

Basic information	
2004/0155(COD) COD - Ordinary legislative procedure (ex-codecision procedure) Directive	Procedure completed
Credit institutions: taking up and pursuit of the business. Recast Repealing Directive 2000/12/EC 1997/0357(COD) Repealed by 2011/0203(COD) Amended by 2005/0245(COD) Amended by 2006/0166(COD) Amended by 2006/0284(COD) Amended by 2008/0190(COD) Amended by 2008/0191(COD) Amended by 2009/0099(COD) Amended by 2009/0161(COD) Amended by 2010/0232(COD) See also 2010/2074(INI)	
Subject 2.50.04 Banks and credit 2.50.10 Financial supervision	

Key players			
European Parliament	Committee responsible ECON Economic and Monetary Affairs	Rapporteur RADWAN Alexander (PPE-DE)	Appointed 21/09/2004
	Committee for opinion JURI Legal Affairs	Rapporteur for opinion BERGER Maria (PSE)	Appointed 03/02/2005
Council of the European Union	Council configuration Economic and Financial Affairs ECOFIN	Meetings 2628	Date 2004-12-07
		Economic and Financial Affairs ECOFIN	2682 2005-10-11
		Economic and Financial Affairs ECOFIN	2734 2006-06-07
European Commission	Commission DG Economic and Financial Affairs	Commissioner	

Key events			

Date	Event	Reference	Summary
14/07/2004	Legislative proposal published	COM(2004)0486 	Summary
07/12/2004	Debate in Council		
14/04/2005	Committee referral announced in Parliament, 1st reading		
13/07/2005	Vote in committee, 1st reading		
29/08/2005	Committee report tabled for plenary, 1st reading	A6-0257/2005	
26/09/2005	Debate in Parliament		
28/09/2005	Decision by Parliament, 1st reading	T6-0351/2005	Summary
07/06/2006	Act adopted by Council after Parliament's 1st reading		
14/06/2006	Final act signed		
14/06/2006	End of procedure in Parliament		
30/06/2006	Final act published in Official Journal		

Technical information	
Procedure reference	2004/0155(COD)
Procedure type	COD - Ordinary legislative procedure (ex-codecision procedure)
Procedure subtype	Recast
Legislative instrument	Directive
Amendments and repeals	<p>Repealing Directive 2000/12/EC 1997/0357(COD)</p> <p>Repealed by 2011/0203(COD)</p> <p>Amended by 2005/0245(COD)</p> <p>Amended by 2006/0166(COD)</p> <p>Amended by 2006/0284(COD)</p> <p>Amended by 2008/0190(COD)</p> <p>Amended by 2008/0191(COD)</p> <p>Amended by 2009/0099(COD)</p> <p>Amended by 2009/0161(COD)</p> <p>Amended by 2010/0232(COD)</p> <p>See also 2010/2074(INI)</p>
Legal basis	EC Treaty (after Amsterdam) EC 047-p2
Stage reached in procedure	Procedure completed

Documentation gateway				
European Parliament				
Document type	Committee	Reference	Date	Summary
Amendments tabled in committee		PE357.763	24/05/2005	
Committee report tabled for plenary, 1st reading/single reading		A6-0257/2005	29/08/2005	
Text adopted by Parliament, 1st reading/single reading		T6-0351/2005 OJ C 227 21.09.2006, p. 0085-0166 E	28/09/2005	Summary

Council of the EU

Document type	Reference	Date	Summary
Draft final act	03669/4/2005	14/06/2006	

European Commission

Document type	Reference	Date	Summary
Legislative proposal	COM(2004)0486 	14/07/2004	Summary
Document attached to the procedure	SEC(2004)0921 	14/07/2004	Summary
Commission response to text adopted in plenary	SP(2005)4139	20/10/2005	
Follow-up document	COM(2010)0262 	28/05/2010	Summary
Follow-up document	COM(2010)0327 	23/06/2010	Summary
Follow-up document	SEC(2010)0754 	23/06/2010	
Follow-up document	COM(2012)0400 	17/07/2012	Summary
Follow-up document	SWD(2012)0218 	17/07/2012	
Follow-up document	COM(2012)0769 	18/12/2012	Summary

Other institutions and bodies

Institution/body	Document type	Reference	Date	Summary
ECB	European Central Bank: opinion, guideline, report	BCE(2005)0004 OJ C 052 02.03.2005, p. 0037-0046	17/02/2005	Summary
EESC	Economic and Social Committee: opinion, report	CES0244/2005 OJ C 234 22.09.2005, p. 0008-0013	09/03/2005	

