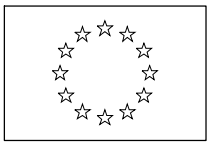

EUROPEAN COMMISSION
Internal Market DG

WORKING DOCUMENT OF THE COMMISSION SERVICES ON CAPITAL REQUIREMENTS FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS

COVER DOCUMENT

18 November 2002

Contents

Part 1 – Introduction and overview

Introduction

1. The Commission Services have published on the Commission website a Working Document based closely on the draft legislative proposal as so far developed for the implementation of a new capital adequacy regime for credit institutions and investment firms in the European Union.

2. The Working Document will provide the basis for a structured dialogue with representative organisations at both the EU and the National levels. This dialogue will run until the end of January 2003.

3. At the EU level this dialogue will take place directly between the Commission and European representative organisations – from both the financial services sector and other sectors including small- and medium-sized enterprises (SMEs) and consumers. At the National level, the dialogue will be co-ordinated by Member State supervisory authorities.

4. Notwithstanding the significant and invaluable input of Member State supervisory authorities in the development of the proposals to date – in particular through the efforts of the Banking Advisory Committee (in its expanded composition to include investment firms supervisors) and its nine capital review-dedicated technical working groups – the Working Document is a document for which the Commission Services take sole responsibility. Accordingly the input of supervisory authorities themselves as part of the dialogue exercise will be warmly welcomed.

5. The objective of the exercise is to provide an early sight of the emerging draft legislative proposal that will form the basis for the new framework. And to seek input which will contribute to optimising the quality of the proposals to be consulted on in the Commission Services' third consultative document.

6. This cover document is designed to provide an introduction to the Working Document; to set out the approach of the Commission Services and indicate the thinking behind a number of important aspects of the proposed new capital adequacy framework; and to assist in focusing the structured dialogue on a number of EU specificities which are of key concern.

Key objectives of the Commission Services' review

7. The Commission Services' review of capital adequacy requirements for credit institutions and investment firms is being undertaken with a view to modernising the existing capital adequacy framework for such institutions.

Need for a new framework

8. The existing capital adequacy harmonisation framework which was introduced for credit institutions on the basis of directives of 1989 and extended to investment firms and amended over the intervening period has served its purpose well. It has provided a sound prudential basis for the carrying on of the financial services activities provided by such institutions

within the context of the ever-strengthening single European market in goods and services, and for their supervision. As such it has contributed significantly to the key objectives of financial stability and consumer protection while promoting the economic and social benefits deriving from a competitive level playing field within European financial services markets.

9. However recent years have seen significant financial innovation, advances in the techniques for the measuring and management of risks, and increased regulatory and supervisory sophistication. This has led to a pressing need to update the existing capital adequacy framework. Accordingly the development of legislative proposals in this area forms a key component of the Financial Services Action Plan. The FSAP, which aims to achieve integrated financial services markets in the EU, is a key priority of the EU's economic reform agenda.

Parallel review of the Basel Accord

10. The Commission Services' review of the existing legislation in this area is taking place in the context of the parallel review by the Basel Committee on Banking Supervision[1] of the 1988 Capital Accord ('the 1988 Accord') upon which the existing EU framework is based.

11. The Commission Services strongly support the efforts of the Basel Committee in the revision of the 1988 Accord which, though formally applicable only to internationally active banks in the 13 countries represented on the Committee, has been adopted in over 100 countries throughout the world and applied to institutions of all sizes and levels of sophistication.

12. The existence of an international framework governing regulatory capital requirements has brought and will continue to bring significant benefits to the global economy as a whole. The Basel Accord makes a central contribution to a sound and stable global financial system, enhancing the resilience of the banking system in the face of adverse events. It facilitates an international level playing field which helps prevent the benefits of competition from being undermined by regulatory arbitrage. And it promotes the efficiencies that result from having similar prudential standards in force throughout the world.

Suitability of the new Basel Accord as the basis for the new EU regime

13. The Commission Services are in particular supportive of the overall design of the proposed new Accord, which is conceived to ensure the continued suitability of the Accord for banks of all sizes and levels of complexity. This is based on a differentiated and evolutionary approach which incorporates significant flexibility around a range of methods for the calculation of capital requirements. This in the Commission Services view represents a design

[1] The Basel Committee was established by the central bank Governors of the Group of Ten countries. It consists of representatives of the central bank, and of the authority responsible for prudential supervision of banks where this is not the central bank, from the following countries: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States The European Commission, along with the European Central Bank, is an observer at the Committee and participates in the task forces and working groups working on the capital review.

which will make the new Accord a highly suitable basis for the new capital adequacy framework in the EU.

14. For example, in relation to the calculation of capital charges for credit risk, three approaches are prescribed. The revised Standardised Approach, while incorporating increased sensitivity and the wider recognition of risk mitigation techniques, is closely linked to the approach under the 1988 Accord. Thus it represents an appropriate methodology for those institutions not seeking to adopt the more sophisticated internal ratings-based methods for the calculation of capital charges.

15. The Internal Ratings Based Approach will be made available in two modalities. The Foundation Approach, which will require institutions to calculate own estimates only in relation to the probability of the borrower defaulting; and the Advanced Approach under which institutions' internal estimates of losses in the event of default and of exposure amounts at default will also be recognised.

16. The incorporation of the Foundation Approach as a core feature of the new Accord, which will be available to institutions for ongoing use in their calculation of capital charges, is of particular significance in the EU, where it can be expected to be adopted by a large number of institutions seeking to improve their risk measurement and management techniques and to receive appropriate recognition for this in their capital requirements.

17. The calibration of the new Accord is a key aspect. The Commission Services strongly support the objective of the Basel Committee to calibrate the new regime so that minimum capital requirements for Standardised Approach banks remain, after taking into account the new operational risk charge, on average the same as under the 1988 Accord. As proposed by the Basel Committee, in terms of capital requirements there should be modest incentives for institutions moving to the more advanced approaches.

18. The third Quantitative Impact Study (QIS3) which commenced on the 1st October will provide the basis for the achievement of these calibration objectives by the Basel Committee. All EU Member States and a number of Acceding Countries are participants in the QIS3 exercise which includes both internationally and non-internationally active banks. The Commission Services have also requested supervisory authorities to collect impact data from investment firms during the data gathering exercise.

Approach of the Commission Services

19. Against this background, and bearing in mind the as yet unfinalised nature of the new Basel Accord, the Commission Services with the support of competent authorities in the Member States have adopted as a foundation for its efforts in this area, the working principle that the EU capital adequacy framework should be revised in a manner that is consistent with the new Basel Accord, but appropriately differentiated where necessary to take account of specificities of the EU context.

20. In addition to the prudential implications, failure to reflect the new Accord in the legislative framework within the EU would have the potential to undermine the competitive position of EU financial institutions in the global

market place, with significant implications for EU economic and social objectives.

21. At the same time, there are a number of highly significant specificities of the European context which must be fully taken into account and reflected in the design of the new framework. Ensuring that this objective is achieved is a central focus of the work of the Commission Services in this area. A number of core EU specificities are described in the following paragraphs.

EU specificities

22. ***The scope of application of the proposed new EU framework.*** In accordance with the principle that capital requirements should be proportionate to the risks of activities carried on regardless of the legal nature and level of complexity of the institution in question, the new EU requirements will, as is the case under the existing directives, apply to all credit institutions and investment firms within the Union. As well as fulfilling the prudential imperatives of financial soundness and stability and of consumer protection, this approach also underpins the competitive level playing field. This reflects the realities of a highly diverse European market, where institutions of different types, sizes and levels of complexity compete directly with one another in the provision of financial services. It should also contribute to enhanced risk management practices within the EU financial services sector as a whole.

23. ***The nature of the EU framework.*** The legislative nature of the EU framework compares with the Basel Accord which takes the form of an agreement amongst national banking supervisory authorities. As was stated in the Commission Services second consultative document (CS CP2), there are three key objectives relating to this aspect. Firstly, that the new legislative framework needs to be adopted as speedily as possible. In particular, it is of great importance, if EU institutions are not to be disadvantaged, that the new framework is implemented in the EU Member States in accordance with the implementation date of the new Basel Accord. This is fixed for the end of year 2006. Secondly, the new framework should be sufficiently flexible to allow for the update of technical aspects to reflect ongoing market, regulatory and supervisory innovation. And thirdly, there must be a structure and process to ensure appropriate supervisory consistency and convergence to avoid inter-jurisdictional competitive distortion and regulatory arbitrage.

24. ***Small- and medium-sized enterprises (SMEs).*** SMEs represent a core component of the European economy. They play a crucial role in promoting the innovation, growth and employment which is essential to the economic success of the Union and to the welfare of its citizens. It is therefore a central requirement that the new capital adequacy framework does not result in disproportionate capital requirements in relation to financing of such entities. Ensuring the achievement of this objective has been a key aspect of the work which has taken place since the publication of the second consultative documents of the Basel Committee and the Commission Services.

25. These EU specificities are considered in greater detail below. The Commission Services will be seeking as part of the dialogue exercise mentioned above to obtain input in relation to these aspects.

Timetable and process ahead

26. As mentioned above, the Working Document published on the Commission's website will provide the basis for a period of structured dialogue co-ordinated by the Commission Services at the European level, and by Member State supervisory authorities at the national level. This period will run until end-January 2003.

QIS3

27. The first part of the QIS3 exercise (data gathering and returns from institutions) commenced on 1st October and is due to be completed by 20th December 2002. Thereafter the data will be analysed and compiled into country reports by supervisory authorities. The Commission will co-ordinate the analysis of the data gathered in relation to the impact of the new Basel framework in non-Basel EU Member States and in participating Acceding Countries. The Commission will also carry out a similar exercise based on country reports provided by supervisory authorities in relation to the potential impact of the new framework on investment firms.

