



## **The Basel Capital Accord and the Capital Requirements Directive**

### **FAQs**

#### **What is the 1988 Basel Accord?**

The 1988 Basel Accord is the globally agreed standard by which supervisors calculate and set capital charges for all internationally active banks. The Accord sets out a set of one-size fits all rules which require firms to hold a minimum of 8% capital to mitigate against credit and market risk. The Accord was amended in 1996 to allow some firms to use internal models to calculate their market risk capital charge.

#### **Why has the original Basel Accord been updated?**

The revised Basel Framework replaces the 1988 Accord. The revised Framework responds to the need for capital rules to catch up with advances in risk management practices and introduces a more risk sensitive approach was needed.

#### **How does the new Framework differ from the original Accord?**

The revised Framework proposes a risk-based approach with capital charges in proportion to the risks the firm runs. Likewise, institutions will be presented with a menu of options from which to choose how they calculate their capital charges. These are of varying degrees of sophistication and comprise the standardised, foundation or advanced internal risk based approaches.

#### **Why will there be a menu of options for institutions?**

This will allow institutions of varying degrees of complexity to decide which capital calculation approach (Pillar 1) would be best suited to their business. Typically, more complex institutions would adopt the more advanced methods to calculate their capital. However, all institutions will have capital incentives to improve risk management standards and then move to the more advanced approaches.

#### **How will the Supervisor assess compliance?**

Institutions' minimum capital requirements are derived from the institution's internal view and supervisory judgement. The more complex the business and the better its systems and controls, the more discretion supervisors will assign to institutions in the setting of their own minimum capital requirements.

The overarching objective of the Supervisory Review Process must be conducted in a way that enhances understanding on the part of the group, and its supervisor, of a group's whole risk profile. This process should be confidential and conducted at group level. Supervisory action should be the exception but where action is

required, Supervisors must consider other ways to mitigate risk rather than by automatically requiring the firm to provide additional capital.

### **What role will the market play?**

Under Pillar 3 of the revised Framework, institutions will disclose their capital charge to the market. Disclosure of this figure will inform investors' decisions so this measure will incentivise good practice and raise standards.

### **How will the Basel Framework be implemented in the EU?**

The Capital Requirements Directive (CRD) will implement the Framework in EU Member States. The CRD recasts Directive 200/12/EC relating to the taking up and pursuit of the business of credit institutions and Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions.

### **Why is the CRD important for Europe?**

On the basis that there will be (a) consistent implementation throughout the EU in parallel with the revised Framework, (b) steps taken to promote supervisory convergence and (c) a flexible directive, then the CRD will help to deliver the EU's social and economic objectives.

More widely, a well managed and a proportionately capitalised banking system will mean that firms will be better placed to offset any losses they incur and continue to be able to lend throughout the economic cycle. Greater stability in the banking sector delivers the economic boon of providing a sound platform for businesses to expand and innovate. Meanwhile, consumers will benefit from (a) the same conditions leading to increased confidence in the financial system and, (b) according to a recent Pricewaterhouse Coopers' study into the impact of Basel II on Europe's economy, an increase in average GDP.

### **Why should the CRD be consistent with the Basel Framework?**

The EU stands most to gain if the CRD is implemented in parallel with the Basel Framework, thereby creating a level playing field across the world in financial services. This would promote the competitive position of Europe's financial institutions globally, thereby delivering the greatest benefits to Europe's consumers.

### **Will there be any differences between the Basel Framework and the CRD?**

The content, approach and implementation timetable of the CRD should mirror that set out by the Framework taking into account EU specificities. However, in terms of scope of application, the CRD goes wider than the Framework to incorporate investment firms as well as banks.

### **Why are investment firms included in the scope of the CRD?**

Essentially, where investment and banking institutions are exposed to the same risks, then the same rules must apply. This maintains the status quo and builds on the steps taken in those directives to level the playing field between the banking and investment firms sectors, where the same risks apply. It also responds to the current trends of conglomeration in the financial services industry to create hybrid institutions.

### **What are the risks to the EU from inconsistent implementation?**

The quality and timing of implementation are crucial to the long term success of any legislation. Inconsistent implementation in the EU would create an unlevel playing field, which would be contrary to the objectives of the single market.

### **What will be the impact of the CRD be on SMEs?**

The Basel Committee has paid special attention to how the Framework would impact on SMEs with the result that firms with exposures of less than €1 million, and turnover of €75 million, will be treated as retail counterparties. SMEs ought not to be subjected to a disproportionately high cost of capital or a higher than usual cost of borrowing.

### **Why is flexibility important?**

The principle of flexibility built into the legislation would pave the way for the CRD to achieve its full potential, thereby contributing most to the EU's social and economic objectives. This way, firms would be able to respond to changing risk profiles in a timely fashion by undertaking additional risk assessments as appropriate. The CRD should be sufficiently flexible to accommodate any changes to the Framework for the benefit of borrowers and to promote confidence in Europe's banking system.

### **How best to realise the industry's investment in implementation?**

Institutions have already invested heavily in preparation for the move to the new capital standards. The full benefits from this investment would best be realised if the CRD is assigned top priority in the European Parliament and Council of Ministers. This is vital if good progress is going to be made. Slow progress through the co-decision process would delay national implementation thereby threatening the global competitive position of Europe's financial institutions to the detriment of Europe's consumers.