

## HM Treasury Consultation on CAD3 Summary of Responses

1. HM Treasury issued a consultation document on 3 December 2003 on the Commission's implementation of the new Basel Accord through the so-called CAD3 directive. The comment period for written responses ended on 5 March 2004.
2. During the consultation process, the Treasury heard from around 100 firms and organisations. 34 written responses were received from a wide range of interested parties. During the consultation period, the Treasury also held ten industry roundtable meetings, focusing on specific issues and sectors. Respondents to the consultation through all these channels included representatives from banks, building societies, consumers groups, investment firms, venture capitalists, small businesses, private investment managers and stockbrokers and academics, as well as various trade associations<sup>1</sup>.
3. This document summarises the main points that were raised during the consultation. Copies have been sent for information to the Commission, and to the Finance Ministries of the other EU Member States.

### ***Executive summary***

4. There was general agreement amongst respondents that the new prudential capital framework as it will be implemented in the EU will lead to improvements in risk management practices, and embody more risk-sensitive capital requirements, in line with the objectives of the new Basel Accord. Some noted that this would probably reduce the likelihood of a banking crisis in the future.
5. Respondents were generally uncertain about the impact of the new Directive on the price of their services, or on the economic capital they actually hold. One estimate suggested that the overall impact on economic output is likely to be beneficial, but very small, for Europe and the UK.
6. Many non-bank respondents noted that the Accord has been calibrated towards banks, and felt it was less suited for other types of firm. There were concerns that the underlying risks for many of these firms had not been properly assessed. It was noted that for some types of risk, regulatory capital requirements will increase rather than decrease as organisations apply the more advanced approaches. There was also overwhelming support for the general principle that capital requirements should be proportionate and take into consideration the size and complexity of the organisation. These respondents generally supported some divergence from Basel II in the EU application to alleviate these perceived difficulties.

---

<sup>1</sup> A full list of respondents can be found in the annex.

7. Particular areas of concern highlighted in this general context related to various aspects of the proposed treatment of investment firms, commodity derivatives markets, venture capital and project finance.

8. Generally, respondents supported the parallel implementation of Basel II and CAD 3. Some banks were concerned about the risks of further slippage in the implementation timetable, although some firms wanted more time to prepare for implementation.

9. Many respondents called for consistency and convergence in the implementation of the Directive across Member States. Several respondents were concerned about possible differences in application of the principles of the Basel Accord between Europe and the US. Many respondents also said that the number of national discretions allowed in the EU, and the extent to which they were taken up, would be one of the key factors determining competitive impacts between countries. The treatment of intra-group exposures and group consolidation was an important issue for several respondents in this context.

10. Most respondents suggested that greater supervisory transparency and cooperation would be needed to ensure consistency of implementation, particularly in relation to Pillar 2 (supervisory review).

### ***Implementation Issues***

#### a) Timing

11. Overwhelmingly, respondents were in support of parallel implementation of Basel II and the new European Directive. But it was noted that the EU legislative timetable will make achievement of this objective challenging. Some suggested that, if the US does not sign the new Basel Accord, then industry generally would be less willing to support an EU Directive designed to implement the Basel proposals.

12. There continues to be concern that the timetable for implementation of Directive is too optimistic, and likely to slip. This stems from uncertainties over the finalisation of the Basel Accord, and also concerns that the cost and resources required to develop and implement appropriate measurement and monitoring systems in the time frame proposed will be considerable for certain sectors and markets.

#### b) Flexibility

13. Respondents were in favour of a flexible Directive, that can be amended relatively easily to reflect subsequent changes to the Basel Accord. Flexibility would also enable adjustments to be made to reflect further innovation in financial markets.

#### c) Consistency of application

14. The need for consistency and convergence between countries in implementing the Directive was one of the main points raised. Many noted the large number of national discretions currently permitted, and uncertainties around how additional capital requirements under the supervisory review process might be imposed. Some were also concerned that Member States might implement rules that are super-equivalent to the Directive. Respondents therefore wanted greater clarity over the supervisory review process and setting of national discretions.

15. Some respondents suggested that the objective of consistency and convergence could be achieved through greater transparency (ie disclosure) of Pillar 1 and 2 capital requirements, as well as more intensive cooperation between supervisors. A particular concern was the need to define the relationship between home and host supervisors effectively. One suggestion from industry to achieve that was to adopt a lead supervisor model.

16. The other main concern over the supervisory review process was that it might be overly-prescriptive, which could hinder developments in risk management, and that it could be used as a means of imposing an automatic regulatory capital “add on” to Pillar 1 capital requirements.

d) Complexity and cost

17. Respondents suggested that the proposals in some parts seem overly complex. For instance, the treatment of credit cards, particularly when the complexities of securitisation requirements were overlaid, is extremely complex. It was felt that this may impede evolution in risk management and may also mean that firms will take time to adjust to the new process.