28. Early in 2003 the results of QIS3 will be analysed by the Basel Committee in order to finalise the proposed calibration of the new Accord.

29. During this period, the Commission Services will consider the outputs of the structured dialogue and the data gathered in relation to investment firms' impact.

Third consultation exercise

30. The Commission Services will publish a third and final consultative document in late Spring / early Summer 2003 shortly after the Basel Committee publishes its final consultative document.

'Consequences Report'

31. The Commission Services are completing preparations for the carrying out of a study into the consequences of the new capital adequacy framework for all sectors of the EU economy, and in particular for the SME sector, as requested by the European Council at its meeting in Barcelona in March of this year. This report (the 'Consequences Report') will be finalised in advance of the adoption of a legislative proposal by the Commission and will inform that proposal and the subsequent legislative process.

Future deadlines

32. The new Basel Accord should be agreed in the autumn of next year. The Commission Services expect a proposal for the new framework to be adopted by the Commission in the first part of 2004.

33. While the timetable will be tight, this should allow the new legislation to be agreed and national implementation achieved in time for the global implementation date of the end of the year 2006.

34. With regard to achieving this implementation date and generally, the Commission Services very much welcome the strong interest taken by the European Parliament in the work in this area from an early date.[2] The work of the Commission Services has been significantly informed by the views expressed by Parliament to date. The Commission Services look forward to the publication of the own initiative report which is currently in preparation and to ongoing informal dialogue with European Parliamentarians which will be important to the successful completion and timely implementation of the new framework.

Introduction to the Working Document

35. As mentioned above, the Commission Services have published on the Commission's website a Working Document based closely on the draft legislative proposal as so far developed for a new capital adequacy regime for credit institutions and investment firms in the European Union.

A work in progress

36. It should be clearly noted that this Working Document is an ongoing work in progress and can in no way be taken as representing finalised Commission Services thinking. It will be subject to change arising from the ongoing work of the Commission Services in conjunction with the dedicated working groups structure of the Banking Advisory Committee and from the continuing work of the Basel Committee on the development of a new international Accord (including in relation to finalising the calibration of the new regime).

A flexible framework

37. The format of the Working Document follows that of the likely Directive proposal. The provisions are divided between two strands. Firstly, that part of the Document consisting of articles. These should contain the principles and central rules governing the issue in question. And secondly annexes - which should contain the more detailed implementation and elaboration of those principles and rules.

38. It is the intention of the Commission Services that the draft directive proposal in its entirety (i.e. articles and annexes) should be submitted for adoption through the co-decision legislative procedure.

39. Given the need to achieve flexibility and capacity for speedy legislative response to market and regulatory innovations as mentioned above, the Commission Services envisage that the provisions contained in the annexes should be subject to amendment by comitology procedure in the future. (In relation to the question of possible future comitology arrangements for banking legislation, readers are referred to the open consultation on improving banking, insurance and conglomerates legislation, launched by the Commission, on behalf of the Danish Presidency on 14th October 2002.[3])

[2] See, for example, European Parliament resolution on the evaluation of Directive 89/299/EEC on the own funds of banks (2000/2207(INI)) – text adopted 17 November 2000.

[3] See http://www.europa.eu.int/comm/internal_market/en/finances/cross-sector/index.htm

40. In developing the draft proposed directive text, the Commission Services seek to incorporate in the articles the determining principles and governing rules for the new capital adequacy framework. It is important that these establish firmly the basis of and constraining requirements for the more detailed implementing and technical provisions contained in the annexes. Again, as for the text as a whole, the draft proposed respective contents of articles and annexes represent work in progress.

41. During the period of the structured dialogue, the Commission Services will be seeking observations in relation to the proposed respective contents of the two strands of the draft legislative proposal.

Structure of the Working Document

42. The Working Document is divided into six titles.

43. Title I sets out the definitional provisions for the proposed new regime, the general provisions establishing its core requirements, and the provisions prescribing its scope of application.

44. Title II contains the minimum capital requirements in relation to credit risk (including chapters on the Standardised Approach, the IRB Approach, credit risk mitigation, and asset securitisation) and operational risk. It also contains provisions relating to market risks, the core requirements in relation to which continue to be found in the Capital Adequacy Directive (CAD)[4] as amended.

45. Title III is concerned with institutions' risk identification, measurement and management and includes the draft proposed directive requirements in relation to capital adequacy over and beyond compliance with minimum capital requirements. The second part of this Title deals with the Evaluation Process to be undertaken by supervisory authorities and prescribes powers and obligations of authorities in this regard.

46. Title IV is concerned with disclosure requirements to harness the prudential effects of market discipline.

47. Title V deals with powers of execution; and Title VI contains transitional and final provisions.

Open issues

48. However, the Working Document does not represent a fully complete document in terms of its coverage of all of those aspects which will be eventually included in the legislative proposal. In particular in this respect, readers' attention is drawn to the following aspects.

49. ***Investment firms / investment services.*** The work in relation to the development of draft proposals for the application of the new framework on operational risk in the context of investment firms / investment services is ongoing. The Commission Services continue to consider key aspects such as the calibration of the capital charge and the scope of application of the proposals. Accordingly, while draft text is included in the Working Document, it is not yet fully developed. A detailed discussion of this question is included in Part 2, Section 3 of this Cover Document.

[4] 93/6/EEC

50. ***Operational risk.*** The Commission Services continue to consider the desirability and feasibility of giving a certain level of recognition to the mitigation of operational risk that may be achieved through institutions' use of insurance. This matter is discussed in Part 2, Section 2 of this document. Accordingly, the text included in the Working Document in this regard is tentative and subject to satisfactory resolution of a number of important prudential concerns.

51. ***Mortgage lending.*** The issue of the capital treatment of lending secured by residential and/or commercial real estate is a very important one in the EU. The Commission Services have been giving close consideration to the recently finalised draft proposals of the Basel Committee in relation to this matter. The Commission Services consider that these proposals constitute an appropriate basis upon which to develop the provisions of the new EU framework in this regard. Nonetheless there are important features of the EU market and legislative context that need to be taken closely into consideration. In Part 2, Section 5 of this document the line of the Commission Services' thinking in this regard is set out. At this stage draft text in the Working Document is incomplete.

52. ***Market discipline & certain aspects of Title III.*** In view of the fact that the Basel Committee has not yet published its most up-to-date proposals in relation to supervisory review (Pillar 2) and market discipline (Pillar 3), complete Working Document draft provisions in relation to disclosure requirements and aspects of Pillar 2 such as CRM residual risk, risks associated with asset securitisation, and cyclicality stress-testing are not included at this stage.

53. ***Comitology.*** In view of the ongoing consideration of the future architecture of EU financial services advisory committees, complete draft comitology provisions are not included in the Working Document.

54. ***Amendment of existing legislation.*** At this stage, for the most part, the Working Document does not contain draft provisions relating to the precise mode of amendment and/or repeal of existing directive provisions.

55. ***Recitals.*** The Commission Services have not yet finalised proposed legislative wording for the *considerants* to be included in the draft directive proposal. Accordingly, the draft recitals are not at this stage included in the Working Document.

56. A brief introduction to the structure of each area of the Working Document is set out at Part 3 of this Cover Document.

Part 2 – Some important EU specificities

Section 1 – Smaller and less complex institutions

57. As discussed in Part 1 of this Cover Document, ensuring that the design and requirements of the new regime are suitable for application to all credit institutions and investment firms in the EU, whatever their size and level of sophistication, is a key objective of the Commission Services.

58. Activity in this regard must be effective at two levels. Firstly, it must be ensured that the proposals for the new Basel Accord take fully into account the EU imperative that the new framework will apply to institutions of all shapes and sizes. The new Basel Accord must provide a suitable basis, in design and calibration, for the new EU regime having regard to this fact.

59. Secondly, in developing the Commission's legislative proposals, the Commission Services are giving detailed consideration to the question of the need for differentiation in the EU context.

60. As outlined in Part 1 of this document, and subject to the outcome of QIS3 and the subsequent calibration exercise, the Commission Services believe that the Basel proposals as so far developed represent a highly suitable basis for the new EU framework in this regard. In particular, as mentioned, the Commission Services warmly welcome the differentiated design of the new Basel framework which provides a range of options for institutions of different levels of complexity and sophistication of risk measurement and management. The Commission Services also strongly support the calibration objectives of the Basel Committee as outlined above.

The Standardised Approach

61. The revised Standardised Approach is modelled quite closely on the existing credit risk framework, with risk weights determined by the allocation of assets and off-balance sheet items to a limited number of risk buckets. The risk sensitivity of this approach has however been enhanced by an increase in the number of asset classes and risk buckets, and the use of credit rating agencies' ratings to assign risk weights where these are available ('external ratings').

62. The Commission Services consider that the proposals in this regard represent a highly appropriate approach for those institutions in the EU which do not seek approval for the use of the internal ratings based approach. On the one hand, the proposals do not represent a significant increase in levels of complexity as compared with the current framework. On the other, they introduce a degree of risk sensitivity which represents a welcome improvement as compared with the existing rules.

63. A new risk weight is proposed for non-mortgage retail items. This will be 75% as compared with 100% currently. Similarly it is proposed that the risk weight for residential mortgage loans be reduced from 50% to 40%. The Commission Services consider that these risk weights represent the appropriate ones for lending of this kind.

64. It is proposed to introduce a 150% risk weight for assets which are 90 days past due (100% for residential mortgage loans 90 days past due).

65. The definition of retail lending includes small business lending, subject to an exposure limit of €1 million and to the general Standardised Approach retail exposure size limit of 0.2% of the institution's retail portfolio.

66. Significantly, in the case of corporate borrowers (other than those falling within the retail asset class) which do not have an external rating, the proposed risk weighting will be 100%. This means that for these borrowers the capital charge will remain the same as under the current regime. This is particularly important in the case of smaller borrowers which are unlikely to have external ratings.

