection scheme should be equivalent or partly equivalent to criteria (b) and (c). Allowing for preferential treatment to one or another group would cast a dubious light over the evenness of the playing field.

The disclosure of ratings to loan applicants

There have been discussions about further regulating the disclosure of banks' rating decisions to individual applicants for loans. In fact, this was specifically debated in the context of increasing transparency and communication between SMEs and their lenders.

Art. 145(3) of the Commission's proposal explicitly requires banks to adopt a formal policy to comply with the disclosure requirements set by the new Directive. It was very vague, however, with respect to the disclosure of rating decisions to loan applicants.

Amendment X of Art. 145(3) in the ECON proposal[35] calls on banks to voluntarily disclose their rating decisions to individual applicants for loans; otherwise, there should be further national legislation in this respect. The Presidency compromise[36] kept the main provisions of this amendment, with a slight change calling on banks to disclose their lending decisions only if requested by SMEs and other corporate applicants. In principle, this amendment favours SMEs and other corporate applicants who are aware of the possibility to obtain further explanations of a bank's decision to extend credit and also the recourse to national measures. However, the amendment does not sufficiently explain the national measures to be taken if the bank abstains from giving the adequate explanation.

Yet, if the intention is to not to overwhelm banks with extra national regulations, one has first to look at what should and should not be disclosed, the format, the comprehensibility and relevance of the information disclosed, etc.

For example, owing to the complexity of the lending process which is highly linked to the rating process nowadays (the quantitative process involving historical

---

33 See European Parliament (2005c).

34 See Council of the European Union (2005).

35 See European Parliament (2005c).

36 See Council of the European Union (2005).

data collection, analysis of individual factors and statistical procedures to obtain the rating classes and the associated probabilities of default), explaining the detailed process to clients is deemed to be not only burdensome for the bank, as it implies mobilising extra human resources to explain the process,[37] but also for clients, who may not be interested in learning about the whole rating process, notably if this would result in an extra cost involved in the banking service they receive.

Moreover, in the event that banks voluntarily disclose individual ratings and since the application of different risk-management approaches (standardised versus IRB approaches) would lead to different capital charges for the same borrowers' quality,[38] it is very likely that informed SMEs would shop around to obtain the best assigned banking rating.[39] Undoubtedly, the SMEs would prefer a higher bank rating irregardless of whether their effective quality implies a lower rating. This may lead to a competitive disadvantage for banks that should normally be rewarded for their use of more sensitive risk-management techniques.

In sum, it is important to involve SMEs in the decision-making process to grant credit by giving them an overview without disclosing strategic information that could be negatively manipulated to the banks' disadvantage. This overview could, for example, include the key variables and factors that have a strong explanatory power to derive the probability of default and the loss-given default. This approach would be very helpful to understanding why a credit application is accepted or rejected. The relevant information should also be accessible either on the bank's website or elsewhere to make sure that applicants can access it and increase their credit application's probability of success.

A firm and voluntary EU code of conduct could work better in this respect than further national regulations as being proposed by Parliament – which at best will be divergent and create even more burdens for banks. A non-legislative EU code of conduct would serve as a framework for setting out the main principles for the credit-rating disclosure process. Industry should be consulted on the code-of-conduct principles, which would then be agreed upon and implemented by the member states.

Conclusions

Despite its complexity and high level of technicality, the new CRD is a step forward towards more risk-based banking regulation. The Commission has achieved a far-reaching piece of legislation due to be applied from the end of 2006 to all credit institutions and investment firms in the 25 member states.

The inclusion of the new trading book rules into the CRD is essential to ensure that trading book instruments are subject to appropriate risk-sensitive capital treatment. But at the same time, flexibility is required to allow any adaptation of these rules when the results of the impacts studies are to be available.

Therefore, to ensure the success of its implementation, the CRD should not be dispossessed of the comitology provisions. These are essential for allowing flexible updates and changes related to the continuous development in market practices.

The related role of the CEBS is key to a consistent and coherent implementation and application of EU banking regulation in all member states. Putting comitology provisions at risk implies a step backwards in banking regulation; in turn, this would cast serious doubts over the successful implementation of the CRD.

Further, 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 or whether banks and their subsidiaries are to be supervised as solo entities in the medium term.

In addition, providing the conditions for a level playing field is one of the chief objectives in the development of new banking regulation. Therefore, favouring one interest group over another is not acceptable as it undermines this principle.

