Background

EU Bank Capital Requirements Regulation and Directive

[15-04-2013 - 19:25]

The EU Capital Requirements Regulation (CRR) and Directive (CRD) aim to stabilise and strengthen the banking system by making banks set aside more and higher quality capital as a cushion against crises. The new rules should also foster a convergence of supervisory practices across the EU. Banks that are better able to withstand future crises should be more capable of financing investment and growth.

This background note looks at why the new rules have been set out in two legal instruments, a regulation and a directive, and how they have changed compared to the previous rules in force. After Parliament's vote, the Council needs formally to approve the rules. The Regulation and the Directive will then be published in the Official Journal (OJ) and enter into force. The new rules will apply from 1 January 2014, if published in the OJ by 30 June 2013, otherwise from 1 July 2014.

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Why two legal instruments?

The new legislation consists of two instruments governing capital requirements for investment firms and credit institutions, including banks.

The Capital Requirements Regulation (CRR), a new instrument added during the current revision of the existing Capital Requirements Directive, lays down prudential requirements for capital, liquidity and the credit risk for investment firms and credit institutions in EU member states.

As a regulation, the CRR applies directly in every member state. It can therefore impose a single set of rules across the EU, thus leaving no scope for arbitrary interpretation and ensuring certainty as to the law for all EU single market players.

The directive, by contrast, will have to be incorporated into the national laws of the member states. The rules on bankers' remuneration and bonuses, prudential supervision, corporate governance and capital buffers will remain the responsibility of the member states' national competent authorities.

Capital Requirements Regulation - single rule book

The CRR introduces the first single set of prudential rules for banks across the EU. It aims to close regulatory loopholes and create harmonised rules that level the playing field and guarantee legal certainty for all single market players.

The CRR rule book should also help to ensure that the Basel III international standards for bank capital adequacy are fully respected in all EU member States.

EU member states will be able to make exceptions to the single rule book, but only if they notify competent authorities of these exceptions and ensure that they comply with the rules on flexibility and capital buffers laid down in the CRD IV directive).

Capital Requirements Regulation - capital and risk

The purpose of setting aside capital is to enable a bank to absorb losses. The amount of capital that a bank is required to hold, compared to its assets, should be enough to cover unexpected losses and keep it solvent in times of stress. The amount of capital required depends on the kinds of assets that a bank holds - generally, the riskier the asset, the more the capital that has to be set aside.

Cash is seen as a safe asset, and hence is disregarded for capital requirements purposes. Other assets, such as shares, bonds or loans are considered riskier, and are assigned various risk weightings, which need to be balanced by differing grades of capital.

For example, "Tier 1" capital allows an institution to continue its activities and keeps it solvent, whereas Tier 2 capital allows an institution to repay depositors and senior creditors in case of default.

EU banks will be required to set aside more and better capital as a cushion against hard times, i.e. a minimum of 8% good-quality capital, of which just over half must be Tier 1, the highest-quality, lowest-risk form (a doubling of today's Tier 1 requirement). This capital must be reasonably liquid, i.e. readily convertible into cash needed to pay depositors and creditors in an emergency

The CRR gives a comprehensive definition of capital assets that qualify as Tier 1. For example, these assets need to be issued directly by the institution, paid up but not funded by the institution, perpetual, clearly and separately disclosed in the financial statements, and able to absorb losses. The principal of Tier 1 assets may not be reduced or repaid unless the institution is to be liquidated.

Capital Requirements Regulation - liquidity

The latest financial crisis revealed that banks were holding insufficient liquid assets. The CRR will require them to constitute "liquidity buffers" to enable them to remain stable in times of stress.

The 30-day "liquidity coverage requirement" (LCR) buffer must suffice to cover part of the difference between a bank's financial inflows and outflows in times of stress. It is to be phased in at 60% of this difference starting in 2015, rising to 100% in 2018. However, the European Commission may be able to delay the introduction of the 100% requirement, if justified by international developments.

For the medium term (over one year), the CRR would also introduce a "net stable funding requirement" (NSFR).

Although member states may impose their own national liquidity requirements, the CRR will require that banks hold liquid assets equal to at least 25% of outflows.

Capital Requirements Regulation - leverage

"Leverage" occurs when a bank's assets exceed its capital base. The CRR does not preclude leverage, as buying assets in the hope that their value will rise is a normal investment activity, but it does aim to reduce excessive leverage which may eventually compromise the bank's solvency.

The CRR could also require banks to disclose their "leverage ratio", defined as a bank's Tier 1 capital divided by its average total consolidated assets. This ratio gives a measure of a bank's ability to meet its long-term financial obligations.

