Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 14/07/2004 - Legislative proposal

PURPOSE: to recast Directive 2000/12/EC and lay down rules on the business of credit institutions and their prudential supervision.

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 new proposal aims to ensure that financial institutions' capital is more closely aligned with the risks they face and sets out new rules on capital requirements. The framework consists of three different approaches allowing financial institutions to choose the approach most suited to them: simple, intermediate and advanced. The simple and intermediate approaches would be available by end 2006 (but banks could still opt to apply the current rules until end 2007) and the most advanced approaches from end 2007. In addition, specifically designed rules on capital requirements for financing small- and medium-sized enterprises indicate lower capital requirements for lending to such institutions and preferential treatment for certain types of venture capital. The new framework also recognises the lower risks associated with retail lending to individuals – both for general purposes and for house purchasing – by introducing lower capital requirements for these types of lending.

To reduce single market barriers arising from the responsibilities of separate national supervisory authorities, supervisors will be required to work more closely together, including in deciding on applications by financial institutions to use the more sophisticated methodologies. The Committee of European Banking Supervisors will have an important role in promoting consistency of approach between different supervisors.

The new provisions replace the existing solvency ratio requirements for credit risk and introduce two methods to calculate risk weighted exposure amounts. The Standardised Approach is based on the existing framework, with risk weights determined by the allocation of assets and off-balance sheet items to a limited number of risk buckets. Risk sensitivity has been increased by the number of exposure classes and risk buckets. There are lower risk weights for non-mortgage retail items (75%) and residential mortgages (35%). A 150% risk weight for assets which are 90 days past due (100% for residential mortgages) is introduced. The use of credit rating agencies' ratings to assign risk weights where these are available is permitted. The Internal Ratings Based (IRB) approach permits credit institutions to use their own estimates of the risk parameters inherent in their different credit risk exposures. These parameters form the inputs into a prescribed calculation designed to provide soundness to a 99.9% confidence level.

The 'Foundation' Approach allows credit institutions to use their own estimates of probability of default, while using regulatory prescribed values for other risk components. Under the 'Advanced' Approach, credit institutions may use their own estimates for losses given default and their exposure at default. Credit institutions are allowed to use pooled data in the estimation of risk parameter values. This allows smaller credit institutions to apply a more risk sensitive approach to calculating capital requirements.