EU Amendment Directive

REVISED CAPITAL REQUIREMENTS FOR BANKS (BASEL II)

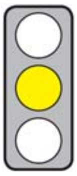
Status: 26.10.09

Centrum für Europäische Politik

MAIN ISSUES

Objective of the Directive: Amendments to the capital requirements for banks are to increase the stability of the financial markets.

Groups Affected: Banks, supervisory authorities, financial markets participants and borrowers.



Pros: (1) Raising capital requirements by means of the increased inclusion of stress scenarios and securitisation positions is appropriate.

(2) The taking into account of the risks inherent in remuneration models is consistent.

Cons: The proposed shifting of the burden of proof in the case of complex re-securitisation is not convincing, as it contravenes the need to avert a credit crunch by using risk-sensitive securitisations.

CONTENT

Title

Proposal COM (2009) 362 of 13. July 2009 for a **Directive** of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards **capital requirements for the trading book and for re-securitisations**, and the supervisory **review of remuneration policies**.

Brief Summary

Unless otherwise provided for, the articles quoted refer to the Directive 2006/48/EC on the taking up and pursuit of the business of credit institutions.

- **Background**
  - Directives 2006/48/EC and 2006/49/EC constitute the European implementation of the Basel-II Agreement on capital requirements for banks and investment firms (hereinafter "institutions") in the EU. They prescribe complex risk-measurement methods for all institutions. These risks must be accounted for by retained own funds serving as a "buffer" for unexpected events.
- **Reinforced capital requirements for positions in the trading book**
  The capital requirements for positions in the bank's trading book (which, as a rule, are held for short-term resale) are to be reinforced. Institutions must:
  - take better account of crises accompanied by volatility and liquidity shortages ("stress conditions"). Institutions must assess at least once a week the risks of individual positions, thereby taking into account stress conditions by drawing on historical data approved by the national supervisory authorities (amended Annex V No. 5a and 5h of Directive 2006/49/EC);
  - capture losses short of issuer default, e.g. in the case of rating downgrades, when defining capital requirements for the trading book (amended Annex V Nr. 5c of Directive 2006/49/EC);
  - apply the more risk-sensitive risk weights to securitisation positions (i.e. credits pooled and converted into securities) which are already prescribed for positions in the banking book (normally held in the books for a longer period) (amended Art. 57 (1) letter r).
- **Reinforced capital requirements for re-securitisations**
  - Re-securitisations are securitisations where at least one of the underlying exposures meets the definition of a securitisation position (new Art. 4 No. 40a).
  - In the case of "highly complex" re-securitisation types, national supervisory authorities must verify investments on a case-by-case basis in order to identify whether or not a bank is assessing the type and risk of the underlying exposures adequately.
    - The Committee of European Banking Supervisors (CEBS) is to establish guidelines to define which types of re-securitisations are categorised as "highly complex" (Recital 16).
    - If a bank is not able to demonstrate that it has a "comprehensive and thorough understanding" of its securitisation positions ("due diligence"), it must fully deduct the securitisation position as a loss from its own funds or fully substitute it by new own funds (Recital 16, new Art. 122a (4) and 5, new Art. 122b).
  - These provisions apply to all new re-securitisations as of 1. January 2011. In respect of existing securitisations they are to apply from 1. January 2015 (new Art. 122b (2)).
- **Supervisory review of remuneration policies**
  - In order to prevent "poorly designed remuneration policies and incentive schemes" from increasing the risks for institutions "to an unacceptable extent", supervisory authorities should impose on these

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institutions measures which reduce the risks inherent in their activities (Recital 11).
– The remuneration of employees whose activities "have a material impact on the risk profile" of an institution must be consistent with a "sound and effective risk management". In respect of banks, the Committee of European Banking Supervisors (CEBS) will establish guidelines to ensure that remuneration models (amended Art. 22 Abs. 1 and 3, amended Annex V, No. 11):
  - do not encourage "excessive risk-taking by employees";
  - be in line with the business strategy, objectives, values and long-term interests of the institution;
  - take account of existing and future risks as well as the costs of the capital when calculating bonuses;
  - reflect both the actual performance of individuals and their business units and the overall results of the credit institution;
  - contain fixed remuneration components which are high enough to mean that staff are not dependent on bonus payments;
  - contain compensation provisions based on the actual performance achieved over time and do not "reward failure";
  - provide that the major parts of "significant bonus" payments be paid only after an "appropriate period" and be linked to the future performance of the firm.
– The national supervisory authorities are responsible for reviewing the remuneration models. They have the power to demand that existing models be modified or more own funds be retained to account for risks (new Art. 54 (3)).
– Infringements of the Directive are to be punished by sanctions which must be "effective, proportionate and dissuasive"; this includes penalties (new Art. 54 (2)).

