Opinion of the European Economic and Social Committee on the 'Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms'

COM(2011) 452 final — 2011/0202 (COD)

(2012/C 68/07)

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On 30 November 2011, the Council, and, on 17 November 2011, the Parliament decided to consult the European Economic and Social Committee, under Article 114 of the Treaty on the Functioning of the European Union, on the

Proposal for a Regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms

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The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 19 December 2011.

At its 477th plenary session, held on 18 and 19 January 2012 (meeting of 18 January 2012), the European Economic and Social Committee adopted the following opinion by 179 votes to 2 with 7 abstentions.

1. **Conclusions and recommendations**

1.1 The EESC welcomes the main thrust of Capital Requirements Directive IV [1] (CRD IV) and the Basel III accord on which it is based. However, CRD IV will increase banking costs and this is an important consideration for EU business, especially SMEs. The Basel framework is designed for internationally active banks all of which should adhere to the framework.

1.2 EU Capital Requirements Directives have always applied to all banks and this is important because of the role of regional banks and non joint stock banks in supporting the economy.

SMEs are very dependent on bank funding and so care should be taken to avoid imposing cost penalties on EU SMEs in relation to their international competitors. It is in this context that the EESC urges the Commission to facilitate the further development of ethical and participatory banking [2].

1.3 The impact study conducted by the Commission found that SMEs would not be especially disadvantaged by the new capital requirements but the Committee remains *mefiant* and requires that the Commission closely monitors the development of bank lending and bank charges to SMEs. In addition, the EESC supports the risk rating review for SME lending to be conducted by the Commission.

1.4 The new framework brings together both micro-prudential and macro-prudential elements. On the micro-prudential side, there is higher and better quality capital, better coverage of the risks, the introduction of a leverage ratio as a backstop to the risk-based regime, and a new approach to liquidity. On the macro-prudential side, CRD IV requires the build-up of capital buffers in good times that can be drawn down in periods of stress, as well as other measures to address systemic risk and interconnectedness. Conceptually, at least, the proposals address all the problems revealed by the banking crisis and spelt out in the previous EESC opinion on CRD III [3].

1.5 Ultimately, the effect of the legislation will depend on its implementation and the actors involved. The banking crisis had no single cause; all the actors were culpable. The directors responsible for the governance of many banks were clearly at fault, but so were statutory auditors, rating agencies, institutional investors and analysts, Member State regulators and supervisors, central bankers, treasury ministries and politicians, while academic economists and media commentators also failed to see what was happening. The EESC would like to believe that the actors have learnt the lesson of the last crisis, but the way the sovereign debt crisis has been handled suggests otherwise. In some cases, bank recapitalisation has not been addressed, stress tests have been unconvincing (Dexia), auditors have not required rigorous provisioning against sovereign debt write downs while politicians, by applying political remedies to economic problems, are responsible for letting the crisis get out of control.

1.6 The counterweight to the new Regulation must be the implementation of recovery and resolution regimes based on devices such as living wills. While the State will continue to

(1) OJ L 329, 14.12.2010, p. 3–35, EESC opinion: OJ C 339, 14.12.2010, p. 24–28.
(2) OJ C 48 of 15.02.2011, p. 33.
(3) OJ C 228, 22.9.2009, p. 62–65.

provide guarantees for small deposits, the moral hazard represented by unlimited State support to failed banks must be removed. If the situation is clear enough, investors, creditors and directors will have to take direct responsibility for the future health of each credit institution.

1.7 To restore stability and confidence in the markets, the EU Heads of State and Government in their crisis resolution plan of 26 October 2011 agreed to require a number of banks to hold a capital ratio of 9 % of the highest quality capital by June 2012, including an exceptional and temporary buffer against sovereign debt exposures. This was necessary since under the proposal for Regulation the transition of new capital requirements was foreseen to take place over a number of years. As a result of this fiat, some banks will find it very difficult to raise new capital, not least because they must also roll over existing debt which is itself a critical issue because funding had already dried up in the second half of 2011. The Committee recognises that these measures are exceptional but, nevertheless, the impact is immediate, whatever relief might be ultimately available.

1.7.1 If they were to apply, these capital requirements could have a tremendous effect on smaller banks and local banks, which are normally more SME and micro enterprise friendly than international banks. If the smaller banks were to have difficulty in raising such capital, then it will be harder for SMEs to gain access to finance.

