

Economic and Financial Affairs Department

21 October 2003

**REVIEW OF CAPITAL REQUIREMENTS FOR BANKS AND INVESTMENT FIRMS
("BASEL-II")
COMMISSION SERVICES THIRD CONSULTATION PAPER**

UNICE welcomes the opportunity to comment on the Commission Services' third consultation paper on the review of capital requirements for banks and investment firms. It acknowledges the significant improvements that have been made to the Basel Committee's original proposals through the various consultation procedures at the global level and the structured dialogue at EU level, in particular with regard to the firm-size adjustments to risk weights of loans to corporates and SMEs under the Standardised Approach and the IRB Approach.

In spite of these improvements, companies are still worried that the new framework may not only lead to a tightening of loan financing, but also to more difficult access to equity financing. UNICE wants to ensure that the new framework for capital requirements does not impact negatively on companies' access to capital and on capital charges while at the same time aligning the capital position in banks and investment firms to their overall risk profile in order to promote systemic stability. We would like the Commission to take into account the following points with regard to its forthcoming proposal for an amended EU Capital Adequacy Directive (CAD-3).

- **Procyclical effects of the Basel-II framework**

Procyclicality of lending is an intrinsic concern of the new regulatory framework. The tendency of risk-based capital requirements to fluctuate with the business cycle is indeed an inevitable side effect of the new risk-sensitive regime. It is, however, difficult to estimate at this point in time the changes in banks' lending behaviour prompted by the new regime. Procyclicality is not a new issue since it already exists under Basel-I. This is the reason why banks hold economic capital - which is greater than the regulatory capital - to serve as a capital buffer in times of recession. However, if the procyclicality of lending under the new framework for capital requirements turned out to increase excessively, a flexible procedure to update the new legislative framework quickly could help to accommodate desired changes.

UNICE therefore believes that the European Commission should carefully monitor developments for adverse effects on companies of the new regime, and ensure that the new legislation can be amended quickly through a comitology fast-track procedure.

- **Impact on equity and venture capital finance**

UNICE welcomes the Commission's view that firm size adjustment to risk weights should be available for equity exposures to SMEs, by analogy with the treatment of loans to SMEs via the retail approach in the Standardised and in the Advanced IRB Approach, and to the "discount" applied to capital requirements in the IRB approach, reflecting the relative risk exposure of these holdings. While taking into consideration the Commission's premise that the capital requirements for venture capital and equity investments must reflect the fact that the loss in the event of the recipient's default is higher for an equity holder than for a loan provider, UNICE nevertheless believes that current rules might lead to a more restrictive attitude of banks and investment firms vis-à-vis such exposures.

This potential problem might be alleviated by the creation of a retail approach that would apply reduced risk weights to equity exposures to SMEs compared with unrated claims on corporates. Alternatively, it could be addressed through a "discount solution" that would allow for reductions in capital requirements related to equity holdings in small and medium-sized businesses with annual sales of less than 50 million Euros. As with loans, these reductions should be inversely proportional to the annual sales of the firm.

- **Legislative procedures**

UNICE welcomes the Commission's intention to provide for a legislative procedure to transpose the Basel-II accord into EU law that allows speedy adjustment of provisions contained in the annexes to the Basel Committee's proposals. While general comitology procedures can achieve this, UNICE nevertheless favours a legislative procedure under the Lamfalussy process as it provides for stronger consultation of market participants. To this end, UNICE supports the extension of the Lamfalussy approach to banking and insurance, on the condition that certain adjustments to the procedure are made beforehand in order to provide for better representation of market participants and the European Parliament and to ensure high quality of regulatory approaches. UNICE submitted its opinion in this regard in July 2003 in its comments to the Interinstitutional Monitoring Group.

- **Cross-border concerns about supervisory discretion**

UNICE strongly promotes supervisory convergence in the manner of application of the new framework, so as to ensure a consistent application of the new regime across Member States, and possibly across the world. In this respect, we urge the Commission to do its utmost to ensure that mutual recognition between home and host supervisory control is adopted, in particular with the United States. To avoid regulatory burdens and inefficiencies, reciprocity and mutual recognition have to be the cornerstones of the process to ensure equal treatment and internal market convergence. In particular, coordination between host and home supervisors should be ensured in the supervisory review process of international groups, including the approval of Advanced IRB models and Advanced Measurement Approach (AMA) models at group level, and supervision on the consolidation of capital at group level. EU financial institutions operating in non-EU countries should not be penalised by the potential burden arising from divergent requirements between their home and host supervisory authorities.

Basel-II contains a large number of 'national options'. Regarding EU implementation, the different national options might endanger the level playing field and increase compliance costs for cross-border financial groups. We therefore call for every effort to be made to ensure co-operation between EU national regulators and to rationalise these national discretions, so that enforcement and implementation of the new rules is as consistent as possible throughout the EU. We fear that there might be divergences in interpretation and

application of the new framework by national supervisors. These national discretions could give rise to competitive inequalities between institutions in different jurisdictions, additional reporting costs for financial institutions operating in different Member States and consequently, regulatory arbitrage. While we acknowledge that national discretions can be necessary in order to take into consideration local market conditions, the Commission should nevertheless scrutinize national options allowed for in the Basel Accord and identify those that could lead to distortions of competition.

Practical cooperation and information exchange among supervisors to facilitate effective implementation is important to this end. There should also be appropriate mechanisms in place to provide for enhanced transparency of supervisory approaches, in particular concerning how national regulators are planning to exercise the national options available under the directive.

- **Importance of consistency in application Basel-II/CAD-3**

Consistency in time and in substance between Basel-II and CAD-3, taking account of EU specificities, should be a guiding principle for the European Commission in order to ensure a coherent framework and an international level playing field, in particular for large EU financial institutions that also operate in non-EU countries.

We welcome the fact that the regulators will be obliged to disclose their supervisory methods as this should lead to greater consistency of approach across Europe and the greater transparency will inspire greater confidence among companies. The greater consistency of approach created will help to ensure a single market across Europe. It will also assist firms in understanding the regulatory requirements and therefore in complying with them. Banks and regulators will need to work together to provide greater transparency and clarity.