EUROPEAN CENTRAL BANK

OPINION OF THE EUROPEAN CENTRAL BANK

of 17 February 2005

at the request of the Council of the European Union on a proposal for directives of the European Parliament and of the Council recasting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions and Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions

(CON/2005/4)

(2005/C 52/10)

1. On 15 September 2004, the European Central Bank (ECB) received a request from the Council of the European Union for an opinion on a proposal for two directives of the European Parliament and of the Council [1]: the first directive (hereinafter the 'proposed banking directive') recasting Directive 2000/12/EC of the European Parliament and of the Council of 20 March 2000 relating to the taking up and pursuit of the business of credit institutions [2] and the second directive (hereinafter the 'proposed capital adequacy directive') recasting Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions [3] (hereinafter together the 'proposed directives').

2. The ECB's competence to deliver an opinion is based on the first indent of Article 105(4) of the Treaty establishing the European Community, which provides that the ECB shall be consulted on any proposed Community act in its fields of competence. The proposed directives contain provisions which are essential for the soundness and stability of the financial system. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

3. The proposed directives are essential components of the Financial Services Action Plan. Their objective is to modernise the existing capital adequacy framework for credit institutions and investment firms. They will ensure the coherent application throughout the EU of the revised framework for international convergence of capital measurement and capital standards for internationally active banks [4] (hereinafter 'Basel II') agreed in June 2004 by the Basel Committee on Banking Supervision (BCBS) and endorsed by the central bank governors and heads of bank supervisory authorities in the Group of Ten countries. In particular, the proposed directives provide for a more comprehensive and risk-sensitive approach, fostering enhanced risk management by financial institutions, which will contribute to financial stability, inspire confidence in financial institutions and strengthen consumer protection.

4. In its previous contributions [5], the ECB has been very supportive of the work of the BCBS and the European Commission over recent years to establish a revised set of rules on capital adequacy for credit institutions and investment firms. The ECB welcomes the fact that the BCBS reached a final agreement on Basel II. It also welcomes the fact that the Commission shortly afterwards adopted proposals which will ensure a consistent and timely implementation of Basel II by internationally active banks and investment firms in the EU, and will also extend the Basel II approach to other EU financial institutions, taking into account their specific features.

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[1] COM(2004) 486 final, Volumes I and II and Annexes techniques.

[2] OJ L 126, 26.5.2000, p. 1 (hereinafter the 'Consolidated Banking Directive'). Directive as last amended by Commission Directive 2004/69/EC (OJ L 125, 28.4.2004, p. 44).

[3] OJ L 141, 11.6.1993, p. 1 (hereinafter the 'Capital Adequacy Directive'). Directive as last amended by Directive 2004/39/EC (OJ L 145, 30.4.2004, p. 1).

[4] Basel Committee on Banking Supervision, 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework', Bank for International Settlements (BIS), June 2004; available on the BIS's website.

[5] See in particular the comments of the ECB on the BCBS's second consultative package of 31 May 2001, the reply of the ECB to the BCBS's third consultative proposals (CP3) of August 2003, and the comments of the ECB on the third consultative document of the European Commission on regulatory capital review (hereinafter the 'third consultative document') of November 2003; documents all available on the ECB's website.

5. The ECB is convinced that the proposed directives, once properly transposed by the Member States, will considerably strengthen the soundness and stability of the EU banking system through the application of more sophisticated, risk-sensitive capital standards. The ECB therefore stresses its generally positive view of the proposed directives. However, without prejudice to this general view, the ECB has a number of general and specific remarks with regard to the proposed directives and their future application ([1]).

GENERAL REMARKS

Legal instruments for consistent implementation across the EU

6. The ECB has on several occasions, in particular in ECB Opinion CON/2004/7 on the proposed committee structure directive ([2]) (which aimed to introduce into a number of existing Community directives the required amendments for the extension of the 'Lamfalussy process' for financial regulation from the securities sector to all other financial sectors), supported the recommendations of the Inter-Institutional Monitoring Group to limit Level 1 Community legal acts to framework principles and use regulations wherever possible at Level 2. As stated in paragraph 6 of ECB Opinion CON/2004/7, the ECB considers that implementation of the Inter-Institutional Monitoring Group's recommendations could gradually lead to Level 2 acts emerging as the main body of technical rules applicable to EU financial institutions.

7. In the same vein, in its comments on the third consultative document, the ECB suggested that in order to implement Basel II the technical annexes to the proposed directives should be adopted directly as Level 2 measures, and, where compatible with necessary flexibility in terms of national implementation, via Community regulations.

8. In the ECB's view, the implementation of Basel II offered a unique opportunity to revise EU capital requirements along these lines, which has not been seized. The ECB acknowledges that pursuant to Article 150(1) of the proposed banking directive, the Commission will have the power to adopt, in accordance with the 'comitology' procedure referred to in Article 151 of the proposed banking directive, 'adjustment[s] of the provisions in Annexes V to XII in order to take account of developments on financial markets in particular new financial products, or in accounting standards or requirements set out in Community legislation'.