1.8 This *fiat* gives rise to two major concerns if the present funding crisis continues. For banks that cannot or do not want to raise new Tier 1 equity capital in the short term, an action which could dilute existing shareholders, the alternative is to shrink their balance sheets, reducing their loan books to bring them in line with their capital reserves. At a time when all Member States are seeking to revitalise their economies, the withdrawal of bank credit would be a disaster. To avert such an outcome, Member State and EU authorities should seek to collaborate with the banking sector, rather than continually confronting it. They should also seek to take comprehensive measures to encourage alternative financing such as participatory banking as was already proposed in an earlier EESC opinion ([4]).

1.9 The second concern affects those banks that do raise additional own funds in the markets. Most of the available capital is in Sovereign Wealth Funds and Asian and Middle Eastern banks. There is a real danger that the ownership of the EU banking system will move out of the control of EU Member States.

1.10 A particular problem which has emerged during the sovereign debt crisis is the clear evidence that, contrary to the guidelines in both the Accord and the series of Capital Requirements Directives, sovereign debt is clearly not risk free. This is an important weakness of the quality of capital provisions of the Regulation. It has profound implications for banks which have been left little choice by the regulations but to load up on sovereign debt. The mechanistic application of the risk free rating must be reconsidered by regulators while banks will have to revise their internal risk methodologies.

1.11 The cumulative effect on capital, liquidity and leverage of CRD II, III and IV, the forthcoming resolution regimes, the growing interest in the Volcker type proposals to limit bank own account trading and in the concept of ring fences between retail and investment banking are likely to mean that the business model employed so profitably by the larger banks in the last decade will have to be redeveloped for the austere and capital constrained circumstances of the present decade. It is in the interest of all stakeholders – borrowers and lenders', employees and investors – and society at large, that the banks can establish a new business model – certainly less profitable but hopefully more sustainable for the years ahead.

1.12 In the opinion of the EESC, new business models must be ethical and sustainable. Customer relationships need to be improved, business practices need to be scrupulously ethical and reward structures must be radically revised. All the actors were culpable as the crisis developed. They must all come together now to build credit institutions capable of supporting the EU economy in the difficult decade ahead.

2. Introduction

2.1 EU Capital Requirements Directives are designed to establish the framework for the banking internal market. In doing so, they transpose Basel Accords into EU law. The Basel Committee was established in 1975. In 1988, the Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework. The EU transposed the Accord into its first Capital Requirements Directive (CRD) ([5]) on the capital adequacy of investment firms and credit institutions in March 1993.

2.2 A second Basel Accord (Basel II) was published in 2004. The EU transposed this into a new CRD adopted in June 2006 to come into effect in December 2006. The EESC had approved its opinion ([6]) on the proposed CRD at its plenary meeting in March 2005.

2.3 The Commission adopted a proposal of key amendments to the CRD in October 2008 (CRD II). This review of the CRD was, in part, a response to the recommendations of the G-7 Financial Stability Forum (FSF) and the market crisis. The text was published in July 2009 for implementation in December 2010.

([4]) OJ C 48 of 15.02.2011, p. 33.

([5]) OJ L 141, 11.6.1993, p. 1–26.

([6]) OJ C 234, 22.9.2005, p. 8–13.

2.4 Consistent with the parallel work undertaken by Basel, the Commission consulted and issued proposals (in July 2009) on amendments to the trading book, re-securitisation and banker remuneration as part of the CRD III package. The EESC approved its opinion [7] at the plenary in January 2010.

2.5 In response to the financial crisis, the third Basel Accord was published in December 2010. The capital and liquidity buffers proposed are many times greater than before. Basel III requires banks to hold 4.5 % of common equity (up from 2 % in Basel II) and 6 % of Tier I capital (up from 4 % in Basel II) of risk-weighted assets. Basel III also introduces additional capital buffers, (i) a mandatory capital conservation buffer of 2.5 % and (ii) a discretionary countercyclical buffer, which allows national regulators to require up to another 2.5 % of capital during periods of high credit growth. In addition, Basel III introduces a minimum 3 % leverage ratio and two required liquidity ratios. The Liquidity Coverage Ratio requires a bank to hold sufficient high-quality liquid assets to cover its total net cash flows over 30 days; the Net Stable Funding Ratio requires the available amount of stable funding to exceed the required amount of stable funding over a one-year period of extended stress. The proposals to transpose Basel III into CRD IV were published in July 2011 and form the basis of this present opinion.