The IRB Approach

67. The Commission Services consider that the proposed IRB framework represents an appropriate balance between soundness and prudence on the one hand and a level of complexity which ensures applicability to a wide range of EU institutions on the other. Considerable developments have taken place in this regard since the publication of CP2.

68. In particular the new framework has been streamlined and rendered less complicated. Amendments have been introduced which further enhance accessibility for smaller and less complex institution. The Commission Services draft proposals introduce some modifications in addition to those introduced in the draft Basel proposals.

69. A key component of the IRB framework is the availability of a Foundation Approach. This allows institutions to make use of their own estimates of probability of default, while using regulatorily prescribed values for other risk components. The Commission Services consider that this 'middle' approach will be attractive to and suitable for a large number of institutions within the EU.

70. Regarding the IRB rules for retail, it is proposed to have only one IRB modality, viz the Advanced Approach. Given the significantly greater levels of data which are available to institutions for the retail portfolio as compared with other asset classes, the Commission Services consider that this represents an appropriate approach which should be achievable by institutions which are able to comply with the requirements of the Foundation Approach for other asset classes.

71. The draft proposals contain provisions providing for the use by institutions of pooled data in the estimation of risk parameter values. This is subject to requirements as to the comparability and consistency of the rating systems and criteria used by other institutions in the pool. This will allow institutions to apply a more risk sensitive approach to calculating regulatory capital requirements where the size of the institution's own portfolios would in themselves provide insufficient data to comply with the minimum requirements for the estimation of risk parameters. The Commission Services consider these provisions very important in the EU context.

72. The proposed 'roll-out' rules, as now developed, provide flexibility for institutions to move different business lines and asset classes during a

reasonable timeframe to the Foundation or the Advanced IRB Approach. In addition the Commission Services draft proposals provide further flexibility within the retail asset class. Here it will be possible for institutions to move to the IRB Approach for each sub-asset class. These proposals allow a step by step application of the IRB treatment across business units and asset classes and facilitates access to the IRB Approach in general.

73. The proposed new framework also allows partial use for non-material asset classes and business lines, i.e. capital requirements for these exposures can be calculated permanently according to the rules of the revised Standardised Approach even if an institution uses the IRB Approach for calculating minimum capital requirements for other asset classes.

74. Furthermore, and significantly, the draft proposed EU framework recognises that for small institutions with a limited number of sovereigns or institutions as counterparties, the requirement to develop a rating system for this kind of counterparty is potentially unduly burdensome. Therefore a permanent partial use for these asset classes is proposed even in cases where institutions exposures to such counterparts are material.

75. To facilitate the commencement of the new IRB framework it is proposed, in line with the Basel rules, to include transitional provisions which will allow for a limited period the relaxation of a number of proposed requirements that institutions will need to comply with to use the IRB Approach. Especially important in this context is the initial proposed relaxation in the data requirements for the estimation of probability of default from five years data to two years (increasing by one year during each of the first three years of the new regime).

Credit Risk Mitigation (CRM)

76. All institutions, including smaller and less-complex institutions, stand to gain from the significant advances in the recognition of techniques of credit risk mitigation which are incorporated into the proposed new capital adequacy framework. These include the recognition of a significantly wider range of collateral and guarantee / credit derivative providers than is the case under the existing regime. Under the IRB Foundation Approach, it is proposed also to give a prudentially appropriate level of recognition to financial receivables and physical collateral.

77. Alternative methodologies are made available so that institutions have the opportunity to choose methods of different levels of complexity. For example, in relation to the recognition of the risk-reducing effects of financial collateral, institutions may choose the Simple Method – which is based on an easy-to-use ‘risk weight substitution’ approach; or they may opt for the Comprehensive Method – which involves the application of volatility adjustments to the value of the collateral received. Similarly, in the calculation of volatility adjustments more and less complex approaches are made available – a straightforward ‘Supervisory’ approach where the amounts of the benchmark volatility adjustments are set out in a table in the draft proposed legislation; and a more risk-sensitive ‘Own Estimates’ approach.

The recognition of unrated securities issued by institutions

78. Article 45 of Directive 2000/12/EC has been implemented in some Member States so as to provide a 20% risk weighting to asset items secured by debt securities issued by credit institutions other than the lending institution. Under the Basel proposals, recognition in this regard would be limited to securities issued by institutions which are either externally rated investment grade or better, or if not so rated, are listed on a recognised exchange and meet other criteria designed to ensure adequate value assessment and market liquidity.

79. Some concerns have been expressed that these proposals are insufficiently sensitive to the EU context. There are concerns that, at least in some parts of the EU, these proposals could have an unduly adverse effect due to the more limited extent to which institutions are externally rated and their securities listed. On the other hand, it is necessary that any proposed recognition and treatment of such collateral instruments should be prudentially sound and justified.

80. The Commission Services is giving consideration to the recognition of such instruments as collateral. Work is ongoing in an effort to develop criteria which would ensure appropriate levels of confidence as to realisable value assessment and liquidity. Data is being sought on the basis of which an appropriate supervisory valuation adjustment could be prescribed. Assistance in gathering such data and input related to these aspects from representative associations and bodies during the period of the structured dialogue will be welcomed.

Operational risk

81. The framework for operational risk capital requirements has been designed so as to be suitable for application to the full range of institutions – including smaller and less complex ones. Important features in this regard include the availability of three different methodologies for the calculation of credit risk capital charges and the re-calibration that has taken place since the publication of the Basel Committee's and the Commission Services' second consultative documents. The Commission Services are also giving consideration to the wider recognition of insurance in this context. The proposed new framework is discussed in Section 2 below.

Supervisory Review Process

82. The draft proposed provisions in relation to the Supervisory Review Process (SRP) are discussed in greater detail in Section 7 below. The Commission Services considers it very important that all institutions, whatever their size and complexity, should be adequately capitalised having regard to their overall risk profile and the quality of their management and organisation. The draft proposed SRP provisions are a key component in ensuring such capital adequacy. At the same time, for smaller and less complex institutions the requirements should be proportionate and adapted to the different context and risk profiles of such institutions.

83. Accordingly, while it is proposed that the draft SRP provisions will apply to all EU credit institutions and investment firms, whatever their size or level

of complexity, these provisions have been worded in the form of high level principles which will be applied by institutions – and evaluated by supervisors - in the context of the institution's particular individual characteristics. This will ensure that the requirements in this regard are proportionate to the nature, scale and complexity of the individual institution. For example, the requirement to have an appropriate control environment and risk management strategies and procedures would have a different meaning in the context of a smaller locally-focused savings bank on the one hand, and a large internationally active universal bank on the other.

Market Discipline

84. Similarly in relation to the disclosure requirements that will be proposed under the new framework in order to harness the beneficial prudential effects of market forces, the draft proposals will be designed to integrate fully the principles of proportionality and flexibility.

85. A key aspect in this regard is the proposal that only material information will be required to be disclosed. Accordingly, smaller and less-complex institutions will be required to make disclosures only in relation to the risks to which they are materially exposed.

86. Moreover, it will be left to the discretion of institutions to choose the medium and location of disclosures. This will help avoid the need for double disclosure as institutions will be able to rely on disclosure made in compliance with, for example, accounting requirements. While the proposed new Basel Accord will require a minimum semi-annual disclosure frequency for banks other than 'small banks with stable risk profiles', the Commission Services propose to require disclosure on a minimum annual basis for the generality of institutions - while requiring them to assess whether more frequent disclosure is necessary in light of specific criteria. This in the view of the Commission Services appropriately reflects the specific features of the EU context and is conceptually coherent with the approach of the Basel Committee.

Section 2 – Operational risk

87. As mentioned above, the framework for operational risk has been designed to be applicable to a wide range of institutions. There have been a number of substantial developments since the release of the second consultative documents in early 2001.

A range of methodologies

88. Three different methodologies will be available for use by institutions in calculating their operational risk capital charge.

89. A simple approach based on a single aggregate income indicator: the Basic Indicator Approach (BIA). This approach will provide a capital buffer against operational risk, without requiring institutions to develop sophisticated and costly information systems about their operational risk exposure. Institutions using the BIA will nevertheless be required to comply with a set of basic risk management standards applicable to every institution.

90. A more precise approach based on business lines: the Standardised Approach (STA). This approach aims to be more risk-sensitive, as the capital requirement for operational risk will be differentiated to reflect the relative riskiness of different business lines. The use of the STA will be conditional upon compliance with more developed risk management standards. In particular, institutions will be able to map their activities into different business lines, and will have a process to identify their exposure to operational risk. This approach is likely to be attractive to a large number of smaller / less complex institutions.

91. More sophisticated methodologies: the Advanced Measurement Approaches (AMAs). Under this category, institutions will have to be able to generate their own measure of operational risk, subject to more demanding risk management standards. AMAs are expected to be gradually adopted mainly by the large internationally active institutions; but could also prove well suited for smaller specialised institutions which have developed advanced risk monitoring systems for their main activities.

92. To facilitate the transition of smaller institutions to more advanced methodologies, the Commission Services intend at a later stage to make articulated proposals for the combined use of different approaches for different business lines, and for different activities within a group (e.g. the possibility to apply different methodologies at solo and consolidated level).

A revised calibration

93. Following the second quantitative impact study – carried out by the Basel Committee in 2001 - the target capital charge for operational risk has been substantially reduced under all methodologies. This is reflected in the provisionally proposed percentage requirements under the BIA and the STA. The capital requirement under the BIA would be 15% of the income indicator under the current proposals. Under the STA, the capital requirement would range between 12% and 18% of the income indicator, depending on the perceived relative riskiness of different business lines.

