EU-Amendment Directive

CAPITAL REQUIREMENTS FOR BANKS (BASEL II)

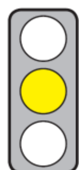
cep Centrum für Europäische Politik

Status: 02.02.09

MAIN ISSUES

Objective of the Directive: The effectiveness of the Capital Requirements Directive is to be improved in order to increase the stability of financial markets and the protection of creditors' interests.

Groups Affected: Banks, supervisory authorities, financial market participants and debtors



Pros: (1) Both the due diligence to be applied to the granting of credits, which are to be securitised later, and the qualitative requirements for investments in such securitised exposures, lower the risks in the securitisation market.
(2) The reform of banking supervision improves the quality of the supervision of banks operating at cross-border level.

Cons: (1) If large exposure rules are also applied to all inter-bank exposures, this might compromise liquidity in the money market.
(2) The obligation to retain at least 5% of securitised credits in the books undermines efforts to improve risk management.
(3) The Directive contains procyclic elements expediting an economic downturn.

CONTENT

Title

Proposal COM(2008) 602 of 1 October 2008 for a **Directive** of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC **as regards banks** affiliated to central institutions, **certain own funds items, large exposures, supervisory arrangements, and crisis management**

Introduction

All paragraphs quoted refer to Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, unless otherwise indicated.

► **Obligation for Risk Assessment and Risk Hedge**
- As already set forth in the Capital Requirement Directive ("Basel II"), which is mainly based on negotiations held in the Bank for International Settlements (BIS), banks in the EU will have to continue to assess their credit risks, market risks and operational risks as well as to retain own funds to avert them in future.
- Banks may still assess credit risks according to self-developed IRB models (Internal Rating Based Approach) which have to be approved by supervisory authorities, or may alternatively apply the statutory EU standardised approach. The latter weights all exposures of a bank with certain percentages ("risk weights"), depending on the type of exposure and the credit quality of the debtor, as estimated by a rating agency.

► **Reform of Banking Supervision**
- Banks operating at cross-border level are supervised by "colleges of supervisors":
  - The competent supervisory authority of the Member State in which a bank with branches also in other ember States has its head office "plans and coordinates" supervisory activities. In so doing, it cooperates closely with the authorities of the Member States which are in charge of supervising the according branches. (new Art. 129 (1) lit. c)
  - If supervisory authorities fail to agree on measures required – in particular on the amount of the own funds to be retained – the supervisory authority of the Member State where the head office is seated may decide on its own. (Art. 125, new Art. 129 and Art. 131a)
- Supervisory authorities may decide whether branches of a bank with the head office being seated in any other Member State are "systematically relevant". In such a case, the supervisory authority of the home Member State must inform the competent authority of the host Member State on the following:
  - unfavourable trends which might seriously impair any bank of the group concerned
  - extensive sanctions or unusual measures imposed on banks of a group (e.g. the obligation to provide additional own funds). (new Art. 42a)
- In taking their decision, national supervisory authorities must take into account the impact of their decisions on "the stability of the financial system in all other Member States concerned" (new Art. 40 (3)).

► **Hybrid Capital Instruments and own funds**
- Hybrid capital instruments are securities that contain features of both equity and debt. However, they may be included in own funds subject to the following requirements solely (new Art. 57 and Art. 63a):
  - they have to be paid up and may be used to compensate losses;
  - in the event of bankruptcy or liquidation they rank after all other claims;
  - they must be undated or have an original maturity of at least 30 years;

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- they may be called or redeemed subject to the prior approval of the competent supervisory authority solely;
- they do not provide for regular payments of interest or dividends (the bank must cancel such payments if it does not comply with the capital requirements set out above).

– Hybrid capital instruments which do not comply with these requirements may – in gradually diminishing steps – be deemed equivalent to own funds up to 30 years (Art. 154 Abs. (8) and (9)).

- **Large Exposures and Inter-Bank Exposures**
  – A credit institution must report every credit issued to each single client which exceeds 10% of the bank's own funds to the national supervisory authority at least biannually ("large exposure", new Art. 110).
  – A credit institution must not incur exposures exceeding 25% of its own funds to single clients or to a group of "connected clients".
  "Connected clients" means all undertakings being likely to experience financial problems if at least one of them encounters funding or repayment difficulties (new Art. 4 No. 45b and Art. 111 (1) Sentence 1).
  – This limitation applies also to exposures between banks. However, a bank with less than EUR 600 million in own funds may incur single inter-bank exposures of up to EUR 150 million if the total exposure amount issued to connected clients, other than banks, does not exceed 25% of its own funds. As for exposures between banks being part of the same company group, exceptions are admitted. (new Art. 111 (1) Sentence 2 and Art. 113 (4) lit. c)

