EU Regulation

CAPITAL REQUIREMENTS (BASEL III)

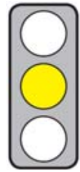
Status: 14.11.2011

cep Centrum für Europäische Politik

MAIN ISSUES

Objectives of the Regulation: Higher capital requirements for banks and investment companies are to stabilise the financial markets.

Parties affected: Credit institutions and investment companies, their contract partners and borrowers in particular.



Pros: Higher and better-quality capital requirements enable the institutions to cover any losses themselves.

Cons: (1) Government bonds must still not be covered with own funds.

(2) A leverage ratio can restrict lending to enterprises and private parties.

(3) The Commission should not initiate a liquidity ratio as a delegated act.

(4) The implementation of the capital regulations in EU alone undermines Europe's position as a business location and does not strengthen financial stability.

CONTENT

Title

Proposal COM(2011) 452 of 20 July 2011 for a **Regulation** of the European Parliament and of the Council **on prudential requirements for credit institutions and investment firms**

Brief Summary

Note: The Policy Brief is based on the English version of the Commission Proposal.

- **Background and objectives**
  - The Regulation and the simultaneously proposed Directive [COM(2011) 453, s. CEP Policy Brief) on the capital requirements for credit institutions and investment firms (hereafter referred to as 'institutions') are to replace the Directives 2006/48/EC and 2006/49/EC (Art. 152 of the Directive) as of 1 January 2013.
  - The Regulation contains provisions on the volume and quality of capital to be held in reserve and includes a maximum leverage ratio as well as rules regarding liquidity and counterparty risk.
  - The Regulation is to strengthen the "effectiveness of institutional capital regulation" and to contain the adverse impacts on the "procyclicality of the financial system". In so doing, the "competitive position of the EU banking industry" is to be maintained. (Explanatory Memorandum p. 2)
  - The Commission wishes to harmonise the requirements ("uniform rules"), as the existing differences in national decision-making has led to distortion of competition and hindered the cross-border transactions of institutions (Recitals 7, 8, 9).
- **Qualitative capital requirements**
  - In future, regulatory (not: balance sheet) capital will consist of common equity Tier 1, additional Tier 1 capital and Tier 2 capital (Art. 69). Capital with low liability quality ("Tier 3") does not count as regulatory capital (Explanatory Memorandum p. 2).
  - The classification of capital into categories such as common equity Tier 1, additional Tier 1 or Tier 2 is carried out on the basis of a catalogue of criteria (Art. 24 (1) lit. a, Art. 26, Art. 48, Art. 49 (1), Art. 59, Art. 60). The classification criteria are set out in an accompanying document.
  - The common equity Tier 1 capital consists of retained earnings, open reserves, funds for general banking risks and in general all issued ordinary shares (Art. 24 (1)).
    - Shares from cooperative banks and silent deposits are allocated to common equity Tier 1 capital, irrespective of the legal form of the respective institution, as long as they meet additional requirements; in particular, it must be possible to use them to offset losses (Art. 27).
  - Additional Tier 1 capital normally consists of preference shares and hybrid financial instruments (instruments characterised by debt and equity capital such as convertible bonds), provided they meet the relevant classification criteria (Art. 48 – 49).
  - Tier 2 capital normally consists of long-term subordinated liabilities placed at the disposal of an institution for five years and profit participation rights (capital investment with participation rights to an institution's profit but without voting rights), provided the relevant classification criteria are met. (Art. 60)
- **Quantitative capital requirements**
  - As of 1 January 2013, higher quantitative minimum capital requirements exist for institutions. The common equity Tier 1 share of both total Tier 1 and total capital is to be gradually increased, while the Tier 2 capital share of total capital is to be gradually decreased (see table). (Art. 87 (1) and 2, Art. 448 (1)) Capital requirements are calculated on the ratio between the capital form concerned and the total risk-weighted assets. The riskier the assets, the higher they are weighted. (Art. 87 (1), (2)).

