EUROPEAN CENTRAL BANK

COMMENTS OF THE ECB ON THE THIRD CONSULTATIVE DOCUMENT OF THE EUROPEAN COMMISSION ON REGULATORY CAPITAL REVIEW

Introduction

On 1 July 2003 the European Commission's Services issued its third consultative proposals (CP3) on the review of the EU capital adequacy regime for banks and investment firms, in which it requested that all interested parties submit any comments. This paper, which benefited from consultation with the Banking Supervision Committee (BSC), presents the views of the European Central Bank (ECB). Furthermore, the ECB will make an additional contribution in its opinion on the formal proposal for a Directive on capital adequacy, which will be presented by the European Commission.

The ECB has already put forward its views on the new framework for capital adequacy in its comments on the third consultative proposals (CP3) of the Basel Committee on Banking Supervision (BCBS),[1] which focuses mainly on EU-related issues. This note is organised in two sections: the first contains remarks of a general nature, while the second addresses more specific and technical issues.

General remarks

The ECB remains *very supportive of the general thrust of the proposed capital adequacy framework for EU banks and investment firms*, and shares the view that, subject to proper finalisation, the new framework will contribute to a strengthening of financial stability in the EU. In this context, the ECB trusts that the principal topics recently identified by the BCBS for further improving the regulatory framework[2] will also be given due consideration by the European Commission, with a view to ensuring consistency between the EU capital adequacy framework and the New Basel Accord. Areas identified for change include the treatment of expected and unexpected losses in the context of the Internal Ratings Based (IRB) approach to credit risk, a simplification of the treatment of asset securitisation, a review of the treatment of credit card commitments and the treatment of certain credit risk mitigation techniques.

The ECB is also supportive of the additional work being undertaken in order to better understand the impact of the new framework on the structure and performance of the EU banking sector and on the financing of the EU economy. Indeed, the ECB expects that the forthcoming "consequences report" being prepared under the auspices of the European Commission on the impact of the new capital adequacy regime on all sectors of the EU economy and in particular the SME sector will provide useful input in view of a proper finalisation of the EU regulatory framework. The ECB reiterates its commitment to contribute to the work of analysing the structural implications of the new framework for the EU banking sector. This work will also need to continue once the proposal for a Directive has been finalised, as any ex ante assessment is bound to be overly reliant on the current behaviour and practices of financial institutions.

In order to enable the revised EU capital adequacy framework to be properly finalised and implemented, the following issues have been identified as worthy of attention.

First, a *parallel implementation* of the EU regulatory framework and the New Basel Accord at the global level is of the utmost importance in ensuring competitive equality. The recent decision of the BCBS to postpone the timeframe for finalisation from end-2003

1 *The reply of the ECB to the third consultative proposals for the revision of the New Basel Accord can be found on its website: http://webint.ecb.de/pub/pdf/bcbscommentsecb-cp3.pdf.*

2 *Press release of the BCBS dated 11 October 2003 entitled "Basel II: Significant Progress on Major Issues".*

to mid-2004 opens a window of opportunity for further improvements to the EU legislative text, on the one hand, and creates an implementation challenge for the EU on the other. In particular as regards possible improvements, the additional time available until the new framework is finalised could be invested in further reshaping the draft proposal for a Directive in the pursuit of a flexible text that supports consistent implementation throughout the EU (see comments on this issue below). In this context, the ECB notes that the issue of simultaneous implementation of the revised EU capital adequacy rules and the New Basel Accord is instrumental in ensuring a level playing field. The ECB is aware that this poses a challenge for the EU legislative process, but is confident that the deadline for parallel implementation by the Commission will be met.

Second, the *need for maintaining consistency* between the New Basel Accord and the revised EU capital adequacy framework. In this regard, the ECB is broadly supportive of the current degree of convergence (few comments are made in the section on specific remarks) and expects that consistency will be pursued until the framework is finalised.

Third, *flexibility and workability* of the proposed regulatory framework in the light of the implementation of the Lamfalussy framework in the banking sector. The EU regulatory capital review presents a unique opportunity to introduce a common framework – a backbone of banking regulation – that will enhance financial integration and effectively contribute to the further development of the Single Market. The ECB fully shares the objectives of drawing up a legislative framework on capital adequacy that ensures comprehensiveness on the one hand while avoiding being overly prescriptive and unduly complex on the other. The ECB appreciates the efforts of the Commission in pursuing these objectives and welcomes the call for comments in order to achieve a successful implementation of the EU regulatory framework.[3] Although the draft proposed CP3 legislative text is still incomplete and in a relatively early stage of development, it appears to meet, to a certain extent, the aforementioned objectives. In this context, the intended separation in the proposed legislative text between level 1 principles – which would be amended in the future under the co-decision procedure – and technical annexes – which should be amended via a comitology procedure and assisted by the forthcoming level 2 European Banking Committee – could provide the necessary flexibility required in a fast-changing and increasingly integrated EU market. The ECB trusts that the level 3 banking committee, the Committee of European Banking Supervisors, will provide valuable advice and input to ensure appropriate and timely amendments in the technical parts of the new banking regulation.

However, there seems to be scope for reducing the degree of complexity of the proposed legislative text and for enhancing its effectiveness. In particular, a better distinction between the level 1 general principles and the detailed implementing measures will make the text more adherent to the Lamfalussy approach and at the same time more comprehensible. In the same vein, the Articles' purely technical content could be included in the Annexes. Some other parts, such as purely qualitative or vague references, which do not seem to be easy to implement on the basis of the current text, could instead be removed. For the latter, a non-legislative level 3 supervisory involvement, aimed at developing more concrete guidance and pursuing a consistent implementation, seems a more appropriate way forward. In the Annex attached, the ECB gives some initial comments in this regard, which are by no means exhaustive but may be of assistance when drafting the final legislative proposals or in the context of further work in this field that may be carried out by the technical working groups assisting the European

3 *See paragraph 152 of the explanatory document.*

Commission.[4] It also notes that the additional time that is now available to finalise the regulatory framework could also be used to reshape the legislative text in accordance with the Lamfalussy framework.

The ECB sees great value in the development of genuine EU secondary legislation, i.e. a common body of technical rules, distinct from framework principles and easily adaptable to changing market practices. This would suggest that it would be worth adopting the technical Annexes directly as level 2 measures and, where compatible with necessary flexibility in terms of national implementation, via EU regulations that would lead to a more uniform rulebook. This would facilitate compliance by banking groups operating across EU countries, while increasing transparency and reducing compliance costs.

Fourth, *consistent application and convergence of supervisory practices* should be given top priority. The need for a consistent application of the new regulatory framework has been widely acknowledged at international level with regard to the New Basel Accord.[5] A consistent application of the new rules is also gaining political momentum in the EU and is becoming a priority issue for the EU regulatory and supervisory committees under the new institutional setting. In this context, one issue that needs to be addressed is the significant extent of national discretion introduced in the Commission's proposals for a Directive on capital adequacy.

