The Changing Regulatory Capital Regime in Europe: A Challenging New Business Concept

Summary of a Conference
Hosted by CEPS, PriceWaterhouse Coopers (PwC) &
the Federation of European Securities Exchanges (FESE)

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1. Introduction

Despite its characterisation by Martin Taylor, Chairman of Goldman Sachs Asset Management International as "one of those ghastly cinematic sequels which (…) often lack the raw vitality of the originals, have a highly contrived plot and are far too long", Basel II is also hailed for its increased risk sensitivity which reflects the significant advances in risk management practices of the last decade that rendered Basel I outdated and inadequate. The process of reforming the Basel capital adequacy rules has generated an unprecedented debate involving many regulators, practitioners and academics, and numerous contentious issues remain unresolved. Disagreements over the role of expected and unexpected losses in the calculation of risk weights threatened to derail the process in the summer. Following the breakthrough proposal agreed at a week-end meeting in Madrid in October, which adopted the stance of US banks and regulators to base risk weights on unexpected losses only, the Basel II process seems now firmly back on track. Its implementation into EU and national law, level playing field issues, supervisory convergence, remaining technical issues as well as implications for business were the subjects of this joint conference hosted by CEPS, PriceWaterhouse Coopers (PwC) and the Federation of European Securities Exchanges (FESE) on 12 and the 13 November 2003 at the Conrad Hotel in Brussels.

2. Implementation of Basel II into EU law

Setting the scene, José Mariá Roldán, Chairman of the EU Banking Advisory Committee, said that the new capital regime in the EU has to be seen in the broader context of the common financial market objective. In particular, level playing field considerations are paramount in the EU's implementation of the Basel II rules. As a consequence, the EU has decided on a wide application of the Basel II rules not only to all banks but also to all investment firms, so as to achieve consistent treatment of similar activities with similar risk profiles. The flexibility afforded by the three Pillar 1 approaches specified in the Basel framework (standard, foundation IRB and advanced IRB), should ensure adequate regulation of the wide range of financial institutions within the EU – in fact the availability of the three different approaches is in part the result of this EU objective. However, the broad application raises further issues and requires modifications in some areas. These as well as other implementation details will be addressed in the third European Capital Adequacy Directive (CAD 3), which is envisaged to translate the new Basel Accord into EU law by the end of 2006.

European specificities

Partial Use Provisions

EU Commissioner Frits Bolkestein and Patrick Pearson, Head of Unit – Banking and Financial Conglomerates, DG Internal Market, gave the following concrete examples: Smaller institutions will be permitted to make use of partial use provisions, i.e. they will be allowed to apply different risk measurement approaches to different business lines. Similarly, following extensive industry consultation, the Commission decided to exempt smaller investment firms (defined as firms of limited systemic importance and limited risk profile) from operational risk charges. They will continue in turn to comply with the existing expenditure-based charges which exceed the charges they would have to pay for credit and market risk. To avoid knock-on effects in the form of exemption demands by banks, such exceptions will not be made for those investment firms that compete strongly with banks, including the larger investment firms that have potential systemic significance. The ensuing panel discussion clarified that the distinction between small and large investments firms will continue to be defined by the current cut-off points on turnover (50k and 73k, respectively).

Smaller Investment Firms

Open Issues

In addition, there are European specificities which the Commission is currently debating and seeking comments on. In order to minimise the compliance cost for smaller institutions, the Commission may be prepared to allow and even to encourage shared and outsourced risk management systems, as well as data pooling. Acknowledging the catalytic role of venture capital for innovation, the Commission has asked the industry for sound and precise evidence to help showing whether the treatment of venture capital exposures is on target in Europe. Furthermore, the Commission decided that any new rules will only be applied to new but not current equity holdings, so as to avoid disruption in the industry. Other open issues remaining include the definition and risk weighting of physical collateral as well as the admissibility of bank equity holdings in the calculation of qualifying capital.

Venture Capital

Trading Book Rules

Trading book rules currently debated in Basel are of great significance for a wide application in the EU, in particular as investment firms tend to have large trading books relative to banking books. The current Basel rules would conflict with existing EU legislation, in the areas of settlement risk (where capital charges are applied only from day 5 onwards) and of the treatment of risk of securities with maturity below one year (where the EU law defines different minimum requirements). Other trading book issues include OTC add-on treatment, the treatment of repos, whose risks may be overestimated by current calibrations with the consequence of a negative impact on the price of such products. Mr Pearson affirmed the Commission's commitment to negotiate the most appropriate solutions in Basel.

Finally, other factors that could still significantly influence both timing and content of CAD 3 are EU enlargement as well as elections for the European Parliament in June 2004.

