



European Banking Industry Committee

European Banking Federation (EBF) • European Savings Banks Group (ESBG) • European Association of Cooperative Banks (EACB) European Mortgage Federation (EMF) • European Federation of Building Societies (EFBS)
European Federation of Finance House Associations (Eurofinas)/European Federation of Leasing Company Associations (Leaseurope)
European Association of Public Banks (EAPB)

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EBIC POSITION PAPER on the

THE PROPOSED CAPITAL REQUIREMENTS DIRECTIVE

1. The European Banking Industry Committee (EBIC) congratulates the European Commission for the high quality of the proposal for a directive on capital requirements (CRD). EBIC feels that the quality of the draft legislation reflects the unprecedented level of consultation, including participation in the Basel Committee's impact studies, carried out by the Commission during the process of converting the Basel rules into the EU law. EBIC looks forward to further constructive dialogue with key interlocutors throughout the ongoing negotiations on the Directive.
2. Europe's banking industry and its consumers alike, look forward to enjoying the benefits that the proposed Directive is designed to bring as soon as feasible. This is to best realise the considerable investment the industry has made in preparing for the transition to the new methods of calculating regulatory capital. However, EBIC believes that there are a limited number of issues which must be addressed if the proposed Directive is to truly fulfil its stated aims and make the fullest contribution to the EU's social and economic objectives.
3. The following paper deals for the most part with areas of consensus within EBIC. There are, however, differences of opinion between the member associations on a limited number of important issues. In this context, the paper should not be taken as an exhaustive list of problematic issues within the proposal for a Directive.

Executive summary

4. EBIC states its priorities on the Directive as:
 - securing a quality directive agreed without delay;
 - parallelism between the revised Basel Framework and the proposed Directive, whilst taking account of EU specificities; and
 - application of the Directive to all sizes of credit institution, and those investment firms competing on banking business on a day to day basis, large and small.

5. EBIC highlights that the level of application of the proposed capital requirements is an important issue in the wider directive. However, it has proved necessary to present two points of view on this issue to best reflect Members' respective positions.
6. As regards more specific issues, EBIC:
 - believes that the proposed Directive improves the conditions for **SME financing**, from the perspective of both the lender and borrower;
 - highlights that there are a number of practical problems that still must be resolved in respect of **accounting** and proposes reconciling the proposed Directive's definition of lease exposures with the definition of minimum lease payments given in IFRS;
 - believes that **national discretions** contained in the proposed Directive need to be analysed thoroughly with an aim of achieving greater convergence over time. To this end, EBIC offers its support to CEBS in identifying those national discretions which would have a distortive effect on competition and are not justified by differences in national regimes (e.g. in the mortgage area) so as to eliminate them to the greatest extent possible;
 - welcomes greater clarity in the proposed Directive surrounding the definition of **retail exposures**;
 - strongly supports the intention of the Council's amendment to allow exposures to or guaranteed by all EU central governments and their public authorities as eligible collateral irrespective of their rating, but calls for a lowering of the supervisory LGD for **covered bonds**;
 - considers that the requirements for the monitoring and **revaluation of real estate** under the Standardised and the IRB Foundation Approaches are excessive from a risk perspective;
 - seeks clarity on the calculation of the **operational risk** capital charge;
 - calls for thorough consideration at EU level of the definition of the boundary between the Trading and Banking Books, following the Basel / IOSCO Joint **Trading Book Review**.
7. Finally, EBIC notes that there is no mention in the proposed Directive of which national supervisor is responsible for exercising specific national discretions. In the Directive, the competence to exercise a national option is either given to the consolidating supervisor, (mainly in application of article 129), or to the national competent authority (regulator or supervisor) of the country where the lender or the borrower is domiciled, or where the guarantee is located. For many options the allocation of regulatory competencies is not clear at all. Therefore, EBIC proposes that each national discretion be definitively attributed to the appropriate supervisor.

I. **PRIORITY ISSUES**

A quality directive agreed without delay

8. EBIC firmly believes that agreement of a flexible directive that is consistent with the revised Basel Framework and encourages convergent application across the EU will contribute to the delivery of the European Union's wider economic and social objectives. There should be a drive towards agreement without unnecessary delay. Nevertheless, EBIC urges that the quality of the finalised Directive is not sacrificed for rapid agreement alone, especially in respect of the incorporation of the ongoing work of the Trading Book Review.
9. The emphasis on improved risk management in the proposed Directive and the move from a one-size-fits all approach to capital adequacy will lead to a better targeting of capital. It is of paramount importance to ensure that the benefits of the industry's €20 to €30 billion¹ investment in improved risk management systems is realised without unnecessary delay. Delayed implementation would put Europe's banking industry at a competitive disadvantage in the global market which would ultimately impact negatively on Europe's consumers. EBIC urges that the CRD is adopted at the same time in Europe as the revised Basel Framework is adopted in the jurisdictions of Europe's competitors worldwide.
10. A flexible directive will ensure that the capital requirements framework is able to keep pace with developments in industry practice, markets and supervisory need. This is necessary to protect the interests of depositors and borrowers and to ensure that the EU maintains its reputation as a best practices market. The European Commission's approach of defining enduring principles and objectives in the articles of the recasting Directive and technical measures in annexes which are open to amendment using the comitology procedure, is an effective way to deliver the necessary flexibility. EBIC is also supportive of the European Parliament's right to call back on the Directive under the recently agreed extension of the Lamfalussy process to banking.

