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**COMMISSION STAFF WORKING PAPER**

**EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT**

***Accompanying the document***

**Proposal for a**

**REGULATION OF THE EUROPEAN PARLIAMENT AND THE COUNCIL**

**on prudential requirements for credit institutions and investment firms**

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## 1. BACKGROUND

The extent of the financial crisis has exposed unacceptable risks pertaining to the current regulation of financial institutions. According to the IMF estimates, crisis-related losses incurred by European banks between 2007 and 2010 are close to €1 trillion or 8% of the EU GDP.

In order to restore stability in the banking sector and ensure that credit continues to flow to the real economy, both the EU and its Member States adopted a broad range of unprecedented measures with the taxpayer ultimately footing the related bill. In this context, by October 2010 the European Commission (Commission) has approved €4.6 trillion of state aid measures to financial institutions of which more than €2 trillion were effectively used in 2008 and 2009.

The level of fiscal support provided to banks needs to be matched with a robust reform addressing the regulatory shortcomings exposed during the crisis. In this regard, the Commission already proposed a number of amendments to bank regulation in October 2008 (CRD[1] II) and July 2009 (CRD III). The legislative package that this report accompanies contains globally developed and agreed elements of bank capital and liquidity standards known as Basel III. The Commission services actively participated in the process of their development on behalf of all EU Member States. The package is extended to include a proposal for harmonisation of other provisions of CRD with a view to deepening the Single Market and strengthening the effectiveness of supervision. This report pertains only to the assessment of impacts of the measures described below.

## 2. STAKEHOLDER CONSULTATION

Throughout the project the Commission services have participated in the work of international forums, particularly the Basel Committee on Banking Supervision (BCBS) that was in charge of development of new policy measures in the areas of liquidity and counterparty credit risk management, definition of regulatory capital and pro-cyclicality. The European Banking Committee and the Committee of European Banking Supervisors (CEBS) have been extensively involved and consulted throughout the project.

To support the analysis of impacts of this legislative package on the EU banking industry, CEBS conducted a quantitative impact study. 246 banks from 21 member countries of CEBS participated in the study, including 50 Group 1[2] banks and 196 Group 2 banks, together representing some 70% of the consolidated EU banking sector in terms of capital. CEBS also provided a technical advice to the Commission in the area of harmonisation of national options and discretions.

The Commission services organised a public hearing in April 2010 and conducted four public consultations in 2009-2011 on the policy measures comprised by the legislative package[3].

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1 Capital Requirements Directive.

2 Group 1 banks are those that have Tier 1 capital in excess of €3 billion, are well diversified, and are internationally active. All other banks are considered Group 2 banks.

3 See http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm.

Responses to the consultations constitute an important source of data and stakeholder views as regards the impacts and effectiveness of potential measures. In addition, the Commission services conducted separate extensive consultations with the industry, including the Group of Experts in Banking Issues, various EU banking industry associations and individual banks.

## 3. PROBLEM DEFINITION

### 3.1. Management of liquidity risk

The global financial crisis has brought to light shortcomings in the current liquidity risk management of institutions, including stress testing exercises and asset and liability maturity mismatches. More specifically, existing liquidity risk management practices were shown to be inadequate in fully grasping risks linked to originate-to-distribute securitisation, use of complex financial instruments and reliance on wholesale funding with short term maturity instruments. Assumptions pertaining to asset market liquidity and interaction between market liquidity and funding liquidity turned out to have been erroneous while behavioural aspects of financial institutions also played an immense role in the course of the crisis. These factors contributed to a demise of several financial institutions[4] and strongly undermined the health of many others, threatening the financial stability and necessitating unprecedented levels of public sector and central bank liquidity support. Between September and December 2008, ECB loans to the euro area credit institutions increased by some 70% to over €800 billion.

While a number of Member States currently impose some form of quantitative regulatory standard for liquidity, no harmonised sufficiently explicit regulatory treatment on the appropriate levels of short-term and long-term liquidity exists at the EU level. Diversity in current national standards hampers communication between supervisory authorities and imposes additional reporting costs on cross-border institutions.

### 3.2. Definition of capital

The EU banking system entered the crisis with capital of insufficient quantity and quality. More specifically, certain capital instruments and, particularly, hybrid capital instruments[5] (hybrids), did not meet expectations of markets and regulators with regard to their loss absorption[6], permanence[7] and flexibility of payments[8] capacity on a going-concern basis. In fact, compliance of hybrids with the above three criteria in the EU was enforced by the Commission policy of 'burden sharing', when assessing national bank recapitalization measures.

Also, the list of adjustments to regulatory capital proved to be incomplete as a number of balance sheet items such as minority interests and deferred tax assets, whose loss absorption potential is less certain on a going-concern basis in times of stress, have been effectively

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[4] Bear Sterns, Lehman Brothers, Northern Rock, HBOS, Bradford and Bingley.