94. QIS3 will help fine-tune these requirements further. The Commission Services have encouraged the participation of a wide number of smaller institutions in the process. Also, a data collection exercise on actual operational risk losses will inform the calibration of the operational risk framework.

About insurance as a risk mitigation factor

95. In the EU context of application to a wide range of institutions of different type, size and complexity, the recognition of insurance as an operational risk mitigant is under consideration not only under the AMAs - as contemplated in Basel - but also under the BIA and STA.

96. The recognition of insurance might be argued to be consistent with the objectives of developing a more risk-sensitive capital adequacy framework and with encouraging sound risk management practices. There is some empirical evidence that insurance has effectively reduced the final net impact of adverse operational risk events for institutions. Subject to compliance with a set of eligibility criteria, the Commission is considering whether insurance might be recognised as a risk mitigation technique, and

some capital alleviation provided for institutions that take steps of this kind to reduce their net potential exposure to operational risk.

97. However, any framework for the recognition of insurance would need to be able to adequately address the following supervisory concerns.

98. A first series of concerns relates to the reliability of the insurance cover. In particular, insurance may give rise to credit and legal risks. The transfer of operational risk leaves the 'buyer' of insurance cover exposed to the risk of default of the provider. There may be concerns about the creditworthiness / claims paying ability of certain insurance providers (in particular, non-regulated providers, insurance undertakings subject to leaner regulation, insurance undertakings not participating in a compensation scheme for policy holders). Legal risk is also of concern: there are examples of legal disputes over insurance contracts, which often make payouts contingent upon restrictive conditions. The risk of litigation might also be perceived as proportional to the amount at stake, which raises questions about the effectiveness of insurance against high impact events. Of concern to supervisors are also the stability of the insurance cover over time (e.g. cancellation policy) and the timeliness of payments (e.g. when further investigation is required).

99. A second category of concerns relates to recognition feasibility. Surveys of industry best practices show that even highly sophisticated institutions have difficulties in factoring insurance into their own models. It is also challenging to develop a straightforward and simple formula for the recognition of insurance under the BIA and STA.

100. A third category of concerns relates to the incentive structure of the capital adequacy framework. The Commission Services share the view that incentives should be maintained for institutions to adopt more advanced risk monitoring and management systems for operational risk. This raises the question of the respective calibration of the recognition of insurance across the different approaches.

101. Finally, the recognition of insurance raises concerns about the transfer of risks between the banking / investment firms sectors and the insurance sector, and about the impact on the insurance industry. The recognition of insurance would probably create incentives for institutions to buy more insurance, and increase the exposure of the insurance industry to the banking / investment firms sectors.

102. Tentatively, the recognition of insurance – if any - could be based on two main elements:

(i) A set of eligibility criteria to ensure that only reliable insurance contracts shall be rewarded in the form of capital alleviation. These eligibility criteria could pertain to the (regulated) status of the provider of the insurance cover, the creditworthiness / claims paying ability of the provider, the legal robustness of the insurance contract and the stability of the insurance cover over time.

(ii) A formula for recognising insurance in a manner commensurate with the methodology chosen for operational risk (i.e. a simple formula for BIA and STA). The formula should include limits to capital alleviation

reflecting appropriate levels of prudential soundness, and maintaining incentives to move towards more sophisticated methodologies. Different formulas would need to be tested and calibrated over the coming months. Institutions will be aware that a data collection exercise on the use of insurance against operational risk will be started shortly after the release of this document. This will require the active cooperation of the industry.

103. Tentative possible legislative text has been included in the Working Document, Annex H. The Commission Services emphasise that recognition of insurance for these purposes remains an open question, contingent upon the satisfactory resolution of the prudential concerns indicated above.

104. In relation to operational risk charges in the context of investment firms / investment services see also Section 3 below.

Section 3 – Investment firms and investment services

105. In the EU the new capital requirements regime shall apply to both credit institutions and investment firms. Both types of institution operate and compete in many of the same markets; and both benefit from the EU passport for the provision of investment services. Ensuring an equal treatment of these institutions is a major policy concern. At the same time, the Commission Services believe that EU rules need to be proportionate and to take fully into account the 'biodiversity' of financial institutions in the EU. This requires appropriate adaptation of the general rules.

106. With specific regard to investment firms the main issues at stake are:

- the impact of a new capital charge to cover operational risk
- the new rules concerning the trading book
- the new rules on consolidation.

107. The draft proposals elaborated by the Commission Services in relation to Operational Risk and on consolidation are described in the next paragraphs. Those relating to the trading book are covered in Section 6 below.

Operational risk

108. Investment services are subject to harmonised regulation based on the Investment Services Directive (ISD)[5] and the Capital Adequacy Directive (CAD). Both credit institutions and investment firms have to comply with rules covering not only capital requirements but also conduct of business, segregation of clients' assets, administrative and accounting procedures, internal controls, etc.[6]

109. Building on these principles and rules, the Commission Services consider that the general approach to operational risk for investment firms / services in the EU should be articulated as follows: (i) there should be a capital

[5] Directive 93/22/EEC. This Directive is currently under revision in order to respond to the structural changes that have occurred in the EU financial markets since its entry into force.

[6] See in particular Articles 10 and 11 of the ISD.

charge for operational risk related to investment service activities for all European credit institutions and investment firms; (ii) the methodologies to calculate this charge should be consistent with those elaborated in the Basel proposals; in particular, the risk indicator and the formulas for calculating the capital charge shall be the same as in the Basel proposals; (iii) the calibration of the capital charge should be adapted to take account of the specific situation in the EU; (iv) this approach should be combined with more stringent risk management principles targeting the provision of investment services.

110. For a discussion of the proposed operational risk framework generally, see above Section 2.

An alternative calibration for investment firms/ services

111. The Commission Services consider that in respect of some specific investment firms / investment services business lines a lower calibration of the operational risk charge - as compared with the charges currently being proposed in Basel - would be justified in the EU legislation, in order to take account of EU specificities. In reaching this view the Commission Services have had regard to the study carried out in 2001 in relation to the likely impact of the new operational risk charges on investment firms and to the fact that within the EU such services are covered by the customer protection requirements and risk management standards of the Investment Services Directive (whether they are carried out by credit institutions or investment firms).

112. In order to benefit from the alternative operational risk charge, firms would need to comply with a number of specific risk management standards and operational arrangements for investment services, as these can play a role in reducing the frequency and severity of operational risk losses.

113. The proposals developed so far consist of the following:

- an adapted mapping of the ISD activities into the business lines contained in the Basel proposals in order to take account of investment firms' features, in particular the high degree of specialisation that can be achieved by these institutions. This should be reflected in the provisions relating to the definitions of the exposure indicator per business line;

- a lower calibration for investment firms with limited licence. This should apply to firms that: (i) are only authorised to provide certain specific low risk investment services, notably: reception/transmission of orders; execution of such orders on behalf of their clients; placing of issues with no firm commitment; investment advice; and (ii) are not allowed to come into possession of money or instruments belonging to investors to which they provide investment services. As neither the ISD nor CAD currently define the concept of 'holding clients' money', specific rules are introduced in order to identify investment firms that could be eligible for this treatment;

- a lower calibration of the operational risk charge - as compared with the charges currently being proposed in Basel – for certain ISD business

lines. This treatment should cover the low risk business lines mentioned above plus asset management and should be supplemented by risk management standards specifically covering the segregation of clients assets.

114. The Commission Services are of the view that a more favourable treatment should not be allowed for some investment services business lines, notably (i) dealing on own account and (ii) underwriting of issues on a firm commitment basis. For these, the calibration of the operational risk charge should remain in line with the Basel proposals.

115. Further work is being devoted to the identification of the business lines that pose low risks of operational risk losses. Specifically, there is the intention to consider further: (i) management of the proprietary portfolio when this is not used for trading purposes; (ii) placing/selling of financial instruments; (iii) agency/custody services; and (iv) operation of multilateral trading facilities. This issue shall be examined in tandem with the recalibration of the operational risk charge for investment firms/services. The Commission Services will be seeking input during the structured dialogue in relation to these technical aspects and on the viability of the proposed approach.

Scope of application of the alternative calibration for operational risk capital charges

116. The Commission Services consider that any specific treatment envisaged for certain categories of institutions in the EU, in addition to being prudentially justified, must avoid giving rise to distortion of competition between market participants.

117. The Commission Services have not reached a final view on whether the alternative calibration of the proposed operational risk capital charges based on identified investment services business lines should become available not just to investment firms whose authorisation is limited to providing the services in question but also to: (i) investment firms holding a wider authorisation either directly or through subsidiaries belonging to their group; and (ii) credit institutions that provide investment services either directly or through subsidiaries belonging to their group. The Commission Services will be soliciting the views of supervisory authorities and representative associations on this issue as part of the structured dialogue.

Risk management standards

118. The Commission Services consider that a lower calibration of the operational risk charge should be dependant upon the institution being compliant with well identified risk management standards for investment services. These standards should cover in particular three areas: (i) the holding of ‘client assets’ (this concept covering both money and financial instruments); (ii) the segregation of assets and funds belonging to the clients; and, more generally (iii) risk management principles for investment services, including internal controls. These would take account of existing and incoming Basel and ISD regulation.

The expenditure-based requirement in Annex IV CAD

119. The Commission Services have not – for the time being – considered the articulation between the new risk based capital requirements for investment firms (including the operational risk charge) and the existing expenditure-based requirement under Annex IV CAD. It is intended to do so at a later stage, based on updated information on the impact of the new requirements on investment firms/services and on further developments regarding operational risk.