- **Securitisation of Exposures**
  – After 1 January 2011, banks may invest in securitised credits – i.e. a pool of exposures being combined and converted into tradable securities – only if the issuer retains at least 5% of it in its books (new Art. 122a).
  – A bank must be able to demonstrate at all times to supervisory authorities that it has "a comprehensive and thorough" qualitative understanding of each individual securitisation position. This is to apply in particular to:
    - the risk characteristics of the individual securitisation position and its underlying exposures,
    - the structural features of the securitisation that can substantially impact their development. To this end, banks must regularly, both prior to and after investing in securitisation, and independent of the rating agency having rated the securitisation activity, perform their own "stress tests" in order to assess risks. (new Art. 122a (4))
  – A bank must monitor the development of exposures underlying its securitisation positions "on an ongoing basis and in a timely manner" by means of "formal procedures". In particular, it must monitor the percentage of loans more than 30, 60, 90 days past due or in foreclosure. Where it fails to do so, it has to retain a significantly higher amount of own funds by applying a risk weight of 1250% to these securitisation positions. (new Art. 122a (5))
  – In granting credits which are later securitised a bank must apply the same due diligence as it applies to the usual credit-granting. Moreover, it has to provide its investors with all relevant data on the securitisation positions concerned. In failing to do so it has to retain further own funds for the exposures securitised. (new Art. 122a (6) and (7))

- **Entry into Force**
  Member States must apply the Directive as of 31 March 2010 at the latest.

Changes Compared to the Status Quo

- To date, the recognition of hybrid capital instruments as own funds has not yet been regulated by EU law.
- To date, notification requirements regarding large exposures and upper limits for credits have differed between Member States. These will now be harmonised. The option to exclude inter-bank exposures from large exposure rules has been cancelled.
- To date, there are no statutory supervisory rules as to the securitisation of exposures.

Statement on Subsidiarity

The Commission holds the view that distortion of competition can be avoided through EU-wide harmonised supervisory principles and rules only.

Political Context

With its proposals regarding the treatment of inter-bank exposures and securitisation and the restructuring of supervision the Commission addresses issues which are generally believed to have played a crucial role in the current financial crisis. The proposals are mainly based on the EU Finance Ministers Roadmap dated 9 October 2007 designed to overcome turbulences on the financial market. On 13 March 2008, heads of states and governments pressed for the adoption of the measures proposed by April 2009.
In view of such a tight schedule, the Commission was not willing to await the results of the "Basel Committee" of the BIS. The supervisory authorities attending this Committee – which originally prepared the Capital Requirements Directive of 2006 – represent many EU Member States, the US and Japan and announced new proposals on the amendment of bank regulation for spring 2009.

Legislative Procedure

01.10.2008 Adoption by Commission
02.12.2008 Debate in the Council
Open Adoption by European Parliament and Council, publication in the Official Journal of the European Union and entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market and Services
Committees of the European Parliament:	Economic and Monetary Affairs (in charge), rapporteur Othmar Karas (EPP-ED-Group, AT); Legal Affairs
Committees of the German Bundestag:	Finance (in charge); Affairs of the European Union; Economics and Technology; Budget
Decision Mode in the Council:	Qualified majority (approval by a majority of Member States and at least 255 out of 345 votes; Germany: 29 votes)

Formalities

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

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The planned restructuring measures for banking supervision reflect the fact that because of cross-border operations, the risk profile of many banks can no longer be based on the activities of a bank in one single country. To this end, it makes sense to oblige national supervisory authorities to take the risks in other Member States into consideration. Otherwise any cross-border cooperation between competent authorities would be meaningless. **The idea of supervisory colleges** is justified and promising: it **might help to avoid having to do the work twice and to improve supervisory quality** if based on a joint risk profile of a bank. However, it is extremely important to establish minimum standards for the supervision in all EU countries. Otherwise incentives would be generated for banks to set up their head offices in Member States where supervisory standards are lowest (so-called "cherry picking").

Capital requirements restrict the banks' freedom to act. They lock up capital which, as a result, is no longer available for other purposes. Nonetheless, they do make sense from an ordoliberal standpoint, as they take full account of the risks of the entire financial market and thus – if shaped correctly – have a positive impact on the overall financial stability.