9. However, in line with the agreement to extend the Lamfalussy process from the securities sector to all other financial sectors ([3]), it would have been preferable to have limited the proposed directives to cover framework principles reflecting the basic political choices and substantive matters in the field of capital adequacy for credit institutions and investment firms and to have brought the technical provisions on capital adequacy together in one directly applicable Level 2 regulation. This approach would reinforce a convergent implementation of Basel II throughout the EU, facilitate compliance by financial groups operating across different EU countries and reduce costs, as well as promoting a level playing field and further financial integration.

10. If it is considered that the proposed directives cannot at this stage be amended in line with this approach, the ECB considers that the envisaged legal structure should not be viewed as the final desirable outcome, but rather as one step in a long-term process towards establishing, whenever possible, a directly applicable set of Level 2 technical rules for financial institutions within the EU.

The reduction of national options and national discretion

11. The reduction of national options is of the utmost importance, as this would simplify the regulatory framework, assist the convergence of supervisory practices and contribute to a level playing field. The ECB recognises the progress that has been achieved by the Committee of European Banking Supervisors (CEBS) towards reducing the number of options and waivers. It fully supports the endeavours of CEBS and strongly encourages further work in this field as, despite the progress achieved, a significant number of options remain which potentially hinder a level playing field. Articles 68 to 73 of the proposed banking directive contain options to waive capital requirements at

([1]) It is noted that at its meeting on 7 December 2004 the ECOFIN Council agreed on a general approach regarding the proposed directives (hereinafter the 'Council's general approach'). It requested the Presidency of the Council to continue contacts with representatives of the European Parliament in order to explore the possibility of adopting the proposed directives at the first reading. The Council's general approach also addresses some of the issues that the ECB raises in this opinion. Where appropriate, reference is made to the Council's general approach.

([2]) ECB Opinion CON/2004/7 of 20 February 2004 at the request of the Council of the European Union on a proposal for a Directive of the European Parliament and of the Council amending Council Directives 73/239/EEC, 85/611/EEC, 91/675/EEC, 93/6/EEC and 94/19/EC and Directives 2000/12/EC, 2002/83/EC and 2002/87/EC of the European Parliament and of the Council, in order to establish a new financial services committee organisational structure (OJ C 58, 6.3.2004, p. 23).

([3]) See page 12 of the press release of the 2 580th ECOFIN Council Meeting held in Brussels on 11 May 2004; available on the Council's website.

various levels within groups. In the ECB's view, if these options are considered too important to dispense with in some jurisdictions, there should at least be convergence and transparency on the situations in which they are exercised, to ensure a level playing field in the EU. Given the need for a further reduction in national options, the ECB would support the introduction of a specific provision requiring the Commission to monitor the progress made in this direction and, within a reasonable period of time (e.g. three years), to report to the Community institutions on the use of residual national discretion, assessing how necessary it is and whether there is a need for further regulatory initiatives.

12. The general wording of several provisions of the proposed directives leaves a substantial margin for divergent interpretations by national authorities, thereby creating the risk of there not being a level playing field throughout the EU. A specific, but not unique, example of this issue is Article 84(2) of the proposed banking directive, which provides that the competent authorities may allow the use of the Internal Ratings Based Approach (hereinafter the 'IRB Approach') by a credit institution if its systems for the management and rating of credit risk exposures comply with a number of conditions (such as being 'sound', 'implemented with integrity' and providing for a 'meaningful assessment'). This article refers to additional conditions laid down in Part 4 of Annex VII to the proposed banking directive, which leave a large degree of discretion to national implementation. While the ECB acknowledges that it is sometimes necessary to use wording which leaves a significant degree of discretion to national authorities (for instance in order not to hamper the development of risk management practices in credit institutions or to facilitate flexible transposition and application taking into account the different structures of national banking systems or national regulatory regimes), as best practices emerge in the market it would be beneficial to foster a consistent interpretation of such terms by the competent authorities. To this end, the Commission may decide to issue recommendations based on advice from CEBS.

13. The ECB also recommends the use of consistent terminology to express how the competent authorities can intervene prior to the use of certain risk weights and measurement techniques. A clear distinction could be made between cases where the competent authorities are expected to communicate a formal administrative decision upon application by the credit institution and those where the competent authorities can simply review the proposed technique without the need to take a formal decision.

Role of the authority responsible for supervision on a consolidated basis

14. The ECB considers that enhancing the role of the authority responsible for supervision on a consolidated basis (hereinafter the 'supervisor on a consolidated basis'), as envisaged in Articles 129 to 132 of the proposed banking directive, is a step forward, which may, however, raise complex issues when the proposed directive is transposed and applied. The coordinating role provided for in Article 129(1), together with the provisions on information sharing laid down in Article 130(2) and Article 132, will streamline relations between supervisory authorities and between supervisory authorities and banks, thereby increasing efficiency by facilitating the decision-making process and reducing the overall cost of supervision. This constitutes an appropriate response to the increasing demand from banking groups with substantial cross-border activities [1] to reduce the costs they incur in meeting supervisory and regulatory requirements imposed on them by different national supervisors and regulators, which in some cases overlap or are not fully harmonised.