The leverage ratio requirement is to be introduced from January 2018, if agreed by the Council of Ministers and European Parliament on the basis of a European Commission report to be presented by 31 December 2016. Banks will be required to notify the Commission of the leverage ratios during an observation period starting on 1 January 2015.

Capital Requirements Regulation - lending to small firms

The banking crisis hit EU small and medium-sized enterprises (SMEs) hard because it made bank loans difficult to get and they had few other sources of funding.

To make it easier for banks to lend to SMEs, the CRR will reduce the nominal risk that banks must assign to loans. Reducing nominal risk in this way also reduces the amount of capital that has to be set aside to cover it, thus releasing more capital for loans.

The CRR would require supervisory authorities to check periodically that banks' exposure to SMEs is properly assessed.

Capital Requirements Directive - remuneration

The fourth Capital Requirements Directive (CRD IV) aims to ensure that every credit institution and investment firm, including banks, has sound and fair remuneration policies, so that pay reflects effective risk management and performance, without encouraging unjustified risk-taking.

CRD IV distinguishes between fixed remuneration, including pay regular pension contributions and benefits, and variable remuneration, which includes additional payments or benefits depending on performance.

Capital Requirements Directive - bonuses

To curb excessive risk-taking, the basic salary-to-bonus ratio will be 1:1, but could be raised to a maximum of 1:2 with the approval of shareholders. To approve this higher ratio would require the votes of at least 66% of shareholders owning half the shares represented, or 75% of votes if there is no quorum.

Up to the 25% of variable remuneration should consist of long-term deferred assets (at least 5 years). The European Banking Authority (EBA) is to prepare guidelines on the discount factor applicable to such deferred assets. The first bonuses determined in line with these new measures will paid in 2015 for performance in 2014.

The new rules will apply to the employees whose professional activities have a material impact on risk, such as senior management, risk takers, employees with control functions and also to anyone receiving remuneration equal to the that of those in these groups.

The new rules will apply to all credit institutions and investment firms including banks in the EU, to subsidiaries outside the European Economic Area (EEA) that have head offices in the EEA and to subsidiaries in the EEA that have their head offices outside the EEA.

Capital Requirements Directive - flexibility and buffers

Although the single rule book will ensure that a single set of harmonised prudential rules apply EU wide, member states will retain the right to require their home banks to hold more capital, e.g. for real estate lending, as a cushion against property price crashes. They will also be able to impose additional requirements on specific banks as part of a supervisory process that involves notifying the European Commission, European Banking Authority (EBA) and European Systemic Risk Board (ESRB), where stricter measures are justified. The Commission may oppose such measures if it feels that they could distort the single market, but the Council of Ministers may overrule its objections.

The Directive provides for a mix of mandatory and optional capital buffers to help member states to mitigate the pro-cyclical factors that helped start the financial crisis and aggravated its effects.

Banks will be required to hold a "capital conservation buffer" and a "countercyclical capital buffer" to ensure that in good times they accumulate a sufficient capital base to enable them to absorb losses in times of stress. Both these buffers were introduced by the Basel III agreement.

The capital conservation buffer, equal to 2.5 % of a bank's total exposure, must be secured by an additional amount of the highest quality capital (Tier 1 capital). This buffer, which supplements the CRR capital requirement of 4.5% Tier 1, aims to protect the bank's capital. If a bank breaches the buffer, it will have to limit or stop dividends or bonus payments.

The countercyclical capital buffer should reflect the economic cycle affecting the bank's lending activity and help it provide a stable supply of credit.

Member states may also require banks to hold a "systemic risk buffer" against financial market disruptions that threaten the financial system and real economy of any given member state. From 1 January 2014, member states may set the systemic risk buffer rate between 0 and 3%, and notify the Commission, EBA and ESRB. From 2015, they may set this rate at between 3% and 5% and must notify the Commission, which gives its opinion. To set a buffer rate above 5%, a member state would need the Commission's authorisation.

The European Parliament ensured that a mandatory buffer of Tier 1 capital requirement will be included for banks that member states identify as "global systemically important institutions" (G-SIIs) in order to compensate for the higher risk and potential impact of their failure. Parliament also introduced a voluntary buffer for "other systemically "important institutions" (O-SIIs).

The G-SII buffer, of Tier 1 capital equal to between 1% and 3.5% of a bank's total exposure, will apply from 1 January 2016. The O-SIII buffer, of Tier 1 capital equal to 2% of a bank's total exposure, will apply from 2016.

