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# PROPOSAL FOR A DIRECTIVE ON EU CAPITAL REQUIREMENTS

## UNICE COMMENTS

## Introduction

UNICE welcomes the opportunity to comment on the Commission's proposals for implementing the new Basel Accord on capital requirements into EU law. In UNICE's view, a regulatory framework that aligns the capital requirements of financial institutions more closely with the economic risks of their transactions can help raise awareness for companies' financial needs and increase the inclination and the possibilities of banks and investment firms to provide funding for the corporate sector.

Companies are banks' and investment firms' transaction partners as issuers, borrowers and users of financial services. As such, it is vital for them that these services do not become more costly or impact negatively in any other way on their access to finance in response to the new regulatory framework. This is true for loans and equity as well as for other forms of capital.

In this regard, UNICE would like to draw attention to some general principles the Commission proposals should reflect and to make detailed comments on some provisions of the proposals regarding Pillar 1 of the Basel Accord that seem to carry the risk of restricting the availability of capital for companies.

Currently, own funds requirements of financial institutions are regulated by EU Directive 2000/12 based on the Basel Accord of 1988 and its amendment in 1996 which require institutions to hold minimum regulatory capital of 8% of their risk-weighted assets to offset credit risk and market risk.

The Commission's proposal for a new Capital Requirements Directive (CRD) was adopted in July 2004 in order to implement the preceding Basel-II Accord in the EU. It was mainly developments in financial institutions' risk management procedures that necessitated a new approach to calculating minimum required capital charges based on a closer alignment of own funds with the real risks of those institutions' exposures. Apart from credit and market risk, the Basel Accord also foresees that banks should hold capital against operational risk.

## A. General comments

In UNICE's view, the directive will have to fulfil the following requirements:

- **EU-wide consistency and level playing field**

Differences between countries in the implementation of the directive that will lead to unequal treatment of banking groups located in those countries will have to be kept to the minimum necessary for prudential reasons. There must also not be any significantly different treatment of capital requirements for identical underlying business. Financial institutions which do

business predominantly with counterparties in other EU member states must not be at a disadvantage compared with institutions with a more domestic business focus. To this end, the number of national discretions provided for in CRD needs to be evaluated critically.

A level playing field is also necessary with regard to the different types of banks. In particular, the implementation cost of applying different rating procedures, notably the IRB approach, must be proportionate for small banks which tend to have a large retail loan portfolio.

- **International consistency**

The directive must be in line with the Basel Accord: requirements for banks concerning their loan and equity exposures that are not foreseen in the Basel Accord and that are not necessary for EU-specific reasons may in many cases make it more difficult for EU financial institutions compared with non-EU banks to provide capital to companies.

- **Support for SME financing**

The directive's provisions must not restrict the availability of finance for SMEs. They must reflect the fact that, due to the diversification effects of SME portfolios, the risk involved in small loans is lower than that involved in large loans. For the same reasons, they must recognise that equity exposures to SMEs and to small start-ups usually carry lower risk than equity exposures to large companies. In particular, small banks, which tend to hold a relatively larger portfolio of exposures to SMEs must not be impacted disproportionately. In this respect, there is a need for supervisors to provide flexibility in the practical application of the retail threshold to apply to SME financing such that this requirement would not potentially restrict the availability of funding to SMEs compared with current underwriting practices.

- **Provisions must correspond to market practices**

Supervisors' regulatory practices should be in line with banks' risk management techniques. For example, where risk is managed on a group basis, application of own funds adequacy rules and supervisory review must take place at the highest consolidated level and not at the level of the individual financial institution. This is particularly true for operational risk requirements where no sufficient data are available at the individual entity level.

- **Increases in capital requirements must be proportionate to the prudential benefit**

Issuers are concerned that a significant increase in capital requirements might be passed on to the financial institutions' customers without there being a proportionate prudential benefit.