Parallelism between the revised Basel Framework and the Directive

11. The revised Basel framework is designed to deliver a level playing field for internationally active banks by establishing minimum regulatory standards. The Commission has delivered a framework which is largely in line with the revised Basel framework whilst taking account of EU specificities. This consistency will significantly reduce the burden of meeting two different sets of standards for internationally active banks operating both in EU and non-EU jurisdictions. EBIC believes that the proposed CRD by and large assures consistency with the revised Basel framework to appropriately reflect the global nature of banking and investment business while ensuring a level playing field for both industry and consumers within the EU.
12. In tandem with ensuring parallelism between the revised Basel Framework and the Directive, convergence of implementation and application of the Directive across the EU is also necessary to deliver the full benefits of a Single Market to Europe's banking

¹ PWC study on the financial and macroeconomic consequences of the draft proposed new capital requirements for banks and investment firms: final report, 8 April 2004.

industry and its consumers alike. In this context, EBIC is fully supportive of the ongoing and future initiatives taken by Committee of European Banking Supervisors to achieve the same goal.

A wide scope of application

13. EBIC is strongly in favour of the Directive applying to all credit institutions (and those investment firms competing on banking business on a day to day basis), large and small. This is because EBIC is persuaded that the Directive puts in place sufficient measures to incentivise good risk management practice in all sizes of institution, thereby increasing the stability and efficiency of European financial markets. Therefore, EBIC believes that, in the context of benefiting all consumers and businesses in the EU, the scope of the Commission's proposal for a Directive is correct.
14. Furthermore, Europe's banking industry believes that credit institutions of all sizes stand to benefit from the revised regulatory capital regime. The Commission's text strikes a sensible balance between providing incentives for smaller institutions to move to the more advanced approaches over time and delivering a proportionate framework which takes account of the resource limitations of smaller credit institutions.

Level of application of capital requirements: towards increasing EU-wide convergence

15. The proposal for a Directive currently applies the rules on a solo-entity basis (Article 68) and then allows Member States to waive the requirement domestically (Article 69).
16. Some EBIC Members believe that consolidated supervision is the only mechanism which can deliver an efficient supervisory environment for banks active on a cross-border basis in the EU. The reality of how banking business operates is recognised by the Basel Committee, which set the consolidated approach as a principle. In the opinion of some EBIC members the current CRD proposal to apply capital requirements at the solo-entity level is the source of a major inconsistency with the international framework and a significant competitive distortion within the EU and with the rest of the world. Therefore, the impediments to consolidated supervision (the fragmented supervisory regime, liquidity risk management, deposit guarantee schemes, the role of the lender of last resort) must be urgently addressed through the Commission's post-FSAP agenda. The same EBIC members believe, therefore, that the level of application of the capital requirements should be reviewed in 2009.
17. Other EBIC Members believe that the current draft CRD strikes the right balance in addressing the particular demands of banking groups while assuring the soundness and the stability of the EU banking system. These Members furthermore consider that an extension of the scope of application of the waiver of Art. 69 of the CRD to the EU at this stage would be premature as many decisive questions are as of yet unresolved (liquidity risk management, deposit guarantee schemes, the role of the lender of last resort). In this context, it should be borne in mind, that on stability issues, quality is more important than speed. Once these open questions are dealt with the issue remains as to how the stability of the banking system overall can be guaranteed by assuring that the capital would be available at the level of the risk. In doing this the EU regulator would meet the

requirements not only of national supervisors, but also the requirements of the Basel II Accord² and the ECB³.

18. Article 69 should also be extended to the parent company in order to avoid combining entity and consolidated level requirements. The current proposal is a step backwards from the current situation in this regard. Article 52(7) of Directive 2000/12/EC explicitly gives the possibility to exempt the parent undertaking from the individual application.
19. A 0% risk weight is a correct reflection of the risk associated with both domestic and cross-border IGEs. There has never been a default on an IGE even in situations where banks have pulled out of foreign subsidiaries. The discretionary waiver in Article 80(7) leads to competitive distortions in the Single Market. Credit institutions from Member States not applying the option are required to hold capital against IGEs whereas institutions from other Member States can risk weight them.
20. Applying a risk weight to IGEs would not only result in a massive cost to the banking industry, it could also impact on the calibration of the Accord given that IGEs were not included in the Quantitative Impact based on consolidated data. Limiting the 0% risk weighting to counterparties within the same Member State would be inconsistent with the Single Market and would have no prudential justification. Intra-group exposures to counterparties in another Member State have the same risk profile as exposures to counterparties within the same Member State.
21. There is a divergence of views within EBIC on the criteria set out regarding the waivers in Article 69 and Article 80(7). Some EBIC members believe that these criteria are the correct reflection of the cross-guarantee schemes, centralised management and consolidated accounts needed for a banking group to qualify for consolidated supervision or for the 0% risk weighting of IGEs. Other EBIC members believe that Article 80(7) is incomplete and should be applied to group structures with comparable risk profiles. This should apply in particular for the operations concluded between members of networks or groups recognised by the competent authorities of each Member State as benefiting, directly or indirectly, from a financial guarantee/solidarity mechanism internal to the group to which they belong, ensuring their liquidity and solvency, as it is currently the case already in some countries.

II. TREATMENT OF SMEs

22. Europe's banking community understands the vital role played by SMEs in creating dynamism and stimulating growth in the Single Market. It is right therefore to look at the potential impacts the proposed CRD could have on SME financing.

Benefits for all, lender and borrower

23. Based on the results of QIS3 and amendments to the revised Basel Framework made by the Basel Committee to specifically address issues around SME financing, which have

² "Accordingly, supervisors should test that individual banks are adequately capitalised on a stand-alone basis"

Basel II Accord, Part 1, Scope of Application, Para. I Introduction, Nr. 23, last sentence;

³ See also ECB opinion on the CRD, OJEU C 52/37.

subsequently been incorporated into the proposed CRD, EBIC considers that the proposed Directive will not have an adverse impact on borrowing by, or lending to, SMEs. Moreover, Europe's banking industry considers that institutions that finance SMEs are likely to benefit from more generous capital treatment under the new proposals.