The ECB is of the view that the issue of national discretion encompassed in the options proposed for the various approaches as well as in the identification of elements such as "sufficient", "material" and "significant" in the roll-out plans and in the pillar two review should be considered with the aim of possibly reducing national options. Such an initiative would also simplify and facilitate the work of applying the new framework in a consistent manner throughout the EU. Evidently, the numerous national choices, as they are currently proposed, render supervisory convergence difficult in practice. Namely, the aim should be to reduce national options in the context of pillar one capital requirements. For the more qualitative types of provisions (e.g. the capital adequacy assessment process, the supervisory evaluation process), co-operation should be ensured as a means of effective convergence.

Fifth, the importance of tackling potential *pro-cyclical features* of the new capital adequacy framework. As a general stance, the ECB would like to acknowledge that the *concerns regarding pro-cyclicality*, which have been raised in previous consultations, have already been dealt with in the Commission's current proposals (e.g. flattening of the risk weights, stress test, supervisory review).[6] In this context, the ECB would like to stress the importance of an effective implementation of the proposals by banks and supervisory authorities as a key issue to avoid excessive fluctuation of capital requirements, which in turn may give rise to financial stability concerns.

Finally, the *application of the New Capital Accord* by the US authorities and other non-EU countries. As this topic is of significant importance for the EU, the ECB reiterates the comments made to the BCBS on this issue. Indeed, the expressed intention of the United States to apply the new rules only to the largest internationally active commercial banks[7] and to require them to use only advanced methodologies for credit and

4 *Namely the Technical Sub-Group on the future of Capital Regulation and its sub-structures assisting the Banking Advisory Committee and the European Commission in the development of the proposed Directive.*

5 *The IMF identified the lack of international convergence and the potential for an uneven playing-field and competitive distortion as major concerns related to the implementation of Basel II. Attaining consistent implementation and convergence of the regulatory framework among the Member States is a fundamental cornerstone to the effective development of a financially integrated Single Market.*

6 *It is also noted that the ECB addressed the issue of pro-cyclicality in its comments on the third consultative proposals on the revision of the Basel Accord.*

7 *It should be noted, however, that the coverage is, in principle, adequate, as the 15-20 banks that will be required or are expected to opt, mainly for competitive reasons, for applying the New Basel Accord account for approximately two-thirds of US banking assets.*

operational risk may have a potentially adverse impact on EU banks operating there. First, from an EU perspective, it should be ascertained what treatment would be applied to EU banks operating in the United States through branches or subsidiaries, in case the United States does not provide for the implementation of less advanced approaches. Second, there is the issue of ensuring that US banks operating in EU countries would meet the requirements of EU supervisory regimes.[8] The ECB would welcome the Commission's initiatives in this regard.

The following remarks mainly cover issues that are of specific relevance to the EU.

First, *additional initiatives in the regulatory field.* Areas warranting further work in the regulatory field are mentioned in the ECB's comments on the third consultative proposals for the revision of the New Basel Accord. It should be recalled that in order to maintain the effectiveness of the overall approach in the long run, it is necessary for the BCBS and, as far as the EU is concerned, the Commission, to initiate work at some stage on other related issues which the ECB considers to be priorities, such as the accounting, provisioning and definition of own funds. Indeed, there is a need to ensure harmonisation of IAS accounting standards and capital requirements. As regards the treatment of provisions and own funds, the BCBS has already begun work in the wake of the recalibration of the IRB approach. Besides the above-mentioned issues, the ECB would like to stress the importance of further regulatory convergence in the field of liquidity risk in a longer-term horizon. In this context, the ECB welcomes the respective requirements that institutions need to meet in relation to liquidity risk as provided for in Annex I, Section 5, including ongoing measurement and contingency plans to be put in place. However, improvements in liquidity risk management on behalf of institutions should be accompanied by convergence in the supervisory treatment of such risks. A lack of initiatives in this field will increase the compliance cost and impede the development of the required measurement and monitoring programmes.

Second, *the treatment of investment firms.* The ECB is broadly supportive of the revised proposals on the treatment of investment firms, namely the exclusion of investment firms with a limited license[9] from the application of the operational risk requirement, whilst maintaining the application of the Expenditure Based Approach (EBA) prescribed in Annex IV of Directive 93/6/EEC as a backstop. On the one hand, the proposed treatment does not seem to raise particular concerns regarding level playing-field issues between banks and investment firms and, on the other hand, it maintains the maximum convergence possible with the respective rules being developed by the Basel Committee. Nevertheless, the proposed treatment could be reinforced with the introduction of a pillar two scrutiny for a sub-category of the investment firms exempted. In particular, the proposed waiver for applying the operational risk capital charge encompasses both the 125K investment firms as well as the 50K firms which can be authorised to manage individual portfolios of investments in financial instruments. As the activity of managing individual portfolios of investments in financial instruments is conducive to operational risk, a pillar two scrutiny of investment firms performing the services of individual portfolio management to ensure a prudent level of capital and/or sound operational risk management standards is deemed appropriate. To this end, a reference to supervisory scrutiny is proposed to be made in the recitals of the forthcoming Directive on the revision of capital adequacy of banks and investment firms in order to ensure a level of capital for 50K and 125K investment firms providing individual portfolio management services that is commensurate with their risk profile. In general, regulatory

8 *For example, the use of advanced approaches requested by the US authorities might not meet the requirements of the EU authorities.*

9 *Investment firms with limited licence are those not authorised to (i) deal on their own behalf and (ii) underwrite and place financial instruments on a firm commitment basis, as prescribed in Annex H-1.*

arbitrage opportunities that may arise from the differentiation in the regulatory framework (e.g. by shifting activities to investment firms subject to a less stringent regime) need to be carefully monitored.