- **Adjustability**

The directive must remain easily adjustable to market developments, in particular in risk management. This applies mainly to the technical annexes that must remain amendable in a comitology procedure. CEBS and the Commission should have a clear mandate to be able to change quickly with the necessary flexibility the annexes and some requirements in the articles of the directive under the Lamfalussy procedure.

## B. Detailed comments

### 1. Reducing national discretions

There are currently about 150 national discretions in the CRD proposal, many of which are not justified on prudential grounds. We support the CEBS proposals for eliminating a number of those discretions, but agree with the comments by the European Banking Federation (FBE) that further changes might be necessary for the sake of maintaining international competitiveness of EU banks' financing activities with regard to their corporate customers. The national discretions that are of major concern to financial institutions relate to the right of

member states to allow or prohibit the calculation of risk on a consolidated basis and the supervision of the adequacy of own funds on a consolidated basis.

- **Consolidation (individual or group level calculation of capital requirements)**

Compared with the status quo, some provisions regarding the possibility of group level calculation of capital requirements are more restrictive, such as the conditions laid down in Art.69(1). The waiver implied in this provision can only be applied, i.e. group consolidation can only be allowed by member states if the parent and the subsidiary are located in the same member state and if it does not include the parent undertaking.

In UNICE's view, increasing centralisation of risk management within banking groups is at odds with tightened provision to calculate own funds requirements on an individual basis. This provision does thus not provide a correct risk profile of the group as a whole. Also, leaving the national discretion would lead to different treatment of banking groups in different member states.

- **Supervision of adequacy of own funds**

Article 69(1) allows member states to decide at which level supervision of the adequacy of own funds is exercised. This implies that member states may decide to continue to apply own funds requirements on an individual basis even though a banking group meets the conditions of Article 69(1) that would entitle the supervisory authority to allow capital requirement calculation at group level. Rather, all member states should be required to exercise supervision at the consolidated level.

- **Risk weighting of intra-group exposures**

Article 80(7) foresees that member states can decide on the risk weights to be applied to intra-group exposures. They may exempt intra-group exposures from the application of risk weights only if the parent and subsidiary are located in the same member state. (para. 7(d).

In UNICE's view, intra-group exposures should be treated the same whether they are domestic or cross-border. Moreover, in the Basel framework, intra-group exposures are not risk-weighted. Thus, EU financial institutions will have to hold capital against a theoretical risk (there has never been any default on intra-group exposures) which will lead to a competitive advantage for US banks. The position of depositors and borrowers would be fully protected by the conditions, particularly condition (e).

## 2. Reducing banks' capital requirements for equity exposures

The probability of default and the loss given default values for equity exposures subject to the PD/LGD method have to be calculated by credit institutions under the IRB approach according to the provisions of Annex VII Part 2 Chapter 3. As it is of key importance to UNICE that the new framework will, in general, be supportive to building up a strong equity base in companies, in particular in SMEs and in start-ups, these rules need to be scrutinised closely with regard to their impact on incentives of potential private equity investors subject to the new requirements.

There is an unequal treatment in the proposed directive between banks whose home supervisor allows the use of the PD/LGD approach and banks whose home supervisor does not allow this approach. It is the only approach allowing a preferential treatment for what are

de facto “strategic investments” (venture capital). However, some home supervisors do not allow the use of this approach and thus the preferential risk weights for strategic investments are limited to banks allowed to use the approach. These preferential risk weights should therefore be extended to the other equity approaches to avoid unequal treatment in the EU (Annex VII-Part 1, 1.3. – Para.15).

**3. Wider recognition of risk-mitigating collateral when calculating risk weights**

This concerns in particular physical collateral typically provided by many SMEs. The new rules seem to be stricter than the current framework as the value of commercial and private real estate provided as collateral will have to newly assessed at a minimum once every year. Property values of real estate collateral provided for loans exceeding 3 million Euro or 5% of the own funds of the financial institution have to be evaluated at least every three years by an independent evaluator (Annex VIII, Part 2, 1.4. (8) lit. (b).

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