Additional information

Source	Document	Date
European Commission	EUR-Lex	

Final act

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 23/06/2010

The minimum capital requirements for banks under the EU Capital Requirements Directive (CRD), which comprise Directive 2006/48/EC and Directive 2006/49/EC, are risk sensitive: the higher the risk, the more capital a bank needs to hold to meet that risk and cover potential losses. By consequence, as credit and market risks increase in a downturn, minimum capital requirements for banks will also increase to meet those higher risks. Banks may need to raise additional capital to meet these higher requirements at a time when their capital resources are being eroded by losses and opportunities for raising capital are scarce and costly. This may potentially constrain banks' lending capacity into the economy. The possibility that the CRD may contribute to the pro-cyclicality observed in the financial system under the predecessor Basel I framework led to the inclusion in the CRD of Article 156 which requires the Commission to monitor whether the CRD has significant effects on the economic cycle¹. This report has been drawn up for that purpose.

It notes that bank capital regulation may potentially amplify the cyclicality endemic to bank lending behaviour. Due to their risk-sensitive nature, capital requirements under the Basel II framework, transposed in the EU by the CRD, are expected to rise more in recessions and grow less during expansions. Since it may be expensive for banks to raise additional capital during economic downturns, this may encourage them to cut back on lending instead. By contrast, as capital requirements become more relaxed during economic upturns, banks may have more room for manoeuvre to extend more and / or riskier credit as compared to historical average over the business cycle.

However, bank lending is pro-cyclical in nature and it cannot be assumed that cyclical capital requirements per se have an amplifying effect. Indeed, the pro-cyclical nature of bank lending has many, often interconnected sources such as limitations in the measurement of risk and information asymmetries between borrowers and lenders. Furthermore, pro-cyclicality in lending may also stem from inappropriate responses of financial system participants to changes in the economic conditions. As pro-cyclicality is driven by various factors, it is difficult to identify the exact impact of minimum capital requirements. In particular, it remains a challenge to distinguish the effects of loan supply from those of loan demand, especially as shifts in demand and supply both have an impact on bank lending rates and credit volumes.

In order correctly to identify those effects, it would be necessary to have a detailed and sufficiently large data set, which – because the CRD has only recently been implemented – is yet not available. This first assessment set out in this report is therefore partly based on qualitative information collected from banks and

borrowers.

In order for the CRD to have pro-cyclical effects, certain conditions must be fulfilled. To determine the extent to which they have held empirically, the report asks following questions:

- does the increased risk sensitivity of the CRD framework lead to a stronger cyclicality of minimum required capital (MRC) and, if so, to what extent?
- do cyclical capital requirements have an impact on the level of capital that banks hold and impact bank loan supply?
- does the cyclicality of bank loan supply have an amplifying effect on the economic cycle?

The report considers these issues and states that overall, **the extent to which the introduction of the CRD has led to more pro-cyclical bank lending is still difficult to assess**. Although the evidence presented does point to some potential links between CRD and bank lending behaviour, analysis over a longer period is needed to draw more robust conclusions. Moreover, it is important to stress that as the implementation of the Basel II framework coincided with the outbreak of the financial crisis, disentangling the effects of these two events is particularly difficult.

With regard to **the impact of credit availability on the economic cycle**, the report states that, notwithstanding the indications of ongoing substitution between market-based and bank-based financing in recent months, the predominant role of banks in providing funds for spending and investment should not be underestimated, especially given the fact that obtaining the necessary funding from alternative sources has been burdensome for some, particularly smaller, businesses. Moreover, there is recent empirical evidence that shocks to loan supply have the potential to affect economic activity in the predominantly bank-based euro area financial system.

On measures to address pro-cyclicality, the report notes that the recent crisis has shown that market participants expect a rise in capital levels where they do not believe that an institution is well placed to absorb losses. Enhanced counter-cyclical measures within the regulatory framework for capital requirements could help to restore confidence in banks' balance sheets, and thus reduce the likelihood that banks will have to increase capital requirements or sharply de-leverage their credit portfolios to meet market participants' expectations. The Commission agrees with international institutions such as the FSB and the Basel Committee that **additional measures are necessary to avoid excessive pro-cyclicality**. It discusses the possibility of introducing **capital buffers and/or through-the-cycle provisions**. The report also states that in line with the Basel Committee, the Commission is considering the **introduction of a leverage ratio** with the aim of limiting the build-up of leverage in the banking sector, and introducing additional safeguards against model risk and measurement error.

