Prudential requirements for credit institutions and investment firms. Capital Requirements Regulation (CRR)

2011/0202(COD) - 20/07/2011 - Legislative proposal

PURPOSE: to strengthen prudential requirements for credit institutions and investment firms that relate strictly to the functioning of banking and financial services markets and are meant to ensure the financial stability of the operators on these markets as well as a high level of protection of investors and depositors.

PROPOSED ACT: Regulation of the European Parliament and of the Council.

BACKGROUND: the extent of the financial crisis has exposed unacceptable risks pertaining to the current regulation of financial institutions. According to IMF estimates, crisis-related losses incurred by European credit institutions 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 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 credit institutions needs to be matched with a robust reform addressing the regulatory shortcomings exposed during the crisis.

Priorities and challenges: it should be noted that one of the priorities of the Commission in the reform of EU financial services regulation has been to ensure that the banking sector is able to fulfil its fundamental purpose, namely lending to the real economy and providing services to citizens and businesses in Europe.

The proposal is designed to tackle regulatory shortcomings in the following areas:

- Management of liquidity risk: existing liquidity risk management practices were shown by the crisis to be inadequate in fully grasping risks linked to originate-to-distribute securitization, use of complex financial instruments and reliance on wholesale funding with short term maturity instruments.
- Definition of capital: institutions entered the crisis with capital of insufficient quantity and quality. Given the risks they faced, many institutions did not posses sufficient amounts of the highest quality capital instruments that can absorb losses effectively as they arise and help to preserve an institution as a going concern.
- Counterparty credit risk: the crisis revealed a number of shortcomings in the current regulatory treatment of counterparty credit risk arising from derivatives, repo and securities financing activities. It showed that the existing provisions did not ensure appropriate management and adequate capitalisation for this type of risk.
- Options, discretions and harmonisation (entire Regulation): in 2000, seven banking directives were replaced by a single Directive. This directive was recast in 2006 while introducing the Basel II framework in the EU. As a result, its current provisions include a significant number of options and discretions. Moreover, Member States have been permitted to impose stricter rules than those of the Directive. As a result, there is a high level of divergence which is particularly burdensome for firms operating cross-border. It also gives rise to the lack of legal clarity and an uneven playing field.

Action at international level: the G20 Declaration of 2 April 2009 on Strengthening of the Financial System called for internationally consistent efforts that are aimed at strengthening transparency, accountability and regulation by, improving the quantity and quality of capital in the banking system once the economic recovery is assured. In December 2010, the Basel Committee on

Banking Supervision (BCBS) issued detailed rules of new global regulatory standards on credit institution capital adequacy and liquidity that collectively are referred to as Basel III. This proposal directly relates to the regulatory standards included in Basel III. At the same time, in the process of developing this legislative proposal, the Commission has made particular efforts in making sure that certain major European specificities and issues are appropriately addressed.

Creating a new legal framework: Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions ("institutions") have been significantly amended on several occasions. Many provisions of Directives 2006/48/EC and 2006/49/EC are applicable to both credit institutions and investment firms. In order to ensure a coherent application of those provisions, it would be desirable to merge these provisions into new legislation applicable to both credit institutions and investment firms. For sake of clarity, the provisions of the Annexes to those Directives should be integrated into the enacting terms of this new legislation. That new legislation should consist of two different legal instruments, a Directive and this Regulation. Together, both legal instruments should form the legal framework governing the access to the activity, the supervisory framework and the prudential rules for credit institutions and investment firms. This Regulation should therefore be read together with the Directive.

IMPACT ASSESSMENT: altogether, 27 policy options have been assessed and compared with a view to addressing the various issues identified. Preferred options are as follows:

- Introduce Liquid Coverage Ratio (LCR) adopted by Basel Committee subject to observation period.
- Introduce Net Stable Funding ratio (NSFR) adopted by Basel Committee subject to observation period.
- Modify eligibility criteria and regulatory adjustments based on Basel approach, with some adjustments for EU specificities.
- Enhance Counterparty credit risk (CCR) requirements and differentiate treatment of exposures to Central Counterparties.
- Introduce leverage ratio.
- Conduct extensive monitoring of leverage ratio.

- Conservation capital buffer.
- Maximum harmonization with some exceptions.
- Limit scope of the CRD and propose a regulation.