Third, *the appointment of a co-ordinating supervisor*. Regarding the proposal to develop a similar approach to the one that appears in the Financial Conglomerates Directive,[10] relating to the appointment of a co-ordinating supervisor for each banking group to co-ordinate supervisory action and to take certain prudential decisions (paragraph 73 of the explanatory document solicits views on this matter), the ECB would see value in establishing such an approach from a medium-term perspective. This would be in the context of the new capital requirements framework for all banking and financial groups with significant presence in other Member States. In addition to the aforementioned tasks, the ECB would also see practical value should the co-ordinating supervisor have an enhanced statutory role in minimising potential burdens arising from the application of divergent approaches by supervisory authorities. Pending the advancement of the medium-term objective, co-operation between supervisory authorities and a convergence of policies and practices should be further enhanced.[11]

Finally, *consistency with other relevant EU directives* needs to be addressed. First, *the treatment of asset management* under the new regime (paragraphs 106-108). The ECB welcomes the inclusion of asset management companies in the consolidated and sub-consolidated requirements, which is also consistent with the respective treatment under the Financial Conglomerates Directive. However, the reference to the definition of asset management companies and the need to align capital requirements related to operational risk (paragraphs 107 and 108) is understood as an intention to review the capital requirements of asset management companies, regardless of whether they constitute part of a banking group or not, by reviewing the UCITS Directive.[12] Following the adoption of Directive 2001/107/EC, asset management companies became eligible for the provision of services, such as individual portfolio management, allowing them to compete equally with banks and investment firms. Hence, the ECB would welcome – should Directive 2001/107/EC be revised – the introduction of prudential requirements for asset management companies performing individual portfolio management services and giving investment advice which are equivalent to those that will be introduced by the forthcoming Directive on the review of the capital adequacy regime for banks and investment firms.

The application of similar prudential rules to asset management activity across different financial institutions and sectors will promote a level playing field. In addition, regulatory arbitrage opportunities may arise owing to the different treatment, as banks may attempt to shift activities subject to an operational risk capital charge, such as individual portfolio management and provision of advisory services, to UCITS activities.[13] As a result, divergent capital charges may emerge for the same types of activities depending on whether a bank, a UCIT company or a banking group carries them out. Hence, the ECB favours the harmonisation of the regulatory treatment by revising Directive 2001/107/EC. In this context, it is worth noting that the last indent of Article 5a, which sets out the

10 *Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate and amending Council Directives 73/239/EEC, 79/267/EEC, 92/49/EEC, 92/96/EEC, 93/6/EEC and 93/22/EEC, and Directives 98/78/EC and 2000/12/EC of the European Parliament and of the Council.*

11 *To note the recent work undertaken by the BCBS on "High level principles for the cross-border implementation of the New Accord".*

12 *Directive 85/611/EEC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) with regard to the investment of UCITS, as amended by Directive 2001/108/EC of 21 January 2002 and Directive 2001/107/EC of 21 January 2002.*

13 *UCITS are included in the consolidated requirements of banking, investment groups and financial conglomerates and their total individual capital requirements are used in the estimation of capital at group or conglomerate level. Thus, the shifting of activities from banking to UCITS subsidiaries will have an impact on the overall capital of the group or financial conglomerate.*

capital requirement for UCITS management companies, requires the presentation of a report by the Commission to the European Parliament and the Council on the application of the capital requirements for UCITS, accompanied where appropriate by proposals for its revision.

Second, *the review of other relevant directives*, such as the E-money Directive.[14] In particular, Article 5, which establishes the limitations of investments by the e-money institutions, needs to be amended (e.g. sight deposits with Zone A credit institutions as eligible investment should, according to the new rules, be substituted with the equivalent credit quality classification).

Third, *consistency with other EU legislation* should be ensured in relation to the recognition of cross-product netting. Several Member States explicitly recognise the legal enforceability of cross-product netting arrangements, and the EU directives on financial collateral arrangements and on the reorganisation and winding-up of credit institutions contain general provisions regarding the recognition of netting arrangements. While the EU CP3 does not include an explicit prohibition of cross-product netting, it is nevertheless silent in terms of its recognition. The Commission may wish to further investigate the potential implications of this issue as an EU specificity which is contrary to the CP3 proposals for the New Basel Accord.

Specific remarks

General provisions of the new framework

The ECB shares the views of the Commission that Article 2 provides a solid and balanced cornerstone upon which the framework can be established. It also agrees that, given that the relationship between Title II (minimum regulatory standards) and Title III (supervisory review) capital requirements has been a contentious issue, at this juncture the Commission's proposals,[15] as stated in paragraphs 93 and 94, represent a feasible way forward (see also the remarks under pillar two). However, the current wording of Article 5, prescribing the capital that institutions should hold, lacks clarity. In particular, the second sentence of paragraph 1 seems to contradict the requirements introduced in the former sentence. The same lack of clarity also characterises the content of paragraph 2 of the same Article.

Transitional arrangements

In relation to the transitional arrangements aiming to preserve the overall level of the regulatory capital, an inconsistency seems to emerge between the Commission's proposals as set out in Article 146(3) of the Working Document[16] and the respective proposals by the Basel Committee as stated in the CP3. Under the New Basel Accord the BCBS proposes a floor of 90% and 80% of the existing capital rules, for the first two years of implementation. This requirement applies to banks using either one of the IRB approaches or the Advanced Measurement Approach for operational risk. By contrast, according to the Working Document (Article 146.4), the same floor treatment applies only to banks opting for the IRB approach, therefore not covering the capital requirements relating to operational risk.

Scope of consolidation

The ECB strongly supports the Commission's view of the critical importance of the application of consolidated and sub-consolidated requirements to prevent double-gearing and downstreaming of debt (paragraph 98 of the explanatory document).

14 *Directive 2000/46/EC on the taking-up, pursuit and prudential supervision of electronic money institutions.*

15 *The current proposals introduce a separate treatment between Title I (regulatory capital) and Title II (internal and economic capital), which is left to the banks' discretion not only as regards the types of risk covered and their calculation but also in relation to the definition of eligible regulatory capital.*

16 *"Review of capital requirements for banks and investment services, Commission Services Third Consultation Paper, Working Document", 1 July 2003, European Commission.*

In this context, the proposed limited exemption of the application of sub-consolidation only in cases of domestic groups is welcomed. Against this background, the thrust of the proposed scope of application as presented in Section 4 (paragraphs 98 to 109) and Articles 16 to 21 is broadly shared with the following remarks.

First, paragraph 103, setting out a further exemption of both the sub-consolidated and the individual requirements, raises doubts as the proposed framework already provides enough flexibility by allowing for the calculation of individual capital requirements of the parent undertaking of the sub-group, subject to the necessary adjustments,[17] as an alternative to the calculation of the sub-consolidated capital requirements. In this context it is worth mentioning that the ECB, in its comments on the Commission's CP2 proposals, mentioned that the application of the minimum capital requirements (i.e. the 8% minimum standard) should be mandatory for every credit institution and investment firm on an individual and a consolidated basis. If the Commission regards it as desirable to maintain the possibility for supervisors to allow *for a waiver at individual and sub-consolidated level*, on a case-by-case basis, this possibility should be subject to strict and clear criteria.

Second, the proposed alternative to the sub-consolidation method of deducting the holdings of the parent undertaking in the other entities of the sub-group (paragraph 102 of the explanatory document) may need to be reviewed. Should this sub-group form part of a financial conglomerate, this alternative method may hinder the tasks of the co-ordinator responsible for consolidated supervision. The ECB proposes that this waiver of sub-consolidation requirements be, in principle, allowed by the co-ordinator, who will be informed by the parent company of the sub-group.