3. **Summary of the Proposals**

3.1 The European Commission has brought forward proposals to change the behaviour of the 8 000 banks that operate in Europe. The overarching goal of this proposal is to strengthen the resilience of the EU banking sector while ensuring that banks continue to finance economic activity and growth. The Commission's proposals have three concrete goals.

— The proposal will require banks to hold more and better capital to resist future shocks by themselves. Institutions entered the last crisis with capital that was insufficient both in quantity and in quality, leading to unprecedented support from national authorities. With its proposal, the Commission translates for Europe the international standards on bank capital agreed at the G20 level (most commonly known as the Basel III agreement). Europe will be leading on this matter, applying these rules to more than 8 000 banks, amounting for 53 % of global assets.

— The Commission also wants to set up a new governance framework giving supervisors new powers to monitor banks more closely and take action when they spot risks, for example to reduce credit when it looks like it's growing into a bubble.

— By putting together all legislation applicable on this matter, the Commission proposes to have a Single Rule Book for banking regulation. This will improve both transparency and enforcement.

3.2 The proposal contains two parts: a Directive governing access to deposit-taking activities and a Regulation governing how activities of credit institutions and investment firms are carried out. The two legal instruments form a package and should be considered together. The proposal is accompanied by an impact assessment which demonstrates that this reform will significantly reduce the probability of a systemic banking crisis.

3.3 The Regulation contains the detailed prudential requirements for credit institutions and investment firms and it covers:

— Capital: the Commission's proposal increases the amount of own funds banks need to hold as well as the quality of those funds. It also harmonises the deductions from own funds in order to determine the net amount of regulatory capital that is prudent to recognise for regulatory purposes.

— Liquidity: to improve short-term resilience of the liquidity risk profile of financial institutions, the Commission proposes the introduction of a Liquidity Coverage Ratio (LCR) - the exact composition and calibration of which will be determined after an observation and review period in 2015.

— Leverage ratio: in order to limit an excessive build-up of leverage on credit institutions' and investment firms' balance sheets, the Commission also proposes that a leverage ratio be subject to supervisory review. Implications of a leverage ratio will be closely monitored prior to its possible move to a binding requirement on 1 January 2018.

— Counter party credit risk: consistent with the Commission's policy vis-à-vis OTC (over the counter) derivatives, changes are made to encourage banks to clear OTC derivatives on CCPs (central counterparties).

— Single rule book: the financial crisis highlighted the danger of divergent national rules. A single market needs a single rule book. The Regulation is directly applicable without the need for national transposition and accordingly eliminates one source of such divergence. The Regulation also sets a single set of capital rules.

(7) OJ C 339, 14.12.2010, p. 24–28.

3.4 The Directive covers areas of the current Capital Requirements Directive where EU provisions need to be transposed by Member States in a way suitable to their own environment, such as the requirements for access to the taking up and pursuit of the business of banks, the conditions for their exercise of the freedom of establishment and the freedom to provide services, and the definition of competent authorities and the principles governing prudential supervision. New elements in this directive are:

— Enhanced governance: the proposal strengthens the requirements with regard to corporate governance arrangements and processes and introduces new rules aimed at increasing the effectiveness of risk oversight by boards, improving the status of the risk management function and ensuring effective monitoring by supervisors of risk governance.

— Sanctions: if institutions breach EU requirements, the proposal will ensure that all supervisors can apply sanctions that are truly dissuasive, but also effective and proportionate - for example administrative fines of up to 10 % of an institution's annual turnover, or temporary bans on members of the institution's management body.

— Capital buffers: it introduces two capital buffers on top of the minimum capital requirements: a capital conservation buffer identical for all banks in the EU and a countercyclical capital buffer to be determined at national level.

— Enhanced supervision: the Commission proposes to reinforce the supervisory regime to require the annual preparation of a supervisory programme for each supervised institution on the basis of a risk assessment, greater and more systematic use of on-site supervisory examinations, more robust standards and more intrusive and forward-looking supervisory assessments.

3.5 Finally, the proposal will seek to reduce to the extent possible reliance by credit institutions on external credit ratings by: a) requiring that all banks' investment decisions are based not only on ratings but also on their own internal credit opinion, and b) that banks with a material number of exposures in a given portfolio develop internal ratings for that portfolio instead of relying on external ratings for the calculation of their capital requirements.

3.6 The Commission estimates that:

— The proposal will increase risk weighted assets of large credit institutions by 24.5 % and of small credit institutions by 4.1 %.

