Background

Bank capital rules - 14 May Economic and Monetary Affairs Committee vote

The Economic and Monetary Affairs Committee took a unanimous stand on the latest bank capital requirements legislation on Monday 14 May. The vote gives Parliament's negotiators, led by rapporteur Othmar Karas (EPP, AT), a strong hand in pushing its reform agenda with Member States.

Put simply, bank capital is the funds held by a bank in the form of cash, real estate, bonds, shares, and loans such as mortgages etc. Bank capital is also categorised by how liquid it is, i.e. how easily it can be converted into cash in order to make payouts to creditors, including depositors.

This note details the key aims that the committee strove for in the vote and how it proposes that they be achieved.

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Key aims

A stable banking sector: European banks must be steady in the international financial market. MEPs want European banks to set aside more and better capital so as to be prepared for difficult times. Tighter rules are to apply to liquidity, and banks' reserves would need to be mobilised more flexibly to respond faster in times of crisis.

Growth and employment: the new rules should encourage banks to lend to the real economy rather than to speculate. They would affect the cost of loans, which is a key factor in stimulating growth and employment in times when they are most needed.

MEPs aim to reduce loan costs for small and medium-sized enterprises (SMEs) and business start-ups.

Fair play in the banking sector: MEPs wish to enforce greater fairness in two areas:

- **Equal treatment**: Basel III [1]is largely based on the Anglo-American investment banking model. European implementation of these rules must take more account of the characteristics of continental European banks to ensure that they are not discriminated, and

- **Bonus cap**: manager bonuses must be capped. The salary/bonus ratio must be such as to prevent encouraging excessive risk taking.

[1] The body of principles agreed at international level which must then be enacted in national law (or in Europe's case, EU law).

How to stabilise the banking sector?

More and better capital: until now, banks have had to hold a minimum total capital of 8% of risk-weighted assets (composed of Common Equity Tier 1 [2] (2%), Additional Tier 1 (2%) and Tier 2 capital (4%). The committee voted to make banks hold 8% of minimum capital but changed the balance (4.5% Common Equity Tier 1, 1.5% Additional Tier 1 and 2% Tier 2 capital).

Moreover, banks would be required to build up two additional capital buffers: 2.5% Common Equity Tier 1 capital is to be held as a conservation buffer and up to 2.5% for the countercyclical buffer. The countercyclical buffer is to be set by national regulators.

Furthermore, systemically-important financial institutions (SIFIS), i.e. banks which are "too big to fail", would have to hold additional Common Equity Tier 1 capital of 1% to 3%. This ratio may increase up to 10% if the bank plays an exceptionally important economic role.

More liquidity: the financial crisis was a crisis of liquidity. It is not enough to hold more capital if this capital is not available in times of crisis. The committee therefore inserted thresholds which could be breached for the liquidity coverage ratio and the net stable funding ratio.

Limiting a bank's business with shadow banks: banks would have to report their top ten exposures to unregulated institutions and would be restricted to placing no more than 25% of their overall exposure with shadow banks.

[2] Capital considered of top quality because of its soundness

How to support growth and employment?

Facilitate SME loans: the committee reduced the SME loan risk ratio by 30% to make it easier for banks to lend to SMEs without excessively affecting their risk exposure.

SME loan facilitation principle for business start-ups, too: to support start-ups, innovation and certain national new business programmes, the same risk ratio reduction mechanism would be applied.

Raising the retail threshold from 1 to 2 million Euro: the definition of retail loans would be changed. To date, the risk ratio of 75% has been restricted to loans of up to 1 million Euro. MEPs intend to raise this threshold to 2 million Euro. This will allow more loans to fall under the retail loans rule.

Facilitating infrastructure lending: the committee voted to halve the risk ratio of infrastructure loans (transport, energy and telecommunication).

Export and trade funding: for certain export and trade funding, the risk ratio is also lowered.

How to ensure more fair play in the banking sector?

Equal treatment: the committee pushed for better recognition of the specific characteristics of continental European banks:

- cross-guarantee schemes and loss-sharing agreements to be recognized,
- decentralised banks to be recognized by taking into account the special nature of institutional protection schemes, and
- bank capital to be rated by the criteria of substantial quality and loss capability rather than by formal criteria such as the legal form by which the capital is defined.

Manager bonuses: the committee approved a salary bonus ratio of 1:1. A banker's bonus must therefore not exceed fixed salary, so as to shift the motivation structure away from excessive risk taking for short term rewards.