Lastly, the content of indent (f) of Article 21, introducing exemptions from consolidated capital requirements for investment firms, needs to be reviewed, as it seems to impose capital on a consolidated basis to the parent undertaking within the group, contrary to the intention of the Article in question.

Standardised approach

The reference to the *valuation of asset and off-balance sheet items* to be effected according to Directive 86/635/EEC[18] (Article 26 paragraph 1) may be deleted as it is not relevant for the purposes of the Directive determining banks' and investment firms' capital adequacy (in any case the Bank Account Directive is valid and its application does not need to be reconfirmed). Also, possible future developments in relation to the application of International Accounting Standards in the EU may also call for such a reference, if deemed appropriate, to be made in the Annexes.

The *definition of eligible External Credit Assessment Institution* (ECAI), as provided for in Article 1 (27) of the Working Document, should be amended by mentioning that the ECAI must be recognised as eligible for regulatory purposes by at least one national competent authority. As mutual recognition of eligible ECAIs is left to the competent authorities and thus an ECAI recognised by one national competent authority may not be considered to be eligible by another authority, the current reference as a condition for eligibility by the national authorities may raise implementation problems.

In this context, the ECB would like to reiterate its interest in ensuring that the overall quality of ratings is high. *First,* the assessment of credibility and market acceptance by way of revenues and market

17 The individual capital requirements should be reduced by the book value of holdings, subordinated claims, etc. held in respect of institutions, financial institutions, asset management companies and ancillary services undertakings which would otherwise be consolidated in accordance with the respective regulatory provisions.

18 Council Directive of 8 December 1986 on the annual and consolidated accounts of banks and other financial institutions.

share may be valid for the existing international ECAIs but may create potential barriers to entry for new players. In the latter situation, criteria relating to ex-post accuracy and validity of the ratings may prove to be more suitable. This could be reflected in Section 2.1.2 of Annex C-2 (entitled individual credit assessments) by stating, for example, that the application of the market share and revenues criteria (first two bullet points) should not create barriers for new entrants. Also, it could be mentioned in sub-section 2.1.1 of Annex C-2 that assessment of the ECAIs' credibility should largely draw on the accuracy and validity of its ratings. *Second,* in the wake of recent financial events the following issues may require further consideration to be addressed in Annex 1:

- prohibition of contacts between analysts and subscribers;

- implementation of procedures to manage potential conflicts of interest that arise from the ancillary fee-based businesses of the rating agencies.[19]

The *mapping of ECAIs*' credit assessments onto the credit quality scales will need to be co-ordinated in order to ensure consistency. The proposed treatment requires the allocation of credit assessments into quality steps which are solely identified by numbers (from 1 to 6 or 7) and in accordance with the mapping set out by the competent authorities, which is currently under optional mutual recognition by competent authorities of other Member States at national level (paragraph 128 of the explanatory document). Therefore, although this treatment may indeed avoid specific references to individual ECAI ratings in a legislative context, it introduces a high degree of discretion, which may hamper the objective of uniformity. Hence, the ECB sees two issues as being of critical importance in terms of ensuring a consistent implementation. First, a clear recommendation for consistency regarding the proposed treatment under the New Accord should be given (where a particular reference to eligible ratings is allowed owing to its non-legislative nature). Second, there should be a specific indication that the Commission will monitor consistent implementation. The level 3 banking committee is expected to pursue consistency in this field.

The proposed treatment of *exposures to regional governments and local authorities* (Annex C-1, Section 2.1) *and public sector entities* (Section 3.1 of the same Annex) offers a number of choices to national authorities that may lead to diverse capital requirements. In order to ensure a consistent application across Member States, as well as transparency in terms of national implementation, the ECB would favour a specific reference in Annex C-1,[20] for example in Sections 2.2 and 3.2, that Member States' treatment of claims to regional governments, local authorities and public sector entities should be submitted to the level 3 banking committee and to the European Commission for information purposes.

In line with the proposal made to the BCBS on the New Basel Capital Accord,[21] the ECB proposes that the *Islamic Development Bank* be added to the list of Multilateral Development Banks (MDBs) eligible for 0% risk weight (paragraph 4.2.2 of Annex G-1).

19 *This issue should be seen in connection with the possible legislative initiatives for parties disseminating information (Market Abuse Directive). If ECAIs are eventually to be included within the scope of Article 6(5), the issue will be settled by implementing the measures of the Market Abuse Directive. Credit rating agencies issue opinions on the creditworthiness of a particular issuer or financial instrument as of a given date. As such, these opinions do not constitute a recommendation within the context of this Directive. However, credit rating agencies should consider adopting internal policies and procedures designed to ensure that credit ratings published by them are fairly presented and that they appropriately disclose any significant interests or conflicts of interest concerning the financial instruments or the issuers to which their credit ratings relate (see Formal Commission drafts on measures implementing the European Parliament and Council Directive 2003/6/EC on insider dealing and market manipulation, submitted to the European Securities Committee (ESC) for voting on 29 October 2003, recital 10).*

20 *Sets out the notification requirements to the Commission by Member States of cases where the claims on regional governments and local authorities are treated as central government claims.*

21 *Please see the ECB's comments on the Basel Committee's third consultative proposals for the creation of a list of those MDBs complying with the criteria.*

The current reference to the *risk weight of institutions incorporated in countries where the central government is unrated* (not more than 100%, in 6.3.2 of Annex C-1) should change to 100% (as in 6.4.2 dealing with claims on unrated institutions) to ensure consistency with the proposed treatment under the New Basel Accord and to avoid any unduly divergent treatment in the EU.

The proposed treatment of *short-term claims* (in 15 of Annex C-1) is understood to refer to the similar Basel CP3 proposals on short-term assessment that are issue specific, such as a particular issuance of commercial paper. This should be specified in the above-mentioned text.

In the penultimate paragraph of Annex C-3, the reference to the paragraph 5 of Annex III of the CAD as prescribing a treatment of OTC contracts cleared by clearing houses similar to the one set out by the Directive 2000/12/EC Article 43(2)(3) needs to be revisited.

The *exercise of the waiver* of the second condition mentioned under 9.1.3 in Annex C-1 (i.e. the risk of the borrower not to be materially dependent on the performance of the underlying property) and to be met by institutions eligible for a 35% risk weight for claims secured by mortgages on residential property, should be notified to the level 3 banking committee and to the Commission as provided for in paragraph 9.1.4.

The "minimum requirements set out in Section III, 2.1.4" that institutions should meet in order to be eligible for *35% risk weight for claims secured by mortgages on residential property*, as stated in Annex C-1, paragraph 9.1.3, penultimate indent, are not specified further in the Working Document.