Authors: Philipp Eckhardt and Dr. Bert Van Roosebeke | vanroosebeke@cep.eu
CEP | Kaiser-Joseph-Straße 266 | 79098 Freiburg | Phone 0761 38693-105 | www.cep.eu

Minimum capital requirements */** (in % of risk-weighted assets)	By end of 2012	From 2013	From 2014	From 2015	From 2016	From 2017	From 2018	From 2019
Common equity Tier 1	2.0	3.5-4.5	4.0-4.5	4.5	4.5 (5.125)	4.5 (5.75)	4.5 (6.375)	4.5 (7)
Tier 1: common equity and additional Tier 1	4.0	4.5-6.0	4.5-6.0	6.0	6.0 (6.625)	6.0 (7.25)	6.0 (7.875)	6.0 (8.5)
Total capital: Tier 1 + Tier 2	8.0	8.0	8.0	8.0	8.0 (8.625)	8.0 (9.125)	8.0 (9.875)	8.0 (10.5)
* subject to any qualitative amendments to the definition of capital components ** in brackets incl. conservation capital buffer from the Directive [COM(2011) 453, s. CEP Policy Brief]								

– The competent national authorities stipulate the minimum rates for 2013 and 2014 for the common equity Tier 1 and the total Tier 1 capital ratio within the prescribed scope (Art. 448 (2) lit. a).
– The Commission may “for a limited period” prescribe minimum capital requirements by way of delegated acts, unless the Parliament or the Council opposes it within two months following their announcement (Art. 443 lit. a, Art. 445 (4) and (5)).
– The institutions are still not obliged to cover government bonds or other exposures to “Member States’ governments” with own funds unless there is an exchange risk inherent (Art. 109 (4)).
– National authorities may set higher risk weights for exposures fully secured by mortgages or residential property in order to stabilise financial markets (Art. 119 (2), Art. 120, Art. 121).
– Investments in “speculative immovable property financing“ are now deemed exposures with “particularly high risks” and therefore are assigned a risk weight of 150% (Art. 123 (2) lit. c in conjunction with Art. 4 lit. 55). The European Banking Authority (EBA) defines in guidelines which of these investments are particularly risky (Art. 123 (3) sub-para. 2).

► **Leverage ratio**
– The leverage ratio of an institution is the ratio of its total Tier 1 capital to its – non-risk weighted – assets and off-balance sheet items (Art 416).
– The institutions must notify national supervisory authorities of their leverage ratios and the data necessary to calculate them. As of 2015, they are obliged to publish their leverage ratio. (Art. 416, 417, 436, 487 (2))
– By the end of 2016, the Commission wishes to submit a report on the “impact and effectiveness” of the leverage ratio and “where appropriate” submit a legislative proposal for a binding ratio (Art. 482 (1)).
– By 2018, the Commission will introduce a binding maximum leverage ratio (Recital 68).

► **Liquidity Coverage Ratio**
– The institutions must as a general rule hold sufficient liquid assets at all times (amongst other things, cash funds and securities which can be liquidated quickly) in order to have enough liquid assets “under stressed conditions” (Art. 401 (1)).
– This requirement generally applies to each subsidiary of a finance group and not only to the parent institutions. Exceptions to this rule are only possible if the supervisory authorities of all Member States concerned agree. EBA may settle any conflicts that may arise. (Art. 7, Art. 19)
– The Institutions must provide the competent authority with comprehensive information regarding all liquidity outflows and inflows (Art. 403 - 413).
– As of 2015, the Commission may substantiate the liquidity coverage ratio by way of delegated acts. In so doing, it is to take account of EBA’s impact assessment (Art. 444).