24. In particular EBIC notes that:

- there has been a reduction in the capital charges for loans to small businesses achieved through a flattening of the risk weight curves;
- a further reduction of capital requirements for loans to SMEs has been achieved by the introduction of a size threshold. Credit institutions will enjoy lower capital requirements for loans to SMEs with annual sales of less than €50 million depending on the size of the company;
- some banks treat their exposures to SMEs as retail exposures and can now administer these exposures on a pooled basis as part of their retail portfolio where capital requirements are lower than for corporate exposures;
- the granularity requirements for the retail treatment of loans to small business have been eliminated thereby allowing more banks to enjoy the preferential treatment; and
- there has been a wider recognition of collateral and guarantees in the new Framework, even if not all unfunded credit protection has been recognised.

25. EBIC believes that the proportionality underpinning the proposed Directive will unlock benefits for all sizes of institution, large and small, and in turn afford better access to capital for institutions' counterparties, large and small. This way both lender and borrower will realise the full benefits the proposed Directive is designed to deliver. In this context, EBIC supports the Commission's treatment of SMEs which, it believes, has resolved the problems raised during earlier consultations. This in turn will have a positive impact on Europe's economy with venture capital and loans to SMEs providing an important stimulus to sustained economic growth across the Union.

III. NATIONAL DISCRETIONS

26. EBIC believes that the application of proportionate supervisory rules by the Member States should be as consistent as possible and as flexible as necessary to deliver both sound prudential supervision and Single Market objectives.

27. Of the 143 national discretions identified by the CEBS' Expert Group on National Discretions in the proposed CRD, EBIC notes that some national discretions have the potential to lead to distortive impacts on competition whilst others are in fact necessary to take into account the current specificities of Europe's markets. EBIC supports the work currently underway at CEBS to highlight which national discretions can be removed now and which are necessary to facilitate local market conditions.

28. EBIC considers that certain national discretions currently proposed in the Directive could distort competition within the Single Market. An example of a national discretion that would produce distortive impacts on competition in the single market is to be found in Article 22 of the recast 93/6/EEC Directive. This article grants competent authorities the right to waive the application of capital requirements on a consolidated basis for investment firms under certain conditions. EBIC believes that the same rules should apply to businesses engaged in the same business and therefore take on the same risks, irrespective of whether they are constituted as credit or investment firms.
29. Furthermore, EBIC considers that exercising these national discretions differently in the different EU Member States potentially has at least two main consequences:
- internationally active banks have to implement the European directives differently for their subsidiaries in different countries. This results in a much higher implementation workload and costs; and
 - from 2008, internationally active banks will have to calculate and report differing requirements for their subsidiaries in different countries under the European directives. This will mean permanently higher prudential reporting costs.
30. EBIC considers that the other category of national discretions, which are deemed not to have a distortive impact on competition, are necessary today to take into account the specificities of individual European markets. For example, in the area of commercial mortgages, lending banks can incur a high level of losses in some Member States with a more variable financing structure. Therefore, supervisors in these countries would request higher levels of capital. In contrast, in other Member States with a different, more fixed-term financing structure, the losses incurred have been lower in comparison over a longer period of time. Against this background the supervisory authorities in these countries would be content with a lower level of capital. A national discretion in this area would allow banks to adapt to national circumstances. It would be inappropriate if banks operating in countries with the lower risk levels would have to provide higher levels of capital which are not justified in view of the national risk situation, while it would be equally inappropriate not to foresee higher levels of capital if required on the basis of the risk. At the same time, the level playing field is assured in so far as all banks operating in this legal and economic (national) environment would benefit from this discretion.
31. Therefore, these discretions are appropriate and should be maintained for the following reasons:
- given that these national discretions address different market situations, keeping them would assure that the capital required would be adapted to the actual risks. An attempt to remove these discretions at EU level would most likely lead to capital requirements being orientated towards the riskier situation and their increase on an overall basis.

- national discretions require different implementation in the different countries and might therefore result in higher implementation workload and costs for banking groups, as described above. These effects might however be out-weighted by the benefits over time resulting from the fact that in some countries their existence would allow banks to apply lower capital requirements.

IV. ACCOUNTING ISSUES: discrepancies between IFRS and the CRD

32. EBIC considers that accounts prepared according to International Financial Reporting Standards (IFRS) provide high quality data which are, in general, reliable. A high level of consistency between IFRS and capital adequacy rules is likely to avoid confusion among market participants and make internal procedures easier and more cost effective. However, it should be noted that not all banks will move to IFRS automatically so the Directive must provide for the present as well as for forward looking accounting arrangements across Member States.
33. EBIC believes that the convergence between both sets of rules should, ideally, enable banks to maintain one single set of figures and a basis for all financial and regulatory reporting requirements. However, regulators may take different views in specific circumstances, particularly where Accounting Standards do not reflect risk exposures in an adequate way or reflect risk exposures differently. Therefore, regulators will need to make some adjustments to the accounting results.
34. If one or several of the objectives of the proposed CRD, for example the protection of depositors, were to be compromised by the treatment provided by the accounting standard setters, prudential filters would be needed in order to assess regulatory capital. For operational reasons these adjustments, the so-called Regulatory Accepted Accounting Principles, should be limited to significant items only.
35. Against this background EBIC welcomes the filter which has been included by the Commission in Article 64(4) of the proposal for a Directive in line with the position of the Basel Committee. EBIC also welcomes the ongoing work of the Committee of European Banking Supervisors (CEBS) in developing prudential filters and wishes to cooperate on this matter. EBIC takes the view that any such filters, as well as other deviations from accounting standards, should reflect decisions taken by the Basel Committee.