— The need to raise new own funds due to the new requirement and the conservation buffer is estimated to be EUR 84 billion by 2015 and EUR 460 billion by 2019.

4. EESC Perspective

4.1 The Directive has not been referred to the EESC. Therefore, with two exceptions, the Committee's opinion is confined to the Regulation.

4.2 CRD IV is a major step forward for capital regulation. It will raise prudential requirements substantially, ensure regulatory capital is truly loss-absorbing and discourage some of the risky activities for which the pre-crisis regime required far too little capital. More generally, both this crisis and past crises have shown that insufficient amounts of high-quality capital and liquidity create large economic costs to society when banks face problems. It is important that this is rectified. While the EESC is supportive of the general thrust of the Regulation, it does have a number of reservations which are spelt out in this opinion.

4.3 Banks need to have sufficient liquid assets to meet the liquidity problems they may face without requiring public support. Only in extreme circumstances should the central bank contemplate acting as a lender of last resort. The liquidity coverage ratio (LCR) therefore fulfils a useful task. Also, banks need to limit the maturity mismatch in their balance sheets. Funding very long-term assets with very short-term liabilities creates risks not only to the bank itself but also to the wider economy. Therefore the EESC supports the proposal to develop and introduce the net stable funding ratio (NSFR) in due course.

4.4 Even so, the liquidity requirements will need to be calibrated very carefully if they are not to inflict severe banking dislocation. The EESC is pleased that the proposals provide the flexibility to allow changes to the NSFR and LCR as the supervisors gain experience of their impact. The traditional business of banks has been maturity transformation, i.e. borrowing short and lending long. If this were to be overly restricted, the economy would suffer. The EESC is wary of the idea of maturity matched bank balance sheets.

4.5 There is an element of pro-cyclicality inherent in the way the financial system works. Risks tend to be underestimated during phases of economic expansion and overstated in times of crisis. But the crisis which followed the Lehman failure has shown how extreme fluctuations can become. In addition to the capital and liquidity requirements of the Regulation, the Directive will also introduce a capital conservation buffer and a countercyclical capital buffer. The EESC welcomes this. Long-term financial stability should be enhanced as a result, which in turn should support economic growth.

4.5.1 Even so, the application of the Basel rules to all banks, systemic or otherwise, may put particular strain on smaller community banks. The Committee calls on the Commission, the EBA and Member State supervisors to ensure that capital buffers for smaller banks are adapted to the business models of those banks.

4.6 The calculation of capital requirements depends on the accounting rules employed. In its investigation into the role of statutory auditors during the financial crisis, the UK House of Lords found that the application of IFRS was a material impediment to the veracity of bank balance sheets. In recent months it has been evident that banks in one or more Member States have not marked sovereign debt to market in reports to shareholders, resulting in inconsistent application of IFRS. Keeping in mind that IFRS is a principles-based system, the EESC urges the Commission to work with the accounting standards authorities, the audit profession and Member State supervisors to ensure that harmonised capital adequacy regulations are supported by harmonised and accurate accounting practice. ESMA should have an important co-ordinating role in this process. This is a vital prerequisite for a harmonised implementation of the new prudential framework.

4.7 The Commission will naturally expect the success of CRD IV to be judged by the way in which the new capital and liquidity regimes react to future financial crises. The EESC, conscious of the scale of the economic crisis which now engulfs the EU, is concerned that nothing in the new regime will restrict credit to the economy or the flow of export credits or trade finance. If banks can only meet prescribed capital and liquidity ratios by shrinking their balance sheets and restricting credit, then the Regulation will have failed. Such a failure would be unacceptable. The Committee is not convinced by the impact assessment already conducted and calls for a more detailed assessment. The EESC proposes that the availability of credit should be continuously monitored (perhaps by an observatory with EESC involvement) until the CRD IV timetable is finished (2019) and the EU 2020 strategy (which must rely on banking support) is completed.

4.8 Accordingly, while the rationale for maximum harmonisation is clearly understood, the economic crisis and the flow of credit may require sensitive tuning of both ratios and timetables if the performance and recovery of each separate Member State economy over the next several years is to be optimised.