The paper goes on to describe **measures already adopted by the Commission**, such as: **to supplement the requirements of the CRD** by an express obligation for credit institutions and investment firms to establish and maintain, for those categories of staff whose professional activities have a material impact on their risk profile, remuneration policies and practices that are consistent with effective risk management; **amendments to the CRD to increase regulatory capital requirements** for the trading book activities and re-securitizations held in the banking book; the **establishment of European**

Systemic Risk Board (ESRB) to oversee the stability of the financial system as a whole. On the latter, the Commission considers that adding a robust macro-prudential overlay to the current micro-prudential approach should help to address sources of procyclicality linked to limitations in the risk measurement and inappropriate responses of market participants to risk. This should support the timely identification of cycles and the build-up of risks in the system which could enable action to be taken earlier to avoid excessive volatility and pro-cyclicality in a downturn.

In conclusion, the Commission notes that many international institutions have emphasised the importance of introducing counter-cyclical measures in the prudential framework in order to reduce excessive pro-cyclicality within the financial system. In parallel with work going on in the Basel Committee, the Commission will **examine the options which address systemic risk and pro-cyclicality in the most effective way**. These measures should be able to limit excessive risk-taking in times of economic growth but should also be designed in a way that they can be drawn down during economic downturns to increase the resilience of the banking sector and to support the credit flow into the economy. The Commission will take into account the ongoing work by the international accounting standard setter (IASB) and prudential supervisors (in particular, the Basel Committee) when considering a legislative proposal.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 11/10/2005

The Council noted agreement on two draft directives introducing new capital adequacy requirements for banks and investment firms, accepting all amendments voted by the European Parliament in first reading.

The two directives can be now adopted without discussion at a forthcoming Council meeting, once the texts have been finalised.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 28/05/2010 - Follow-up document

The Commission presents a report on the expected impact of Article 122A of Directive 2006/48/EC.

The document recalls that since the summer of 2007, securitisation markets have been in broad distress after large unexpected losses on securitisations of mortgage loans surfaced and are only slowly and partially recovering. Because this distress has deeply affected the financial system and the wider economy, it is crucial that regulation addresses the root causes of the large unexpected losses in certain securitisations. A root cause can be identified as a lack sound loan underwriting practices on the part of the issuers that was made possible because professional investors in the securitisation tranches did not exercise due diligence in their investments and did therefore not impose effective discipline on the issuers.

Article 122a imposes requirements on credit institutions in the European Union in order to make sure that they invest only in securitisations where they have applied appropriate due diligence and where the originators have an incentive to act diligently in the underwriting of the loans to be securitised. The article also obliges credit institutions – where they act as originators themselves – to cater for the relevant disclosures needed for investors' due diligence.

The Article underwent substantial change during the legislative process and there was, also given the difficult condition that securitisation markets were in, no impact assessment carried out about its requirements in their final shape. In particular, during the legislative process, concerns were expressed about the effectiveness of one of its elements, the requirement for issuers of securitisations to retain exposure to the securitisation ("the retention requirement") so that they have an incentive to diligently originate loans.

In accordance with Directive 2008/46/EC, this report provides a high level assessment of the overall impact of Article 122a, and then considers the questions about effectiveness of the retention requirement and the appropriateness of raising its minimum level. There is also an Annex of this report that discusses technical suggestions made by CEBS for improving specific aspects of the retention rule.

In terms of **overall impact**, the Commission expects that Article 122a will help aligning the incentives of issuers and investors more closely. Thereby, it will make securitisation sounder and instil new confidence in this source of financing. The ultimate consequence will be that securitisations return in larger volumes as a source of refinancing of the financial sector's lending to the real economy, while however preventing the excesses that became apparent in the course of the crisis. Regarding the specific question of the effectiveness of the minimum retention level chosen, the Commission concludes that the existing moderate **minimum retention level of 5% should be kept**, acknowledging that investors should require higher retention levels depending on the securitisation in question.