IRB approach

In line with the policy introduced in the New Basel Accord, a clear reference to the fact that *banks' internal credit risk models' estimates* are not recognised for the time being should be made in the draft legislative text.

The use of *"internal capital"* (Art. 46), which seems to be comparable to the more widely used concept of "economic capital", should either be defined or not used.

The Commission intends to allow for a *permanent partial use of the IRB approach* and, in this context, to permit small and medium-sized banks with a limited number of exposures to sovereigns and financial institutions to use the standardised approach, even in cases where such exposures are material (paragraph 147 of the cover note). However, the relevant text in Article 50, does not seem to adequately reflect the underpinning rationale mentioned in paragraph 74 of the cover note. More specifically, the current drafting seems to permit a generic application of this permanent partial use to all banks, including international ones. The ECB would prefer this permanent partial use of the standardised approach to be, in principle, confined to small and medium-sized banks and for non-material exposures.[22] This can be justified on the grounds that, should such exposures become material, it would not be overly cumbersome for a credit institution to apply at least the foundation IRB approach, given that the number of such counterparts should be limited.

The *transitional provisions* on the minimum requirements that may be relaxed by competent authorities for banks using the IRB approach, as introduced in Article 126.2, may have undesirable effects in cases where banks are unlikely to start applying the IRB during this period. More specifically, under these transitional arrangements, credit institutions are required to have a minimum of two years' data at 31 December 2006; this requirement will increase by one year for each of the three years up to 31 December 2009. As the minimum requirements on data

22 *In this context, the development of EU thresholds could be addressed by the level 3 banking committee.*

will thus increase in parallel to time during this transitional period, any bank that fails to meet the minimum data requirements at the end of 2006 is unlikely to meet them until end-2009, as each year, the increase in its data set is matched by an equal increase in minimum requirements. Such an effect may need to be further investigated and, if necessary, the provision may be modified in a more realistic way, for instance by increasing the minimum requirements in a manner which is less than proportional to time.

The *performance of prudent stress test scenarios* in the assessment of capital adequacy is a critical element to ensure the robustness and appropriateness of a bank's IRB systems. In this context, more concrete guidance needs to be developed under strand three for ensuring overall prudent estimates by banks and consistent supervisory practices when evaluating the outcome of such scenarios. It is worth noting that the reference in the technical Annex to the need to fulfil certain specific conditions for carrying out stress tests is vague and has no practical content. Also, the requirement to consider the effects of mild recession scenarios needs to be developed as non-legislative supervisory (strand three) work, since the manner in which it is to be implemented is rather unclear. For instance, in a period of recession which is seen as being more severe than a "mild" recession, the outcome of a stress test may lead to a reduction of capital buffers, while other banks and/or supervisors may request to leave the buffer unchanged or even to increase it further, thus exacerbating the duration of the downturn.

The minimum requirements for the *recognition of receivables as collateral* under the IRB foundation approach include a reference to potential concentration risk within the institution's total exposures beyond that controlled by the institution's general methodology (Annex E-2, paragraph 2.1.5.2, Risk management). The latter part of the sentence should either be clarified or – preferably – deleted.

The notion of *portfolios* introduced in the last paragraph of Article 53.6, whereby different approaches for different portfolios may be allowed, subject to supervisory approval, for the calculation of the Exposure at Default (EAD) for equity exposures, needs to be clarified.

A *voluntary return by the bank to the standardised or foundation IRB approach*, subject to approval by the supervisory authority and in extraordinary circumstances, is provided for in Article 49 paragraph 6. A broader reference to the enforcement power of supervisory authorities, which may also request a bank – either during the roll-out period or in the context of a regular review of its IRB approach – to move to less sophisticated approaches, would enhance supervisors' enforcement powers. Evidently, supervisory action for either approving voluntary return or enforcing such a return to less sophisticated approaches should be consistent across countries.

Credit risk mitigation

The ECB agrees with the proposed *recognition of non-financial collateral* only under the IRB approaches (paragraphs 200 to 204 of the explanatory document). It also agrees with the substance of the argumentation presented in the subsequent paragraphs (209 to 212) which conclude that it would not be appropriate to recognise non-financial collateral under the standardised approach, as banks would benefit from the lower risk weights for riskier assets, owing to the limited degree of sensitivity in terms of differentiation of risk weights. However, due consideration should be given to the possible adverse incentives for less sophisticated banks which opt for the standardised approach not to take non-financial collateral, as this exposes them to an even greater degree of risk with even less capital compared with a bank which has opted for the IRB approach. Treatments such as those mentioned above may be warranted for prudential purposes, but they

may reinforce adverse incentives for banks requiring supervisory attention under pillar two.

Explicit reference should be made to the *debt certificates issued by the ECB in the list of eligible collateral* (Annex E-1, 1.1.3), which should be eligible irrespective of the existence of a rating.[23] By way of reminder, the ECB may issue debt certificates with the aim of adjusting the structural position of the Eurosystem vis-à-vis the financial sector so as to create (or extend) a liquidity shortage in the market. As the ECB does not impose any restrictions on the transferability of the certificates, they could be used as collateral.

The proposed *treatment of uncovered bonds* issued by banks, which may be eligible as credit risk mitigants provided that the issuing institution repurchases them, could, upon request (paragraphs 215 to 221 of the explanatory document), be supported. However, it is not clear from the proposed text how it is intended to ensure that the above-mentioned condition of the repayment will indeed be respected by the issuing institution. The respective draft text (Annex E-1 paragraph 1.1.4.3 and Annex 1.1.4.3) provides for the regulatory treatment of uncovered bonds as guarantees for regulatory purposes by the issuing institution, which is not deemed to be adequate as an eligibility condition.

The ECB would concur with the *recognition of unrated and unlisted bonds issued by credit institutions and investment firms for credit mitigation purposes* (paragraphs 215 –221 of the Explanatory Document). However, the recognition of such bonds should be confined to institutions whose solvency status ensures the repurchase of such securities by the issuing institution. A proliferation of such instruments beyond a certain level may give rise to concerns about possible implications for their liquidity. In this context, additional monitoring involving co-operation between NCBs and supervisory authorities is warranted should unrated and unlisted bonds become eligible as credit risk mitigants.

The *treatment of "debt securities issued by institutions"* (Annex E-1, 1.1.3.1 (c)) should be clarified.The text states that "debt securities issued by institutions which securities have a credit assessment by a recognised ECAI which is mapped by the competent authority into credit quality step 3 or above under the credit assessment based methodology for the risk weighting of claims on institutions under title II, Chapter 1, Section 1 of the Directive". But, the Standardised Approach provides for two options when referring to the treatment of institutions, which differ as regards the credit quality step 3. When the central government risk weight methodology is used, then the credit quality step 3 corresponds to a 100% risk weight. By contrast, when a credit assessment based methodology is used, the credit quality step 3 corresponds to a 50% risk weight. As the different options lead to different risk weightings under credit quality step 3, depending on whether the risk weight is based on the credit assessment of the sovereign or on the credit assessment of the bank itself, confusion may arise if the current wording is kept.