Scope of consolidation

120. It is proposed to amend the existing alternative to consolidated capital requirements for investment firms groups. It is proposed that this alternative be available only to groups that meet a number of stringent specified conditions. It will be required, inter alia, that (i) no credit institution is included in the group; (ii) the group engages in a limited range of activities which does not include own account dealing or underwriting of issues with firm commitment; (iii) the group is not allowed to hold client assets; and (iv) the group is adequately capitalised. In such very limited cases the Commission Services have considered that the objectives of prudential supervision on a consolidated basis can be achieved without imposing consolidation. The proposed new rules are set out in Article 21 of the Working Document.[7]

Supervisory review process and market discipline

121. A tailored application of the principles on Supervisory Review to investment firms – based on their size, risk exposure and risk management features – is fully consistent with the proposals in Title III of the Working Document.

122. As to disclosure requirements, the materiality criterion and the recognition of disclosures made in compliance with accounting or other requirements will provide, in the opinion of the Commission Services, an appropriately flexible general framework.

123. Readers are referred to paragraphs 82-86 above and to Section 7 below.

Section 4 – Small- and medium-sized enterprises (SMEs)

124. As mentioned in Part 1 of this document a key aspect of the work in developing the new framework is ensuring that the capital requirements in respect of lending to SMEs are proportionate to the risks involved and do not give rise to undue burdens for such entities. There have been significant developments in the proposals in this regard.

125. Under the Standardised Approach, as mentioned previously, it is now proposed to introduce a 75% risk weight for retail loans. Loans to small businesses may be included in this category, subject to an aggregate exposure limit per borrower of €1 million and to the general Standardised Approach retail exposure limit of 0.2% of the overall retail portfolio. For unrated borrowers not falling within the retail asset class, the risk weight remains the same as under the current regime – i.e. 100%.

[7] Under CAD, this aspect is covered by Article 7(4).

126. In relation to the IRB Approach a number of significant new proposals have been introduced. Firstly the corporate risk weight curve has been flattened significantly. This results in a lower capital requirements for borrowers with higher PDs. This may be considered to be of particular importance to SME borrowers. Whereas under the proposals in CP2 for example, for a loan with a PD of 3% the capital requirement under the IRB Foundation Approach would have been close to 20%, the capital requirement for such a loan under the new proposal would be below 12%.

127. Secondly, exposures to SMEs falling within the corporate asset class will receive a reduction in capital requirements as compared with loans to larger corporates based on a firm size-related adjustment to the risk weights. This incremental discount factor will start when borrowers have total annual sales of less than €50 million and will increase in inverse proportion to the size of the firm. The largest discount - 20% - will be available for lending to borrowers with annual sales of €5 million or less. And the average discount will be approximately 10%.

128. Thirdly, SME loans below an exposure size of €1 million can be treated in the retail portfolio (subject to the 'use test' – i.e. the requirement the lending institution treats the exposure as a retail exposure). The capital requirement in the retail portfolio is generally lower than in the corporate portfolio because empirical evidence suggests that for any given combination of risk parameters the contribution to portfolio credit risk for retail and small SME exposures is lower than for other exposures.

129. Finally, loans to corporates situated in the EU with a turnover as well as total assets for the consolidated group below €500 million can be excluded from the explicit maturity adjustment (to be replaced by an implicit maturity assumption of 2.5 years) under the IRB Advanced Approach where the competent authorities opt for such an approach for all institutions authorised by them.

130. The Commission Services believe that the changes which have been made ensure a prudentially sound treatment of SME lending which is suitable to the situation of such borrowers. As part of the current QIS3 exercise, data is being gathered to assess the likely impact on institutions' capital charges arising from lending to SMEs.

Section 5 – Treatment of mortgages

131. This section sets out the Commission Services proposed approach to the treatment of loans secured by residential real estate (RRE) and commercial real estate (CRE) under the new capital adequacy framework. As mentioned in Part 1 of this Cover Document, complete draft legislative text in relation to the treatment of such lending is not at this stage included in the Working Document.

132. It should be noted that under the Standardised Approach, RRE lending and CRE lending are treated as separate asset classes; whereas under the IRB Approach, RRE and CRE are types of collateral which can modify the LGD of the loan in question.

The underpinning principles

133. The Commission Services proposed approach is to have as consistent as possible a treatment for RRE and CRE across the different approaches. This should help limit level-playing-field issues and gaming possibilities. Therefore it is likely to be proposed that the definitions of RRE and CRE lending for the Standardised Approach and of eligible real estate collateral for the IRB Foundation Approach will be similar. (For the IRB Advanced Approach, there are no restrictions on the eligibility of collateral).

134. Consideration is being given to introducing in the Standardised Approach, minimum requirements to be complied with by institutions applying the lower risk weights for RRE and CRE lending. Such requirements, which would represent the minimum standards that any institution should be expected to comply with if it is engaged in this type of lending, would be designed to ensure reliable management and prudent valuation of the mortgaged property.

135. In developing its proposals the Commission Services will have regard to the full set of Basel proposals for the treatment of real estate lending including under the Standardised Approach, the IRB Foundation Approach, and the IRB Retail approach, and related 'footnote' treatments.

Proposed treatment of RRE

136. In line with Basel, the Commission Services intend to propose a 40% risk weight for RRE lending under the Standardised Approach subject to minimum requirements as mentioned above. The definition of RRE is likely to be the same as in Basel.

137. The likely proposed RRE treatment under the IRB Foundation Approach will be close to the Basel treatment. The Commission Services are likely to propose the same risk weight curves, loan to value ratios, LGDs and minimum requirements for RRE collateralised loans as Basel. The definition of eligible RRE collateral will be the same as under the Standardised Approach (having regard to the conceptual differences between the two approaches).

138. For the treatment of RRE in the IRB Retail portfolio the Commission Services are likely to propose the same definition and treatment that is proposed in the Basel rules text. Consequently RRE lending which falls under the Retail IRB definition would be required to be treated on the retail mortgage curve.

Proposed treatment of CRE

139. The Commission Services will propose a preferential 50% risk weight for CRE lending under the Standardised Approach, subject to specific minimum requirements as mentioned above. The Commission Services recognise that for this kind of lending riskiness might differ across countries. Therefore the 50% risk weight should, as under the current framework, be based on national discretion.

140. Nevertheless the Commission Services consider that some kind of CRE lending might be riskier than others. In order to take this into account, a requirement is likely to be introduced which limits the range of eligible CRE

lending. In particular, the Commission Services intend to propose that the 50% risk weight be restricted to CRE lending where the risk of the borrower is not materially dependent upon the performance of the underlying property and where the value of the property is not materially dependent on the performance of the borrower.

141. However the Commission Services recognise that for some well-developed and long-established markets such kinds of lending have the potential to receive a preferential risk weight. Therefore a transitional provision based on national discretion is likely to be proposed for competent authorities to waive this requirement. It will be proposed however that this discretion be exercisable only where the competent authorities have evidence that there is a well-developed and long-established market with loss-rates justifying such a treatment. During the transitional period the Commission would observe developments with a view to developing longer term proposals.

142. Regarding the IRB Foundation Approach the Commission Services are likely to propose the same loan to value ratios, LGDs and minimum requirements in relation to the recognition of CRE collateral as under the Basel proposals. The definition of eligible CRE collateral will be the same as under the Standardised Approach (having regard to the conceptual differences between the two approaches). The Commission Services are likely to propose a waiver based on national discretion similar to that suggested above for CRE lending under the Standardised Approach.

Mortgage bonds

143. Mortgage bonds play a significant role in European capital markets and in the funding of mortgage lending in Europe. Under the current transitional capital rules for such exposures, mortgage bonds are risk-weighted at 10%. This is subject to the conditions laid down in Article 22(4) of the UCITS Directive.[8]

144. The intention of the Commission Services is to elaborate a continuing prudentially sound and suitable treatment for these instruments. Notwithstanding the robust performance of mortgage bonds across jurisdictions, there are considerable differences between mortgage bonds issued in the various countries. Over the coming months, the Commission Services will be considering the legislative frameworks underpinning mortgage bonds in the different jurisdiction and other aspects relating to the risk characteristics of these instruments with a view to developing risk-sensitive proposals for inclusion in the new framework.

Section 6 – Trading book

145. The methodologies for the calculation of a market risk charge for items booked in the trading book are currently specified in CAD, Annexes I, III, VII and VIII. Apart from a few exceptions, it is not proposed that these rules should be changed significantly.

146. There are however a number of issues regarding the trading book that deserve attention.

[8] Directive 85/611/EEC

Identification of trading book items

147. The draft proposed new rules in relation to the identification of trading book items, are fully consistent with Basel. They are designed to create a closer link between an institution's risk management practices and its capital requirements. Specifically, the possibility to apply a trading book capital treatment will depend on trading intent and prudent valuation on the part of institutions. The consequent amendments to CAD are specified in Article 103. In this area, the proposals conform to the line set out in CS CP2. As part of the structured dialogue, the Commission Services will be seeking comments on these proposals.

Credit risk mitigation (CRM) in the trading book

148. This aspect, which gave rise to concerns because it was not explicitly addressed in CP2, is now the subject of clear proposals as described below and set out in the Working Document.

149. Repurchase agreements, reverse repurchase agreements, and securities or commodities lending or borrowing transactions will be treated as collateralised exposures and, along with other collateralised transactions in the trading book, be subject to capital requirements for counterparty risk following the proposals for credit risk and the recognition of collateral under the 'Comprehensive Method' in the banking book.

150. Both the Basel Committee and the Commission Services consider that these proposals, as they have been modified in the period since CP2, represent sound and appropriate rules for calculating the capital charges for counterparty risk in relation to such transactions.

