New european banking legislation

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The financial system is global, but unfortunately it is not much stronger than its weakest link. This fact has been proved for many times in practice and the latest examples are Greece, Spain and Cyprus. Therefore, it is important that all countries implement as soon as possible uniform banking standards prescribed in line with Basel III. Almost half of the members of the Basel Committee on Banking Supervision have adopted so far laws implementing the rules specified in Basel III. It is expected that other members will do the same by the end of 2013. European Parliament and Council adopted new capital directive and regulation known as CRD IV which tries to introduce changes and improvements passed by Basel III to single EU market.

We often wonder why the current banking rules did not stop the largest financial and economic crisis after great recession that occurred in 1930s. Current effective capital requirements directives 2006/48/EC and 2006/49/EC represent implementation of the Basel II in EU.

The crisis revealed Basel II weaknesses that could be summarised in the following:

- capital that actually absorbs losses,
- insufficient liquidity management,
- procyclicity,
- inadequate risk management of banking groups and
- inefficient supervision.

1. Regulation and directive

CRD IV package consist of the Capital Requirements Regulation[1] (CRR) and the fourth publishing of the Capital Requirements Directive[2] (CRD). The objective of both documents is to provide financial stability and strengthen banking sector regulations. Due to long-term adjustments, new legislation was published in the Official Journal of the European Union only on 27 June 2013 and it fully entered into force on 17 July 2013. Banks and investment companies must use new rules from 1 January 2013 with full implementation on 1 January 2019.

The areas in which the rate of regulations is lower and when connections with national laws are very important will remain in the form of directive. This particularly refers to powers and responsibilities of national authorities (e.g. licenses, supervision, capital buffers and sanctions), requirements on risk management that intertwine with national laws on economic undertakings, and the regulations concerning management of undertakings.

Directive sets rules and requirements on:

1. access to the credit institutions' activities,
2. freedom of establishment and freedom of providing services,
3. prudential supervision,
4. capital buffers,
5. Corporate governance,
6. remuneration policies and sanctions.

On the other hand, detail and normative provisions for the calculation of capital requirements and capital, liquidity, financial leverage, disclosure of balance sheet and other items needed to be unified in the EU will be in the form of regulation.

The regulation established single rules on:

1. capital,
2. liquidity,
3. leverage,
4. counterparty credit risk,
5. large exposures and
6. disclosures.

While member states must transpose directive into the national legislation, the regulation is directly effective, which means that it represents the law to be immediately implemented in all member states the same as the national law without any intervention by the national authorities. This removes main source of national divergences, i.e. different interpretations of single rules. It increases transparency since one written rule in Regulation is valid for entire EU market.

2. Single Rule Book and Technical Standards

Current European banking rules are based on the directive that leaves space for significant differences in the national regulations. This created regulation mosaic that leads to legal insecurity which enables institutions to take advantage of regulatory gaps and bend the competition. Single Rule Book will ensure that the financial situation in the institution is more transparent and comparable throughout EU – both from the regulator's aspect and from the depositors and investors aspect. The financial crisis showed that the main root of the financial instability was opaqueness of regulatory requirements in different member states. Lack of transparency is an obstacle to effective supervision but also to market and investor confidence.

The European Banking Authority (EBA) will play key role in additional establishment of single rules, since it is authorised to draft several proposals of the Regulatory and Implementing Technical Standards (RTS) for the implementation of specific aspects of CRD and CRR texts. RTS are legal acts that regulate specific points of legislation from the directive or regulation and they are aimed at ensuring consistent harmonisation. RTS will be adopted by European Commission via regulations or decisions and they will be legally binding, which means that they will be directly implemented in all member states.

3. Capital

A part of regulation that refers to defining individual components of regulatory capital of banks in our region should not represent a big problem[3] surely under the assumption that losses of the banking sector and/or individual banks will not continue in the following years. Based to the new rules, total capital ratio will remain at 8% of its total exposure to risks. The only thing that will increase is a share of capital of the highest quality - Common equity tier 1 (CET1) – from 2% to 4.5%. The criteria for each capital instrument will become more severe.

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

[2] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

[3] Tier 3 capital will be eliminated.

4. Capital Buffers

The introduction of new and numerous capital buffers will potentially bring a lot of problems.

