

# Financial institutions: capital requirements for the trading book and for re-securitisations; supervisory review of remuneration policies

2009/0099(COD) - 13/07/2009 - Legislative proposal

**PURPOSE:** to amend Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies

**PROPOSED ACT:** Directive of the European Parliament and of the Council.

**BACKGROUND:** a new capital requirements framework, based on the 'Basel-II' revised international capital framework, was adopted in June 2006 as the Capital Requirements Directive ('CRD'): this comprises Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions (recast) and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions (recast).

There is widespread recognition that further regulatory reform is needed to address weaknesses in the regulatory capital framework and in the risk management of financial institutions that contributed to the turmoil in global financial markets. As part of its response to the financial crisis, in November 2008 the Commission mandated a High Level Group chaired by Mr. Jacques de Larosière to propose recommendations for reforming the European financial supervision and regulation. Building on the Group's recommendations, in its Communication "[Driving European Recovery](#)" for the spring European Council of March 4, 2009 the Commission set out an ambitious programme of financial services reform.

The present proposal is one of the several measures that the Commission has already taken to implement that programme.

**IMPACT ASSESSMENT:** altogether, fourteen different policy options have been assessed. The preferred option is as follows:

- **Trading Book:** with respect to capital requirements for bank trading books, the following targeted amendments, aligned with what is envisaged by the Basel Committee, will be introduced.
- **Re-securitizations:** in line with the approach developed by the Basel Committee, re-securitization positions would be assigned a higher capital requirement than other securitisation positions to reflect the higher risk of unexpected impairment losses. For particularly complex re-securitizations, the proposals reinforce both the due diligence requirements and the supervisory process to enforce them.
- **Disclosure requirements:** these changes will improve investor understanding of banks' risk profile and, by enhancing transparency, reinforce banks' risk management. The incremental administrative burden for the EU banking industry is estimated at EUR 1.3 million per year and is expected to fall mostly on larger institutions with more advanced approaches to risk management.
- **Supervisory Review of Remuneration Policies:** the proposed amendments will impose on credit institutions and investment firms to have remuneration policies that are consistent with effective risk management. The relevant principles will be set out in the CRD, but will be closely aligned with those set out in Commission Recommendation on remuneration policies in the financial services sector. Making the relevant principles of the Recommendation binding will increase the rate of compliance by credit institutions and investment firms.

**CONTENT:** the Commission is proposing a further revision of EU rules on capital requirements for banks that is designed to tighten up the way in which banks assess the risks connected with their trading book; impose higher capital requirements for re-securitisations; increase market confidence through stronger disclosure requirements for securitisation exposures; and require banks to have sound remuneration practices that do not encourage or reward excessive risk-taking.

Under the new rules, banks will be restricted in their investments in highly complex re-securitisations if they cannot demonstrate that they have fully understood the risks involved, while national supervisory authorities will review banks' remuneration policies and have the power to impose sanctions if the policies do not meet the new requirements.

The main amendments are as follows:

**Capital requirements for re-securitisations:** re-securitisations are complex financial products that have played a role in the development of the financial crisis. In certain circumstances, banks that hold them can be exposed to considerable losses. The proposal will impose higher capital requirements for re-securitisations, to make sure that banks take proper account of the risks of investing in such complex financial products. For particularly complex re-securitizations, the proposals reinforce both the due diligence requirements and the supervisory process to enforce them. For investments in re-securitizations of particularly high complexity, banks will have to demonstrate to their supervisor that necessary due diligence standards have been met. If they cannot do so, a general deduction from capital would apply. In instances where compliance with required due diligence is found to be inadequate, institutions would be debarred from future investment in such instruments.

In exceptional cases where a bank cannot demonstrate to its regulator that it has complied with the required due diligence in respect of a highly complex re-securitisation, a risk weight of 1250% will be applied to the position in that re-securitisation. This capital treatment applies to new re-securitisations issued after 31 December 2010, and will only apply to an existing re-securitisation position after 31 December 2014 if new underlying exposures are added or substituted after that date. Accordingly, the 1250% risk weight cannot be applied to banks' legacy positions in re-securitisations (unless the underlying exposures of those positions are changed after the end of 2014).

**Disclosure of securitisation exposures:** proper disclosure of the level of risks to which banks are exposed is necessary for market confidence. The new rules will tighten up disclosure requirements to increase the market confidence that is necessary to encourage banks to start lending to each other again. In particular, the disclosure requirements will in future cover the risks not only of securitisation positions in the non-trading book, but also those in the trading book.

**Capital requirements for the trading book:** the trading book consists of all the financial instruments that a bank holds with the intention of re-selling them in the short term, or in order to hedge other instruments in the trading book. The proposal will change the way that banks assess the risks connected with their trading books to ensure that they fully reflect the potential losses from adverse market movements in the kind of stressed conditions that have been experienced recently. Capital requirements for securitisations in the trading book are currently calculated as if these instruments were normal debt positions. This contrasts with the banking book, where there is a separate, more differentiated and risk sensitive set of capital requirements. This proposal envisages that the trading book capital requirements be based on those for equivalent securities in the banking book.

**Remuneration policies and practices within banks:** under the current European supervisory framework, there is no requirement that the remuneration policies of financial institutions should be subject to supervisory oversight. As a result, supervisory authorities have generally not focused on the implications of remuneration policies for risk and effective risk management.

The purpose of this proposed amendment to the CRD is:

- to impose a binding obligation on credit institutions and investment firms to have remuneration policies and practices that are consistent with and promote **sound and effective risk management**, accompanied by **high level principles** on sound remuneration;
- to bring remuneration policies **within the scope of the supervisory review** under the CRD, so that supervisors would be able to require the firm to take measures to rectify any problems that they might identify;
- to ensure that supervisors may also impose **financial or non-financial penalties** (including fines) against firms that fail to comply with the obligation.

The requirement will apply to credit institutions and to investment firms that are authorised and regulated under Directive 2004/39/EC on markets in financial instruments. The **scope** of the obligation is restricted to remuneration for staff whose professional activities have a material impact on the risk profile of the bank or investment firm. This targets the remuneration policies for those individuals who take decisions that may affect the level of risk assumed by the institution.

The principles on sound remuneration are not intended to prescribe the amount and form of remuneration, and institutions remain responsible for the design and application of their particular remuneration policy. Prudential oversight in the course of the supervisory review would focus on whether the remuneration policies and practices are consistent with sound risk management given the nature of the firm's business. In order to align supervisory assessments, and to assist firms in complying with the principles, the proposal requires CEBS to ensure the existence of guidelines on sound remuneration policies.

If a supervisor identifies problems it may require the credit institution or investment firm to take qualitative or quantitative measures to address those problems. Those measures may include a ('qualitative') requirement for the firm to rectify the situation by changing its remuneration structure to reduce the inherent risk and – in appropriate cases – a ('quantitative') requirement for the firm to hold additional own funds against the risk.

In addition, competent authorities must also have the power under the CRD to impose penalties for a breach of any requirement of the Directive (including the proposed requirement in relation to remuneration policies). This sanctioning power is separate from the power to require firms to take qualitative or quantitative measures. The amendment is intended to ensure that supervisors have both financial and non-financial sanctions at their disposal.

**BUDGETARY IMPLICATION:** the proposal has no implication for the Community budget.