15. Furthermore, the ECB expects that the coordinating role played by the supervisor on a consolidated basis, together with the explicit requirement to exchange information, will contribute to the stability of the banking sector both at EU and Member State level. From the perspective of the supervisor on a consolidated basis, enhanced input from national supervisors regarding the local activities and risks of EU subsidiaries of a group should be combined to provide a thorough review and evaluation of the group as a whole, as required by Article 124 in conjunction with Articles 71 to 73 of the proposed banking directive. From the perspective of national supervisors, the information gathered by the supervisor on a consolidated basis could make it easier to assess potential financial problems occurring in other entities of a group, which may affect local subsidiaries. Moreover, the additional information available to national supervisors should also facilitate the exercise of central banking functions in the area of financial stability, payment systems and monetary policy.

16. Article 129(2) of the proposed banking directive (in conjunction with Article 37(2) of the proposed capital adequacy directive) offers an opportunity to foster financial integration. It lays down a legal basis for group-wide use of the IRB Approach, Advanced Measurement Approaches (AMAs) and the Internal Models Approach for market risks, which is complemented by a procedure streamlining the group-wide approval process. This should enable alignment of group-wide management practices in relation to compliance with regulatory capital requirements, which should improve integration of group structures and, as a consequence, of the banking sector as a whole.

[1] An indicator of the increasing relevance of cross-border activities is the growing share of non-domestic branches and subsidiaries in total banking sector assets, which was more than 20 % in 2003. See the ECB's 'Report on EU Banking Structure', November 2004; available on the ECB's website.

17. Notwithstanding the potential benefits of Article 129(2), complex issues may arise when it is applied and these need to be anticipated and resolved in order to maximise its effect. For instance, problems could arise if there are disagreements between the home and host supervisors of subsidiaries of a group that are considered significant [1] over the interpretation of the proposed banking directive's requirements. Even though the third subparagraph of Article 129(2) requires the supervisor on a consolidated basis to make a determination in the absence of an agreement between supervisory authorities within six months, disagreements between home and host supervisors need to be addressed so as not to undermine the powers of the competent national supervisory authorities, which have to rely on the outcome of the group-wide approach at local level and guarantee a level playing field [2].

18. The potential benefits of Article 129(2) also depend on how the powers of competent national supervisors to impose supervisory measures on local subsidiaries under the second pillar of Basel II (the supervisory review process) interact with group-wide approval decisions. Credit institutions filing applications under Article 129(2) need legal certainty. In this respect, applicable procedures and review by the courts of group-wide decisions as well as the ongoing supervision of use of the group-wide IRB Approach and AMAs deserve attention. The respective powers of supervisory authorities to rectify shortcomings in a group's approach, which arise after approval has been granted, and to withdraw an approval, should therefore be addressed in the proposed banking directive.

19. Given the importance of the above issues for an effective application of Article 129(2) of the proposed banking directive, the ECB strongly supports the work to be carried out by CEBS on the application of Article 129 as a whole and is confident that consistent application will result. However, it recommends inserting a provision into the proposed banking directive which requires an assessment and, if necessary, a revision of Article 129 three years after transposition of the directive in order to take into account how Article 129 is being applied in practice and whether it is achieving its ends.

20. The ECB would also support work of CEBS with respect to Article 131 of the proposed banking directive, which requires the supervisor on a consolidated basis and the other competent supervisory authorities to have 'written coordination and cooperation arrangements in place'. The ECB therefore supports work by CEBS to develop a model arrangement for coordination and cooperation to be used by all supervisory authorities concerned.

Timing and transitional provisions

21. The ECB welcomes the provisions on the timing of the introduction of the new capital requirements in Chapter 1 of Title VII of the proposed banking directive. These provisions mirror the timing provided for in Basel II and should ensure that European credit institutions are not put at a disadvantage vis-à-vis their competitors from third countries. Furthermore, a postponed application would, to a certain extent, undermine the preparations which EU credit institutions have made to keep to the initial timeframe. For these reasons the ECB encourages the Community institutions to maintain the schedule proposed by the Commission.

22. Moreover, the ECB considers that attention should be given to the far-reaching nature of the reform and the residual uncertainty about its influence on the level of capital in the EU financial system as a whole (even if this uncertainty has been reduced as far as possible by quantitative impact studies). For this reason, the ECB fully supports the introduction of the transitional requirements in Article 152 of the proposed banking directive, which limit the impact on credit institutions' minimum capital requirements over the first three years after transposition of the directive.