Supervisory convergence within the EU

Level Playing Field

Committee of Banking Supervisors

The supervisory judgment inherent in Pillar 2 as well as the numerous kinds of options for the calculation of risk weights under Pillar 1 afford considerable scope for national discretion. As Mr Bolkestein pointed out, this leads to a trade-off between flexibility and comparability. Level playing field considerations have to be paramount in the determination of the right balance, and thus the Commission is currently considering and consulting on various ways to promote convergence in supervisory practices within the EU. Mr Pearson elaborated that they strongly considered a significant reduction in the number of options available under Pillar 1 as those may not be justified by the much more homogenous markets and institutions within the EU. In addition, there is significant momentum to eventually require EU supervisors to publish a kind of rulebook detailing and making transparent their individual practices, and thus fostering best supervisory practices. This could be one of the major tasks, in addition to building a bridge to the industry, of the Committee of European Banking Supervisors (CEBS), to be established as of 1 January 2004.

Thinking further into the future, Mr Pearson argued very much in favour of the establishment of a lead supervisor for all European cross-border banking groups. The regulatory cost savings resulting from a single validation process, a single regulator to report to and to perform capital calculations, etc. would justify the loss of power of national regulators.

The legislative process

Unprecedented Transparency

As mentioned repeatedly in the conference's discussions and speeches, risk management practices have been developing rapidly and are likely to continue to undergo significant change in the future. This dynamic and increasingly complex nature of the developments constitutes great challenges for the legislative process. In response, the EU Commission and the Basel Committee have adopted a transparent and thorough consultation process, which has lead to significant improvement in areas such as the definition of Pillar 2 requirements or consolidation requirements in the draft CAD 3 and is currently shaping the Commission's thinking about the treatment of trading book risks and unexpected losses.

Flexible, Evolutionary Approach

In addition, it is envisaged that the body of the Directive would contain only the key principles and central requirements, whereas technical details are to be specified in annexes. This structure ensures a more responsive, flexible and evolutionary legislation as technical amendments reflecting changing industry practices, can be made much more quickly through the so-called 'comitology procedure'. That means that only changes in the key principles would be decided by the more involved co-decision of member states procedure, with the technicalities adjustable by a banking advisory committee whose structure and operating framework are yet to be fully determined.

On a more general note, Mr Bolkestein pointed out that the rules should be incentive-driven, i.e. they should contain mechanisms to encourage banks to improve upon their risk measurement and management.

3. International issues

Finding the right balance between flexibility and consistency of supervisory approaches is an even more pronounced issue at the international level. It probably constitutes one of the biggest challenges to efficient implementation of the Basel II rules.

Implementation of Basel II into US law

Transparency

As outlined in the speech of Roger Ferguson, Vice Chairman of the Board of Governors of the US Federal Reserve, the US similarly reaffirmed its commitment to a thorough and transparent drafting process, as solid evidence and convincing arguments brought forward by interested parties constitute a real opportunity to achieve optimal enhancement of the final rules.

Procedure

Following the closure of the comment period for the US draft legislation, its Advance Notice of Proposed Rulemaking (ANPR), in the beginning of November, supervisors are now reviewing the comments received. However, further procedural steps are envisaged: Mr Ferguson explained that the US plans another Quantitative Impact Study evaluating the effects of the Basel proposals to be agreed upon by mid-2004 and that there would be another ANPR before final implementation. Mr Ferguson emphasised that the amount of procedural steps do not signify the lack of commitment to the Basel II process but are a sign of transparency and meticulousness.

Guidance Notes

Mr Ferguson also stated that parallel to the ANPR, draft supervisory guidance for the interpretation of the advanced corporate approaches were published and are also under review, whereas guidance to clarify application of the advanced approaches to other portfolios (such as retail) were in preparation.

Scope

As to the broad principles of implementation, Mr Ferguson explained why the US would apply only the advanced approaches of Basel II only to its largest banks. The need for improved risk management practices for the major banks is recognised, and it is thought that the complexity and scale of these operations are best addressed through the advanced approaches. On the other hand, there is the belief that benefits from switching to standard and foundation approaches are negligible for smaller institutions. This is partially attributable to the significant implementation costs as well as the advanced nature of the current US regulatory system. Given that it already incorporates elements comparable to pillars 2 and 3, and the fact that most smaller institutions hold capital well in excess of current minimum requirements and more or less comparable to the requirements under Basel II, it is widely believed that the current regime is at least as prudent, and that the implementation costs outweigh the benefits. Finally, it should be noted that mandatory banks account for more than two-thirds of the assets and 99% of foreign claims held by US banking organisations, and that non-mandatory banks will be allowed to opt in, i.e. to voluntarily adopt the advanced approaches.

Home Host Issues between EU and US

Cooperation

To the extent that home/host issues outside the EU were considered, Mr Bolkestein and Mr Ferguson both affirmed that the SEC and the Commission were working together to achieve alignment of regulation and thus to avoid unnecessary costs, minimise the regulatory burden and level the playing field as much as possible for financial firms on both sides of the Atlantic.