With regard to *collateralised OTC derivatives transactions which are assigned a 0% risk weight*, the debt securities issued by the ECB should be added to eligible financial collateral along with other eligible items issued by central governments and central banks, as mentioned in Annex E-3, paragraph 3.1.3.1 (b).

Real estate lending

In its comments on the third consultative proposals for the revision of the New Basel Accord, the ECB identified the proposed treatment of real estate lending as one of the issues warranting particular attention. In this context, one caveat mentioned was that the extended recognition of real estate collateral should not lead to excessive real estate lending and an overheating of property markets. Such a cautious stance is even more justified in the EU context as the proposed

23 *This is consistent with the assignment of a 0% risk weight for claims on the ECB, according to 1.1.3 Annex C-1.*

treatment is less stringent than the one in the New Accord (e.g. common preferential treatment for Loss Given Defaults (LGD), which can be reduced to 35% for exposures secured with Commercial Real Estate (CRE) and Residential Real Estate (RRE), the exclusion of forms of lending from eligibility criteria (paragraph 256 of the Explanatory Document). The ECB considers that there is a need for prudent valuation by banks to prevent increases in credit availability from fuelling asset price bubbles for residential and commercial properties.

Asset securitisation

In line with the above comments on ECAIs the definitions of unrated and rated exposure in Annex F-1 should be amended by referring to ECAIs which are recognised as eligible for regulatory purposes by at least one national competent authority. The inclusion of the wording "by at least one competent authority" also applies to Article 83(1).

Operational risk

With regard to the *scope* (Article 106) it should be specified, preferably in Annex H, that strategic and reputational risks are excluded from the definition of operational risk. Otherwise, some authorities could interpret this to mean that this type of operational risk should attract a pillar one capital requirement. These two categories of risk, as well as legal risk, need to be defined.

The reference to a rating of A or equivalent as an eligibility criterion for insurance companies to be considered as *risk mitigants in the context of AMAs for operational risk* (Annex H-4 Section 2, second bullet point) is most welcome, as it is consistent with the proposed treatment in the New Basel Accord. However, alternative ways of addressing the credit quality may need to be exploited, as a reference to the rating of a particular ECAI may not be appropriate for a legislative text.

In Annex H-2 on the *Basic Indicator Approach*, under the title methodological indications, reference is made to the fact that income should be gross of any provisions and of any operational risk cost and loss. The ECB would welcome a better specification of the constituents of the income indicator in order to promote a common understanding and support convergence in interpretation and implementation.

The explanatory reference to the *treatment of negative figures for income indicators* when estimating the operational risk capital charge (Annex H-3, third paragraph) is welcome. However, the current drafting does not clarify whether the negative figure to be taken as equal to zero refers to the three-year average or to each single year. It would be worth revising the relevant sentence in order to clarify how the figure is calculated.

In the same vein, the requirement of Annex H-3, indent (d), that the sum of the *indicators of business lines* should be equal to the indicator as defined under the Basic Indicator Approach under Annex H-2, may not be applicable if gross income components with a negative value are calculated as zero under the Standardised Approach. For that reason, a reference to the second paragraph of the first section of Annex H-3, instead of Annex H-2, is proposed in Annex H-3 (d).

The *allocation of activities* provided for in Annex H-3 is welcome as it provides a useful insight into possible mapping for regulatory purposes. However, this type of regulatory work – given that it may require a substantial amount of additional work on interpretation and guidance – may be appropriate for development under strand three work.

The text on the *qualitative qualifying criteria for the Advanced Measurement Approaches* under Annex H-4 Section 1 – with the possible exemption of indents (b) and (c) – seems more appropriate for further development, with concrete guidance for implementation as strand three work. The same may apply to the generic quantitative

standards under 1.2.1 of the aforementioned Annex.[24]

Also, the text of 1.2.5 of Annex H-4 on business environment and internal control factors could be subject to further strand three implementation guidance.

Trading book issues

Article 98(i) refers to *close-out prices* in relation to marking to market techniques. First, the reference to examples of readily available close-out prices may not make sense in the context of a legislative text. The selection of close-out prices may be suited to strand three work. In this context, it may also be worthwhile further investigating prudent ways of using close-out prices under strand three work. As prices tend to differ with the traded volume, it may be useful to take an average of prices in cases where the sum of the individual positions from which the price quotes are taken equals the exposure in question. The relative volume of the single position would be taken as weighting factors when calculating the average. This treatment would ensure that the exposure could actually be traded at this price.

Pillar two

Despite the progress made in the development of the legislative text on pillar two, the current text does not ensure a *consistent application of pillar two across countries*. A consistent application is also becoming important owing to the fact that the essence of pillar two evaluations should not be conducive to "automatic" add-ons but should be associated with a prudent assessment of the overall risk profile of the institutions and groups. As possible sources of divergent implementation, the following factors should be mentioned. First, the ample discretion that banks have in defining and assessing their risks, as well as in defining their "internal capital" for the purpose of assessing these risks (Article 116 2) and, second, the subsequent supervisory evaluation process of banks' internal measurements (Article 126).[25] In addition, elements inherent in the supervisory assessment, such as the "offsetting" of capital between pillars one and two, may aggravate divergence across countries in implementing a pillar two supervisory review. Against this background, it remains of critical importance to ensure a level playing-field for institutions, hence potential sources of significant divergent implementation, such as those mentioned above, need to be addressed not only by reinforcing the text of pillar two but also under strand three in pursuit of supervisory convergence.

Also, given that there will be further work on converging pillar two assessments, it is desirable that at least some pillar two elements, such as the interest rate risk in the banking book for banks that are outliers, pro-cyclicality buffers resulting from bank stress tests, as well as elements from the securitisation framework need to be addressed against surpluses resulting from a prudent definition of regulatory capital. Furthermore, and without prejudice to their importance, other types of risks under pillar two (i.e. concentration risk, residual risk from the application of credit risk mitigation techniques, as well as strategic, reputational risks related to new products, expansions, additional buffers for a targeted rating) may leave some scope for a wider interpretation of internal own funds.