23. Notwithstanding the need to base estimations of risk factors on data histories that are long enough to cover fluctuating economic conditions, the transitional provisions should support credit institutions in their transition to the more sophisticated IRB Approach by temporarily relaxing certain requirements, which are gradually tightened as an institution's ability to collect data improves. This refers to the obligation to have a minimum of five years' data on historical observations of the probability of default (paragraph 66 of Part 4 of Annex VII to the proposed banking directive). In that respect, Article 154(5) of the proposed directive will permit Member States to apply a reduced two-year data requirement to credit institutions which have decided to implement the IRB Approach before 31 December 2007. However, institutions adopting the IRB Approach after 31 December 2007 must have three years' data by the end of 2008, four years' data by the end of 2009 and five years' data by the end of 2010. In practice, it will be impossible for them to have three years' data by the end of 2008 unless they have already gathered two years' data by the end of 2007. The ECB consequently considers it desirable to modify this provision in a way which would realistically allow use of the IRB Approach to be recognised during the transition period as well. In this regard, the ECB welcomes the changes to Article 154(5) and (6) set out in the Council's general approach, which represent a pragmatic solution.

[1] 'Significant' can refer either to the relative importance of the subsidiaries for the group as a whole or for the banking system in the host jurisdiction.

[2] The level playing field could be jeopardised if some banks' IRB Approaches were validated by the supervisor on a consolidated basis, whereas for other banks the validation was carried out by the domestic supervisor.

Monitoring the structural and possible pro-cyclical impacts of the new framework

24. The overall structural impact of the proposed directives has been an issue of concern stemming, *inter alia*, from the challenging task of combining capital neutrality and increasingly sophisticated approaches. The ECB fully supports the overall calibration of the regulatory capital requirements set out in the proposed directives and notes that the results of a quantitative impact study (QIS3) ([1]) covering Member States gave an overall positive assessment regarding the effect on smaller EU credit institutions, EU investment firms and lending to small and medium-sized enterprises (which, it seems, will not be disadvantaged by the proposed directives), as well as the preservation of a level playing field within the EU vis-à-vis competitors from third countries. The ECB also notes the overall positive assessment provided by a report prepared under the auspices of the European Commission on the financial and macroeconomic consequences of the revised capital requirements ([2]). However, an *ex-ante* assessment of the quantitative impact of the proposed directives cannot cover their dynamic effects, given that the behaviour of financial institutions may change due to the incentives provided by different risk weights under the revised as compared to the current capital requirements. Therefore, the ECB would support regular *ex-post* monitoring, which should also cover the structural implications and the allocation of risks.

25. In addition to monitoring of the general impact of the proposed directives, certain specific features may also require future monitoring. By way of example, the ECB observes that the preferential treatment available for commercial real estate lending under the Standardised Approach and Foundation IRB Approach ([3]) offers enhanced flexibility compared to Basel II. The ECB would emphasise that the interaction between the availability of commercial real estate lending and property prices should, apart from prudent valuation of collateral by banks, also be subject to close monitoring from a macro-prudential perspective. The ECB intends to contribute to this monitoring process.

26. With regard to the potential pro-cyclical impact of the proposed directives (i.e. the possibility that capital requirements could tighten during a recession and relax during an economic upturn, thus exacerbating cyclical swings), the ECB acknowledges the importance of tackling this issue and the significant progress made in reducing these concerns by means of adjusting the proposed directives to limit pro-cyclical effects. Indeed, EU supervisory authorities have a common interest in considering appropriate ways to reduce the risk of heightened pro-cyclicality, since macroeconomic conditions are gradually becoming more closely interwoven, particularly in the euro area. A common approach to addressing pro-cyclicality would also support a level playing field and transparency in the single market. However, the ECB still considers monitoring by the Commission and the competent national authorities to be necessary.

27. Therefore, the ECB supports the proposal that the Commission should periodically monitor whether the proposed banking directive has significant effects on the economic cycle, as set out in Article 156 thereof. Furthermore, the ECB observes that it is the Commission's prerogative to adopt proposals for any amendment to the recast Consolidated Banking Directive, and that this also applies to the possible legislative 'remedial measures' mentioned in Article 156. However, from a macro-prudential perspective it is crucial that possible legislative 'remedial measures' are of a symmetric nature and that capital standards are only changed when the adjustment is prudentially sustainable through the entire cycle. The ECB suggests explaining this need in recital 59 to the proposed banking directive.

SPECIFIC REMARKS

Definition of central banks

28. The ECB sees a need to clarify its status regarding the exemption of central banks from the proposed banking directive. The first indent of Article 2 exempts 'central banks of Member States' from the scope of the proposed banking directive, while Article 4(23) defines the term 'central banks' (as opposed to 'central banks of Member States') to include the ECB unless otherwise indicated. The ECB proposes amending Article 2 to indicate expressly that the exemption also applies to the ECB.

Solo consolidation

29. Article 70 of the proposed banking directive gives the competent authorities the possibility to allow, on a case-by-case basis and subject to certain conditions, parent credit institutions in a particular Member State to incorporate subsidiaries located in the EU into the calculations required by Article 68(1) of the proposed banking directive. This process is referred to as 'solo consolidation'.