Capital conservation buffer

Banks will have to have, in addition to common equity tier 1 capital that meets minimum capital requirement (4.5%), also capital conservation buffer of 2.5% (CET1 capital). This buffer is aimed at preserving bank’s capital. When a bank breaches the buffer, i.e. when its CET1 capital ratio falls below 7%, automatic safeguards kick in and limit the amount of dividend and bonus payments a bank can make. The more conservation buffer reduces, the stricter constraints become.

Counter-cyclical capital buffer

The purpose of counter-cyclical capital buffer is to neutralise effects of the economic cycle on the banking lending activity, which makes the loan offer less volatile and reduces the possibility of credit bubbles or crunches. In good times, when the economy is booming and the credit growth is strong, the banks are required to hold additional CET1 (up to 2.5%). This prevents loans from being too cheap and banks from granting too much loans. If a bank does not have sufficient capital to meet this buffer, constrains will be imposed the same as in case of conservation capital buffer. When economic cycle is turned and economic activity slows down or even stops, this buffer can be released. This enables the bank to continue with lending to real economy or at least reduce lending less than it should be.

Global systemically important institutions buffer

CRD IV covers mandatory buffer for systemic risk for banks which the authority has identified as global systemically important institutions (G-SIIs). Mandatory buffer will amount to between 1 and 3.5% of total exposure to risks. It is intended to reduce moral hazard, which represents money support of tax payers. Financial Stability Board included 14 institutions from EU in the interim list of 28 G-SIIs. In addition to capital buffers listed above, which are envisaged by Basel III, new European rules also envisage another two additional buffers.

Other systemically important institutions buffer

National regulators may determine buffer for other systemically important institutions. In order to prevent negative effects at internal market, special criteria for defining important domestic institutions will be developed. This buffer will amount to 2% of total exposure to risks and it will be applied from 2016 onwards.

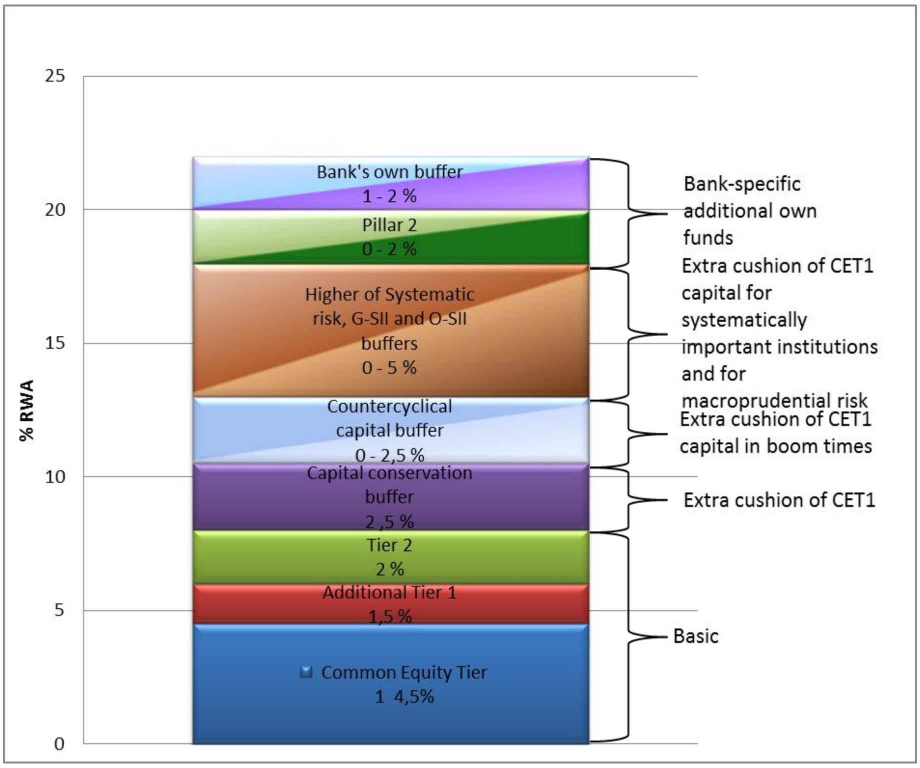
Systemic risk buffer

Member states may introduce also systemic risk buffer in the form of CET1 for financial sector or one or more subsets of the sector, in order to prevent and mitigate long-term non-cyclical systemic or macro prudential risks that are not covered by the Regulation, with regard to the risk of disruptions in the financial system that might have serious negative effects on the financial system and real economy in individual member state.