Reconciling the definition of lease exposures with IAS 17

36. Under the proposed CRD, lease exposures are defined as discounted lease payment streams while residual values, guaranteed or not, are taken into account separately. Thus, the current split of exposures as defined in the proposed CRD does not reflect the commercial and economic substance of leasing transactions and is therefore subject to ambiguity. Indeed, transactions with same risk profiles would be risk weighted quite differently. These issues go clearly against the stated objective of achieving a level playing field.

37. A straightforward solution would be to reconcile the CRD definition of lease exposures with the definition of minimum lease payments given in IAS 17 (the IASB standard that sets out accounting rules for leasing) as this concept is commonly accepted.
38. Accordingly, to guarantee consistency under all approaches, it should be ensured that the present value of retail minimum lease payments is considered as belonging to the retail claims or contingent retail claims class.
39. Please refer to Annex 1 for specific technical detail and suggested amendments.

Practical problems for banks are only partially solved

40. EBIC is concerned that certain discrepancies remain between the proposed Directive and IFRS. It is felt that, for the moment, several aspects of the Directive do not reflect actual business practice or take into account a number of IFRS definitions. This will undoubtedly lead to significant difficulties in the implementation of the Directive.
41. EBIC seeks to resolve the differences between the proposed Directive and the accounting standard IAS 39 as the differences may have an impact in practice. This list is not exhaustive and is subject to further analysis, but two examples are:
 - While the Directive considers a client approach to default, the accounting standard takes into account a loan or product status view.
 - The Directive focuses on unexpected losses on defaulted assets while impairment allowances under IAS 39 relate to incurred losses.

V. THE DEFINITION OF RETAIL EXPOSURES

42. EBIC attaches the utmost importance to having a single and unambiguous definition of what would constitute a retail exposure under the proposed Directive. Ambiguity in this regard creates unnecessary compliance costs for all institutions. Excessive leeway given to Member States could endanger the creation of a Europe-wide level playing field. Against this background, EBIC believes that the eligibility criteria put forward in the proposed Directive clarifies the rather ambiguous framework designed by the Basel Committee.

Clarity is welcome but problems still remain

43. EBIC considers that important problems in respect of the definition of retail exposures remain. For example, in order to be eligible for the retail treatment for both the Standardised and IRB approaches, credit institutions are forced to demonstrate that their aggregate exposures to one counterparty are below €1m. For the IRB approaches, credit institutions have to demonstrate that their aggregate exposures to small or medium sized entities are below €1m. This poses a number of fundamental and practical problems:
 - it is not clear whether mortgage loans should be included in the aggregation calculation or whether it is treated separately under exposure class labeled “claims or

contingent claims secured on real estate property”. Therefore, EBIC seeks clarity on this issue.

- aggregating all of counterparties’ exposures to include credit cards, small business loans, overdrafts and mortgages could in many cases prove impossible. These exposures could span a number of subsidiaries, a number of systems and a number of countries.
- the revised Basel Framework highlighted the need for ‘supervisors to provide flexibility in the practical application of such thresholds such that banks are not forced to develop extensive new information systems simply for the purpose of ensuring perfect compliance.’ EBIC strongly suggests that the finalised text of the proposed Capital Requirements Directive follows the wording set out in this regard in the revised Basel Framework since this requirement.

44. Please refer to Annex 2 for further technical detail and suggested amendments.

VI. COVERED BONDS

45. Covered bonds are on balance sheet debt instruments secured by a cover pool of mortgage loans (property as collateral) or public-sector debt to which investors have a preferential claim in the event of the issuer’s default. As they remain on the issuer’s balance sheet, the bonds benefit from the additional security of the issuing institution’s own funds and from the restrictive legal regulation of the issuing credit institutions.

46. According to current EU law, covered bonds that fulfill criteria set out in the legislation on UCITS⁴ are allowed 10% weighting because of their secure nature. At present, covered bonds have emerged as the most important segment of privately issued bonds on Europe’s capital markets with volume outstanding at the end of 2003 amounting to over €1.5 trillion. Currently, around 20-25% of home lending is refinanced through covered bonds. For this reason, EBIC would like to emphasise the need to recognise the low risk profile and security of covered bonds in any future European legislation.

Collateral from all Member States should be considered as eligible

47. In the proposed Directive there is a real danger that exposures to or guaranteed by many of the new EU Member States (central governments and other public authorities), along with Greece, will not be eligible as cover assets for covered bonds. This is because of the explicit link between the eligibility of these assets and their rating level. EBIC strongly supports the intention of the Council’s amendment to allow exposures to or guaranteed by all EU central governments and their public authorities as eligible collateral irrespective of their rating.

Lowering supervisory LGD levels

48. EBIC calls for a lowering of the supervisory Loss Given Default (LGD) for covered bonds. Research undertaken by the European Mortgage Federation and sent to the

⁴ Article 22 (4) of Directive 85/611/EEC.

European Commission on 16th April, 2004, showed that based on data for the six largest markets, the true LGD figure is closer to 6%, regarding the real estate cover pools. Based on this evidence, the Commission agreed to lower the LGD figure to 12.5% compared to the initial proposal of 20%. This still does not reflect the high credit quality of covered bonds. In particular, it has not been taken into account that the cover pools consisting of exposures to public borrowers, which make up over 50 % of the cover assets in covered bonds, show no losses at all. EBIC therefore calls on the European Parliament to amend the EU Commission's proposal by lowering the LGD value from the currently proposed 12.5% to 10%.