([1]) European Commission 'Review of the Capital Requirements for Credit Institutions and Investment Firms, Third Quantitative Impact Study: EU Results', 1 July 2003; available on the Commission's website.

([2]) PricewaterhouseCoopers, MARKT/2003/02/F, 'Study on the financial and macroeconomic consequences of the draft proposed new capital requirements for banks and investment firms in the EU', 8 April 2004; available on the Commission's website.

([3]) The Standardised Approach is described in Articles 78 to 83 of the proposed banking directive. The Foundation IRB Approach is an IRB Approach as described in Articles 84 to 89 of the proposed banking directive, but where a credit institution does not make use of own estimates of losses given default (LGDs) and/or conversion factors pursuant to Article 84(4).

30. The ECB recommends reconsidering the conditions under which solo consolidation [1] may be applied. One of these conditions is in Article 69(1)(a) of the proposed banking directive, which requires that there are no impediments to the transfer of own funds from the parent undertaking to the subsidiary. In the ECB's view this is not an appropriate condition to impose on the parent undertaking in the context of solo consolidation requirements. In this regard, the ECB strongly welcomes the fact that the changes to Article 70 of the proposed banking directive set out in the Council's general approach will impose requirements with respect to the availability of own funds from the subsidiary to the parent undertaking and remove the requirement that there must be no impediments to the transfer of own funds from the parent undertaking to the subsidiary. The ECB notes that solo consolidation would extend to subsidiaries located in Member States other than that of the parent undertaking. In practice this implies that a subsidiary's financial position will be treated for capital adequacy purposes as if it were part of the parent undertaking's own financial position. The parent undertaking's supervisor must therefore have full access to information regarding the quality of the assets, liabilities and capital of the subsidiary. The ECB suggests adding a further criterion to ensure that the parent undertaking's supervisory authority can effectively verify such information regarding the financial position of subsidiaries located in another Member State. As a matter of principle, the ECB also strongly supports transparency on the use of Article 70 of the directive and welcomes the provisions to this end set out in the Council's general approach.

31. The ECB notes that Article 70 of the proposed banking directive does not question the application of individual capital requirements to EU subsidiaries incorporated into the parent credit institution's individual capital requirements. It would be beneficial to clarify that Article 70 is without prejudice to the requirements imposed by Article 68 on the subsidiaries concerned.

Capital requirements for intra-group interbank lending

32. Article 80(7) of the proposed banking directive allows the competent authorities, under certain conditions, to exempt lending by a credit institution to its parent undertaking, to its subsidiary or to other subsidiaries of the same parent undertaking from capital requirements for credit risk [2]. The ECB emphasises that all exposures to credit risk should be subject to adequate capital requirements. The conditions under which the exemption pursuant to Article 80(7) applies do not eliminate credit risk in the lending transactions concerned given that, for example, one credit institution may fail to meet its obligations vis-à-vis another credit institution controlled by the same parent undertaking. In addition, the ECB notes that Article 80(7) will primarily apply to interbank lending where capital requirements are essential to limit systemic risks. The ECB further notes that such an exemption is not available under Basel II [3] and could, in certain banking systems, affect the level playing field at national level. Consequently, the ECB recommends that this form of lending remains subject to capital requirements.

External Credit Assessment Institutions

33. As regards the recognition of External Credit Assessment Institutions (ECAIs), the ECB would like to raise three issues.

34. First, the ECB sees scope for further specification of the requirement of 'independence' in Section 1.2 of Part 2 of Annex VI to the proposed banking directive. In the assessment process, competent authorities should take into account factors such as the ownership and organisation structure of the ECAI, its financial resources, staffing and expertise, as well as its corporate governance. In the ECB's view, the competent authorities should also verify that ECAIs have effective internal procedures in place to identify, avoid and manage potential conflicts of interest, thus ensuring that confidential information is not inadvertently disseminated, disclosed or misused. These issues are widely recognised as key policy concerns and are acknowledged in the International Organization of Securities Commission (IOSCO) Statement of Principles Regarding the Activities of Credit Rating Agencies of 25 September 2003 [4].

[1] Solo consolidation is an element of the proposed banking directive which is not addressed in Basel II. Paragraph 23 of Basel II requires supervisors to test that 'individual banks are adequately capitalised on a stand-alone basis'.

[2] This exemption only applies to the Standardised Approach; however it may also be applied to credit institutions by means of a specific type of permanent partial use (Article 89(1)(e) of the proposed banking directive).

[3] Basel II applies to internationally active banks at every layer of a banking group on a consolidated basis. This means that a subsidiary which is an internationally active bank will have to hold capital to cover credit exposures to other group entities that are not its subsidiaries. Basel II does not permit a waiver of such capital requirements.

[4] Available on IOSCO's website.