24 *The lack of concrete guidance also applies to the proposed confidence interval, as institutions are required to achieve a soundness standard comparable to a 99.9% confidence interval over a one-year period.*

25 *Although banks can and should use their own internal capital estimates in the context of their Capital Adequacy Assessment Process (CAAP), it is the Supervisory Evaluation Process that is decisive, as it will translate the banks' CAAP into formal regulatory capital). Therefore, the separation of the two notions (regulatory versus internal capital) for banks' internal measurements will inevitably be treated under the supervisory pillar two assessment relative to regulatory capital requirements. Accordingly banks will ultimately be requested to abide by other prudential measures, such as those mentioned in Annex J Section 2.*

The text on the pillar two treatment of *interest rate risk* is still incomplete.[26] The ECB understands that the relevant developments by the Basel Committee[27] as regards the qualitative and quantitative requirements in terms of treating interest rate risk will be incorporated in the final proposals and technical Annexes of the legislative text.

Last but not least, *convergence in pillar two assessment* should be consistent with international developments. In this context, the application of pillar two assessment by major non-EU countries and the way that such an assessment is translated into regulatory capital is an issue that needs to be fully explored. In this regard, the relevant work of the Accord Implementation Group, the specific sub-structure set up by the Basel Committee on Banking Supervision to deal with implementation issues, would provide useful input for the respective work in the EU.

Pillar three

With regard to the entities subject to disclosure requirements (Article 137), an exemption could be introduced for institutions that are not a parent company but are relevant within a banking sector of a given Member State. In such cases, the institutions concerned could also be subject to disclosure requirements.

The suggested drafting regarding disclosures is on the right track as it provides for enhanced and more frequent disclosure (Article 139 paragraph 2 in connection with Annex L-1, paragraph 4). However, the relevant text of paragraph 2 of Article 139 as well as of paragraph 4 of Annex L-1 could be strengthened, as it would appear that the *final assessment relies on the regulated entities themselves*. In this context, it is suggested that the text of paragraph 2 of Article 139 could clearly empower the authorities to require disclosure to be published more frequently than on an annual basis on account of the criteria stated in paragraph 4 of Annex L-1.

Also, the generic reference under Article 141 (b) that Member States shall empower competent authorities to require institutions to publish one or more disclosures more frequently than annually leaves ample discretion and may influence the choice of location for disclosure by institutions. In addition, Article 141 (c), which empowers competent authorities to require entities to use specific media and locations for disclosures, seems to conflict with Article 140, which states that the competent authorities shall permit the entities to determine the appropriate medium and location to effectively comply with the disclosure requirements, thus increasing confusion.

In response to the particular request by the Commission on the need for *supervisory disclosure requirements* to be included in the proposal for a Directive (paragraph 66 of the Explanatory Document), the ECB is supportive of the proposed disclosure. A supervisory disclosure should encompass, as mentioned in paragraph 63 of the same document, the national options exercised in implementing the proposal for a Directive (which attracts particular importance given the numerous national options and degree of discretion), the written policies for approval of institutions' more sophisticated approaches, as well as information on the use of the various approaches by credit institutions.

Given the importance of ensuring an effective implementation of disclosure requirements, a reference in the main part of the Directive (e.g. in Article 141) to the possibility of competent authorities having recourse to supervisory prudential measures, as set out

26 *Particular reference is made to Section 6 of Annex I, which requires the institutions to ensure that they have systems in place to capture all material sources of interest rate risk and provide the competent authorities with the results, while Annex J, Section 1 (2) provides for prudential measures in case of a decline of the exposures to interest rate risk by more than 20% of own funds.*

27 *A revised document on the "Principles for the Management and Supervision of Interest Rate Risk" was issued by the Basel Committee on Banking Supervision for comments to be received by 31 October 2003.*

in Section 2, Annex J, will enhance the legal certainty of empowering competent authorities to apply the respective requirements of the proposal for a Directive.

Large exposures

A specific reference should be made to the ECB for the purpose of exemption from the application of large exposures in (Article 49, paragraph 7 (a) and (f). This is consistent with the respective reference made in Annex C-1 (setting out risk weights for a standardised approach), paragraph 1.1.3.

Exemptions to the rules governing large exposures under Article 49, paragraph 2 should be reported to the Commission and the level 3 Committee of European Banking Supervisors. The latter, if need be, could inform the forthcoming level 2 European Banking Committee (currently Banking Advisory Committee, as referred to in the text of Article 49.2).

Although Article 50, which concerns the provisions for supervision of large exposures on a consolidated or unconsolidated basis, is under review, the current drafting of paragraph 3 could be maintained provided that none of the regulated institutions within this group is a parent institution of another group or financial conglomerate which benefits from a monitoring of large exposures on a consolidated basis only. In the latter cases, such a provision would not facilitate cross-border supervision and/or the tasks of a co-ordinator if this concerns a financial conglomerate.

Annex

Specific drafting suggestions

Strand allocation

The ECB would welcome the use of the comitology procedure in the proposed directive, as recommended by the Committee of Wise Men. Notwithstanding the importance of improving the efficiency of the regulatory framework by making use of regulations, there also seems to be some scope for improving the legislative proposals in their present form, mainly with a view to increasing consistency in strand allocation. In this context, the following remarks, which are merely indicative and are by no means exhaustive, may be of assistance to the Commission services:

Definitions

The definitions of default, probability of default (PD) and loss given default (LGD) provided for in Article 1 (46), (48) and (49), respectively, could be included for the purpose of consistency in Annex D-1 (technical definitions). With regard to the definition of PD in particular, its incorporation in Annex D-1 is justified by the current reference to the probability of a default of a counterparty over one year, which may change in the future. It should also be noted that the third consultative paper for the New Basel Accord states that although the time horizon is set to one year, banks must use a longer time horizon in assigning ratings (paragraph 376 of the consultative document).

Standardised approach

References to the concrete risk weights currently under the core principles (Article 28) may be moved to the technical Annex C-1, as potential further graduated risk buckets for the standardised approach cannot be precluded in the future.

General criteria for the recognition of ECAIs (Annex C-2) are included in strand 2, in contrast with the principles for recognising CRM techniques (Article 68), which are included in strand 1.

As an indication of the need to revise the relevant content of Articles versus Annexes, it should be mentioned that the risk weights of the European Community, the ECB and international institutions such as the IMF and the BIS are mentioned in the Annexes. By contrast, thresholds, such as those listed above pertaining to retail exposures, are mentioned in the core Articles.

The proposed treatment of multiple credit assessments (Article 32) should be addressed in Annex C, owing to its technical nature and its potential for being amended in the future.

Paragraphs 3 and 4 of Article 34, dealing with the risk weights of short-term rated facilities as thresholds versus other unrated claims of the same obligor, could also be included in the technical Annexes.