Finally, provisions in the CRD that promote transparency and better communication between SMEs and their lenders would be appreciated, but this should be done 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 to update it and a continuous impartial dialogue with the interested parties – will lay a firm cornerstone to successful implementation.

---

[37] The banking agent who deals with the company is not necessarily the person who assigns the ratings and calculates the probabilities of default; further, s/he is not necessarily qualified to understand the whole rating process.

[38] See Ayadi & Resti (2004).

[39] In extreme cases this may lead to manipulation and fraud.

Postscript

On Wednesday, 28 September 2005, the European Parliament adopted the CRD at first reading, including the package of amendments related to the trading book activities. The uncertainties that were clouding its timely adoption a few weeks ago were addressed in a last minute compromise reached between the European Commission, Council and Parliament. This compromise means that the current comitology system – which largely excludes the European Parliament – can be used to implement and update the CRD for a maximum of two years (or until 1 April 2008), after which time these powers may be renewed only with the agreement of the three institutions. In the meanwhile, there will be a revision of the comitology system used for such implementing provisions.

References

Ayadi, R. (2005), "Report of the first meeting of CEPS Task Force on the New Basel Capital Accord: The Remaining Challenges", CEPS, Brussels, March (available upon request).

Ayadi, R. and Andrea Resti (2004), *The New Basel Capital Accord and the Future of the European Financial System,* CEPS Task Force Report No. 51, CEPS, Brussels, April.

Bank for International Settlements (BIS) (2005a), *The application of Basel II to trading activities and the treatment of double default effects*, BIS, Basel, April.

————— (2005b), *The application of Basel II to trading activities and the treatment of double default effects*, BIS, Basel, July.

Canabarro, E. (2002), "Collection of responses, research and findings" in ISDA, LIBA and TBMA (2004), *Trading book and credit risk mitigation capital review, Collection of responses, research and findings that served in the revision process* (retrieved from www.isda.org).

European Commission (2004), *The new capital requirements for banks and investments firms*, Brussels, July (retrieved from http://europa.eu.int/comm/internal_market/bank/regcapital/).

————— (2005), *Review of capital requirements for credit institutions and investments firms – Commission Services consultation paper on trading activities related issues and the treatment of double default effects*, Brussels, April.

European Council (1999), Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission.

European Council (2005), Revised working document n° 1 on the capital requirements Directive (CRD), Presidency Compromise September.

European Financial Services Roundtable (EFR) (2005), *On the lead supervisor model and the future of financial supervision in the EU – Follow-up recommendations of the EFR*, Brussels, June.

European Parliament (2005a), Draft report on the proposal for a directive of the European Parliament and of the Council re-casting directive 200/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions – Voting list, ECON, July.

————— (2005b), Draft report on the proposal for a directive of the European Parliament and of the Council re-casting directive 200/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions – List of amendments, ECON, April.

————— (2005c), Draft report on the proposal for a directive of the European Parliament and of the Council re-casting directive 200/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions – List of oral and compromise amendments, ECON, July.

Fleck, M. and T. Wilde (2004), "Collection of responses, research and findings" in ISDA, LIBA and TBMA (2004), *Trading book and credit risk mitigation capital review, Collection of responses, research and findings that served in the revision process* (retrieved from www.isda.org).

ISDA, LIBA and TBMA (2004), *Trading book and credit risk mitigation capital review, Collection of responses, research and findings that served in the revision process* (retrieved from www.isda.org).

Picoult, E. (2002), "Collection of responses, research and findings" in ISDA, LIBA and TBMA (2004), *Trading book and credit risk mitigation capital review, Collection of responses, research and findings that served in the revision process* (retrieved from www.isda.org).

Wilde, T. (2001), "Collection of responses, research and findings" in ISDA, LIBA and TBMA (2004), *Trading book and credit risk mitigation capital review, Collection of responses, research and findings that served in the revision process* (retrieved from www.isda.org).

————— (2002), "Collection of responses, research and findings" in ISDA, LIBA and TBMA (2004), *Trading book and credit risk mitigation capital review, Collection of responses, research and findings that served in the revision process* (retrieved from www.isda.org).

Bookshop: http://shop.ceps.be

Website: www.ceps.be

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.

C E P S
CENTRE FOR EUROPEAN POLICY STUDIES

Place du Congrès 1 • B-1000 Brussels
Tel: (32.2) 229.39.11 • Fax: (32.2) 219.41.51
www.ceps.be • info@ceps.be