Cumulative impacts of the proposed package are as follows:

- this proposal together with CRD III is estimated to increase the risk-weighted assets of large credit institutions by 24.5% and of small credit institutions by a modest 4.1%;
- the need to raise new own funds due to the new requirement and the conservation buffer is estimated to be 84 billion by 2015 and 460 billion by 2019;
- there are clear net long term economic benefits of an annual increase in the EU GDP in the range of 0.3%-2%. They stem from a reduction in the expected frequency and probability of future systemic crises;
- the proposal would reduce the probability of a systemic banking crisis in seven Member States within the range of 29% to 89% when credit institutions recapitalise to a total capital ratio of at least 10.5%.

LEGAL BASIS: Article 114(1) TFEU provides a legal basis for a Regulation creating uniform provisions aimed at the functioning of the internal market.

CONTENT: the proposed Regulation streamlines the prudential requirements for credit institutions and investment firms, which are currently set out in two different Directives (2006/48/EC and 2006/49/EC), in one legal instrument, which considerably simplifies the applicable legal framework.

The individual policy measures proposed are as follows:

Management of liquidity risk:

- To improve short-term resilience of the liquidity risk profile of financial institutions, a Liquidity Coverage Ratio (LCR) will be introduced after an observation and review period in 2015. LCR would require institutions to match net liquidity outflows during a 30 day period with a buffer of 'high quality' liquid assets. The outflows covered (the denominator) would reflect both institution-specific and systemic shocks built upon actual circumstances experienced in the global financial crisis. The provisions on the list of high quality liquid assets (the numerator) to cover these outflows should ensure that these assets are of high credit and liquidity quality. Based on the LCR definition included in Basel III, compliance with this requirement in the EU is expected to 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 mismatches, the Commission will consider proposing a Net Stable Funding Ratio (NSFR) after an observation and review period in 2018.

Definition of capital:

- The proposal builds upon the changes made in CRD2 to strengthen further the criteria for eligibility of capital instruments. Furthermore, it introduces significant harmonisation of the adjustments made to accounting equity in order to determine the amount of regulatory capital that it is prudent to recognise for regulatory purposes. This new harmonised definition would significantly increase the amount of regulatory capital required to be held by institutions.
- The new requirements for going concern regulatory capital - Common Equity Tier 1 and Tier 1 capital - would be implemented gradually between 2013 and 2015. The new prudential adjustments would also be introduced gradually, 20% per annum from 2014, reaching 100% in 2018. Grandfathering provisions over 10 years would also apply to certain capital instruments in order to help to ensure a smooth transition to the new rules.

Counterparty credit risk:

- Requirements for management and capitalisation of the counterparty credit risk will be strengthened. Institutions would be subject to an additional capital charge for possible losses associated with the deterioration in the creditworthiness of a counterparty.
- Risk weights on exposures to financial institutions relative to the non-financial corporate sector will be raised.
- The proposal would also enhance incentives for clearing over-the-counter instruments through central counterparties.

Leverage ratio: 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 a non-risk based leverage ratio. As agreed by BCBS, it will be introduced as an instrument for the supervisory review of institutions. The impacts of the ratio will be monitored with a view to migrating it to a binding pillar one measure in 2018, based on appropriate review and calibration, in line with international agreements.

Single rule book (entire Regulation): the proposal harmonises divergent national supervisory approaches by removing options and discretions almost altogether. Some specific well defined areas, where divergences are driven by risk assessment considerations, market or product specificities and Member States' legal frameworks, are exempted, allowing Member States to adopt stricter rules.

BUDGETARY IMPACT: EBA will play an important role in achieving the objective of this Regulation, as the proposals ask it to develop more than 50 binding technical standards (BTS) on various policy issues. BTS which would eventually be endorsed by the Commission will be key to ensure that provisions of highly technical nature are implemented uniformly across the EU and that the proposed policies work as intended. For this significant workload, EBA would need more resources than those already provided within the context of its establishment under Regulation (EU) 1093/2010. Further details are set out in the attached legislative financial statement.

DELEGATED ACTS: the proposal contains provisions empowering the Commission to adopt delegated acts in accordance with Article 290 of the Treaty on the Functioning of the European Union.