In addition to these requirements, regulators will be able to prescribe, within Pillar II powers, additional buffer to individual institution for covering other risks identified in supervisory review. Institutions can decide by themselves to have additional own buffer.

The illustration below shows the composition of regulatory capital requirement of individual institution from the highest values of individual buffers (although some buffers contain specific range, only the highest values are shown) even though they will be smaller in practice, i.e. some individual requirements will not exist.

Illustration 1: New capital requirements



5. Liquidity

The crisis revealed that the institutions did not have sufficient amount of liquid funds that could be easily and swiftly turned into money with little or without loss in value.

In line with Basel III, CRD IV also introduces two liquidity buffers:

1. Liquidity Coverage Requirement[4] (LCR) is introduced for the improvement of short-term (over a thirty day period) resilience of the liquidity risk profile of financial institutions
2. Net Stable Funding Requirement (NSFR) is introduced in order to provide that the institution has an acceptable amount of stable funding to support the institutions assets and activities over the medium term (over a one year period).

The introduction of liquidity coverage, as it has been anticipated in line with Basel III, would have negative effect on real economy. Numerous banks redirected loans to more liquid funds (e.g. money, deposits with central bank) since the institutions would be prepared to meet LCR.

Therefore, Basel Committee published new rules[5] on 7 January 2013 which referred to liquidity coverage and which propose gradual introduction of LCR in fiver-year period starting from 60% LCR in 2015, and gradual increase by 10% each year to reach the level of 100% LCR in 2019. EU Regulation sets out faster introduction of LCR since 100% of LCR should be reached already in 2018, therefore a year earlier. Liquidity coverage acts similarly as capital conservation buffer. It is some type of warning signal for institutions and regulators. In exceptional circumstances, the institution may use its liquid funds, which means that its LCR may temporary drop below 100%. However, in this case the institution must immediately inform the authorities and propose a plan for timely recovery of LCR ratio above 100%.

Regulation does not give detail list of liquid funds. Instead, it provides minimum list of items that are deemed to be liquid, while the European Banking Authority will inform until 31 December 2013 the Committee on single definition of liquid funds of high and extremely high liquidity and credit quality.

In its report, the European Banking Authority will take into consideration different funds, including commercial papers, shares listed at recognised exchanges, corporate bonds and other securities. Expecting single definition of liquid funds, institutions will identify and report on high or extremely high liquidity and credit quality assets by themselves. The authorities determine general guidelines which the institutions will take into consideration when determining such funds. Similarly, the European Banking Authority will report to the Commission on the inflow and outflow rates.

The Regulation has already determined general rule that since 1 January 2016 institutions must ensure that long-term obligations are adequately met by various instruments for stable financing both in ordinary and stress conditions. It is expected that more detail and binding standards for net stable financing will be established based on reporting and previous experience.

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4 Liquidity Coverage Ratio according to Basel III.

5 Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, 2013.

7. Conclusion

Banking rules and standards are constantly changing because they want to follow up changes in financial environment and on the other hand they want to ensure stable and credible banking system. Basel III is the latest form of the developing set of internationally agreed standards developed by regulators and central banks. However, these standards cannot be copied automatically into European legislation as they must be harmonised with the existing laws or agreements both at the EU level and at the level of individual member states. While the Basel capital adequacy agreements apply to 'internationally active banks', CRD IV in the EU has applied to all banks (more than 8,300) as well as investment firms. Internationally agreed rules that would be valid only for specific subset of European banks (e.g. only for large, internationally active banks) would distort the competition and enable regulatory arbitrage. These particular circumstances were taken into account during transposition of international standards of Basel III into EU legal framework.

8. References

1. Basel III: A global regulatory framework for more resilient banks and banking systems - revised version June 2011, Basel Committee on Banking Supervision, Bank for International Settlement.
2. Basel III: International framework for liquidity risk measurement, standards and monitoring, December 2010, Basel Committee on Banking Supervision, Bank for International Settlement.
3. Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013, Basel Committee on Banking Supervision, Bank for International Settlement.
4. Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, Official Journal of the European Union, 27 June 2013.
5. Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012, Official Journal of the European Union, 27 June 2013.

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Jernej Doles is the founder and managing director of Omega Finance.

Mr Doles has many years of experience teaching and consulting on financial topics, such as derivatives, hedging portfolios, fixed income, equities and risk management. Practical trading with different financial instruments has helped him understanding their logic, functioning and beneficial application, functioning of the financial system as well as the practical understanding of the risks present on the financial markets.

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