4.9 The required total capital proposed by the regulation is 8 %. Of this, the required common equity capital ratio is 4.5 %, additional Tier 1 capital is 1,5 % and Tier 2 capital 2 %. In addition the capital conservation buffer is 2,5 % common equity Tier 1. When all the changes are phased in by 2019 the required total capital plus conservation buffer will be 10,5 %. The Regulation requires maximum harmonisation i.e. homogeneous prudential capital requirements across the European Union achieved by a truly single rule book. The rationale is that inappropriate and uncoordinated stricter requirements in individual Member States might result in shifting the underlying exposures and risks to the shadow banking sector or from one EU Member State to another. It is possible that some Member States which intend to propose higher rates will choose to challenge this view before the Regulation is finalised. The EESC would oppose such a move if it were to have an adverse impact on small banks and or credit for SMEs.

4.10 The Basel framework is designed for internationally active banks. The EU makes its Capital Requirements Directives applicable to all EU credit institutions. The Basel framework more or less restricts the definition of common equity Tier 1 capital to just shares and retained earnings. This could present a problem for non-joint stock companies, such as co-operatives, mutuals and savings banks in Europe. Article 25 of CRD III does recognise that these institutions require a different approach to core capital. It is essential that the final provisions of the Regulation fit with the alternative business models of these institutions.

4.11 Although this is not an opinion on the Directive, the EESC feels that it must comment on the proposal to reduce the reliance placed by credit institutions on credit ratings (point 3.5 above). In its May 2009 opinion ([8]) on the regulation of Credit Rating Agencies, the EESC urged EU regulators not to place undue reliance on ratings, especially in the light of the experience with mortgage backed securities where the ratings had been found to be worthless. The EESC therefore welcomes the current proposal because, although it continues to allow the use of external credit ratings, it does require that Member States ensure that their regulated institutions do not rely solely or mechanistically on external ratings and that they have internal methodologies for assessing creditworthiness. It also implies that where an institution's internal methodology would imply a higher level of capital than that implied by an external rating, the internal methodology should be applied.

([8]) OJ C 54, 19.2.2011, p. 37-41.

4.12 A particular problem which has emerged during the sovereign debt crisis is the clear evidence that, contrary to the guidelines in both the Accord and the series of Capital Requirements Directives, sovereign debt is clearly not risk free. This is an important weakness of the quality of capital provisions of the Regulation. It has profound implications for banks which have been left little choice by the regulations but to load up on sovereign debt. The mechanistic application of the risk free rating must be reconsidered by regulators while banks will have to revise their internal risk methodologies.

4.13 The EESC accepts that the Regulation will maintain the capital requirements for loans to SMEs at 75 % of the norm, but doubts that it will be sufficient in the current climate. The Committee believes that the key issue for SMEs is the risk appetite of banks. Historically, banks have been prepared to partner promising SMEs and support their growth. Defaults as a result of the financial crisis and the general weakness of bank balance sheets have made banks increasingly risk adverse. Therefore, to mitigate this risk aversion, the EESC recommends that the ratio be reduced to 50 % for SMEs. The Committee understands that the Commission plans a further examination of this issue.

4.14 It is in this context the EESC urges the Commission to facilitate the further development of ethical and participatory banking. This form of banking has survived the test of the financial crisis and even though it was not immune to the repercussions of the crisis, it has certainly proved its resilience and its value. Given the pressures on the banking system, it can offer a valuable additional source of credit to SMEs. Therefore the Committee urges the Commission to come forward with a Directive relating to ethical and participatory banking, as already proposed by the EESC in a previous opinion ([9]).

4.15 Taken together, CRD II, III and IV are a huge burden on banking operations, increasing the regulatory burden and conformance costs while reducing the return on capital and long term profitability. Given the role of bankers in the recent crisis, and in the context of their incomprehensible reward structures, most European citizens will feel that bankers are getting what they deserve. Yet the EESC must express a caveat. For the EU to prosper, banks must prosper. If they are to supply credit, they must be profitable. Unfortunately, EU banks are not now in good shape: It is difficult to estimate how much more damage the sovereign credit crisis may yet do to the balance sheets and long term profitability of EU banks.

4.16 In these circumstances, the final drafting and subsequent implementation of the CRD IV package will be critical to the success of the project and, in particular, the ability of the banks to both make the required changes and restore themselves to health. In the fall out of the sovereign debt crisis, banks in different regions of the EU may not be able to move at the same speed. Legislators and supervisors must be prepared for this, even though the implementation time-table extends to 2019.

Brussels, 18 January 2012.

The President
of the European Economic and Social Committee
Staffan NILSSON

([9]) OJ C 48 of 15.02.2011, p. 33.