***Behavioural impacts of the proposed Accord***

18. Improved risk management may help mitigate procyclicality of the capital framework, but many respondents suggested that increased risk sensitivity may lead to the new regulatory framework becoming more procyclical. However, respondents generally do not support any further amendments to the directive to counter procyclicality, preferring instead that it be the subject of bilateral discussions between individual firms and their supervisors.

19. The fact that neither the Basel Accord nor the Capital Adequacy Directive have yet been finalised means that firms remain uncertain about both the changes in capital requirements that will result, particularly given supervisory discretion under Pillar II, and the subsequent impact on lending activity and lending rates.

20. If the Accord were to improve efficiency then the spread between borrowing and lending rates should fall. However one estimate suggests that the net impact on output is likely to be very marginal for Europe and the UK.

***The relationship between economic and regulatory capital***

21. There was agreement that the impact of changes in regulatory capital on the availability or pricing of credit will depend on whether such changes affect economic capital – the amount which firms desire to hold – because banks and credit institutions in the UK tend to price off economic capital.

22. Most respondents suggested that firms may hold a buffer over and above their required regulatory capital. To the extent that firms wished to retain such buffers, then changes to regulatory capital could lead to changes to economic capital and consequently prices.

23. Many respondents also suggested that certain sectors, such as unrated corporates and equity finance, might be subject to sufficiently large increases in regulatory capital requirements to put the new required regulatory capital above currently-held economic capital.

***Balance between improving risk management practices while minimising competitive distortions.***

24. Concerns were raised over the effects of certain boundary requirements and constraints in the proposed rules. For instance, in order to qualify as part of the retail portfolio, exposures to any single entity must be below € 1 million. But that will create a cliff edge effect regarding capital requirements for lending to firms which marginally exceeds the limit. Similarly, constraints on collateral recognition imply that many assets may still not be eligible to be considered as collateral, or be eligible only when banks apply the most advanced approaches.

25. Questions were also raised as to why for certain types of lending the regulatory requirements actually rise when banks and organisations move from the standardised approach to the more advanced approaches. The treatment of equity finance was one example: the requirements rise from a 150% risk weight in the standardised approach up to 400% in the more advanced approaches.

26. Some respondents suggested that perverse incentives also exist with regards to the income-based capital requirements for operational risk. Using that measure, a well run, low cost, highly profitable company is likely to be subject to a higher regulatory operational risk capital requirement than a less well run, high cost, unprofitable company.

27. Concerns were raised that the various criteria which would need to be satisfied in order to qualify for the most advanced approaches could adversely impact on competition between firms. Stringent data requirements could hinder the movement towards the more advanced approaches. This was felt to be a problem for small lenders, long-term mortgage lenders, and housing associations, as well as some non-banks (i.e. commodity derivatives traders) who lack the historical data in certain markets to apply the more sophisticated approaches. This could also lead to increased concentration in some markets and act as a barrier to entry, although it was recognised that such firms could

join a data pool. Respondents also suggested that setting low threshold levels of data collection could lead to burdensome bureaucracy.

### ***Detailed issues***

#### a) Emerging Markets

28. A handful of respondents suggested that the Directive fails to deal adequately with the issue of international diversification of lending to emerging markets. They argued that this could lead to regulatory capital for lower rated borrowers – disproportionately represented in developing countries – being higher than it would be if the risk-spreading benefits of diversified portfolios were more explicitly recognised, and an increase in cost and/or reduction in the quantity of international bank lending to these countries.

#### b) Local Authorities/PFI Projects, Housing Associations

29. Some respondents have a general concern that the new Accord is not well structured to accommodate low default portfolios and that contrary to expectation these high-quality portfolios may be denied access to the Internal Ratings Based (IRB) approach. In their view, this concern is very relevant to the treatment of PFI transactions and lending to housing associations.

#### c) Investment firms

30. A number of large investment firms believe that they are being “lumped in” with firms, such as commercial banks, that are likely to see significant capital savings under the Basel Accord and the new Directive. Respondents suggested capital savings under Accord/Directive are equally as unlikely for international investment banks as they are for the many smaller investment firms. It has also been suggested that the impact of the Directive is likely to be detrimental for any firm that is predominantly focused on trading book activities and that small firms are hit by high operational risk charges.

- Trading Book: the key specific concerns related to the treatment of short dated maturity, specific risk offsets, and the restructuring of credit derivatives. There was also a general concern that not enough time had been spent on calibrating the credit risk of trading book activities relative to banking book activities. Respondents therefore welcomed the announcement of a trading book review by the Basel Committee.

- Operational Risk: concerns were raised over the lack of sensitivity in the standardised approach to operational risk, and the fact that business lines do not match with risk categories. Some respondents also argued generally that the capital requirements for operational risk were set too high, given industry experience and practice in controlling such risk.