► **Transparency**
– In disclosing their risk management targets and procedures, banks must assess whether their disclosures "convey their risk profile comprehensively to market participants". If their disclosures do not suffice, banks are obliged to disclose more information. (amended Art. 145 (3))
– In future, banks must also disclose their calculated capital requirement for the interest rate risk of securitisation positions in the trading book (amended Annex XII Part 2 No. 9).
– Banks which have their own risk measurement models must disclose the following information separately for both the trading and the banking book (amended Annex XII Part 2 Nos. 9 and 14):
  - to which amount securitisations are issued or acquired,
  - which (liquidity) risks are inherent in securitisations,
  - which risks are inherent in claims underlying (re-)securitisations,
  - a description of the processes in place to monitor the credit and market risks of securitisation exposures,
  - a list of all material hedge counterparties,
  - which special purpose entities are used for securitisation activities and to what extent the institution has exposures to these special purpose entities;
  - the amount of securitisations that are deducted from own funds due to significant risks.

► **Entry into force**
Member States must transpose all amendments into national law by 1. January 2011 at the latest.

Changes Compared to the Status Quo

► According to current EU legislation, capital requirements for securitisations in the trading book are calculated as if these instruments were normal debt positions. In future, the higher risk weights, now used for the banking book, will be applied to these securitisations, too.
► Remuneration models of institutions are currently not subject to the rules of the European regulatory law. In future, national supervisory authorities will have to ensure that no inappropriate risks be generated by these remuneration models.
► To date, disclosure requirements apply only to the risks of securitisation positions in the banking book, but not to risks of positions in the trading book.
► The principles on sound remuneration policies in the financial services sector established by the Commission's Recommendation C(2009) 3159 will take binding legal effect if included into the Annex of the Directive 2006/48/EC.

Statement on Subsidiarity

According to the Commission, only harmonised EU rules can ensure that banks operating at cross-border level are subject to the same requirements wherever they are active.

Policy Context

Since the advent of the financial crisis, many players have been engaged in establishing a new legal framework for the financial services sector and its supervision. Crucial here are the "Basel Committee" of the Bank for international Settlements in Basel (BIS), the European and US legislators and G20. On 1. October 2008 the EU Commission proposed amendments (Proposal COM(2008) 602 cp. CEP Policy Brief) to the Directive 2006/48/EC (Basel II). Amongst other things, it includes stricter rules on the securitisation of credits. On 30. April 2009 the Commission presented the "principles on sound remuneration policies in the financial services sector" in the form of a non-binding recommendation [Recommendation C(2009) 3159, cp. CEP Policy Brief]. This Commission Proposal followed on directly from the conclusions drawn during the London G20 Summit of 2. April. There the Heads of State and Government advocated that the quality of capital be strengthened and "sustainable remuneration models" be supported. Now, the Commission wishes to make these principles binding through the proposed Directive. During their meeting of 25. September 2009 in Pittsburgh, the G20 States stated that supervisory authorities should be entitled to demand higher capital requirements from institutions maintaining high-risk remuneration models.

Legislative Procedure

13.07.2009	Adoption by Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market
Committees of the European Parliament:	Economic and Monetary Affairs (in charge); Employment and Social Affairs; Legal Affairs
Committees of the German Bundestag:	EU-Committee (in charge); Finances; Domestic Matters; Economics Affairs
Decision mode in the Council:	Qualified majority (adoption with a majority of the Member States and 255 out of 345 votes; Germany: 29 votes)

Formalities

Legal basis:	Art. 47 (2) TEC (Freedom of Establishment)
Form of legislative competence:	Concurrent legislative competence
Legislative procedure:	Art. 251 TEC (Co-decision)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The financial crisis has demonstrated that the existing supervisory rules are insufficient. They failed to prevent a situation in which several banks had to be bailed out by tax money as they saw their very existence under threat. In order to avoid such bail-outs in future, it is justified that the Commission is now striving to change capital requirement rules.

The proposed reinforced risk management of the trading book is necessary, since the trading book – e.g. as a result of the increased investment banking – has gained substantially in volume and relevance in many institutions. **Integrating stress scenarios into the calculation of the required capital for the trading book will improve the quality of risk assessment and reduce the volatility of these calculations**. This will mean that in "times of stress" – which often accompany low liquidity – capital requirements are prevented from skyrocketing in a counterproductive manner ("procyclic effect").

