

Investment firms and credit institutions: capital adequacy. Recast

2004/0159(COD) - 14/07/2004 - Legislative proposal

PURPOSE : to recast Directive 93/6/EC on the capital adequacy of investment firms and credit institutions.

LEGISLATIVE ACT : Directive of the European Parliament and of the Council.

CONTENT : The Basel Accord in 1988 (Basel I) led to the adoption of minimum capital requirements across over 100 countries. The EU adopted, inter alia, Directive 2000/12/EC which addressed credit institutions' risks arising from credit-granting activities. Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions extended both the credit risk and market risk rules to investment firms. The existing rules have made a significant contribution to the single market and high prudential standards. However, various important shortcomings have been identified. These include the following:

- crude estimates of credit risks result in an extremely crude measure of risk and is in danger of falling into disrepute;
- scope for capital arbitrage: innovations in markets have enabled financial institutions to effectively arbitrage the mismatch between institutions' own allocation of capital to risks and minimum capital requirements.
- lack of recognition of effective risk mitigation: the present Directives do not provide appropriate levels of recognition for risk mitigation techniques.
- incompleteness of the risks covered under the existing directives, including operational risk, which are not subject to any capital charges.

There is strong consensus that the present situation is unsustainable. Capital requirements and risks would continue to be misaligned resulting in limited effectiveness of the prudential rules and increased risks to consumers and financial stability. The Commission has presented a proposal on re-casting Directive 2000/12/EC (Please see COD/2004/0155.) This proposal specifies how the requirements apply to individual investment firms, groups of investment firms and mixed groups.

It prescribes, for credit institutions and investment firms, the minimum capital requirements for market risk. The treatment of positions in collective investment undertakings and credit derivatives and a number of other modifications for increased risk-sensitivity are new. It extends the rules on capital requirements for credit risk and operational risk in Directive 2000/12 to investment firms, as at present. New credit risk elements include the provision of a treatment for credit derivatives and an amended measure of exposure for repurchase transactions and securities/commodities financing transactions. For operational risk there are significant modifications to take account of the specific features of the investment firm sector, with an option to continue the 'Expenditure Based Requirement' for investment firms falling into the low-, medium- and medium/high-risk categories.

The new proposal incorporates the obligation for credit institutions (see Directive 2000/12), for investment firms to have in place effective internal risk management systems. Given the diversity of the institutions covered, these requirements will have to be met on a proportionate basis. It also applies the requirement in the new proposal for Directive 2000/12/EC to investment firms to have internal processes

to measure and manage the risk they are exposed to and the amount of capital ('internal' capital) they deem adequate to support those risks. It adds to the existing risk management requirements for investment firms in Directive 2004/39/EC.

Finally, Directive 93/6 needs to keep pace with market developments. The necessary flexibility is brought by distinguishing between core and technical rules (particularly in the annexes) that will need adaptations in the short to medium run. The technical Annexes should be able to be modified following a rapid procedure. To reflect expected further important developments in regulatory practice in the coming years, a review clause is included for the treatment of counterparty risk.