151. A key issue in this regard is the calculation of the volatility adjustments to be applied to the value of the securities or commodities which are the subject of a repurchase agreement or a lending or borrowing transaction. There have been significant developments in relation to this aspect since the publication of CP2. In addition to the use of 'Supervisory' and 'Own Estimates' volatility adjustments as proposed in CP2, it is now proposed to recognise both the effects of Master Netting Agreements and, for institutions meeting the prescribed minimum requirements, the use of internal models to reflect price volatility taking into account correlation effects.[9]

152. The liquidation period to be applied in the case of securities repurchase, lending or borrowing agreements has been reduced from the originally proposed ten days to five days (subject to daily remargining) to reflect the distinctive features and risk-management practices in the case of such transactions. (It should be noted that for transactions of this type involving commodities, it is intended to retain the ten days liquidation period.)

153. It is proposed that all items which are eligible for inclusion in the trading book will be regarded as eligible for the purposes of securities or commodities repurchase or lending or borrowing transactions where such a transaction is booked in the trading book. This means that commodities

[9] The recognition of internal models for these purposes remains contingent upon the development of an appropriate back-testing regime.

will be recognised as eligible collateral in the context of such transactions.[10]

154. For institutions using the IRB Approach in cases where an explicit maturity adjustment applies, securities or commodities repurchase, lending or borrowing transactions fall within the list of examples of transactions where supervisory authorities may prescribe that the one-year maturity floor be replaced by a one-day floor.

155. In terms of the impact of these proposals, as the QIS3 spreadsheets contain specific sections dedicated to the trading book, it will be possible to assess the impact of the new proposals on this area of business.

IRB Approaches in the trading book.

156. IRB approaches should be used by IRB institutions to calculate their counterparty risk charges for items subject to trading book treatment. As regards specific risk, the Commission Services are considering the extent to which internal ratings should be recognised in the definition of 'qualifying items' in the trading book.

157. The Commission Services will continue to consider these proposals and related aspects further in the context of the ongoing Basel process.

Other amendments to CAD

158. ***Unsettled transactions.*** Changes are likely to be proposed that would allow institutions to bring unsettled transactions under the general framework for credit risk; at the same time, Annex II to CAD would be repealed.

159. ***Large exposures arising from counterparty risk in the trading book.*** There is the intention to introduce more flexibility for supervisors in the treatment of large exposures arising from counterparty risk of trading book items. These exposures could be treated either under CAD rules or under the general rules for large exposures on credit risk (Directive 2000/12/EC). In this latter case, exposures over the prescribed limits could be allowed on a case-by-case basis, subject to additional capital requirements. In relation to proposed modifications of the existing 'large exposures' regime, see Section 9 below. These changes would be introduced as amendments to Annex VI to CAD.

160. ***Credit derivatives in the trading book.*** As regards the treatment of credit derivatives, the current capital adequacy regime is silent. In order to submit these transactions to the general framework on market risk, rules should be introduced that clarify how to record/account for positions in credit derivatives when calculating position risk. The Working Document also contains additional provisions that cover internal hedges (i.e. credit derivatives offsetting non-trading book positions); specific risk offsets for trading book positions hedged through credit derivatives; and add-ons for counterparty risk.

[10] It should be noted that in the forthcoming proposal for a Directive on Investment Services and Regulated Markets (which should replace the Investment Services Directive), it is intended that commodity derivatives be included in the definition of 'financial instrument'.

161. ***Collective investment undertakings (CIUs).*** The Commission Services are likely to propose the introduction of a market risk treatment for CIUs booked in the trading book. For institutions trading in CIUs the risk comes from the impact of adverse market movements on the underlying assets held in the CIU rather than from the solvency of the CIU itself.[11] The new proposals would aim to increase the risk sensitivity of the capital charges by allowing the institution to: (i) look through the CIU, and into the composition of the CIU's portfolio; and (ii) apply a market risk charge. This would be based on the information available either publicly or in the mandate.

162. The Commission Services are continuing to work on a number of important aspects, including (i) the definition of CIUs eligible for look-through and market risk treatment; (ii) the treatment of CIUs that can amplify exposure to underlying risks by means of derivatives or borrowing; (iii) the viability/cost of the different methodologies; and (iv) the treatment of options on CIUs.

Section 7 – Supervisory Review Process

163. The foundational requirement of the new framework is that institutions should hold a level of own funds which is adequate having regard to the risk profile of the institution as a whole. This requirement means that an institution's capital is determined not just by those risks in respect of which minimum capital requirements are prescribed, but also by all other risks to which the institution is exposed and by the quality of the control environment, risk management strategies, etc. which obtain in the institution.

164. Accordingly, in relation to the determination of an institution's capital adequacy, there are two distinct yet significantly inter-related facets of the new framework. The first, which is contained for the most part in Title II of the Working Document, sets out the *minimum* capital requirements that must be complied with in relation to a specified range of risks – credit/counterparty risk, market risk and operational risk. The second, which is contained in Title III of the Working Document, addresses the requirement that an institution be adequately capitalised in relation to its overall risk profile.

165. Title III of the Working Document is essentially structured in two parts. Chapter 1 contains requirements addressed to institutions aimed at ensuring sound risk management, internal controls and assessment of capital adequacy.

166. Chapter 2 is addressed firstly to Member States, which are required to grant appropriate legal powers to national supervisors; and secondly, to supervisory authorities themselves, which are required to evaluate institutions on a systematic and consistent basis, to assess whether there are any weaknesses and to take the steps appropriate to address weaknesses detected. To promote harmonization, a mandatory minimum

[11] Currently, these positions are subject to a credit risk charge of 8% and a risk weight of 100 %, based on Annex I, paragraph 11 of CAD. The composition of the portfolio of the CIU is not relevant for the purpose of calculating the capital charge.

set of supervisory powers and a range of factors to be taken into account in the evaluation process are prescribed.

167. This draft proposed supervisory regime has been designed so that it is appropriately incremental and gradated. Where weaknesses are identified they are required to be addressed. At this stage supervisors are free to choose both the remedy to recommend and the means of communication to the institution (including informal ones).

168. If the supervisor considers that own funds are inadequate to an institution's risk profile and control environment, prudential measures are required to be taken as early as possible, but these remain to be decided by the supervisor and not prescribed in law.

169. Finally, a specific capital requirement shall be imposed if in the supervisor's opinion the inadequacy of own funds is unlikely to be rectified within an appropriate timeframe by other prudential measures. In the latter case, there is no choice for the supervisor as to the supervisory tool to use (increased own funds), but there is some space for assessment in relation to the likely effectiveness of alternative measures and to the timing of the application of the higher capital requirement.

170. Provisions designed to achieve appropriate transparency in relation to the Supervisory Review Process have also been incorporated in the Working Document. The general criteria and methodologies used by the supervisory authorities in carrying out supervisory review should be publicly available. Moreover, supervisors should communicate the analysis and results of their evaluation and review as a minimum to the institutions on which prudential measures are imposed.

171. It is proposed to prohibit the publication of requirements imposed by supervisors on individual institutions to hold additional capital would be prohibited. In this respect, the Commission Services, supported by the majority of Member States, re-confirm the arguments and the conclusion set out in the paragraphs 264-268 of CS CP2.

Supervisory convergence

172. Under the existing framework, rules concerning the role and action of supervisory authorities are relatively limited. Member States are required to have established authorities empowered to supervise credit institutions and investment firms. These authorities must confirm compliance by institutions with the minimum requirements prescribed by the legislation and take appropriate steps to ensure compliance in the event of a breach of those requirements by institutions.

173. The proposed new capital adequacy framework is more complex than the existing framework. Supervisory judgement and discretion will play a central role in its implementation and success. Not only is supervisory approval necessary for institutions wishing to adopt the more advanced approaches under Title II, but as described above, the requirement that institutions are adequately capitalised in relation to their risk profile as a whole is a fundamental aspect of the framework.

174. This means in short that under the new regime there is scope for potential divergence in the application of the new framework in different jurisdictions.

175. For the Commission Services, ensuring that the new framework is implemented consistently across the EU and does not give rise to inter-jurisdictional competitive distortions is a key aspect. One way in which this question is addressed is through appropriate harmonisation of the principles and requirements applying to supervisory authorities in carrying out their responsibilities under the new regime. In developing proposals in this regard, as described above, the Commission Services are seeking to strike the right balance between harmonised implementation on the one hand and the need for an appropriate scope for supervisory discretion and judgement on the other. The Commission Services consider that the Title III proposed provisions as outlined above strike the appropriate balance in this regard.[12]

176. A further centrally important factor in achieving a level playing field will be the establishment of appropriate structures for the promotion of supervisory convergence in the implementation of the new framework. The Commission, on behalf of the Danish Presidency, has recently launched a consultation on improving the way the EU institutions draw up, adopt and put into effect legislation on financial services including banking. A central objective is to strengthen supervisory practices and boost regulatory convergence between the Member States.

Section 8 – Cyclicality

177. Financial markets and intermediaries are part of the macroeconomic cyclical process, and thus new rules involving these markets and institutions need to be evaluated in this context. The draft proposed new capital adequacy regime will represent a large step towards a closer alignment of regulatory capital with the risks to which institutions are exposed. This closer alignment will bring significant benefits in terms of increased regulatory robustness, improved competitive equality, enhanced economic efficiency, etc.

178. As a consequence of this improved risk sensitivity, regulatory capital requirements are likely to vary with the general business cycle. Concerns have been expressed that this may have negative results in terms of the deepening of recessionary effects during economic downturns.

179. These concerns have informed developments in the proposals for the new capital framework. An important development since CP2 in relation to the mitigation of cyclical effects is the decision to flatten the risk weight curves in the IRB Approach. The beneficial effects are clear. In time of an economic downturn where average credit quality deteriorates, the increase of capital requirement is lower under a flatter risk weight curve. Consequently the increase in regulatory capital requirements in time of recession will be lower under the new proposals than under the previous proposals.

[12] In developing the current draft proposals in relation to this issue, the Commission Services are grateful for the significant advice and assistance provided by the Groupe de Contact (of European banking supervisors).

