Investment firms and credit institutions: capital adequacy. Recast

2004/0159(COD) - 14/07/2004 - Document attached to the procedure

COMMISSION'S IMPACT ASSESSMENT

Further information concerning the context of this issue may be found in the summary of the Commission's initial document COM(2004)0486.

1- POLICY OPTIONS AND IMPACTS

In the context of the Basel process, there are four main options available to the Commission:

1.1- No policy change approach: in the absence of a revision of the present regime for capital requirements in Europe: financial institutions' activities would keep being imposed a misallocation of resources and/or a suboptimal financial structure; capital requirements and risks would continue to be misaligned resulting in limited effectiveness of the rules on MCR; significant capital arbitrage would continue and would increase, with likely serious consequences to the economic and social objectives at which prudential regulation is aimed; the full extent or nature of the risks that some financial institutions are undertaking would keep not being captured by the present requirements; the most sophisticated and most effective risk management techniques would not be actively encouraged or recognised; financial services groups operating in more than one Member State would continue to be subject to disproportionate burdens resulting from multiple layers of regulation and supervision; market forces would keep not being leveraged to strengthen the safety and the soundness of the financial system; the EU would be unable to benefit appropriately from future developments in financial markets and in institutions' risk management practices or from improvements in regulatory or supervisory tools, given the difficulty in speedily updating the current EU regulatory framework; in view of the proposed global implementation of the new Basel Accord at end-2006 (Basel 2), the EU financial services sector would be significantly disadvantaged as compared with its overseas competitors.

1.2- The "Basel only" option:no action is taken at the EU level to revise the existing prudential standards framework and banks apply voluntarily the new Basel II accord on the basis of indications by their regulator and / or supervisor. At the same time, banks would continue to apply the EU framework derived from Basel I as prescribed in the Consolidated Banking Directive and in the Capital Adequacy Directive. This option has the benefit of minimizing the workload for EU institutions, but creates a series of very undesirable consequences. First, it does not promote financial stability in the EU as it does not foster the adoption by banks of the most advanced risk management and control methods. Second, it obliges de facto banks acting at the international level to apply a double set of prudential standards, with an important additional regulatory burden. Third, it does not respond to the development of globally agreed prudential standards among supervisors which reflect EU needs and perspectives. Fourth, it puts EU financial institutions at a competitive disadvantage vis à vis their international competitors as they would not be able to benefit from any reduction in capital requirements deriving from the new set of rules. For the above reasons, this option has not been retained by the Commission as a possible working method in developing the new prudential standards framework.

1.3- The "EU only" option:action is taken at the EU level without a close link with the work done by the Basel Committee. The results of the discussions at the EU level would be translated into a new EU prudential framework. This option presents the theoretical advantage of developing a framework tailored on the specificities of the EU financial system, and of ensuring a fully-fledged discussion at all moments of the development of the new rules with all Member States. However, it also presents a series of very serious drawbacks. First, it duplicates the work by EU regulators and supervisors involved in the Basel process. Second, it leads to the creation of double prudential standards for EU banks acting at the international level which would be subject to two completely different sets of rules: those imposed in the EU and those agreed by supervisors in Basel. Third, it does not allow the creation of a level playing field between the EU and the other major actors of the global financial system, such as the US, Japan and Canada. For the above reasons, this option has not been retained by the Commission as a possible working method in developing the new capital requirements framework.

1.4- The "Basel and EU" option:action is taken at the EU level in parallel with the Basel process. Discussions are held at the same time in Basel and in the EU. While the new rules on capital adequacy are agreed by supervisors in Basel, at the same time the development of the discussions is presented in the EU to all Member States so that EU interests and points of convergence can be identified on specific issues and agreed if possible in Basel. If, however, the EU presents the need to pursue a line which cannot be agreed in Basel on selected topics, such a line can still be pursued in the EU. Disadvantages of this option include the use of heavy procedures to make sure that all Member States are informed of the discussions in Basel and the issue that not all Member States are present at the negotiations in Basel. It presents however a series of very important advantages. First, it allows the creation – except for specific topics – of a globally agreed prudential framework which ensures a worldwide level playing field in the financial system. Second, it allows the EU to benefit from the discussions in Basel without the need to replicate an important amount of technical work in order to ensure that the EU financial institutions are subject to a state-of-the-art prudential framework. Third, it allows the EU to influence the Basel process and to arrive at the creation of a broadly single prudential framework (in Basel and in the EU) for European financial institutions with an important limitation in the regulatory burdens they have to sustain. Fourth, it provides the EU with a sufficiently flexible framework for necessary departures from the Basel agreed solutions whenever strong EU reasons require doing so.

CONCLUSIONS: For the above reasons, the **"Basel and EU" option has been retained** by the Commission services as the only possible working method in developing the new capital requirements framework.

2- FOLLOW-UP

There is now a need to adopt a legislative approach and to apply the new capital adequacy rules across all types of EU financial institutions. The proposal is expected to follow normal implementation procedures, i. e. transposition in Member States within 18-24 months.