



The Basel Capital Accord and the Capital Requirements Directive

Background summary

Why institutions hold capital

Institutions use capital as a basis from which to fund future growth and as a reserve against unexpected losses. Well capitalised institutions can continue to provide credit to consumers and businesses throughout the economic cycle. This promotes public confidence in the banking system and widespread economic stability.

Existing regulatory capital standards

The Basel Accord of 1988 introduced a conceptually simple rules-based system that required internationally active institutions to hold minimum regulatory capital of 8% risk-weighted assets to offset credit risk. The 1988 Accord was amended in 1996 to broaden the focus of regulatory capital to include market risk. Certain institutions were also permitted to use their own models to calculate their market risk capital requirements.

Revised Basel Capital Framework

The advantages of the relative simplicity of the 1988 Accord capital rules were undermined over time by advances in risk management methodology. New capital standards were required to keep pace with market developments and also to better calibrate firms' capital charge with actual risks.

A new set of standards for establishing minimum capital requirements for banks was published on 11 May 2004. These are set out in the revised Basel Capital Framework. Institutions will be required to allocate capital against the following three areas of risk:

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| Credit risk | The risk of a trading partner not fulfilling their obligations in full on a due date or at any time thereafter. |
| Market risk | The risk to an institution's financial condition resulting from adverse movements in the level or volatility of market prices of interest rate instruments, equities, commodities and currencies. |
| Operational risk | The risk of unexpected losses arising from deficiencies in a firm's management information, support and control systems and procedures. |

Structure of the proposals

The European Commission intends that the legislation that will implement the revised Framework in the EU, the Capital Requirements Directive, will reflect its content as closely as possible, whilst allowing for EU specificities. Conceptually,

the revised Framework proposes a process through which firms will assess the risks they run and calculate their own capital charge accordingly. Institutions' Supervisors will review the capital charge before it is disclosed to the market. This approach is referred to as "the three pillar approach" and is set out below:

Pillar 1	Pillar 2	Pillar 3
Minimum regulatory capital requirements	Supervisory review process	Market discipline and disclosure
This is focussed on setting the minimum regulatory capital charges for credit, market and operational risk. There is a menu of options available to institutions of varying sophistication.	There will be active dialogue between the institution and its Supervisor to ensure that each institution has sound internal processes to assess the adequacy of its capital based on a thorough evaluation of its risks.	The institution discloses its capital charge to the market. Disclosure of this figure will inform investors' decisions. Better run institutions will incur lower capital charges, so disclosure will incentivise good practice and raise standards.

The revised Framework offers a menu of options under Pillar I from which firms can choose the method by which to work out how much regulatory capital they require. These options are of varying sophistication but, in general, institutions with better systems and controls to mitigate risk will move to and benefit from advanced approaches to risk calculation.

Implementation in the EU

In the EU, Capital Adequacy Directives (CAD) I and II implemented the original and amended Basel Accords, respectively. Whereas the Basel Accords applied only to banks, the CADs broadened the scope of application to cover investment firms, as well as banks.

Following public consultations throughout the period of preparation of the Basel Framework, the European Commission adopted a proposal for a Capital Requirements Directive text on 14 July 2004. The Directive will be adopted through the co-decision process with the European Parliament and Council of Ministers working as co-legislators. The Annexes of the Directive will be capable of subsequent amendment using comitology, allowing the Directive to be flexible in order to keep pace with market developments.