► **Measures to reduce counterparty risk**
– Counterparty risk refers to the risk that the counterparty to a transaction could default on outstanding payments before the final settlement or that its credit rating decreases (Art. 267 (1)).
– Institutions must hold capital reserves (Art. 108 (8), Art. 151, Art. 295 (1), Art. 296 (2), Art. 297 (1), Art. 298 (1)) to cover the counterparty risk of all exposures to a clearing house (i.e. undertakings which clear and accomplish transactions between counterparties). Additional capital requirements apply to contributions to default funds of CCP (Art. 298).
– In the case of over-the-counter derivative transactions (OTC), the counterparty risk must be covered by additional own funds (Art. 371, Art. 372).
– Institutions must cover exposures to large (more than 70 million Euro total assets) regulated institutions and non-regulated institutions such as hedge funds with additional own funds (Art. 148 (2), Art. 137 (5) and (6)).

► **Dealing with credits to small and medium-sized enterprises (SME)**
– The risk weight of 75% introduced by the Directive 2006/48/EC for credits to SME remains in effect, provided that (Recital 48, Art. 118)
  - the credit has “many characteristics” in common with other credits so that the risks of such lending are reduced (so-called granularity argument); and
  - the total credit sum of SME does not exceed 1 million Euro.

– After two years at the latest following entry into force of the Regulation, the Commission is to submit a report – and possibly also a legislative proposal – on the potential reduction of risk weights for credits to SME (Recital 48, Art. 485).

- **Entry into force**
  The Regulation is to apply from 1 January 2013 (Art. 487 (1)).

Changes to the Status quo

To date, the prudential rules for capital requirements have been regulated in the form of a Directive; in future, a Regulation applies. Qualitative and quantitative capital requirements are to be tightened. Until now, there has been neither a leverage ratio nor a liquidity coverage ratio in EU law.

Statement on Subsidiarity by the Commission

According to the Commission, Member States are not able to achieve the objectives of the Regulation to a satisfactory extent. To this end, the Commission deems an EU-wide regulation necessary in order to establish an EU-wide level playing field, reduce the complexity of legislation and eliminate differences in the strictness of prudential rules.

Policy Context

Calls by the G20 States in April 2009 to improve the quality and quantity of capital requirements, to regulate liquidity risks more strictly and to introduce a maximum permissible, risk-independent leverage ratio resulted in a package of measures that was adopted by the G20 States in September 2009. On the basis of this, in December 2010, the Basel Committee on Banking Supervision of the Bank for International Settlements published regulatory standards (Basel III) which are to be implemented by 2018. The Regulation and parts of the Directive (capital buffer) serve to implement Basel III for the EU. Following the G20-Summit Conclusions from November 4th 2011, all systemically relevant financial institutions (status to be checked on a annual basis) must, by 2019 present up to 3,5 % more common equity than other financial institutions.

Legislative Procedure

20 July 2011	Adoption by the Commission
Open	Adoption by the European Parliament and 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:	open
Committees of the German Bundestag:	open
Decision mode in the Council:	Qualified majority (adoption by eh majority of Member States and with 255 of 345 votes; Germany: 29 votes)

Formalities

Legislative competency:	Art. 114 TFEU (approximation of laws in the internal market)
Form of legislative competency:	Shared competency (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The financial crisis of recent years and the current eurozone crisis have shown that the institutions' capital buffers have been in part too low to be able to absorb larger losses on their own. This led to massive state aid measures to support the institutions. From an ordoliberal standpoint, this is unacceptable, as it eliminates the notion of taking responsibility for one's own actions. Besides, due to the high level of indebtedness of several Euro states it is no longer possible to finance these measures.

The planned increase of quantitative capital requirements, in particular of the common equity Tier 1 ratio, strengthens the capability of institutions to cover losses themselves and therefore **reduces the likelihood of having to resort to state recapitalization measures**. The consequences of an enforced raise of the capital reserves through the reissuing of shares for the risk potential are of course unclear. On the basis of shareholder pressure, both a reduction in the business risk of an institution and an increase thereof for yield reasons is possible.

Therefore, **it is mandatory that the tightened capital requirements are flanked by a reliable European insolvency statute which allows the orderly insolvency of banks**. Only when shareholders really are faced with insolvency, can an increase of risks for yields reasons be avoided.