35. Second, the ECB would like to highlight the need for a prudent and fair approach to supervisors' assessment of the credibility and market acceptance of ECAIs. In particular, it is important that the competent authorities, when assessing potential ECAIs, do not create any barriers to entry for new market players by imposing an unreasonable burden to meet the criteria set out in Section 2.1 of Part 2 of Annex VI to the proposed banking directive (market share, revenues and financial resources, impact on pricing). Instead, competent authorities are invited to properly focus their evaluation on the robustness and soundness of the assessment methodology. The relevant provisions should therefore be developed further so as to allow for a sufficiently differentiated assessment process. In this context, the ECB would support rewording this section in accordance with Basel II, to ensure that credibility derives both from market acceptance and sound methodology.

36. Third, the ECB stresses the need for adequate supervisory convergence and cooperation regarding the recognition of ECAIs. A high degree of consistency between Member States' practices will be indispensable to ensure the comparability of external ratings assessments and a level playing field for credit institutions making use of these assessments under the Standardised Approach to credit risk, and will also help reduce the risk of regulatory arbitrage. Moreover, supervisory cooperation will be crucial in reducing the costs of regulation for those ECAIs which seek recognition in more than one Member State. At present, Articles 81(3), 82(2) and 97(3) of the proposed banking directive only include a discretionary option for mutual recognition. In line with consistent case-law of the Court of Justice of the European Communities with regard to the free provision of services, the ECB considers that mutual recognition should be the general principle for ECAIs within the EU. This would not preclude a supervisor deciding to impose additional eligibility requirements in order to take account of the specificities of the national market, as long as such requirements did not duplicate equivalent conditions already satisfied in the Member State of origin. The ECB welcomes CESR's consultation paper on potential regulatory approaches for credit rating agencies [1]. It also strongly supports the work currently undertaken by CEBS to harmonise the criteria for recognition of ECAIs. The ECB considers that the Mapping Process (set out in Annex 2 to Basel II) under which, *inter alia*, national authorities map credit risk assessments into the available risk weights is very important, and CEBS should therefore encourage convergence in this field.

[1] 'CESR's technical advice to the European Commission on possible measures concerning credit rating agencies — Consultation Paper', 30 November 2004; available on CESR's website.

Permanent partial use for certain exposures

37. The ECB notes that, in contrast to Basel II, the proposed banking directive allows permanent partial use of the IRB Approach for material exposures and in significant business units, under the various circumstances listed in Article 89(1)(a), (b) and (d) to (g) of the proposed banking directive. The ECB notes that the intention behind restricting permanent partial use is to avoid banks permanently treating high-risk exposures under the Standardised Approach while using their own estimates of risk parameters for lower-risk portfolios, thereby selecting the most advantageous approach in each case.

38. The ECB supports making permanent partial use available to small credit institutions for their exposures to central governments, credit institutions and investment firms because in such cases the application of own estimates would be overly burdensome, thus potentially barring small credit institutions from adopting the IRB Approach. The position of small credit institutions is correctly addressed in a new recital 35A, which is proposed in the Council's general approach. The ECB recommends that the Commission should review whether the application of Article 89 of the proposed banking directive has been effective in achieving its purpose three years after transposition of the directive.

Consistent treatment of commitments in IRB and Standardised Approaches

39. An inconsistency has emerged between the capital treatment of commitments under the Standardised and Foundation IRB Approaches. The ECB understands that the divergence is unintentional. If not addressed, however, it could have the effect of creating, under the Foundation IRB Approach, a capital charge for certain guarantees which reduce risks and protect the stability of the financial system by ensuring the completion of settlement in certain payment systems. The ECB therefore recommends that the wording in paragraph 1.11(a) of Part 3 of Annex VII to the proposed banking directive should be rephrased to match the equivalent clause applying to the Standardised Approach, i.e. to state that for credit lines, which are uncommitted, that are unconditionally cancellable at any time by the institution without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness, a conversion factor of 0 % shall apply.

Supervisory review process

40. The ECB emphasises the importance of the second pillar being treated as of equal importance to the other Basel II pillars, namely minimum capital requirements and market discipline. The ECB considers that the very general wording of Articles 123 and 124 of the proposed banking directive, which reflects the second pillar, may wrongly imply that the three pillars are not of equal importance.

41. From the ECB's perspective, as there is no definition in the proposed banking directive of the concept of 'internal capital' (which is used in Article 123 of the directive), supervisors' and credit institutions' understanding of what internal capital means will need to converge as industry practice evolves. The ECB considers it desirable to develop guidance encompassing what credit institutions should do to fulfil the requirements of Article 123. The ECB is aware that such guidance can only be developed over time in line with evolving industry practices and the experiences of national supervisors and does not insist on a more detailed definition of internal capital at this stage.

42. With respect to capital buffers, attention should be drawn to the BCBS statement of July 2002 which explicitly recognises the importance of capital buffers in relation to potential concerns about pro-cyclicality ([1]). The proposed banking directive currently does not refer to this issue, and the ECB suggests referring to it in a recital to the proposed banking directive, indicating that supervisors should expect banks to operate with capital buffers so that they can comply with minimum capital levels, even under conditions of stress.