Consistency not Uniformity

However, Mr Pearson made clear that the solution is likely to be one of equivalent rather than identical implementation, of consistency instead of uniformity. Whilst Mr Lannoo, Chief Operating Officer, CEPS, emphasised the potential disadvantage to EU firms of being forced to apply the more expensive advanced approach if they want to compete in the US, Mr Ferguson stated that, as laid out in the principles of the Accord Implementation Group (AIG), such home country rights have to be respected.

Differences in Scope

As regards the discrepancy in scope of application of Basel II between the EU and the US, Nicholas Le Pan, Deputy Chairman of the Basel Committee, stressed in the panel discussion that in Basel II the focus has always been on large internationally active banks and that one has to acknowledge that the broad application within the EU is due to the fact that the single market reflects an objective beyond prudential regulation.

Accord Implementation Group (AIG)

Responsibilities

More generally, Mr Le Pan discussed the possibilities for achieving global supervisory convergence. First and foremost, the AIG recognises that differences in approaches exist and will continue to do so, as both market and banking practises differ. As a consequence, challenges, in particular with respect to level playing field issues and consistency, will have to be met through a dynamic not a static process. Whilst neither lead regulator nor "Basel Control Central", there are a number of concrete actions that AIG, as a forum of exchange and debate, will take or is already taking to promote consistency. These include the coordination of supervisors in limited cases, the cataloguing of different supervisory approaches, the conduct of cross-border case studies, clarification of data requirements and validation work.

Achievements of AIG

Mr Ferguson emphasised further the role and success of the AIG in promoting consistent standards in the application of Basel II rules across countries. He also pointed to progress the AIG made in tackling the inconsistency between operational risk requirements at subsidiary level with lesser requirements at the group level due to diversification.

4. Open Issues

Expected vs. Unexpected Losses

Some of the contentious issues have already been discussed in the context of implementation into national law. Others are still being fiercely debated in the final stages of negotiation of Basel II itself. There is above all, the role of expected and unexpected loss measures in the IRB approach. Mr Bolkestein agreed on the principle that capital requirements should only be based on unexpected loss calculations (because in theory expected losses are already taking into account in banks' provisions). He argued however that regulators have justified doubts as to the degree of coverage of expected losses in practice.

Rainer Masera, Chairman San Paolo IMI, explained that contrary to the CP 3 proposal, in its meeting in October, the Basel Committee endorsed the calculation of IRB capital requirements solely on the basis of unexpected losses. It has also proposed measures that would induce banks to provision adequately for expected losses. As Mr Masera went on to explain, this raises a further question as accounting definitions for provisioning are based on incurred as opposed to expected losses. Whilst Mr Pearson made the point that accounting concepts have a different function than regulatory concepts (e.g. regulatory measures need to reflect permanency or loss-absorption capacity to a greater extent), this debate illustrates the more general problem of achieving at least consistency if not convergence between accounting, actuarial and regulatory concepts.

Diversification

Procyclicality

As mentioned inter alia in the keynote speech by Herman Mulder, Co-Chairman, Group Risk Committee, ABN Amro, it is important that the Basel calculations can account for diversification. Since overall portfolio diversification benefits are captured by lower unexpected losses, Mr Masera pointed out that the new proposals for capital calibrations may well lead to a more coherent incorporation of diversification as well. An adverse effect, on the other hand, may be a further exacerbation of the procyclicality problem given that incurred loss measures fluctuate substantially during the business cycle.

Finally, other issues remaining were the deliberately general formulation of Pillars 2 and 3 principles, democratic accountability of the Basel Committee and process, and the uncertainty about the timescale for implementation.

5. Conclusion

There was a shared view that the current fierce debate and constructive dialogue will eventually lead to more robust rules for a safe and sound banking system. There remain, however, concerns over the efficient and timely implementation of Basel II. They relate firstly to consistency of supervisory approaches and between accounting and regulatory concepts and to the treatment of trading book calibrations, operational risk and other technicalities that have to be specified in national law and regulatory rulebooks.

Second, as raised directly by Charles Ilako, Lead Partner, Pan-European Regulatory Advisory Practice, PricewaterhouseCoopers in a question to Mr Ferguson, there is the possibility that the US Congress will insist on viewing Basel II as a treaty (which would require their consent). Moreover, in December, John Hawke, Office of the Comptroller of the Currency, a leading US regulator who previously took an optimistic stance, criticised the complexity of Basel II, and the Federal Deposit Insurance Corporation published findings suggesting that the Basel II proposals could sharply reduce bank capital and thus reduce the ability of the authorities to prevent bankruptcies. These US issues as well as impending EU enlargement and parliamentary elections cast significant doubt on the ability to maintain the mid-2004 deadline for completion of the final accord.

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