EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

TOWARDS NEW BANK CAPITAL REQUIREMENTS IN EUROPE

Statement No. 19

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On June 26, 2004, the Basel Committee achieved final publication of the Basel II Accord. The Accord is summarised in the overview paper *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, and reflected in the legal text of the proposed EU Capital Requirements Directives (CRDs) of July 14, 2004. In this statement, the European Shadow Financial Regulatory Committee (ESFRC) analyses the new rules for setting regulatory capital requirements. In particular, the Committee addresses supervisory discretion, home/host country issues related to IRB models, level playing field issues, and institutional matters and implementation issues.

Supervisory discretion

The Basel II Accord reflects a subtle, but important, shift relative to earlier drafts towards emphasis on discretion in pillar 2 (supervisory review or qualitative supervision) to counterbalance concerns with banks' internal ratings systems (pillar 1 of the Accord). Underlying this shift appears to be a recognition that the internal systems will not generate sufficient capital to offset low-probability high-risk events, inter alia since the models neglect the characteristic 'fat tails' of loss distributions. In point 9 of the overview paper the Basel Committee explicitly states that "national authorities may use a *supplementary* capital measure as a way to address, for example, the potential uncertainties in the accuracy of the measure of risk exposures inherent in any capital rule or to constrain the extent to which an organisation may fund itself with debt." In point 10 the Committee says that "... even in the case of the internal ratings-based (IRB) approach, the risk of major loss events may be higher than allowed for in this Framework." We doubt that any commercially viable level of capital can protect against all 'major loss events'; nevertheless, we agree that some form of adaptation of the original approach is appropriate.

In fact, the Basel Committee appears to adopt three potentially incompatible ways of boosting capital; system-wide floors, the 'scaling factor', and regulatory discretion vis-à-vis individual banks. On the first, in point 45 the Basel Committee discusses transitional arrangements and so-called *floors* in the implementation of the Accord for IRB models (see also article 152 of the CRDs). For instance, with respect to the advanced approach, "the reduction in regulatory capital is limited to 90% [of Basel I levels] in 2008 and to 80% in 2009." In point 48 it says that "should problems emerge during this period, the Committee will seek to take appropriate measures to address them, and, in particular, will be prepared to keep the floors in place beyond 2009 if necessary." There is a danger that these floors will become permanent, which is inconsistent with the model-based approach. A clear timetable for their phasing out would be appropriate instead of this ambiguity.

Concerning the *scaling factor*, in point 14 of the overview paper the Basel Committee reiterates that it wishes to keep the aggregate level of capital in the banking system stable. In the third quantitative impact study (QIS-3) published in May 2003, it is shown that overall banking capital in the G-10 and EU countries would fall when the IRB approach is introduced, which the Committee states would have to be 'repaired' by using a single scaling factor of 1.06 to the IRB capital requirement. This is logically inconsistent with the validation of models in the IRB approach; furthermore, it is redundant as a transitional mechanism while floors exist. It is also potentially unworkable in a cross-country context owing to asymmetric adjustment of capital ratios. Hence, the scaling factor should be discarded.

The third element is *discretion*. In point 49 it is stated that "supervisors should have the flexibility to develop appropriate *bank-by-bank* floors that are consistent with the principles outlined in this paragraph, subject to full disclosure of the nature of the floors adopted." Three possible motivations can be distinguished. First, to deal with low-probability, high-severity events, we consider this an appropriate motivation, particularly where the supervisor perceives vulnerability in the financial system. However, the requirements must affect a class of assets or institutions and not individual institutions on an ad hoc basis. Second, to reflect generalised unease with the IRB approach in a particular institution. We would be strongly opposed to such a motivation; supervisors should simply validate or reject applications. The third possible rationale for discretion is a desire to raise capital ratios arising from more general concern with an individual institution's stability. This should only be admissible when there is clear and transparent evidence that the model does not give a complete picture of the risk implicit in the institution. In such a case, institutions in a similar situation must be treated similarly.

There remains the question whether market discipline could be a better way of ensuring adequate capital for an institution - and reducing the scope for arbitrary supervisory action - than the elaborate system proposed by the Basel Committee. For with adequate market discipline, the supervisory assessment of the reliability of a bank's internal ratings system would be assisted and objectified by the assessment of professional investors on financial markets. Although the Basel II Accord contains many information-disclosure requirements, it fails to create incentives for professional investors to use this information in an optimal way owing to explicit and implicit protection. Clearly, the risk sensitive approach of Basel II should imply better discipline via the interbank market. However, a mandatory requirement for large banks to issue credibly uninsured subordinated debt could further improve this weak side of Basel II. The sub debt must be made 'credibly uninsured' by a statement from the Basel Committee (to be implemented in national banking laws) that, even in the case of a bail-out of a large bank, subordinated debt holders would always remain outside this rescue operation and would have to bear fully their losses. A corollary would need to be higher capital requirements for banks holding other banks' sub debt.