Therefore, it is to be welcomed that existing incentives for banks to invest in the development of own risk models – and hence to better estimate risks – are maintained: banks having established such models have to retain less own funds than banks which draw up on the fixed standard approach. In other words: **banks which make a real effort to identify existing risks can actually improve their competitive position.**

The new obligation for banks **to demonstrate** to supervisory authorities **that they have a comprehensive and thorough qualitative understanding** of investment risks **of their securitised exposures** is highly desirable. It **adds to an improved risk assessment standard**. **The same is true for the proposed due diligence to be applied to the granting of credits which are later securitised**. These measures have a preventive effect on the so-called "moral hazard problem", i.e. the squandering of credits and, at the same time, restrict the banks' freedom to act only to a relatively moderate extent.

The de facto obligation for issuers **to retain at least 5% of securitised exposures does not generate any convincing benefits.** For the short and medium term it even carries the inherent danger that a bank which invests in securitisation relies on the compliance of that duty instead of assessing the risks actually taken. Hence,**the obligation counteracts** the Directive's **efforts to establish an improved risk management**. In the long run it is even likely to damage confidence since it hampers the issuer when signalizing the reliability of its credit-granting practice. For as long as the keeping-in-the-books of credits is based on a statutory requirement, its informative value is relatively low. Should an issuer wish to substantiate his reliability, he will have to retain more than 5% of exposures and thus incur higher costs. Finally, **this requirement might weaken the competitiveness of European banks** and in turn of Europe as a whole since European banks will no longer be allowed to invest in securities of non-European issuers which do not comply with the European requirements. As a consequence, European banks would no longer have access to certain types of investments which – despite the current turbulences – might be very reasonable in terms of risk diversification and return rates.

Although the Commission claims rightly that "banks, although regulated, can fail", it would not be adequate to consider large inter-bank credits as large exposures as a consequence. On the one hand, it is highly questionable whether or not regulations on large exposures can cope with default risks. Models assessing exactly these

default risks are a much better tool for this purpose. On the other hand, this **requirement might compromise banks' liquidity supply on money markets**.
It is precisely here, however, where banks are normally supplied with liquidity, that massive problems have occurred in the financial crisis. A bank would no longer be entitled to provide any other bank with liquidity if – as a result of inter-bank credit rules – the admitted volume for credits to such a bank were reached. As a result, it might even choose a less sound business partner. Therefore the effects of the Commission's proposal on money markets should be analysed before being adopted.
Approving hybrid capital instruments along general criteria is also to be welcomed. The criteria clear the way for innovative, hitherto unknown capital forms and, at the same time, still allow for an EU-wide standardised approval practice which averts any distortion of competition.

Impact on Efficiency and Individual Freedom of Choice

In modern economies, stable financial markets are an essential prerequisite for an efficient allocation of capital. To this end, the Proposal contains supportive measures which – from an overall view – lead to an improved assessment of existing risks and more effective supervision.

Impact on Growth and Employment

The Directive contains a "procyclical component", which reinforces an economic downturn. If share prices fall, banks must write off portfolio losses, which might lower their own funds. Banks would thus be pushed to grant less credits because they have to retain own funds for such credits. As planned investments fail due to a lack of funding, companies' ratings deteriorate and, as a result, banks must retain even more own funds for credits. Thus credits become more expensive and investments are made less attractive which finally leads to an aggravated downturn. **Supervisory authorities should** therefore **approve only internal risk assessment models which factor all phases of economic cycles** – also the negative ones – **into their risk assessment**. In this way, depreciation and own funds fluctuation will not affect credit issuance dramatically in times of economic downturn.

Impact on Europe as a Business Location

The Proposal could strengthen the stability of financial markets and, to this end, boost the attractiveness of Europe as a business location. If the requirements currently negotiated in BIS fall far below those proposed in the Directive, then credits might become disproportionally expensive in the EU, which would compromise Europe as a business location.

Legal Assessment

Legislative Competence

The legislative competence is laid down in Art. 47 (2) TEC.

Subsidiarity

Unproblematic.

Proportionality

Unproblematic.

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 Policy Options

The requirement to retain 5% of securitised exposures in the books should be deleted. Further, to what extent the inclusion of inter-bank exposures into large exposures impedes the supply of liquidity in the money markets needs analysing. Supervisory authorities should take account of the procyclical effect of the Directive.

Possible Future EU Action

If the European Parliament and the Council agree on the proposals concerning securitised exposures and the restructuring of supervision, then it is highly likely that similar requirements will be introduced for securities-trading and for insurance companies.

Conclusion

Principally, the Proposal is to be welcomed. Supervisory colleges, due diligence for credit-granting and qualitative requirements for investments in securitised exposures add to the stability of financial markets. The obligation to retain 5% of the securitised exposures in the books should be waived as well as the inclusion of large inter-bank credits into large exposures; moreover, procyclical effects should be taken account of.