[5] Hybrids are securities that contain features of both equity and debt.

[6] The instrument must be available to absorb losses, both on a going concern basis and in liquidation, and to provide support for depositors' funds if necessary.

[7] The instrument must be permanently available so that there is no doubt that it can support depositors and other creditors in times of stress.

[8] The instrument must contain features permitting the noncumulative deferral or cancellation of payment of coupons or dividends in times of stress.

removed by market participants from capital ratios reported by institutions. Differences in application of regulatory adjustments across Member States further obstructed comparability and reliability of Tier 1 capital measure. As a result, reported Tier 1 capital ratios were not reflective of institutions' capacity to absorb mounting losses. This necessitated governments to provide support to the banking sector in many countries and on a massive scale.

### 3.3. Counterparty credit risk

The crisis revealed a number of shortcomings in the current regulatory treatment of counterparty credit risk[9] arising from derivatives, repo[10] and securities financing[11] activities. It showed that the existing provisions did not ensure appropriate management and adequate capitalisation for this type of risk. The current rules also did not provide sufficient incentives to move bilaterally cleared over-the-counter derivative contracts to multilateral clearing through central counterparties[12].

### 3.4. Pro-cyclicality of lending

Pro-cyclical effects are defined as those which tend to follow the direction of and amplify the economic cycle. The cyclical nature of bank lending has a number of interconnected sources that include both market and regulatory failures.

One feature of current risk-based minimum capital requirements is that they vary over the economic cycle. Provided that credit institutions and investment firms could meet them, there is no explicit regulatory constraint on the amount of risk they can take on and hence on their leverage. The lack of such constraint and irresponsiveness of capital requirements to the build-up of risk at the macro level led to an accumulation of financial imbalances which precipitated steep credit-related losses and, once the economic cycle turned, prompted a damaging de-leveraging spiral.

### 3.5. Options, discretions and minimum harmonisation

In 2000, seven banking directives were replaced by the Consolidated Banking Directive. This directive was recast in 2006 with CRD, while introducing the Basel II framework in the EU. As a result, CRD provisions include a significant number of options[13] and discretions[14]. CRD is also a 'minimum harmonisation' directive which means that Member States may add stricter prudential rules, which gives rise to a practice known as 'gold-plating'.

As a result, there is a high level of divergence in how the rules are implemented by MS and subsequently applied by the national supervisory authorities which is particularly burdensome

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9 The risk that the counterparty to a transaction could default before the final settlement of the transaction cash flows.

10 In a repo (repurchase agreement) contract, the borrower agrees to sell a security to a lender and to buy the same security from the same lender at a fixed price at some later date.

11 While the rationale behind a repo contract is borrowing or lending of cash, in securities financing, the purpose is to temporarily obtain a security for other purposes such as covering short positions.

12 An entity that interposes itself between counterparties to contracts traded within one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

13 A choice given to competent authorities or MS on how to comply with a given provision, selecting from a range of alternatives.

14 A choice given to competent authorities or MS as to whether apply a given provision.

for firms operating cross-border. It also gives rise to the lack of legal clarity and an uneven playing field.

## 4. OBJECTIVES

The overarching goal of this initiative is to ensure that the effectiveness of bank capital and liquidity regulation in the EU is strengthened and its adverse impacts on confidence in banks and pro-cyclicality of the financial system are contained while maintaining the competitive position of the EU banking industry. This translates into the following four general policy objectives to:

- Enhance the financial stability;

- Enhance safeguarding of depositors' interests;

- Ensure international competitiveness of the EU banking sector;

- Reduce pro-cyclicality of the financial system.

## 5. POLICY OPTIONS: ANALYSIS AND COMPARISON

Altogether, 27 policy options have been assessed and compared with a view to addressing the various issues identified. This section presents expected impacts of policy measures in each area as well as cumulative impacts of the entire proposal.

### 5.1. Liquidity risk

To improve short-term resilience of the liquidity risk profile of financial institutions, a Liquidity Coverage Ratio (LCR) will be introduced from 2015, after an observation period and a review to apply any necessary refinements to both its composition and calibration and to check for any undesired impacts on the industry, financial markets and the economy. Based on LCR definition included in Basel III, compliance with this requirement in the EU in the long run would produce net annual GDP benefits in the range of 0.1% to 0.5%, due to a reduction in the expected frequency of systemic crises.

To address funding problems arising from asset-liability maturity mismatch, the Commission considers introducing a Net Stable Funding Ratio (NSFR). Before deciding on its final calibration and moving it to a minimum standard as of 2018, extensive monitoring of NSFR and its implications will be conducted.