43. Finally, the ECB notes that a number of Member States currently fix, under specific circumstances, the minimum capital ratio above the 8 % threshold stipulated in Article 75 of the proposed banking directive. An automatic application of higher capital requirements to certain categories of institutions is undesirable as divergent minimum capital ratios endanger the level playing field within the EU and provide incentives to restructure groups with a view to regulatory arbitrage between capital regimes.

([1]) 'To help address potential concerns about the cyclicality of the IRB approaches, the Committee agreed that meaningfully conservative credit risk stress testing by banks should be a requirement under the IRB approaches as a means of ensuring that banks hold a sufficient capital buffer under Pillar Two of the new Accord', BCBS press release, 10 July 2002; available on the BIS's website.

Cooperation in an emergency situation

44. The ECB welcomes Article 130(1) of the proposed banking directive, which is particularly important as it establishes the obligation for the supervisor on a consolidated basis to notify the authorities mentioned in Article 49(a) and Article 50 of the proposed directive when an emergency situation arises which could potentially jeopardise the stability of the financial system.

45. The ECB understands that Article 130(1) applies to both the national and EU dimension of the financial system. Therefore the ECB understands that information has to be transmitted to the authorities mentioned in Article 49(a) at either national or cross-border level. This is important as the progress made in the integration of financial markets and market infrastructures in the EU, while increasing the liquidity and efficiency of those markets, may also increase the likelihood of systemic disturbances affecting more than one Member State and possibly increase the risk of cross-border contagion in the EU banking sector. In this context, the ECB welcomes the fact that Article 130(1) follows a recommendation of the Economic and Financial Committee's report on financial crisis management ([2]) by imposing an obligation to inform these authorities in a timely manner in a crisis situation. In order to clarify the scope of Article 130(1), the ECB would recommend stating that the obligation to alert the authorities mentioned in Article 49(a) applies to authorities within the EU.

46. The ECB also understands that the reference in Article 130(1) to the authorities mentioned in Article 50 ([3]) is intended to ensure that members of the governments of Member States responsible for financial services are alerted of the existence of an emergency situation as soon as possible. The ECB suggests making this more explicit by replacing the reference to the authorities mentioned in Article 50 with an express reference to the 'competent government members', thereby ensuring that there is no impediment to the transmission of the confidential information needed to manage the emergency situation, subject to the conditions laid down in national and Community legislation (i.e. when their policy functions are affected by the emergency situation).

([2]) Economic and Financial Committee, 'Report on financial crisis management' of 17 April 2001, Economic Paper No 156, July 2001; available on the Commission's website.

([3]) Article 50 of the proposed banking directive, recasting part of Article 30(9) of the Consolidated Banking Directive, permits Member States to authorise the disclosure of confidential prudential information to 'departments of their central government administrations responsible for legislation on the supervision of credit institutions, financial institutions, investment services and insurance companies and to inspectors acting on behalf of those departments'.

47. The ECB also strongly supports the wording of Article 130(1) of the proposed banking directive, as it leaves the authorities involved at both national and EU level appropriate scope to define flexible arrangements, which are necessary in the context of crisis management. In this regard, the ECB would like to draw attention to the existing arrangements between central banks and supervisors, which specify the principles and procedures for communication and cooperation in situations of financial crisis management. In particular, the Memorandum of Understanding on high-level principles of cooperation between the banking supervisors and central banks of the European Union in crisis management situations (hereinafter the 'MoU') sets out principles and procedures dealing specifically with the identification of the authorities responsible for crisis management, the required flows of information between all the involved authorities and the practical conditions for sharing information at a cross-border level. The MoU also provides for the establishment of logistical infrastructure to support enhanced cross-border cooperation between authorities ([1]).

48. Moreover, the ECB notes that certain initiatives have already been launched to further develop the crisis management arrangements under Article 130 of the proposed banking directive. In particular, the Banking Supervision Committee of the European System of Central Banks and CEBS have established a Joint Task Force on Crisis Management which will assist the development of further practical arrangements for handling crises. In this context, the ECB encourages further work to develop efficient cooperation arrangements. The ECB considers that smooth interaction between supervisory and central banking functions will facilitate an early assessment of the systemic impact of a crisis and contribute to effective crisis management at both national and EU level.

Consistency with Basel II in the context of operational risk

49. The ECB notes that the provisions of the proposed banking directive covering operational risk diverge from Basel II to a degree that might undermine the level playing field. The ECB therefore recommends revising the following elements of the proposed directive.

50. First, the relevant indicator in Parts 1 and 2 of Annex X to the proposed banking directive, calculated on the basis of the 'last six twelve-monthly observations at the middle and at the end of the financial year' and the acceptance of estimated figures when audited figures are unavailable, is inconsistent with Basel II, which stipulates that yearly observations are to be used. The ECB welcomes the fact that the changes to paragraph 3 of Part 1 and paragraph 5 of Part 2 of Annex X to the directive set out in the Council's general approach would align the directive with Basel II in relation to this issue.