Clarification is necessary for the Advanced IRB Approach

49. The criteria set out in the Standardised Approach would, it is assumed, transfer over to institutions using the Internal Ratings Based Approach. However, there would also seem to be a complicating issue as to whether an institution could apply the Advanced Approach to these exposures given proposed limitations on the use of the Issuer's LGD data.
50. Please refer to Annex 3 for further technical detail and suggested amendments.

VII. PROPERTY REVALUATION

Excessive monitoring and revaluation requirements remain

51. The obligation to monitor the value of residential real estate property at a minimum every three years is but one example of excessive requirements from a risk point of view, for the monitoring and revaluation of real estate under the Standardised and the IRB Foundation Approaches. Although the modified revaluation period is an improvement compared to the Commission's original proposal, EBIC still feels that it is an inappropriate and unnecessary requirement. Furthermore, EBIC understands that institutions will be unable to comply with this requirement in practice. We therefore call for the monitoring period to be extended to 5 years.
52. Furthermore, under the proposed Directive residential real estate in the Standardised and IRB Approaches has to be revalued at least every 3 years if the loan exceeds €3 million or 5% of the credit institution's own funds. This requirement goes beyond the requirements of the revised Basel Framework where no periodical revaluation is required. Furthermore, it also represents a tightening-up vis-à-vis the status quo as currently revaluation of property is only required for commercial real estate loans that can be assigned a 50% risk weighting. Therefore, Europe's banking industry believes that this requirement ought to be deleted
53. For risk purposes it is sufficient to review the value of the property if the monitoring indicates that the value of the property has declined materially relative to the general market prices. This especially holds because in order to be eligible the value of the property must exceed the exposure by a substantial margin. Moreover, a compulsory periodical revaluation would lead to substantial additional costs for credit institutions and could thus deteriorate the terms of financing, especially for condominium and cooperative housing.

54. Finally, not only is a high level of over collateralisation required, the level of LGD that may be applied is unwarranted. In addition, numerous conditions and requirements must be respected before a credit institution is allowed to treat a property as collateral (see Annex VIII, Part 2 of the proposed CRD). EBIC deems that these requirements cannot be considered separately and that the combination of these three factors is overly conservative
55. Please refer to Annex 4 for further technical detail and suggested amendments.

VIII. OPERATIONAL RISK

Further clarity is needed in the calculation of operational risk

56. EBIC believes that it is not sufficiently clear whether the possibility to offset positive capital charges from one business line by negative charges in other business lines, as set out in the revised Basel Framework, has been taken up in the proposed Directive. Europe's banking industry seeks clarity on this issue so as to avoid any unnecessary costs in the future.
57. Failure to offset positive by negative capital charges would reduce the credit institutions' incentives to apply the Standardised Approach and would also put credit institutions located in the EU at a competitive disadvantage, vis-à-vis their global competitors.
58. EBIC also feels that the recognition of insurance coverage in the Advanced Measurement Approaches set out in the proposed Directive does not take into account current market practices and would cause unnecessary additional costs for banks. We therefore urge for a review of the requirements as currently drafted in the proposed Directive.
59. Please refer to Annex 5 for further technical issues and suggested amendments.

IX. TRADING BOOK

60. The Basel Committee is undertaking jointly with the International Organisation of Securities Commissions (IOSCO), a review of counterparty risk and Trading Book issues⁵. Europe's banking industry broadly welcomes the commitment by the Commission to ensure that the results of the Trading Book Review are reflected in the Directive before its implementation.

Good progress is welcome but highly technical issues must take time

61. EBIC agrees that the work on double default and counterparty risk should be completed rapidly and incorporated in the Directive using the legislative tools at the disposal of the Commission. However, the matter of the boundary between the Trading Book and the

⁵ Financial Institutions have two primary categories for their assets, the "banking book" and the "trading book." Most long to medium-term transactions are booked through the banking book (loans, deposits, etc.), while the trading book is a proprietary portfolio for short-term financial instruments held by an institution in its capacity as a dealer. Investment banks place virtually all their financial instruments into the trading book. The boundary between the Banking Book and the Trading Book has never formally been defined.

Banking Book is extremely technical and should not be subject to hasty treatment. Incomplete work on this vitally important matter could have a negative impact on European investors in the future. Europe's banking industry would welcome a more thorough review of this issue and incorporation into EU legislation at a later date.

Annex 1 – Accounting issues: Reconciling the definition of lease exposures under the Directive with IAS 17

Annex VII, Part 3, paragraph 4

The exposure value for leases shall be the discounted lease payment stream.

The exposure value for leases shall be the discounted ~~lease payment stream~~ minimum lease payments. Minimum lease payments are the payments over the lease term that the lessee is or can be required to make, excluding contingent rent, costs for services and taxes to be paid by and reimbursed to the lessor, together with, for a lessor, any residual value guaranteed to the lessor by

- (i) the lessee;**
- (ii) a party related to the lessee; or**
- (iii) a third party unrelated to the lessor that is financially capable of discharging the obligations under the guarantee.**

However, if the lessee has an option to purchase the asset at a price that is expected to be sufficiently lower than fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised, the minimum lease payments comprise the minimum payments payable over the lease term to the expected date of exercise of this purchase option and the payment required to exercise it.

Any guaranteed residual value must fulfil the conditions set out in Annex VIII, Part 1, paragraphs 26 to 28 for the eligibility of protection providers as well the minimum requirements provided in Annex VIII, Part 2, paragraphs 14 to 18.