180. Another requirement which mitigates cyclical effects is that institutions must use a lengthy time horizon in assigning ratings and take into account adverse economic conditions. If these effects are recognised properly in the assessment of a borrowers credit quality, the likelihood for a deterioration of its credit quality is lessened and so, consequently, is the likelihood of an increase in regulatory capital requirements.

181. Capital held over and above the minimum IRB capital charges will help to mitigate the need to raise additional capital or reduce asset levels in an economic downturn. To give supervisors a point of reference for assessing whether additional capital is necessary to address the risks of business cycle related-deteriorations in asset quality, institutions employing the IRB Approach under the new framework will be required to carry out cyclicality stress tests.

182. The Commission Services believe moreover, that as well as having potentially pro-cyclical effects, the new framework could have important counter-cyclical properties. In particular, a key aspect of the new regime will be its encouragement of improved risk measurement and management standards amongst institutions. Such improvements, in the context of the risk to institutions arising from potential changes in the economic environment in which they operate, may be thought likely to lead to their being in a better position to withstand such cyclical changes than might otherwise be the case.

183. In the end there is clearly a balance to be struck in relation to all of these aspects. The Commission Services believe that the proposals as now developed represent the appropriate balance between the demands of risk sensitivity of regulatory capital requirements and concerns as to potential cyclical effects.

184. Title III (Pillar 2) text in relation to cyclicality stress tests has not at this stage been incorporated into the Working Document. However, the Title II requirement to carry out stress tests in relation to this aspect is included at Annex D-5, paragraphs 36 and 37.

Section 9 – Large exposures

185. The Commission Services are reviewing the large exposures provisions of Directive 2000/12/EC with a view to introducing necessary consistency changes arising from the proposed new solvency regime as set out in the Working Document. As indicated in CS CP2, a full review of the large exposures regime is not being carried out at this stage.

186. The consistency proposals which are under development, and which will be included in the Commission Services third consultative document., address a number of aspects. Central to these is the question of the extent to which the proposed new credit risk mitigation framework should be available in the large exposures regime.

187. A key aspect in the considerations in this regard is that while the proposed provisions in relation to the solvency framework are designed to provide appropriate capital coverage for credit risk on a continuing basis and in the context of assumptions and calculations applied at a portfolio or asset

category level, those in relation to large exposures are designed to address stressed situations in the context of counterparty-specific large exposures. The Commission Services consider that it is desirable to introduce as much continuity as is consistent with the above considerations between the credit risk mitigation framework applied to the solvency regime, and that applied to the large exposures regime.

188. The proposals under consideration include, permitting competent authorities to allow institutions which opt to use the Comprehensive Method for Financial Collateral under the solvency framework, also to use this method in calculating their compliance with large exposures limits. To ensure the prudential soundness of this proposal, this would be accompanied by requirements that institutions report all large exposures in both their gross and net amounts to competent authorities[13] and that they report their indirect exposures to the issuers of such collateral. There would also be Title III requirements for institutions using this approach. They would be required to carry out stress tests including in relation to the realisable value of collateral taken against large exposures.

189. For institutions using the Simple Method for financial collateral under the solvency regime, the current framework, including Article 49(7)(o) would in general terms continue to apply.

190. In relation to institutions adopting the IRB Advanced Approach, consideration is being given to permitting them, subject to the approval of their competent authorities, to make use of their own estimates of the effects of collateral (subject to their demonstrating their ability to break out these effects from their LGD estimates generally).

191. In relation to unfunded credit protection, it is likely to be proposed that guarantees and credit derivatives may be recognised in the same way that guarantees may be recognised under the current large exposures provisions, subject to compliance with the eligibility and other requirements prescribed under the new solvency framework.

[13] This will represent a continuation of the current situation under Articles 48 and 49 of Directive 2000/12/EC, but with the disapplication of the Article 48(3) exemption to institutions using the Comprehensive Method.

Part 3 – Brief Guide to the Working Document

192. The purposes of this part of the Cover Document is to provide a brief reader's guide to the Working Document as published on the Commission's website. It is not intended to provide a substantive discussion of the contents of the Working Document.

193. It may be noted that some provision numbers in the Working Document do not have draft text associated with them. Unless otherwise indicated, this does not represent omitted text. Rather it is a function of the process adopted in developing the directive structure.

General provisions

194. Articles 2–5 of the Working Document set out the foundational provisions for the new framework as it is likely to be proposed.

195. Article 2 sets out the overarching requirements which underpin the framework as a whole. In particular it is prescribed that institutions have an obligation to maintain at all times own funds which are adequate having regard to the overall risk profile of the institution. Foundational requirements in relation to institutions' risk management and controls and disclosure obligations are also established.

196. The second part of Article 2 sets out the general obligations of competent authorities – that is review and evaluation, and intervention as appropriate.

197. Article 3 sets out the overall obligation on institutions in respect of minimum levels of capital relating to the risks covered by Title II of the Working Document. A 'building block' approach is adopted in this regard. Institutions are required to hold capital which is at all times more than or equal to the sum of the capital requirements prescribed in relation to each of the risks identified in the article. This of course represents minimum requirements and does not prejudice the contents of Article 2. The interaction of Articles 2 and 3 means that institutions are obliged to hold own funds beyond the minimum levels, in relation both to risks included in Article 3 and to risks not included there, where the risk profile of the institution, including its risk management and controls, indicate that that is necessary. This aspect is covered in detail in Title III of the Working Document.

198. The interaction of Articles 2 and 3 is further elaborated by Article 5. In carrying out their capital adequacy assessment processes, institutions are prohibited from assessing to Title II risks less capital than is prescribed under that Title. In other words, in determining their capital adequacy, institutions are prohibited from second guessing the Title II requirements so as to allocate Title II risk-related capital to Title III risks. This proscription applies also to supervisory authorities in carrying out their evaluation of institutions' capital adequacy assessment processes. The wording of Article 5 is at an early stage of development.

199. The above-described provisions also connect directly with Article 127(5) of the Working Document which addresses the situation that arises if an

institution breaches its capital requirements. This provision is based on the existing similar provisions in Directive 2000/12 and CAD and requires Member States to ensure that the institution in question takes appropriate steps to achieve compliance with the requirements as quickly as possible. The provision applies to requirements under Title II and to capital and other requirements imposed by supervisory authorities under Title III.

Scope of application

200. The scope of application section aims at identifying the 'levels' at which capital requirements have to be imposed and applied to the different entities in a banking / investment firms group in order to make sure that the group and its component parts are financially sound and stable.

201. Individual credit institutions and investment firms must, as a first step, be adequately capitalised on an individual basis so that capital is readily available for the protection of depositors and investors (Article 16).

202. Capital requirements applied on a consolidated basis are a further key method for ensuring the integrity of capital in credit institutions and investment firms of the group by eliminating multiple gearing of own funds instruments (Article 17).

203. In the cases where a group is sufficiently complex to contain one or more sub-groups, it may be necessary to strengthen solvency supervision by requiring capital obligations to be fulfilled on a sub-consolidated basis also. This aspect is addressed by Article 18 of the Working Document. Requirements are imposed in this regard in the case of cross-border sub-groups. Other situations where sub-consolidation may be required are left to the prudential assessment of supervisory authorities.

204. Article 21 contains the proposed new rules concerning the alternative to consolidated capital requirements for investment firms groups meeting the strict eligibility criteria set out in the Article.

Standardised Approach

205. Articles 26 to 40 of the Working Document together with Annex C establish the Standardised Approach for the calculation of credit risk capital charges.

206. Article 27 prescribes the methodology for the determination of exposure values for asset and off-balance sheet items. This exposure value is multiplied by the relevant risk weight in order to produce the risk weighted asset amount which is the basis for calculation of the capital charge (Article 26).

207. Article 28 sets out the list of classes to which assets and off-balance sheet items are attributed. The list of possible risk weights to be applied is set out in Article 29.

208. The application of risk weights to individual items based on the asset class and external credit assessments by recognised external credit assessment institutions (ECAIs) is prescribed in detail in Annex C. As mentioned previously, where an external credit assessment is not available then the maximum risk weight (except in the case of 90 days past due items) is 100%. This means for corporate borrowers which are not externally rated,

the minimum capital charge remains the same as under the current framework.

209. Article 30 to 35 prescribe in detail the rules for the use of external credit assessments. Articles 36-40 and Annex C-2 address the recognition of external credit assessment institutions by competent authorities, and the mapping of their assessments into the scales of credit quality steps prescribed under Annex C-1.

IRB Approach

210. The provisions relating to the IRB Approach consist at the moment of Articles 46-51 and 146, and Annex D. In addition, paragraphs 46-55 of Article 1 contain a number of key IRB definitions.

211. Article 46 sets out the requirement for supervisory approval for use of the IRB Approach. Article 47 prescribes the categorisation of exposures into different asset classes and sub-asset classes and contains relevant definitions.

212. The availability of Foundation and Advanced Approaches in relation to different asset classes is dealt with in Article 48.

213. Article 49 sets out the central requirements in relation to IRB institutions' internal ratings and risk estimates systems and processes.

214. Article 50 contains provisions concerning progress from the Standardised Approach to the IRB Approaches and from the Foundation to the Advanced IRB Approach. Paragraph 2 of this Article provides for ongoing use of the Standardised Approach for exposures to institutions and sovereigns by institutions using the IRB Approach for other asset classes.

215. For the moment Article 51 contains the draft outline of the Strand 1 provisions relating to the methodological requirements for the use of the IRB Approach. Work is ongoing to develop the principles, rules and requirements governing and constraining the implementing and technical provisions of Annex D-2 to D-6 in relation to this aspect.