Where an authority could impose a systemic risk buffer or a global systemic institution buffer, the higher of the two should apply. Where the systemic risk buffer requirement applies only to domestic exposures, it should apply in addition to the O-SII or G-SII buffer requirement.

G-SIIs should be identified on the basis of size, interconnectedness with the financial system, complexity, and cross-border activity. O-SIIs should be identified on the basis of size, importance for the economy of the EU or member state concerned, cross-border activity and interconnectedness.

Capital Requirements Directive - benchmarking

Every bank is entitled to use its own internal methods to calculate its risk exposure.

However, it should submit its calculation of this exposure, e.g. the reliability of its creditors, to its competent authority at least once a year.

Competent authorities are entitled to check banks' calculations to ascertain that their risk exposures, and hence their capital requirements, are accurate. These checks should alert them to cases in which banks present differing own-fund requirements for the same risk exposure, or a bank systematically underestimates its own capital requirements.

New transparency rules

Capital Requirements Regulation transparency rules

Banking institutions must disclose their risk management objectives. These disclosures must include:

- strategies and processes to manage risks,
- structure and organisation of the relevant risk management function,
- scope and nature of risk reporting and measurement systems,
- policies for hedging and mitigating risk,
- a declaration approved by the management body on the adequacy of risk management,
- a concise risk statement , and
- bank's overall risk profile associated with the business strategy body.

Banking institutions must disclose the following information, including regular, at least annual updates, on governance arrangements:

- number of directorships held by members of the management body,
- recruitment policy for the selection of members of the management body and their actual knowledge, skills and expertise,
- policy on diversity with regard to selection of members of the management,
- objectives and any relevant targets set out in that policy, and the extent to which these objectives and targets have been achieved,
- whether or not the institution has set up a separate risk committee and the number of times the risk committee has met, and
- the description of the information flow on risk to the management body.

Capital Requirements Directive transparency rules

From 1 January 2015 member states must require each banking institution to disclose annually, specifying by member state and by third country in which it has an establishment, the following information on a consolidated basis for the financial year:

- name(s) nature of activities and geographical location,
- turnover,
- number of employees on a full time equivalent basis,
- profit or loss before tax,
- tax on profit or loss, and
- public subsidies received.

The Directive also requires member states to establish effective and reliable mechanisms to encourage reporting to competent authorities of potential or actual breaches and employees reporting breaches committed within their own institutions should be fully protected.

New powers for the European Banking Authority

New EBA powers under the Capital Requirements Regulation

• EBA must monitor the quality of own funds assets issued by banking institutions across the Union and must notify the Commission immediately where there is significant evidence of those assets not meeting Tier 1 criteria

• Competent authorities must, at EBA's request and without delay, supply all the information that the EBA deems relevant on new capital assets so as to enable the EBA to monitor the quality of own funds assets issued by banking institutions across the Union.

• EBA is to provide technical advice to the Commission

New EBA powers under the Capital Requirements Directive

• EBA should enhance harmonisation of supervisory practices. It is entrusted with developing draft technical standards and guidelines and recommendations ensuring supervisory convergence and consistency of supervisory outcomes within the Union.

• EBA's mediation power is a key element in promoting coordination, supervisory consistency and convergence of supervisory practices. The mediation procedure can be initiated either on EBA's own initiative, where specifically provided for, or at the request of one or more competent authorities party to the disagreement.

How the new EU rules relate to Basel III

The Basel Committee on Banking Supervision (BCBS), draws up international minimum standards for banks' capital. It has members from, inter alia: Australia, Argentina, Canada, China, Hong Kong, India, Switzerland, Turkey, Japan and the United States. There are also EU members, including Germany, the Netherlands, Belgium and the UK. The European Commission and the European Central Bank are the observers.

Basel standards have evolved with time, especially during the current financial crisis. The Basel III proposals for more and better capital in banks, balanced liquidity, supervised leverage and capital buffers are in line with the EU CRD IV and CRR legislation.

However, the Basel III agreement cannot be fully incorporated into the EU legislation. This agreement is not itself a law but a set of internationally agreed guidelines and standards. Moreover, Basel standards were developed for big internationally active banks, while the European law must be applicable not only to interconnected international institutions but to each of the EU's 8,300 banks, many of which are national, regional or retail.

Parliament's key changes to the Commission proposal

The European Parliament has changed the original Commission proposal with regard to:

- bonuses - the salary to bonus ratio of 1:1, or up to 1:2 with the majority support of the board,
- a mandatory buffer of Tier 1 capital requirement be included for banks that member states identify as "global systemically important institutions" (G-SIIs),
- transparency rules,
- management board diversity idea, and
- benchmarking.