EU Directive

CAPITAL REQUIREMENTS DIRECTIVE (BASEL III)

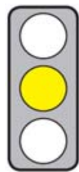
cep Centrum für Europäische Politik

Status: 14 November 2011

MAIN ISSUES

Objectives of the Directive: Additional own funds buffers are to strengthen the banking sector's resistance to losses and to smooth credit lending to economic cycles. Minimum standards for sanctions are to ensure compliance with requirements. The influence of external ratings is to be reduced.

Parties affected: Credit institutions, investment firms, prudential authorities.



Pros: The capital conservation buffer strengthens the ability of institutions to absorb losses without having to apply for state aid.

Cons: (1) The countercyclical capital buffer is problematic in many ways.

(2) Minimum sanctions do not lead to strict supervision; the EBA must be allocated greater powers.

(3) Replacing external ratings with internal ratings or models does not necessarily lead to better risk assessment.

(4) A unilateral implementation of the "Basel III" agreement in the EU only does not strengthen financial stability and has a negative impact on Europe as a business location.

CONTENT

Title

Proposal COM(2011) 453 of 20 July 2011 for a **Directive** of the European Parliament and of the Council **on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms** and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

Brief Summary

- **Background and general points**
  - Together with the Commission's proposed Regulation [COM(2011) 452, s. CEP Policy Brief, below referred to as "Regulation"], the Directive forms "the legal framework governing bank activities and the prudential rules for credit institutions and investment firms" (Recital 2).
  - The Directive introduces capital conservation buffers, countercyclical capital buffers and minimum standards for sanctions and corporate governance. In addition, it should reduce "overreliance on external ratings". (Explanatory Memorandum, p. 2)
  - The Regulation prescribes raising general capital requirements for credit institutions and investment firms (below referred to as "institutions") (Art. 87 of the Regulation).
- **Capital conservation buffer**
  - The capital conservation buffer is to ensure that institutions increase their capital base in order to better absorb losses (Recital 56). It must consist of Common Equity Tier 1 capital (Art. 123). This includes in particular shares and retained profits.
  - The buffer must amount to 2.5% of the risk weighted assets of an institution (Art. 123 (1)). The risk weights of the assets are regulated under the Regulation (Part III, Title II of the Regulation).
- **Institution specific countercyclical capital buffer**
  - The institution specific countercyclical capital buffer is to help prevent credit bubbles and crunches. It, too, must consist of Common Equity Tier 1 capital. (Art. 124, 130)
  - Each national prudential authority must on a quarterly basis set a "national rate". Normally, this varies between 0% and 2.5% of the risk weighted assets. The rate must be higher in the case of a positive "deviation of the ratio of credit-to-GDP from its long-term trend" and a high credit growth within the state concerned. The European Systemic Risk Board (ESRB) may make non-binding recommendations. (Art. 126 (2), (3), (5))
  - For institutions which grant credits in one Member State only, the countercyclical buffer is calculated on the basis of the "national rate" of the respective Member State (Art. 130 (1)).
  - Institutions which grant credits in several Member States calculate their institution specific countercyclical capital buffer as a weighted average of the national countercyclical buffers. However, the institutes' national supervisory authority may amend the national rate for other states and therewith their national buffers. In concrete terms:
    - Rates of other Member States which are below 2.5% are recognised by the national prudential authorities. Rates from EU countries which are above 2.5% and which have not been explicitly recognised by the own national prudential authority are cut to 2.5%. Rates from non-EU countries ("third countries") below 2.5% may be increased by each national prudential authority; those above 2.5% may be reduced if this is deemed "reasonable". (Art. 127; Art. 129 (2), (3); Art. 130 (2))

Authors: Anne-Kathrin Baran and Philipp Eckhardt | baran@cep.eu
CEP | Kaiser-Joseph-Straße 266 | 79098 Freiburg | Germany | Telephone +49 (0)761 38693-105 | www.cep.eu

- The weighting of national buffers depends on the relative volume of the credits issued by the institution in each country: it is determined as the share of own funds retained for credits in that country in total own funds retained for credits in all countries. (Art. 130 (1)).

– If a rate is increased, institutions must apply this after twelve months. Shorter deadlines require "exceptional circumstances" (Art. 126 (7)).

- **Non-compliance with buffer requirements**
  - Institutions which fail to meet the capital buffer requirements
    - are subject to restrictions, in particular regarding profit distributions from Common Equity Tier 1 capital, variable remunerations and discretionary pension benefits (Art. 131 (2) and (3));
    - must submit to national prudential authorities within five working days a capital conservation plan demonstrating how to meet the requirements within an "appropriate period" (Art. 132).