Justification

Under the IRB approaches of the CRD, the scope of the definition of lease exposures does not take into account the particularities of lease financing, thereby creating complications for the leasing industry when it comes to implementation. These expected difficulties go against the stated objective of achieving a level playing field.

Under CRD, lease exposures are defined as discounted lease payment streams while residual values, guaranteed or not, are taken into account separately. Thus, the notion of lease payment streams as defined in CRD is subject to ambiguity and does not reflect the commercial and economic substance of leasing transactions.

A straightforward solution would be to reconcile the CRD definition of lease exposures with the definitions given in IAS 17 (the IASB standard that sets out accounting rules for leasing). It should therefore be made certain that the lease payment stream notion is equivalent to that of minimum lease payments in IAS 17, as this concept is commonly accepted.

Underlying Technical Explanation

The proposal for a Directive calls for a split between lease payment streams and residual values. This has practical implications when it will come to applying the Directive.

- *First and foremost, there is uncertainty regarding the definition of lease payment streams, the notion used to define lease exposures in the CRD. Thus, the current text implies that the calculation of LGDs would have to be aligned with this unsuitable definition of lease exposures. Indeed, the concept does not meet with usual business practice for leasing, nor does it reflect the **economic and commercial substance** of a leasing transaction.*
- *Additionally, in practice, residual values can be included in minimum lease payments, i.e. when they are guaranteed or in the case of leasing contracts with bargain options. Including these types of residual values in the minimum lease payments and therefore in the lease exposures implies that all credit risk relating to the exposure is effectively taken into account. It should be noted that the inclusion of such residual values in the lease exposure should be subject to the fulfilment of (1) the conditions for eligibility given in Annex VIII, Part 1, paragraphs 26 to 28 and (2) the minimum requirements provided in Annex VIII, Part 2, paragraphs 14 to 18.*
- *Furthermore, the concept of lease payment streams may vary from country to country and does not correspond to wording used in any well accepted international accounting standards.*

To avoid these practical application difficulties, lease exposures under the CRD should be equivalent to IAS 17 minimum lease payments as these are clearly defined, i.e. they include guaranteed residual values. Moreover, this solution has the additional advantage of leading to a capital charge that depends on the substance of the leasing contract itself and no longer on the form of the contract.

Article 86, paragraph 8

The exposure class referred to in point (g) of paragraph 1 shall include the residual value of leased properties, if not covered elsewhere in this Directive.

The exposure class referred to in point (g) of paragraph 1 shall include the residual value of leased properties, if not ~~covered elsewhere in this Directive~~ **included in the lease exposure as defined in Annex VII, Part 3, paragraph 4.**

Justification

It has been shown above that lease exposures under the CRD should be equivalent to IAS 17 minimum lease payments as these are clearly defined, i.e. they include guaranteed residual values. This means that in the CRD no split should be made between lease payment streams and guaranteed residual value exposures. Therefore, the definition that the proposal for a Directive provides for residual values should also be adapted in consequence. This solution is particularly effective as it makes for a clear, practicable and consistent separation of an institution's credit and market risks.

Article 79, paragraph 2

2. To be eligible for the retail exposure class referred to in point (h) of paragraph 1, an exposure shall meet the following conditions:

(a) the exposure must be either to an individual person or persons, or to a small or medium sized entity;

(b) the exposure must be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced;

(c) the total amount owed to the credit institution and any parent undertaking and its subsidiaries, including any past due exposure, by the obligor client or group of connected clients must not, to the knowledge of the credit institution, exceed EUR 1 million. The credit institution must take reasonable steps to acquire this knowledge.

Securities shall not be eligible for the retail exposure class.

2. To be eligible for the retail exposure class referred to in point (h) of paragraph 1, an exposure shall meet the following conditions:

(a) the exposure must be either to an individual person or persons, or to a small or medium sized entity;

(b) the exposure must be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced;

(c) the total amount owed to the credit institution and any parent undertaking and its subsidiaries, including any past due exposure, by the obligor client or group of connected clients must not, to the knowledge of the credit institution, exceed EUR 1 million. The credit institution must take reasonable steps to acquire this knowledge.

The present value of retail minimum lease payments is eligible for the retail exposure class.

Securities shall not be eligible for the retail exposure class.

Justification

In order to guarantee consistency under all approaches, it should be ensured that the present value of retail minimum lease payments is considered as belonging to the retail claims or contingent retail claims class

Article 86, paragraph 4

4. To be eligible for the retail exposure class referred to in point (d) of paragraph 1, exposures shall meet the following criteria:

- (a) they shall be either to an individual person or persons, or to a small or medium sized entity, provided in the latter case that the total amount owed to the credit institution and to any parent undertaking and its subsidiaries by the obligor client or group of connected clients does not, to the knowledge of the credit institution, which must have taken reasonable steps to confirm the situation, exceed EUR 1 million;
- (b) they are treated by the credit institution in its risk management consistently over time and in a similar manner;
- (c) they are not managed individually in a way comparable to exposures in the corporate exposure class;

4. To be eligible for the retail exposure class referred to in point (d) of paragraph 1, exposures shall meet the following criteria:

- (a) they shall be either to an individual person or persons, or to a small or medium sized entity, provided in the latter case that the total amount owed to the credit institution and to any parent undertaking and its subsidiaries by the obligor client or group of connected clients does not, to the knowledge of the credit institution, which must have taken reasonable steps to confirm the situation, exceed EUR 1 million;
- (b) they are treated by the credit institution in its risk management consistently over time and in a similar manner;
- (c) they are not managed individually in a way comparable to exposures in the corporate exposure class;

The present value of retail minimum lease payments is eligible for the retail exposure class.