#### d) Consolidation

31. A number of issues were raised relating to the level at which the proposals would apply to group structures.

32. The treatment of goodwill under the proposals is seen as penal particularly for debt-financed acquisitions. Respondents also thought it inconsistent with the corresponding accounting treatment.

33. There were also suggestions that removing the current exemption from consolidated capital requirements for investment firms groups and the potential loss of the “adjusted” solo consolidation regime would cause disproportionate reorganisation in investment banking and banking sector and may also prevent new business start-ups.

#### e) Venture Capital

34. There was uncertainty over the impact of the new regulatory framework on venture capital finance, because of the uncertainty over the scope of the new Investment Services Directive. Concerns were also raised over the significantly large risk weights for equity investments (credit and operational) in the advanced approach, which could adversely impact market activity and could encourage spin-offs of fund management operations from banks. There was general agreement that the US market, on whose loss data the risk weights were calibrated, differed somewhat from the European market.

#### f) Commodity Derivatives

35. It was suggested that the new capital framework had been designed for banks, and did not fit at all well to commodities markets, where the nature of credit, market and operational risks were different. Respondents also suggested that transitional prudential capital provisions were needed, because of the uncertainty over the longer-term scope of the new Investment Services Directive, which would come into force before CAD3.

36. Furthermore, many forms of illiquid physical assets used by firms in the trading of commodity derivatives are not eligible as capital in the Directive. Some forms of physical collateral can only be accepted, under strict constraints, under the IRB approach, while other forms of collateral are entirely discounted by the proposals. Respondents also wanted the extended maturity ladder approach, which currently allows for the offsetting of long and short exposures in the same commodity, to be retained in CAD 3.

#### g) Intra-Group Exposures

37. Some firms are very concerned that CAD3 might require them to hold regulatory capital against credit exposures to other institutions within a group. This is a serious concern for UK banks that centralise their treasury operations.

## **Organisations and individuals consulted**

(\* = Organisations/individuals who have provided a written response)

3i

Aberdeen Asset Managers (\*)  
Abbey National  
AIG United Guaranty  
Alliance and Leicester (\*)  
Alliance Capital  
Allianz  
Amadeus Capital Partners Limited  
Amalgamated Metal Trading  
AMVESCAP  
Aon Limited  
APAX Partners  
Association of Private Client Investment Managers and Stockbrokers (\*)  
Barclays (\*)  
Baseline Capital Limited (\*)  
British Bankers Association (\*)  
British Petroleum  
Brit Insurance  
Britannia Building Society (\*)  
Building Societies Association (\*)  
British Venture Capital Association  
Capital One Bank Europe (\*)  
Cargill Investor Service  
Cazenove  
Confederation of British Industry  
Charles Stanley and Co Ltd  
Chesham Building Society (\*)  
Chartered Institute of Public Finance and Accountancy  
Citigroup  
Clifford Chance  
Council of Mortgage Lenders (\*)  
ConocoPhillips (\*)  
Consumers Association  
Credit Suisse First Boston  
Deloitte  
Deutsche Bank  
Dresner Bank  
Factors and Discounters Association  
Finance Leasing Association (\*)  
Futures and Options Association (\*)  
Financial Services Consumer Panel  
Furness Building Society  
General Electric Capital  
General Electric Mortgage Insurance  
Goldman Sachs (\*)  
Henderson  
Hoodless Brennan and Partners PLC  
HSBC

HBOS PLC (\*)  
Institute of Chartered Accountants in England & Wales (\*)  
Investment Managers Association (\*)  
International Petroleum Exchange (\*)  
International Securities and Derivatives Association  
Kleinwort Capital limited  
Koch Metals Tradings  
KPMG  
Legal and General  
Lehman Brothers  
London Investment Banking Association (\*)  
Lloyds TSB (\*)  
M and G Group  
Man Financial  
MBNA (\*)  
McInroy and Wood (\*)  
Merrill Lynch  
Mortgage Insurance Trade Association  
Morgan Stanley  
National Counties Building Society (\*)  
National Housing Federation (\*)  
Nationwide Building Society (\*)  
Principal Investment Management Limited (\*)  
PMI Group  
PPM Ventrien  
Price Waterhouse Coopers  
Questor Capital Management  
Radian  
Royal Bank of Scotland (\*)  
Refco Overseas  
Royal Institute of Chartered Surveyors (\*)  
Ruffer  
Shell  
Singer and Friedlander Ltd(\*)  
Skandia  
Standard Charter (\*)  
Standard Life Bank  
Stround and Swindon (\*)  
Travers Smith Braithwaite  
UBS  
Ray Barrell  
Jon Danielsson  
E Philip Davis  
Charles Goodhart  
Stephanie Griffith-Jones (\*)  
Rosa Lastra  
Alistair Milne(\*)  
Miguel Segoviano  
Stephen Spratt  
David Miles (\*)