As regards Annex C-2, dealing with the recognition of ECAIs and the mapping of their credit assessments, the contents of paragraph 1.2.2 on independence, 1.3.1 on the ongoing review and 1.4.1 on transparency and disclosure of the methodology could move to Article 37, which sets out the minimum principles for the ECAIs' methodology. In the same vein, paragraphs 2.1.1 on credibility and market acceptance, 2.2.1 and 2.2.2 on transparency and disclosure of individual credit assessments (second section of Annex C-2) could move to Article 38, which provides the minimum principles for ECAIs' credit assessments.

IRB approach

The definitions provided under asset classes (Article 47) and under technical definitions (Annex D-1) may need to be revised in order

to ensure that all elements that remain in the Articles represent core issues, while those in the Annexes are subject to potential changes. In this context, (i) the reference to the threshold of €1 million for retail exposures, as well as its adjustment on the basis of inflation, should be taken out of the main text (last paragraph of Article 47.5) and moved to Annex D; (ii) the reference to the setting of a minimum number of exposures within a pool of exposures by competent authorities could also move to Annex D, given that the current drafting does not provide any obligation for such treatment (Article 47(5) (b)). Furthermore, Articles 47.7 and 47.8 may move to the Annexes, as they prescribe concrete sub-classes of retail and corporate asset classes which also include technical elements.

The content of the first paragraph of Article 48 on the requirements for internal ratings systems should either be substantiated in terms of its content or deleted.

It should be noted that Article 49.1 makes use of the notion of a roll-out plan as defined in Annex D-1, thereby reducing legibility. As is the case in Article 47, for example, the definition could be included within the Article itself.

Paragraphs 37 and 38 in Section 3.1 of Annex D-5 on corporate governance and oversight, dealing with elements of which a bank's senior management should have a good understanding, as well as the internal financial reporting of the bank for management purposes, may be better dealt with under level 3 work on the implementation of the new capital adequacy framework. The same applies to paragraph 39 in Section 3.2 dealing with areas of responsibility for banks' credit risk control units.

In addition to what is mentioned above, the deletion of the following parts currently contained in the Annexes may also be considered with a view to ensuring a flexible and less onerous EU rulebook. Evidently, these parts should become part of the strand three work on the convergence of supervisory practices. In this context:

a) the elements to be taken as indications of "unlikeliness of the obligor to pay" currently under Annex D-5 paragraph 43 may be better justified under strand three rather than incorporated in a legislative text;

b) with the exemption of the first paragraph establishing the need for robust risk management practices that are recognised as sound by competent authorities, most of the text in Section 8.3 (Annex D-5) dealing with broad risk management approaches by banks could be dealt with as strand three supervisory work, given that the text lends itself to a consistent application of supervisory approaches. For the same reason, the text in Section 8.4 on validation and documentation for institutions employing internal models could be significantly streamlined or allocated in its entirety as strand three supervisory input.

The definition of residual value risk for leasing (paragraph 101, Section 7 of Annex D-5) could be included in the technical definitions (Annex D-1).

The definition of exposures treated on a "pooled basis"[28] should be included in the technical definitions (Annex D-1) given the detailed reference to similar terms therein.

Credit risk mitigation

The third condition for treating sovereign counter-guarantees as sovereign guarantees (Annex E-2, Section 2.2.1.3 (iii)) refers to competent authorities' satisfaction that there is no historical evidence to suggest that coverage of a counter-guarantee is less than

28 For instance, reference to a treatment of exposures on a pooled basis has been introduced in order to calculate the Expected Loss (EL) of purchased corporate receivables treated on a pooled basis in Annex D-3 paragraph 1.1.3) and in order to calculate the pooled exposure weighted average of PD or LGD in paragraph 8 of the same Annex.

effectively equivalent to a direct sovereign guarantee. In the absence of more concrete criteria or recommendation, an assessment of the issue lends itself for inclusion in strand three supervisory work.

The qualitative criteria for accepting banks' own estimates for volatility adjustments, as prescribed in Annex E-3, paragraph 3.1.3.2 (ii), lend themselves to more concrete practical guidance under strand three work.

Asset securitisation

The second condition of Annex F-2, which requires significant credit risk associated with the securitised exposure to have been transferred to third parties, does not provide any additional information. In this respect, if, on the one hand, complying with the remaining requirements is considered sufficient, then this requirement should be deleted. However, if, on the other hand, an additional requirement is needed then a more substantiated content could be given. The same rationale applies to c) in Annex F-3.

In the same vein, the references to "Competent authorities shall consider whether to require a minimum period to elapse before the exercise of the call" and the requirement to give competent authorities "prior notice" when intending to exercise the call (Annex F-3) do not provide any additional information. Hence, they could be deleted from the technical Annexes and dealt with under strand three work, where a minimum timeframe could be agreed upon. The same rationale also applies to the reference "materially and systematically higher than the benchmark" when mapping the default rates experienced for the credit assessment of a particular ECAI (Annex F-4, 2, d)).

Market risks

The content of Article 103 and, in particular, the amendments to the Annexes of Directive 93/6/EEC are more suited to transfer to the technical Annex. Indeed, the degree of detail can be justified by the need to introduce amendments to existing directives only in the form of Articles. However, this is indicative of the need to revise all directives in order to harmonise their content by moving the technical details, which should appear in the Annexes subject to the comitology procedure, from the core elements, which should remain as Articles.

Given that the proposed combination of three indicators regarding the calculation of the thresholds of the trading-book business of institutions (Annex A, second paragraph) in practice allows for complete national discretion, it should be dealt with under strand three work on the convergence of supervisory practices.

The last sentence of Article 98 ii), which states that "an extra degree of conservatism is appropriate", should be deleted from the main regulatory text, as it does not provide any additional information. Alternatively, given its broad nature, this reference could be made in the recitals of the Directive.

Supervisory review process

The text of Annex I on the additional requirements of the institutions' assessment process, management and coverage of risks could be streamlined as it includes several qualitative elements which would appear to be more appropriate for further development in the context of supervisory strand three work. This may apply, for instance, to Section 1 of Annex I.

The content of Annex I dealing with additional requirements on the institutions' assessment process, management and coverage of risks and Annex J on additional criteria on the evaluation process, prudential measures and transparency could be revised to ensure that there is no overlap and that it provides a consistent framework for application. In this context, all issues relating to competent authorities' required actions, currently

spanning both Annexes, could be contained in a single Annex, while elements related to institutions' own assessments could remain in Annex J. Such a differentiation would also reduce the level of overlap that is found in the pillar two text on securitisation, which currently appears in Section 4 of Annex J dealing with additional criteria on the evaluation process, prudential measures and transparency and in Section 5 of Annex I on securitisation risks.

Market discipline

Reference to "a meaningful differentiation of credit risk" when referring to the presentation of exposures across a sufficient number of PD grades should be deleted from the text of the Technical Annex, as it does not provide concrete proposals and is dealt with under strand three work.

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