Justification

To guarantee consistency under all approaches, it should be ensured that the present value of retail minimum lease payments is considered as belonging to the retail claims or contingent retail claims class

Annex VII, Part 1, paragraph 25

25. The risk weighted exposure amounts shall be calculated according to the formula:

Risk-weighted exposure amount =
100% * exposure value

25. The risk weighted exposure amounts shall be calculated according to the formula:

Risk-weighted exposure amount =
100% * exposure value

except for when the exposure is a residual value in which case it should be provisioned for each year and will be calculated as follows:

$1/t * 100% * \text{exposure value}$

where t is the number of years of the lease contract term.

Justification

If a lessee is in default before the end of the lease contract term, the credit risk relating to this event is taken into account via LGDs. In the other case of a lessee not being in default, the residual value of the leased asset is exclusively subject to market risk and, even then, this risk is only realised at the end of the contract.

*As a result, we propose that the credit institution should take into account a portion of the residual value risk each year over the lease contract term. The most simple and effective way to determine this proportion is to take into account the same fraction of the exposure every year. Thus we suggest that the risk-weighted exposure amount be calculated as $1/t * 100% * \text{exposure value}$ where t is the number of years of the lease contract term.*

Additionally, it is important to understand the residual value management is a central concern of the lessors' business. Indeed, lessors keep historical records on secondary markets and they also benefit from existing track records, which provide price guides for the majority of assets for which a well-established secondary market exists. Therefore, when returns on leased assets are carefully monitored and residual values set conservatively, and this is reinforced due to the minimum requirements for recognising physical collateral, the weighting ratio should be adapted to a more realistic level than the proposed 100% level.

Annex 2 - The definition of retail exposures

EBIC proposes the following amendments:

Article 79.2(c)

2. To be eligible for the retail exposure class referred to in point (h) of paragraph 1, an exposure shall meet the following conditions:

(a) the exposure must be either to an individual person or persons, or to a small or medium sized entity;

(b) the exposure must be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced;

(c) the total amount owed to the credit institution and parent undertakings and its subsidiaries, including any past due exposure, by the obligor client or group of connected clients, must not, to the knowledge of the credit institution, exceed EUR 1 million. The credit institution must take reasonable steps to acquire this knowledge.

2. To be eligible for the retail exposure class referred to in point (h) of paragraph 1, an exposure shall meet the following conditions:

(a) the exposure must be either to an individual person or persons, or to a small or medium sized entity;

(b) the exposure must be one of a significant number of exposures with similar characteristics such that the risks associated with such lending are substantially reduced;

(c) the total amount owed to the credit institution and **its** parent undertakings and its subsidiaries, including any past due exposure, by the obligor client or group of connected clients, **but excluding claims or contingent claims secured on real estate property**, must not, to the knowledge of the credit institution, exceed EUR 1 million. The credit institution must take reasonable steps to acquire this knowledge.

Article 86.4(a)

4. To be eligible for the retail exposure class referred to in point (d) of paragraph 1, exposures shall meet the following criteria:

(a) they shall be either to an individual person or persons, or to a small or medium sized entity, provided in the latter case that the total amount owed to the credit institution and to any parent undertaking and its subsidiaries by the obligor client or group of connected clients, does not, to the knowledge of the credit institution, which must have taken reasonable steps to confirm the situation, exceed EUR 1 million;

4. To be eligible for the retail exposure class referred to in point (d) of paragraph 1, exposures shall meet the following criteria:

(a) they shall be either to an individual person or persons, or to a small or medium sized entity, provided in the latter case that the total amount owed to the credit institution and to any parent undertaking and its subsidiaries by the obligor client or group of connected clients, **but excluding claims or contingent claims secured on real estate property** does not, to the knowledge of the credit institution, which must have taken reasonable steps to confirm the situation, exceed EUR 1 million;

Justification

In order to be eligible for the retail treatment for both the standardised and IRB approaches, credit institutions are forced to demonstrate that their aggregate exposures to one counterparty are below €1m. This poses a number of fundamental and practical issues. For example, using an arbitrary €1m limit represents inflexible policy making and does not reflect the way in which institutions distinguish between retail and corporate exposures.

It is not clear whether mortgage loans should be included in the aggregation calculation (Art 79.2(c)) or whether it is treated separately under exposure class (i) claims or contingent claims secured on real estate property. Aggregating all a counterparties exposures to include credit cards, small business loans, overdrafts and mortgages could in many cases prove impossible. These exposures could span a number of subsidiaries, a number of systems and a number of countries.

Moreover, under the Basel framework it highlighted the need for ‘supervisors to provide flexibility in the practical application of such thresholds such that banks are not forced to develop extensive new information systems simply for the purpose of ensuring perfect compliance.’ This requirement could potentially restrict the availability of funding to SMEs compared to current underwriting practices.

Therefore, mortgage lending ought to be excluded from the aggregation calculation for the retail treatment.

Annex 3 – Covered bonds

EBIC proposes the following amendments:

Annex VII, Part 2, paragraph 8

- | | |
|--|---|
| <p>8. Credit institutions shall use the following LGD values:</p> <p>(a) ...</p> <p>(d) Covered bonds as defined in Annex VI, Part 1, paragraphs 65 to 67 may be assigned an LGD value of 12.5%.</p> | <p>8. Credit institutions shall use the following LGD values:</p> <p>(a) ...</p> <p>(d) Covered bonds as defined in Annex VI, Part 1, paragraphs 65 to 67 may be assigned an LGD value of 12.5% 10%.</p> |
|--|---|

Annex VII, Part 2, paragraph 10 (a) [new]

[...]