IRB models: home/host country issues

A controversial element of the EU's proposed Capital Requirements Directives (CRDs), which goes beyond Basel II, concerns the authority for the validation process of IRB models for EU banks having subsidiaries in other countries. Article 129, paragraph 2 says that "the competent authorities shall in a single document agree together, *within no more than six months*, their determination on the application [i.e. for the permission to use an IRB model]. In the absence of a determination within six months, the competent authority referred to in paragraph 1 [i.e. the one responsible for the exercise of supervision on a consolidated basis] shall make its own determination on the application." The preceding implies that article 129 empowers the consolidating supervisor, usually based in the home country of the bank, to take the final decisions with respect to the validation and final shape of the IRB models. The essential idea behind article 129 is to streamline the validation process, thus avoiding delays that could put European financial groups at a competitive disadvantage.

Although the ESFRC agrees with this objective, it thinks that the current approach taken by the European Commission is creating an undesirable asymmetry with respect to the responsibilities and burdens borne by home and host country supervisors. In this context, several supervisors have voiced serious concerns about their lack of influence on the validation of IRB models used by foreign subsidiaries in their jurisdiction while, at the same time, they bear the costs of resolving serious financial distress. The issue is particularly acute in the new Eastern European member states where banking systems are often over 70% foreign owned.

The ESFRC proposes a two-tier solution for the situation which arises when the home country and host country supervisors have not been able to agree on the validation process within six months. The first tier of the solution is, in accordance with the CRDs, that the consolidating supervisor in the home country is responsible for the validation of all IRB models of the consolidated bank, including all subsidiaries, but at the same time, the parent country bank formally indicates that it takes financial responsibility for the financial health of these subsidiaries. In case the parent bank is not willing to take this financial responsibility, a second tier of the solution is that the validation period of six months would be extended, requiring home and host country supervisors to continue their deliberations, and that the potential costs of the resolution of a subsidiary's failure are borne by the supervisors and tax payers in the host country.

A misguided concept of a level playing field

While Basel II applies only to banks, the EU legislation proposed in the CRDs applies much more widely. In the words of the Commission (page 4): “There is broad and significant support for the application of the new rules in Europe - to all credit institutions and investment services providers whatever the legal nature and complexity of the institution, also to avoid ‘second class’ institutions that would be likely to result if some were excluded.” We disagree with this extension of Basel II.

The main argument for the broad scope of the CRDs is presumably to create a ‘level playing field’ for different institutions performing the same function. It is naturally in the self-interest of European financial conglomerates to favor the extension of the Basel II capital adequacy framework to non-bank financial institutions. The level playing field argument should not be extended beyond banks, however, because only banks are subject to both systemic risk and extensive protection of depositors. The existence of protection of depositors creates incentives for excessive risk-taking in the absence of appropriate regulation.

If we view the capital adequacy framework as a response to the peculiar features of banks outlined above, then it follows that the Basel II framework should not be applied to non-bank financial institutions. Thus, there is no reason, for example, for an investment firm to hold the same amount of capital for a certain level of market risk as a bank. The same argument applies to specialized mortgage institutions with non-insured financing. In fact, the financial system will be able to carry more risk without threatening financial stability, if such risk is carried to a greater extent outside the banks. Imposing bank-like capital requirements on non-banks is likely to reduce the risk-taking capacity of the system.

Institutional matters and implementation

The European Commission proposal follows the *re-cast* technique, by which the Basel II proposals are directly incorporated into existing legislation, the codified banking directive (2000/12/EC) and the capital adequacy directive (93/6/EEC). While intended to improve readability of the directive, this approach makes the comparison between the EU and Basel proposals very difficult, if not impossible. The explanatory memorandum does not explain any differences with Basel II, nor their rationale (e.g. applications to banks’ venture capital business). The European Commission should have proposed a text which was directly comparable with the Basel II Accord, or should at least have made a comparative table between both.

The directive would also have benefited from an explanation of how the Lamfalussy approach will be applied to it, and in what way the Committee of European Banking Supervisors (CEBS) will be consulted for implementation. In the present draft, it is hard to see how it can be regarded as a ‘framework directive’, and how much will be left to CEBS. Although broadly discussed in the Basel Committee before, it must be recalled that Basel Committee includes only nine of the fifteen old EU member states, and none of the new members.

The above is not just a criticism of form and style. There are likely to be substantive consequences, namely a likely delay to implementation of the CRDs. Better drafts could have made a single reading in the European Parliament and implementation deadline of end-2006 still possible. In the current circumstances, however, it would be better to move implementation to end-2007, and thus have a single implementation date for the whole framework, rather than the differentiated implementation according to the approach followed, as is proposed at present.