51. Second, the proposed calculation of capital requirements under the Standardised Approach places EU credit institutions at a disadvantage vis-à-vis third country credit institutions under Basel II. In addition, this approach may hinder the objective of encouraging banks to move from the Basic Indicator Approach to the Standardised Approach. Basel II allows negative gross income in certain business lines to be used to partially offset positive gross income in other business lines within each year, and thereby achieves consistency with the Basic Indicator Approach under which compensation between business lines in each year occurs as a matter of course. The ECB notes that the approach chosen in the proposed banking directive is in fact more prudent. However the ECB would favour aligning the proposed banking directive with Basel II.

52. Third, the requirements in Part 4 of Annex X to the proposed banking directive deviate from Basel II in that in principle they allow unlimited permanent partial use of AMAs. The ECB notes that restrictions on the scope and duration of the partial use of AMAs were considered crucial in Basel II, to avoid possible regulatory arbitrage and potential adverse effects on the level playing field. The ECB shares the BCBS's concerns and recommends that limits on the partial use of AMAs are put in place as a general rule and not only on a case-by-case basis.

53. Finally, the transitional provisions incorporated in Article 155 of the proposed banking directive allow for a relevant indicator of 15 % to be applied to the 'trading and sales' business line until 31 December 2012, in cases where this business line constitutes at least 50 % of the total relevant indicators. This represents an unwelcome divergence from Basel II, where no such transitional provision is available.

Legal risk as part of operational risk

54. The ECB notes that Article 4(22) of the proposed banking directive introduces the concept of 'legal risk' as one element of the wider notion of 'operational risk'. The ECB recognises that legal risk is an important category of risk which has to be taken into account for capital measurement, but it also notes that the concept of legal risk is not further defined in the proposed directive and could therefore become an area of uncertainty and divergent transposition and application. In this respect, the ECB believes it would be useful to introduce into the EU framework the more precise wording of Basel II, which in particular states that operational risk includes 'legal risk, but excludes strategic and reputational risk' (paragraph 644 of Basel II). The footnote to this paragraph of Basel II states that 'legal risk includes, but is not limited to, exposures to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements'; this could usefully be reproduced in a recital to the proposed banking directive.

([1]) See ECB press release of 10 March 2003; available on the ECB's website.

55. A general definition of legal risk would facilitate proper risk assessment and risk management, as well as ensure a consistent approach between EU credit institutions. It would also be worthwhile examining the extent to which one should take into account the fact that legal risks are inherently unpredictable and do not generally conform to a pattern. In addition, the management of legal risk would have to be consistent with the management of operational risk as a whole. For these reasons, the ECB suggest that CEBS should carry out further work to clarify the definition of legal risk.

56. The ECB notes that the legal certainty requirements for credit risk mitigation techniques listed in Annexes VII to IX to the proposed banking directive can be considered as mitigating the legal risks involved in the use of these techniques. The reason for this is that these requirements do not address the calculation of risk-weighted assets directly, but rather concern the question of whether the credit risk mitigation techniques have a sound legal foundation. However, in the light of paragraph 14 of Section 1.2 of Part 3 of Annex X to the proposed banking directive, the ECB understands that losses due to a legal defect in credit risk mitigation techniques will not be subject to an operational risk charge if they are treated as credit risk for calculating the minimum capital requirements.

Capital requirements for certain investment firms

57. Article 20 of the proposed capital adequacy directive gives the competent authorities the discretion to exempt certain investment firms from capital requirements for operational risk. However, recital 22 to the proposed directive stresses that 'Operational risk is a significant risk faced by institutions requiring coverage by own funds'. The Commission included this discretion on the basis of a study published in July 2004 [1], and the discretion was designed to alleviate the impact of operational risk charges on the overall requirements imposed on investment firms. The ECB notes that the authors of this study adopted a relatively cautious stance on the question of whether an increase in capital requirements on investment firms due to the introduction of a capital requirement in respect of operational risk should be viewed as disproportionate. Furthermore, the study mentioned that the data used seemed to have been incomplete. The ECB would also caution that the discretionary and firm-specific nature of the exemptions allowed under the proposed capital adequacy directive could affect the level playing field in three respects: between different types of investment firms; between investment firms of the same type competing across borders; and between investment firms and credit institutions. The ECB consequently suggests that the Commission should in due course review the effect of these exemptions and the way they are applied by competent authorities, and that a provision should be included in the proposed capital adequacy directive to reflect this.

Done at Frankfurt am Main, 17 February 2005.

The President of the ECB

Jean-Claude TRICHET

[1] European Commission, 'Review of the Capital Requirements for EU Investment Firms — 2004 Quantitative Impact Study — Main Conclusions', undated; available on the Commission's website.