10 (a) Notwithstanding paragraph 8, if a credit institution is permitted to use own LGD estimates for exposures in covered bonds, the institution may use data provided by the issuing institution.

Justification

When calculating the capital requirements under the advanced approach, a covered bond investor has to estimate the probability of default (PD) of the issuer and the loss given default (LGD) of the bond without having access to the relevant LGD-data. The investor will not know the LGDs of the cover pool and he is prevented from using third party data (i.e. the issuer given data, if available) as own estimates. In order to assert its high credit quality, investors must be permitted to use third party data in calculating the capital requirements on covered bonds under the advanced approach.

Annex 4 – Property revaluation

EBIC proposes the following amendment:

Annex VIII, Part 2, paragraph 8(b)

8. For the recognition of real estate collateral the following conditions shall be met:

(a) ...

(b) Monitoring of property values

The value of the property shall be monitored on a frequent basis and at a minimum once every year for commercial real estate and once every three years for residential real estate. More frequent monitoring shall be carried out where the market is subject to significant changes in conditions. Statistical methods may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices. For loans exceeding EUR 3 million or 5% of the own funds of the credit institution, the property valuation shall be reviewed by an independent valuer at least every three years.

8. For the recognition of real estate collateral the following conditions shall be met:

(a) ...

(b) Monitoring of property values

The value of the property shall be monitored on a frequent basis and at a minimum once every year for commercial real estate and once every ~~three-five~~ years for residential real estate. More frequent monitoring shall be carried out where the market is subject to significant changes in conditions. Statistical methods **or index based adjustments of original valuations** may be used to monitor the value of the property and to identify property that needs revaluation. The property valuation shall be reviewed by an independent valuer when information indicates that the value of the property may have declined materially relative to general market prices. ~~For loans exceeding EUR 3 million or 5% of the own funds of the credit institution, the property valuation shall be reviewed by an independent valuer at least every three years.~~

Justification

The requirement under the standardised and IRB approaches in the Commission's draft Directive that the value of property being used as real estate collateral should be monitored at a minimum once every year is inappropriate and unnecessary. Institution will be unable to comply with this requirement in practice. We therefore call for the monitoring period to be extended to 5 years.

Furthermore, under the proposed Directive real estate in the Standardised and IRB Approaches has to be revalued at least every 3 years if the loan exceeds €3 million or 5% of the credit institution's own funds. This requirement goes beyond the requirements of the revised Basel Framework where no periodical revaluation is required. It also represents a tightening-up vis-à-vis the status quo as currently revaluation of property is only required for commercial real estate loans that can be assigned a 50% risk weighting. Therefore, this requirement ought to be deleted.

For risk purposes it is sufficient to review the value of the property if the monitoring indicates that the value of the property has declined materially relative to the general market prices. This especially holds because in order to be eligible the value of the property must exceed the exposure by a substantial margin. Moreover, a compulsory periodical revaluation would lead to substantial additional costs for credit institutions and could thus deteriorate the terms of financing especially for condominium and cooperative residential housing.

Annex 5 – Operational risk

EBIC proposes the following amendments:

Annex X, Part 2, paragraph 1

Under the Standardised Approach, the capital requirement for operational risk is the simple sum of the capital requirements calculated for each of the business lines in table 2.

Under the Standardised Approach, the capital requirement for operational risk is the simple sum of the capital requirements calculated for each of the business lines in table 2. **Thereby negative capital charges in any business line may offset positive charges in other business lines without limit.**

Justification

It is not sufficiently clear whether the possibility, provided for in the New Basel Capital Accord (International Convergence of Capital Measurement and Capital Standards - A revised framework, paragraph 654), to offset positive capital charges from one business line by negative charges in other business lines has been taken up in the directive proposal. In order to avoid difficulties in interpretation, at this point the clear Basel formulation should be used. The inability to offset positive by negative capital charges would reduce the credit institutions' incentives to apply the Standardised Approach and would also put credit institutions located in the EU at a competitive disadvantage vis-à-vis their global competitors.

Annex X, Part 2, paragraph 6

6. If for any given observation the sum of net interest income and net non-interest income is negative, this figure shall be assigned the value zero.

~~6. If for any given observation the sum of net interest income and net non-interest income is negative, this figure shall be assigned the value zero.~~

Justification

The provision would not allow for a negative gross income in any business line. The deletion is necessary to compliment amendment of paragraph 1.

Annex X, Part 3, paragraph 27

The provider has a minimum claims paying ability rating of A (or equivalent);
(a) The insurance policy must have an

The provider has a minimum claims paying ability rating of A (or equivalent);
(a) The insurance policy must have an initial

initial term of no less than one year. For policies with a residual term of less than one year, the credit institution must make residual term of the policy, up to a full 100% haircut for policies with a residual term of 90 days or less.

(b) [...];

term of no less than one year. For policies with a residual term of less than one year, the credit institution must make residual term of the policy, up to a full 100% haircut for policies with a residual term of 90 days or less. **The above provision shall not apply in the case of policies subjected to an automatic renewal at maturity.**

(b) [...];

Justification

In respect of lower capital charges by virtue of insurance policies of more than a year's duration, EBIC highlights that it is standard practice to renew operational risk insurance annually. Policy expiry dates may also coincide with a variety of different renewal dates. Thus on any given observation date for the capital requirement, the residual life of a policy may be less than a year. It therefore seems illogical to pro-rate the diminishing mitigation effect simply because the policy is subject to renewal. Therefore, we request that for policies that are not one-off, but stipulated on a continuing basis, the provision in point a) of paragraph 27 with less than one year of residual life shall not apply.