

Basel II and revision of the Capital Requirements Directives (CRD 4)

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The European Parliament adopted a resolution on Basel II and the revision of the Capital Requirements Directives (CRD 4).

The resolution welcomes the G20 commitment to increase the quality and quantity of capital and the efforts made by the Basel Committee and the Commission. It stresses however that new capital requirement rules should be drafted and implemented with care and their impacts should also be analysed in the wider regulatory overhaul framework.

In this context, Members are **concerned about structural deficits and imbalances in the current proposal**, as well as the risk of harming economic recovery and economic growth. In particular, it will be necessary to monitor that banks are not passing on the cost of the forthcoming proposal to end-users of financial services. Members also call on the Commission to be more pro-active in the process of reforming the Basel II rules, to actively promote and safeguard European interests, to coordinate the approaches of the Member States. The Parliament should be provided with regular reports on the status of ongoing negotiations and actively involve it in the negotiating processes.

The resolution recalls the **important specificities of the European banking sector**, such as the variety of business models operating under different legal forms and the fact that the European corporate sector is predominantly financed through bank lending. Members urge the Basel Committee as well as the Commission to take proper account of such specificities and of the different types of risk affecting the banking sector. They stress the need to **clearly differentiate between investment and traditional retail banking services**, as well as transaction services, in the revised Basel II rules.

Recalling that the Basel II Agreement, and its upcoming revision, is meant to be a **global standard**, Parliament is therefore very much concerned that limitations laid down in various national laws adopted in response to the crisis (in particular in the US Wall Street Reform and Consumer Protection Act, limiting recognition of external ratings) would result in a serious fragmentation of the application of this global standard.

Members deem it necessary to **expand the crisis management minimum intervention toolbox** available to supervisor to include at least the power to: (i) require that adjustments be made to capital, liquidity, the business mix and internal processes; (ii) recommend or impose changes of management; (iii) create a bridge bank or a good bank/bad bank split; (iv) impose profit and dividend retention requirements and restrictions in order to consolidate capital requirements and ensure that shareholders pay before taxpayers; (v) lay down criteria for valuing impaired assets.

The Commission is urged to create incentives for the banking sector to **manage risk and profit with a view to long-term outcomes** and to encourage banks to keep an active and ongoing interest in loans on their own books, without undue reliance on securitisation or off-balance sheet structures.

Parliament is of the view that the **issue of 'too-big-to-fail' financial institutions** must be addressed, and therefore that capital requirements and counter-cyclical buffers should be proportionate to the size, level of risk and business model of a financial institution.

The resolution focuses on the main issues:

Quality of capital: the resolution supports the initiative to increase the quality and level of capital in response to the crisis. However, in order to guarantee a level playing field and not to disadvantage any business models of non-joint stock companies, Members urge the Basel Committee and the Commission, when defining eligible capital instruments, to **take proper account of the needs and particularities of non-joint stock companies** (i.e. cooperatives, mutuals and savings banks), which account for a large portion of the European banking industry.

They also urge the Basel Committee and the Commission to ensure that, in consolidated capital calculations, both risk and capital are taken into account in a balanced and prudent manner, that, in particular, capital received from minorities that has been directly contributed to credit institutions within the same banking group should be appropriately recognised (i.e. minority interest), and that holdings of regional cooperative and savings banks in their central institutions are not hampered (i.e. no deduction from own funds).

The Commission is called upon to **conduct a comprehensive survey of capital instruments** before and after the crisis, in order to assess the importance of specific capital instruments and their relevance in a crisis situation.

Liquidity standards: Members consider developing high-quality liquidity standards to be a key part of the crisis response. Liquidity standards should be **sufficiently differentiated** to take account of the particularities of a bank's business model and risk profile.

Parliament urges the Basel Committee and the Commission to **reconsider the calibration of the liquidity and funding ratios**.

The Commission is invited to:

- make sure that, in its forthcoming proposal on the CRD 4 revision, off-balance sheet liabilities are covered by liquidity standards;
- define the criteria for high-quality liquid assets taking into account the definition of European Central Bank eligible assets for monetary policy operations (repo facility);
- include all eurozone sovereign debt as high-quality liquid assets, regardless of its specific rating.

Underlining that the likelihood that high-quality liquid assets will quickly become illiquid in times of high stress, Members call for credit institutions to **conduct stress tests going beyond the liquidity coverage ratio** and net stable funding ratio.

Counter-cyclical measures: Members welcome the effort to limit excessive credit growth and the risk of credit bubbles. They are concerned about the possible pro-cyclical nature of a fixed bank-specific capital conservation buffer as currently proposed. They consider that both capital conservation buffers and counter-cyclical buffers should be able to absorb losses during a period of stress. They state that in order to make the buffers effective, they should be designed and developed in parallel.

The resolution recognises the **benefits of forward-looking provisioning** (expected-loss approach) as a possible additional measure to reduce pro-cyclicality and encourages recognition of expected credit losses with regard to the business cycle. It calls for **international convergence** between reporting for accounting and reporting for regulatory purposes. It cautions about the need to minimise dual reporting.

Parliament points out that counter-cyclical regulation requires harmonised criteria in order to ensure comprehensive and careful monitoring of the financial markets and the market environment by supervisory authorities, including, amongst other things, full exchange of information, synchronisation of regulatory actions and real-time monitoring of exposure and risk.

Leverage ratio: the resolution states that such a ratio, in order to be effective, must include all off-balance sheet items and derivatives, must be clearly defined, simple and comparable internationally and should take into account regulatory netting and the different accounting standards existing internationally.

Members are concerned, however, that, taken alone, a crude leverage ratio would fail to take sufficient account of risk and would penalise entities providing traditional low-risk banking services (such as retail, corporate and real-estate financing and transaction banking services) or economies where the corporate sector is financed predominantly through lending. They are also concerned that, taken alone, a 'crude' (undifferentiated) LR might create adverse incentives to shift financial assets into more risky exposures.

Parliament favours a leverage ratio to be anchored in Pillar 1 of the Basel Committee framework and calls for further consideration to be given to alternative forms of leverage ratio in Pillar 2.

The Commission is urged to ensure that a leverage ratio **does not lead to inappropriate securitisation** of the kind highlighted by the financial crisis, or to substitutes and less credit, especially for lending in the real economy (these being likely ways for banks to reduce their leverage ratio).

Counterparty credit risk (CCR): the resolution calls for enhanced standards as regards stress tests, back tests and addressing wrong-way risk, as well as assessments of long-term social and environmental risks arising from companies and projects receiving bank loans.

The Basel Committee and the Commission are invited to explore alternatives that will better address the credit value adjustment risk arising from the deterioration of the credit quality of banks' counterparties.

Credit default swaps (CDSs) should not be used to bypass capital requirements.

The resolution calls for counterparty credit risk treatment to be **risk-proportionate** and for capital charges to be higher for non-centrally cleared transactions than for transactions through a central counterparty (CCP), provided that such CCPs meet high-level requirements to be defined in European legislation while taking into account standards agreed at international level.

Lastly, Members take the view that capital requirements for CCR should be stricter for exposures of financial institutions to other financial institutions and should also reflect the dynamic nature of this risk over time.