The adaptation of the capital requirements for securitisation positions in the trading book to those in the banking book is desirable. Banks operating their own risk models have difficulties assessing their securitisation risks properly due to the complexity of the products. At the same time, by adapting the capital requirements, the Commission prevents the securitisation positions from being "moved" to the trading book, since there the underlying capital exposure may be lower than in the banking book.

The embedding of remuneration models in the Capital Requirement Directive is consistent since they definitely do imply risks, though to a lower extent than often assumed (cp. CEP Brief Policy on the Commission's Recommendation C(2009) 3159).

The rules for "highly complex" re-securitisations almost equal a shifting of the burden of proof: banks must prove that they understand securitisations properly and secured them appropriately. **The benefit of this rule is rather questionable**. The financial crisis demonstrated that the proper risk assessment of complex securitisations was too much for both banks and supervisory authorities. **It remains unclear how supervisory authorities will now attest banks that they properly evaluated these risks**.

Impact on Efficiency and Individual Freedom of Choice

According to the Commission, **the increased inclusion of stress conditions when measuring risks leads to a doubling of the own funds required for the trading book**. The exact costs of these measures will differ from bank to bank and depends on how willing investors are to provide a bank with capital. It can be expected that this competition for new own funds will increase the overall competitive pressure among banks.

The reinforced **disclosure requirements** for securitisation risks and the engagement in special purpose entities **are essential for trust building and the sound functioning of markets.** Without reliable information on trading partners a proper risk assessment is impossible and might lead to the disruption of entire markets.

Impact on Growth and Employment

Even though there is no alternative option to the recovery of financial market stability by way of retaining risk-adequate capital, the Commission's proposals also have an impeding impact on growth. **Higher capital requirements reduce banks' ability to grant credits** and thus a credit crunch becomes a threat. **This impact can be moderated by a (risk-adequate) securitisation of credits and their sale, since securitisation releases capital** which can be used for the further granting of credits. **It is therefore important that the "due diligence" requirements do not overburden the securitisation market unduly**.
In respect of the depreciation needs of bank balance sheets and the increased demand for capital due to new provisions, the question is from where banks can obtain this new capital. In Member States with a large amount of smaller banks with only limited access to the capital market, these provisions could speed up a consolidation of the banking community. However, this would undermine efforts to prevent the existence of "too big" banks whose insolvency cannot be accepted ("too big to fail"). It is therefore essential that the Directive be transposed in a "stress-free" period.

Impact on Europe as a Business Location

The measures proposed by the Commission represent the consistent further development of the Capital Requirement Directive. In the medium term, they could strengthen the stability of financial markets and, to this end, boost the attractiveness of Europe as a business location for investments. However, credits should be prevented from becoming disproportionally expensive in the EU compared to economic regions outside the EU, since this would compromise investments. Therefore, **the EU should push for the Basel II framework to be implemented and applied in other regions of the world too**.

Legal Assessment

Legislative Competence

The relevant legislative competence follows from Art. 47 (2) TEC. It also applies to the provisions on remuneration models, since they too are based on the consideration that these models must be compatible with the risk models.

Subsidiarity

Unproblematic.

Proportionality

Generally unproblematic. The provisions on remuneration models still have to be substantiated in the form of CEBS guidelines. Whether such substantiation constitutes an inappropriate intervention, particularly into the freedom of contract and into the autonomy in collective bargaining, remains to be seen.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

In Germany the regulation on adequate own funds of institutes, groups of institutes and financial holding groups (German Solvency Regulation – SolvV) would have to be amended

Alternative Actions

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Possible Future EU Actions

In October 2009, the Commission will propose further amendments to the Capital Requirement Directive (2006/48/EC). In a consultation that ended on 4. September, the Commission already announced a revision of the liquidity risk rules and the introduction of a maximum permissible use of debt capital (leverage). Procyclical effects are to be removed by means of dynamic capital reserves.

Conclusion

The proposed amendments strengthen the stability of the financial system, though at the expense of economic growth. The raising of capital requirements for the trading book through the increased inclusion of stress scenarios and securitisation positions is appropriate. Taking into account risks emanating from remuneration models is consistent. However, the intended shifting of the burden of proof for "highly complex" re-securitisations is not convincing. It contravenes the need to avoid a credit crunch by means of risk-adequate securitisations.