### 5.2. Definition of capital

The proposals tighten criteria for eligibility of capital instruments for the different layers of regulatory capital and make extensive revisions to the application of regulatory adjustments. For Group 1 banks, revised regulatory adjustments reduce eligible common equity Tier 1 (CET1) capital by 42% and that of Group 2 banks by 33%. These reductions are driven by adjustments for goodwill, material investments in other financial institutions and deferred tax assets.

The new CET1 and Tier 1 minimum requirements will be implemented gradually from 2013 and by 2015 would reach 4.5% and 6%, respectively. Revisions to regulatory adjustments will be introduced in 2014 – 2019. Grandfathering provisions for capital instruments that no longer meet the new eligibility requirements are also foreseen.

### 5.3. Counterparty credit risk

Requirements for management and capitalization of the counterparty credit risk will be strengthened. The proposals will also enhance incentives for clearing over-the-counter instruments through central counterparties. These proposals are expected to affect mostly the largest EU banks.

The review of the treatment of counterparty credit risk, and in particular putting in place higher own funds requirements for bilateral derivative contracts in order to reflect the higher risk that such contracts pose to the financial system, forms an integral part of the Commission's efforts to ensure efficient, safe and sound derivatives markets. It complements other Commission's regulatory initiatives in this area, in particular the proposed Regulation on OTC derivatives, central counterparties and trade repositories, adopted by the Commission on 15 September 2010.

### 5.4. Countercyclical policy measures

Proposals for capital buffers comprise a capital conservation buffer and a countercyclical capital buffer. The (CET1) capital conservation buffer of 2.5% of risk-weighted assets (RWA) is aimed at ensuring banks' capacity to absorb losses in stressed periods that may span a number of years. Banks would be expected to build up such capital in good economic times. Those banks that fall below the buffer target will face constraints on discretionary distributions of earnings (i.e., dividend payments) until the target is reached.

The countercyclical capital buffer is intended to achieve the broader macro-prudential goal of protecting the banking sector and the real economy from the system-wide risks stemming from the boom-bust evolution in aggregate credit growth. It will be applied by adjusting the size of the buffer range established by the conservation buffer by additional 2.5%.

In order to limit an excessive build-up of leverage on credit institutions' and investment firms' balance sheets and thus help containing the cyclicality of lending, the Commission also proposes to introduce, as an element of the supervisory review, a non-risk based leverage ratio. Implications of the ratio will be monitored prior to it possibly becoming a generally binding requirement on 1 January 2018.

### 5.5. Single rule book

The proposals harmonise divergent national supervisory approaches by removing options and discretions. Some specific areas, where gold-plating is driven by risk assessment considerations, market or product specificities and Member States legal framework, remain exempted.

### 5.6. Cumulative impact of the package

To supplement their own assessment of the impact of Basel III, the Commission reviewed a number of studies prepared by both public and private sectors.

This package and CRD III together are estimated to increase RWA of Group 1 banks by 24.5% and RWA of Group 2 banks by a modest 4.1%. The extent of CET1 shortfall to meet the new minimum requirement and the conservation buffer, based on the EU bank capital levels in 2009 is estimated to be immaterial by 2013, at €84 billion by 2015 and €460[15] billion by 2019, equivalent to 2.9% of the banking sector's RWA.

To give banks time to retain more of their profits, improve operational efficiency, issue new equity and take other necessary steps to adjust, the new capital requirements entail an eight year transition period. Based on analyses of the Basel Committee, ECB, and the Commission services, transition to stronger capital and liquidity standards will have only a limited impact on the aggregate output.

In terms of long-term economic impact, analysis conducted by the Basel Committee found clear net long term economic benefits of Basel III. This analysis implies net economic benefits of annual increase in the EU GDP in the range of 0.3%-2%. They stem from a reduction in the expected frequency of future systemic crises and are optimised when CET1 is calibrated in the range of 6% to 9%.

Another model developed by the Commission and academics found that the proposals would reduce the probability of a systemic banking crisis in seven Member States within the range of 29% to 89% when banks recapitalise to a total capital ratio of at least 10.5%.

In addition, analysis of the Basel Committee showed that higher capital, including the countercyclical capital buffer, and liquidity requirements should also reduce the amplitude of normal business cycles. This is particularly relevant to SMEs who are dependent on bank financing throughout the economic cycle.

## 6. MONITORING AND EVALUATION

It is expected that the proposed amendments will enter into force in 2013. Measuring the progress of reaching specific policy objectives will be aided by the working groups of the Basel Committee and the European Banking Authority (EBA), that monitor the dynamics of bank capital positions, globally and in the EU, respectively. Special arrangements will be put in place by EBA to ensure that necessary data for monitoring of leverage ratio and the new liquidity requirements are collected to allow for the finalization of these policy measures in due time.

15 Of this figure, €37 billion (measured in Tier 1 capital) is attributable to CRD III proposal.