The fact that institutions are not obliged to hedge state bonds with own funds is no longer justifiable. The underlying assumption that states per se cannot become insolvent is obviously wrong; the acquisition of state bonds is attached to significant default risks. In order to avoid cluster risks and distortion of competition at the expense of private bond issuers, state bonds must be subjected to the capital requirements pursuant to the same criteria – e.g. their rating – as are the bonds of private issuers. In order to avoid a double burdening of institutions, it would have to be related to a reduction in the capital conservation buffer - as proposed in the Directive (s. CEP Policy Brief) – which is also to hedge against a state insolvency risk.

The exact effects of a maximum leverage ratio – not provided for under the Basel II regulatory standards - are still uncertain. To this end, this ratio should not be introduced hastily. It is appropriate that the Commission first wishes to examine the potential impact it will have. The leverage ratio would apply irrespective of the risks entered into by an institution. This can have both positive and negative effects. It is positive that over-indebtedness due to an underestimation of the risks entered into would be prevented. It is negative that institutions could also slash their balance sheets by selling derivatives serving to reduce risks in order to comply with their leverage ratio. Equally negative is the fact that a leverage ratio could eliminate the incentive for institutions to reduce risks: as for low-risk business models the same requirements apply as for high-risk institutions.

It is particularly important to examine if a leverage ratio in combination with a zero risk weighting of state bonds would supplant the granting of credits to companies or private institutions.

A binding liquidity buffer can help reduce the likelihood of a bank run and prevent illiquidity in times of stress. The liquidity buffer can, however, lead to an increased demand – and hence to higher prices – for particularly liquid forms of investment. Irrespective of such an effect, the following applies: the liquidity buffer **is too important to be substantiated by the Commission through delegated acts**. It should be adopted in the normal legislative process.

Where derivative transactions accomplished through clearing houses (CCP) are favoured by lower capital requirements, as opposed to those accomplished over-the-counter, the different risks are considered and this is therefore appropriate. (s. CEP Policy Brief)

Impact on Growth and Employment

Higher capital requirements limit lending capability, which can have a negative impact on growth and employment in the short term. At the same time, the proposed measures reduce the risk of a future financial and banking crisis (including state rescue measures) and thus strengthen the stability of the European financial sector.

Impact on Europe as a Business Location

Negative effects for Europe as a business location, however, **are to be expected where the implementation of the global Basel III guidelines are not followed by third countries, in particular the USA**. In this case, credits in the EU would become unilaterally expensive, thereby lowering general willingness to invest in Europe. Due to the international linking of the financial markets, financial stability in the EU would not then be fundamentally consolidated.

Legal Assessment

Legislative Competency

Art. 114 TFEU (harmonising legislation in the internal market) is applicable as different national capital requirements could impede the internal market significantly.

Subsidiarity

Unproblematic.

Proportionality

In view of the necessity for harmonised rules on capital in all Member States, the choice in favour of a Regulation as the legal form is appropriate.

Compatibility with German Law

Regulations have an immediate effect in all Member States (Art. 288 sub-para. 2 p. 2 TFEU), i.e. national implementation acts are not necessary. In Germany, however, the German Banking Act (*Kreditwesengesetz, KWG*) and the German Solvency Regulation will have to be adjusted.

Conclusion

Raising the quantity of capital requirements, in particular of the common equity Tier 1 ratio, reduces the likelihood of having to take state recapitalization measures. A higher quality of the common equity Tier 1 is target-oriented but must be accompanied by a reliable European banking insolvency statute. It is not justifiable that investment in state bonds do not have to be hedged by own funds neither in future. Before introducing a leverage ratio, it should be examined if this would supplant lending to companies. A liquidity buffer should not be substantiated by the Commission in the form of a delegated act. If the Basel capital requirements are implemented by the EU only, the quality of Europe as a business location would be weakened without strengthening the stability of the financial market.

Authors: Philipp Eckhardt and Dr. Bert Van Roosebeke | Phone 0761 38693-105 | vanroosebeke@cep.eu