216. Article 146 contains a number of transitional provisions relating to the IRB Approach.

217. As mentioned above the Annex contains technical details and specific provisions. Annex D-1 provides technical IRB definitions and specifications. Annex D-2 contains in general the risk weight formulas for the calculation of minimum capital requirements for all asset classes. Furthermore, in this Annex the risk weights for specialised lending exposures which are slotted into the supervisory risk weight buckets are provided.

218. The input parameters for the risk weight formulas are set out in Annex D-3 which gives detailed information about PD, LGD and Maturity (classified according to the different asset classes). Annex D-4 sets out how to calculate exposure at default. Annex D-5 contains the minimum requirements for rating systems and criteria for the estimation and validation of risk parameters. In Annex D-6 the provisions for the recognition of specific and general provisions to cover expected losses are

laid down. Annex D-7 contains the 'slotting criteria' in relation to Specialised Lending exposures.

Credit risk mitigation

219. Articles 66–70 set out the draft key principles for the recognition of techniques of credit risk mitigation (CRM) under the Standardised and IRB Foundation approaches in the new framework. They seek to provide the central requirements that should be met for a CRM technique to be recognised. A 'horizontal' approach is adopted. The approach is not limited to specific types of CRM – rather it is sought to identify cross-cutting principles that may be applied to different types of CRM.

220. This horizontal approach is reflected in the structure of Annex E, which is divided into a number of sections reflecting key aspects that apply, for the most part, to all forms of CRM. These are (1) eligibility, (2) minimum requirements, (3) calculating the effects of CRM, (4) maturity mismatches, (5) combinations of CRM techniques, and (6) basket CRM techniques.

221. Internal to each of the first four of these sections, there is a central division. This is between funded credit protection (such as collateral) and unfunded credit protection (such as guarantees and certain types of credit derivatives).

222. Finally there are further divisions based on whether a technique is used under the Standardised Approach or the IRB Foundation Approach and also, where relevant, based on the options chosen by an institution – for example whether it decides to use the Simple Method or the Comprehensive Method for financial collateral; or whether it decides to use 'Supervisory' or 'Own Estimates' volatility adjustments for calculating the amount of collateral to be recognised.

223. By adopting this horizontal approach, the Commission Services consider that the proposed provisions may be seen to be logically structured, robustly and transparently grounded in central principles set out in the articles, and capable of amendment within the constraints of these principles if necessary to reflect market or regulatory innovation over time.

224. The putative Title III (Pillar 2) text relating to 'residual risk' arising from the use of CRM techniques is not included in the Working Document at this time.

Asset securitisation

225. The draft proposed treatment of asset securitisation is dealt with in Articles 81–85 and Annex F of the working document. The draft provisions in this area may be considered a little less advanced in development than in other areas. In particular, this is the case in respect of the provisions to be included in the articles. The Commission Services are continuing to work to develop the governing principles that should form the content of a number of the articles in relation to this topic.

226. A number of key definitions – including those of 'securitisation', 'tranche' and 'securitisation position' are set out in Article 1 of the directive. Other

draft definitions, which may be regarded as less central are contained in the Annex.

227. The provisions are divided under a number of heads. Firstly there are the requirements that must be met in order for an originating institution to achieve recognition of risk transfer (and thus reduction in its capital requirements). These are set out for traditional securitisations in Article 82 and Annex F-2. For synthetics, the relevant section of the Annex is F-3, which also details the extent to which capital requirements may be reduced.

228. Article 83 and Annex F-4 contain the provisions relating to the recognition of external credit assessments for use in relation to securitisation capital requirements. These provisions also address the issue of mapping by supervisory authorities of external credit assessments into risk weight buckets. (This aspect is incomplete as of the publication date of this document.)

229. The capital treatment for securitisation positions under the Standardised Approach is prescribed in Annex F-5. This includes the treatment of liquidity facilities and securitisations of revolving assets under the Standardised Approach.

230. Annex F-6 sets out the IRB capital treatment for securitisation positions. This treatment is based on two methods – the Supervisory Formula Method and the Ratings Based Method. The circumstances in which each of these methods should be used are prescribed at the beginning of the section.

231. The putative Title III (Pillar 2) text relating to asset securitisation is not included in the Working Document at this time. This aspect continues to be worked on both in the Basel and the Commission Services processes.

Trading book

232. In the Working Document, the provisions on the trading book are found in a number of different locations. It is important to consider that CAD (Directive 93/6/EEC) is for the most part not intended to be repealed and that most of the existing provisions on market risk will continue to be located there. In particular, the market risk charges for items subject to trading book treatment shall continue to be specified in Annexes I, and III-VIII of CAD. These will undergo only minor amendments (some are already specified in Article 103).

233. The major changes with regard to the existing CAD rules will take the form of new rules in the new capital adequacy regime, with repeal of the relevant existing CAD rules. The guiding principle has been to have in the Working Document two types of rules related to market risk and the trading book:

(i) rules dealing with credit risk, including counterparty and settlement risk. These can be found in Article 102 and Annex G-5. CAD Annex II should be repealed; and

(ii) rules that can affect the allocation of items in the trading or non-trading book, and consequently the regulatory treatment applicable to

positions and exposures: notably, the provisions on trading intent and prudent valuation. These can be found in Article 1, definitions 96-102 and in Articles 96-99; corresponding CAD definitions 5 and 6 and Article 6 should be repealed.

234. As regards specific risk, it is considered that there should be links with the treatment of credit risk in the non-trading book. Amendments to the current rules have been introduced, the purpose of which is to deal with specific risk under the new Directive: Article 1 (103), Article 101 and Annex G-4 cover this issue. As a consequence, Article 2, paragraph 12 and Annex I, paragraphs 14 and 32-33 of CAD should be repealed.

235. As regards credit derivatives, the trading book treatment is almost fully covered in the Working Document, except for item (i) below. It consists of the following:

(i) rules on the recording of positions for the purpose of calculating position risk; these shall remain in Annex I of CAD, for reasons of completeness; this should be amended to introduce new wording, as specified in Article 103, paragraph 4;

(ii) wording on internal hedges (Annex G-1);

(iii) rules for specific risk offsets for credit derivatives booked in the trading book (Annex G-4); and

(iv) rules on counterparty risk add-ons (Annex G-5).

236. The introduction of a market risk treatment based on look-through for collective investment undertakings is described in Article 100 and Annex G-3.

Operational risk

237. A minimum capital requirement, to serve as a buffer against adverse operational risk events, is prescribed in Articles 106 to 113 and in Annex H (H-2 to H-7). Operational risk is defined in Article 106.

238. The three different possible methodologies – Basic Indicator Approach (BIA), Standardised Approach (STA), and Advanced Measurement Approaches (AMAs) - for calculating the capital requirement are outlined in Articles 108, 109 and 110 and described in detail in Annex H-2, H-3 and H-4 respectively. Annex H-3 and H-4 include tentative qualifying criteria for the STA and for AMAs. The conditions under which a combination of the different methodologies might be used will need to be developed (placeholders: Article 111 and Annex H-5).

239. As regards the possible recognition of insurance as a risk mitigation technique, possible general conditions are tentatively set out in Annex H-2, H-3 and H-4. The common part of the eligibility criteria for insurance across the three possible approaches is presented in Annex H-6. As mentioned in Part 2, Section 2 above, text in this regard is tentative and its inclusion is subject to satisfactory resolution of the prudential concerns outlined.

240. The provisions pertaining to specific categories of investment firms/investment services are contained in Articles 112 and 113 and in

Annex H-2 and H-3. The related risk management standards are grouped in Annex H-7.

241. Basic risk management standards should be fulfilled by every institution. They are intended to serve as a first line of defence against operational risk. The relevant provisions are to be found in Section 5 of Annex I-1 of Title III.

242. There should also be a set of basic disclosure requirements, that should be proportional to the operational risk profile of the institution. The detailed disclosure requirements concerning operational risk will be developed at a later stage, as part of Title IV.

Supervisory Review Process

243. Provisions on Supervisory Review are contained in Title III of the Working Document. Provisions addressed to institutions are located in Chapter 1 and Annex I-1 and I-2.

244. Provisions addressed to competent authorities are included within Chapter 2 and Annex J-1 to J-3. In this case, principles on the supervisors' evaluation process are laid down in Article 126 and detailed in Annex J-1. Requirements on competent authorities' minimum legal powers and criteria for the adoption of prudential measures on institutions are set out in Article 127; the minimum legal powers mentioned above are listed in Annex J-2, paragraph 1. Factors to be covered at a minimum in the supervisors' evaluation process are laid down in Annex J-2, paragraph 2.

245. Finally, provisions on transparency and accountability of Supervisory Review are articulated across Article 128 and Annex J-3.

Market Discipline

246. The Commission Services intend to articulate this segment of draft legislation into (i) a set of basic requirements, (ii) some additional criteria for their application, (iii) the disclosures required from all institutions (subject to the materiality criterion) and, (iv) the disclosures which are qualifying criteria for the use of particular instruments or methodologies.

247. At the present stage, the first two elements mentioned above are published in draft (i.e. Title IV, Articles 136-138 and Annex L-1), while the other two items (Annex L-2 and L-3) will be published later after the work ongoing at EU and Basel level in this area has been completed. Having regard to the aspects discussed at paragraphs 84, 85 and 122 above and to the general approach outlined in Part 1, divergence between the Basel and Commission Services proposals is not envisaged.

248. The scope of application of disclosure requirements is laid down in Article 136. It is different from that of capital requirements, as disclosures in a group will in principle be provided by the top parent undertaking only.

249. General and additional criteria on disclosure requirements are laid down in Article 137 and will be detailed in Annex L-1, covering the materiality principle, the treatment of proprietary and confidential information, the minimum frequency of disclosures, the means and location of publication of disclosures, and the overriding powers of supervisors.

250. Requirements on disclosure of risk management objectives and arrangements and disclosure policy are set out in Article 138 and will be detailed in Annex L-1, paragraph 4.