- **Provisions on sanctions**
  - EU-wide harmonised minimum standards for sanctions are to be introduced as a response to breaches of the provisions of the Directive and the Regulation (Art. 65 et sqq.).
  - The extent of sanctions is to be determined by the gravity of the breach. In the case of a breach of certain provisions of the Directive (e.g. commencing activities as a credit institution without obtaining prior authorisation) national prudential authorities must "at least" be entitled to give public statements, apply orders requiring the responsible party to cease their conduct and impose administrative pecuniary sanctions (Art. 66 (1) and (2)).
  - In more severe cases of breach, they must be additionally entitled to withdraw the authorisation of an institution and to impose a temporary ban on single persons being allowed to pursue their normal business (Art. 67 (1) and (2) lit. c and d).
  - The national prudential authorities must publish all sanctions and information on the nature of the breach and the responsible persons "without undue delay", unless "such [a] publication would seriously jeopardise the stability of financial markets". Where publication would cause "disproportionate damage" to the parties involved, competent authorities may publish the sanctions "on an anonymous basis". (Art. 68)
  - The European Banking Authority (EBA) adopts non-binding guidelines on the nature and type of sanctions and measures as well as on the level of administrative pecuniary sanctions (Art. 69 (2)).

- **Obligations of the "management bodies", in particular risk management; remuneration policies**
  - The members of the "management body of any institution" must be of "sufficiently good repute", possess "sufficient knowledge, skills and experience" and commit "sufficient time to perform their duties". They must not combine at the same time more than four "non-executive directorships". "Executive directorships" count double, two "directorships" at the same time are not admitted. (Art. 87 (1))
  - Institutions must establish a risk committee "composed of members of the management body". Such a committee advises the management body in its supervision of overall risk appetite and strategy. The members must not perform any "executive function" in the institution concerned (Art. 75 (3)).
  - Institutions are to promote "gender, age, geographical, educational and professional diversity" when selecting the members of the management bodies. (Art. 87 (3))
  - The EBA may specify, through legally binding regulatory technical standards, how much time a member of the management body must commit to its duties and what exactly is meant by diversity (Art. 87 (5))
  - Institutions must establish a "risk management function" to identify, measure and report on risk exposures. The head of such a function is to act independently from the operational and management functions and to have direct access to the management body. They may only be removed by the management body. (Art. 75 (5))
  - The already existing non-binding rules on remuneration policies (s. CEP Policy Brief) are now to become legally binding (Art. 88 to 90).

- **Reducing the impact of external ratings**
  - Institutions must not rely "exclusively or automatically" on external ratings to assess the credit risk of individual borrowers, securities or complete portfolios. When applying external ratings, institutions must rely on their own methods to assess whether the credit risk has been sufficiently taken into account by the capital requirements. (Art. 77 lit. b)
  - Institutions with exposures that are "material in absolute terms" and with a "large number of material counterparties" must develop internal ratings for calculating their capital requirements ("basis IRB approach"; Art. 76 (1)).
  - Institutions whose "exposures to specific risk are material in absolute terms" and who "have a large number of material positions in debt instruments of different issuers" must develop and use "internal models" ("advanced IRB approach") for calculating own funds requirements. These models – which must be approved by the national prudential authority – serve to identify the likelihood and consequences of credit defaults and deteriorations of the creditworthiness of borrowers. (Art. 76 (2))
  - The EBA substantiates the specifications with binding regulatory technical standards (Art. 76 (3)).

- **Transposition**
  - The Member States must transpose the Directive by 31 December and apply it as of 1 January 2013 (Art. 151 (1)).
  - The provisions regarding the capital buffers become effective as of 1 January 2016 (Art. 151 (2)). Between 2016 and 2018, for both the capital conservation buffer and the institution specific countercyclical capital buffer the targets will be met in three stages. (Art. 149 (1) to (4))

Changes to the Status Quo

To date, EU legislation has provided for neither capital conservation buffers nor institution specific countercyclical capital buffers. Moreover, institutions were entitled to decide themselves whether to use the standard rate based on external ratings or to establish an internal risk based approach (IRB) in order to ascertain what own funds to have ready. In future, in certain cases the IRB approach will be obligatory.

Statement on Subsidiarity by the Commission

According to the Commission, only EU action can ensure a "level playing field", avoid "unwarranted compliance costs" for cross-border activities, promote "further integration in the EU market" and help reduce "regulatory arbitrage" opportunities.

Policy Context

The capital buffers are an integral part of the agreement of the Basel Committee of the Bank for International Settlements (BIS) on new prudential rules for credit institutions (Basel III), which was adopted in December 2010 and is to be implemented by 2018. In June 2010 already, the Commission submitted a Green Paper on corporate governance in financial institutions. The EU Rating Regulation (s. CEP Policy Brief) was revised in 2011 (s. CEP Policy Brief). A proposal for a further revision is still planned for 2011.

Legislative Procedure

20 July 2011	Adoption by the Commission
25 April 2012	Committee Meeting in the Parliament
12 June 2012	1st Reading in the European Parliament

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market and Services
Committees of the European Parliament:	Economic and Financial Affairs (in charge), rapporteur: Othmar Karas (EPP Group, AT); Legal Affairs
Committees of the German Bundestag:	Finance (in charge); Legal Affairs; Food, Agriculture and Consumer Protection; Affairs of the European Union
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 competency:	Art. 53 (1) TFEU (self-employed activities)
Form of legislative competency:	Shared competence (Art. 4 (1) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The recent financial crisis and the current eurozone crisis have proven that the institutions' capital buffers were in part too low to be able to absorb on their own large losses. This led to massive financial support measures from the states to the benefit of financial institutions. From an ordoliberal standpoint, this is unacceptable, as it eliminates liability for one's own actions. Besides, it has become impossible to finance these measures due to the high indebtedness of several eurozone countries. Increasing the amount of own funds to be retained by institutions – here the **capital conservation buffer** – is therefore necessary. Combined with the increase in the Common Equity Tier 1 capital to be retained, as proposed in the Regulation, the buffer will **strengthen the institutions' ability to cover losses where needed, without having to apply for state aid**.

Anticyclical own funds requirements are appropriate in principle. If successful, they even out lending across economic cycles and thus help prevent credit bubbles and crunches. **The institution specific countercyclical capital buffer** , however, **is problematic in many ways**. First, an early detection of credit bubbles and crunches is extremely difficult. For instance, there are still disagreements as to whether to take into account changes in credit growth ("credit impulse") as an indicator instead of "the deviation of the ratio of credit-to-GDP from its long term trend" along with credit growth. The right choice of the best observation variables, however, is extremely important in order to avoid any procyclical effects which might even encourage credit crunches during downturns.

Secondly, the effective deadline for the buffer increase is one year. In view of the problems institutions face with mobilising additional own funds at all, that may be understandable. Yet it is questionable whether the countercyclical steering of credit lending is at all possible with such a delay. Thirdly, the provisions regarding the rates lead to problems with incentives. There is a risk that national authorities set low level rates for their countries in order to keep down own funds requirements of national banks and thus support GDP growth. The fact that the Commission provides for an option that national authorities raise rates from third countries proves that the Commission, too, deems this option realistic. Therefore, the **EBA should be given the power to decide on national rates**. Fourthly, the countercyclical buffer can distort competition. For instance, in the EU there are 27 different rates possible for USA credits. Therefore, the **EBA should also decide on EU-wide deviations from rates of third countries**.

Restrictions on profit distributions in the case of non-compliance with buffer rates contribute in the short term to re-attaining buffer requirements. This will, in line with ordoliberal thinking, be financed by shareholders. Thus they have an ex ante interest in complying with the requirements. However, dividend restrictions always bear the risk that capital investors are not willing to provide banks with own funds at all.

Harmonised minimum standards for sanctions in the case of infringements of own funds requirements are justifiable. They can help remove distortion of competition resulting from large differences between national sanction measures. However, **they cannot resolve the underlying cause of the problem**: national authorities will continue to detect whether an infringement is at hand at all. The **EBA should** play a more decisive role here. It should, in particular, be entitled to **settle disputes between national authorities on the necessity of sanctions**, for disruptions in one Member State can quickly affect the stability of the financial market in another Member State.

The introduction of a "risk management function", the requirements regarding the qualification of members for the management body and their obligation to commit themselves to risk management are appropriate. **The requirements as to diversity among the members in management bodies**, however, **restrict the freedom of entrepreneurship** and should be rejected. **The requirement** for certain institutions **to calculate own funds requirements no longer through external ratings but through internal ratings or internal models** reduces the influence of external ratings. This **does not automatically lead, however, to improved risk assessments**. Also, internal risk models can overestimate or underestimate risks.

Impact on Growth and Employment

Capital buffers increase credit costs. This has a negative impact on growth and employment.

Impact on Europe as a Business Location

In general, the proposed measures strengthen the stability of the European financial sector, which in turn has a positive impact on Europe as a business location. However, **negative impacts can be expected where the implementation of the global Basel III rules is not applied in third countries, above all in the USA**. In this case, credits in the EU will become unilaterally more expensive, thereby lowering the general willingness to invest in the EU. Due to the international linking of the financial world, financial stability in the EU is not then fundamentally strengthened.

Legal Assessment

Legislative Competency

The Directive is rightly based on Art. 53 (1) TFEU (self-employed activities).

Subsidiarity

Unproblematic.

Proportionality

The assessment depends, in particular concerning the rules regarding the management body, on how the technical regulatory standards of the EBA are set out. The rest is unproblematic.

Possible EU Follow-Up Action

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.

The EU-Commission has announced an additional revision of the Regulation for rating agencies for November 15th 2011.

Conclusion

The capital conservation buffer strengthens the ability of institutions to cushion losses without having to apply for state aid. The countercyclical capital buffer is problematic in many ways. Harmonised minimum actions do not solve the actual problem – namely, that the national authorities must detect infringements of rules. Instead, the EBA should be granted the power of arbitration. The calculation of own funds requirements on the basis of internal models instead of external models does not necessarily lead to improved risk assessment. A unilateral implementation of the "Basel III" agreement in the EU does not strengthen the stability of the financial market in the EU and has a negative impact on Europe as a business location.