Therefore, the overall design of Article 122a can be expected to meet its purpose. In concluding on this report, the Commission would point to a number of technical points raised by CEBS that are briefly discussed in the annex to this report. The Commission considers that there is **no immediate need to propose legislative changes to Article 122a in this context**. However, the Commission will closely monitor international developments in this field, acknowledging that also in jurisdictions outside the EU there is interest in introducing requirements similar to Article 122a, including retention requirements. As these developments materialise further, the Commission will make sure that Article 122a will also be assessed in light of potentially different solutions found in other jurisdictions.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 28/09/2005 - Text adopted by Parliament, 1st reading/single reading

The European Parliament adopted a resolution drafted by Alexander **RADWAN** (EPP-ED,DE) and made many amendments to the Commission's proposal. (Please see the document dated 13/07/2005.)

On the matter of comitology, Parliament pointed out in a recital to the Directive that it had previously requested that Parliament and Council should have an equal role in supervising the way in which the Commission exercises its executive role in order to reflect the legislative powers of Parliament under Article 251 EC. Parliament did not consider this proposal to preserve its legislative prerogatives. In the view of the European Parliament, Parliament and Council should have the opportunity of evaluating the conferral of implementing powers to the Commission within a determined period. Parliament felt it appropriate to limit the period during which the Commission may adopt implementing measures. Accordingly, a new clause states that, without prejudice to the implementing measures already adopted, upon expiry of a two year period following the adoption of the Directive and, on 1 April 2008 at the latest, the application of its provisions requiring the adoption of technical rules, amendments and decisions shall be suspended. Acting on a proposal from the Commission, the European Parliament and the Council may renew the provisions concerned in accordance with the procedure laid down in Article 251 of the Treaty and, to that end, they will review them prior to the expiry of the period or date referred to above.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 17/02/2005 - European Central Bank: opinion, guideline, report

The ECB is convinced that the proposed directives, once properly transposed by the Member States, will considerably strengthen the soundness and stability of the EU banking system through the application of more sophisticated, risk-sensitive capital standards. The ECB therefore stresses its generally positive view of the proposed directives. However, without prejudice to this general view, the ECB has a number of general and specific remarks with regard to the proposed directives and their future application:

Legal instruments for consistent implementation across the EU : in line with the agreement to extend the Lamfalussy process from the securities sector to all other financial sectors, it would have been preferable to have limited the proposed directives to cover framework principles reflecting the basic political choices and substantive matters in the field of capital adequacy for credit institutions and investment firms and to have brought the technical provisions on capital adequacy together in one directly applicable Level 2 regulation. This approach would reinforce a convergent implementation of Basel II throughout the EU, facilitate compliance by financial groups operating across different EU countries and reduce costs, as well as promoting a level playing field and further financial integration. The ECB considers that the envisaged legal structure should not be viewed as the final desirable outcome, but rather as one step in a long-term process towards establishing, whenever possible, a directly applicable set of Level 2 technical rules for financial institutions within the EU.

The reduction of national options and national discretion : given the need for a further reduction in national options, the ECB would support the introduction of a specific provision requiring the Commission to monitor the progress made in this direction and, within a reasonable period of time (e.g. three years), to report to the Community institutions on the use of residual national discretion, assessing how necessary it is and whether there is a need for further regulatory initiatives. It also recommends the use of consistent terminology to express how the competent authorities can intervene prior to the use of certain risk weights and measurement

techniques. Furthermore, the ECB expects that the coordinating role played by the supervisor on a consolidated basis, together with the explicit requirement to exchange information, will contribute to the stability of the banking sector both at EU and Member State level.

Timing and transitional provisions : the ECB welcomes the provisions on the timing of the introduction of the new capital requirements in Chapter 1 of Title VII of the proposed banking directive. These provisions mirror the timing provided for in Basel II.

Monitoring the structural and possible pro-cyclical impacts of the new framework : the ECB supports the proposal that the Commission should periodically monitor whether the proposed banking directive has significant effects on the economic cycle, as set out in Article 156 thereof. Furthermore, the ECB observes that it is the Commission's prerogative to adopt proposals for any amendment to the recast Consolidated Banking Directive, and that this also applies to the possible legislative 'remedial measures' mentioned in Article 156. However, from a macro-prudential perspective it is crucial that possible legislative 'remedial measures' are of a symmetric nature and that capital standards are only changed when the adjustment is prudentially sustainable through the entire cycle.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 14/07/2004 - Legislative proposal

PURPOSE : to recast Directive 2000/12/EC and lay down rules on the business of credit institutions and their prudential supervision.

LEGISLATIVE ACT : Directive of the European Parliament and of the Council.

CONTENT : The Basel Accord in 1988 (Basel I) led to the adoption of minimum capital requirements across over 100 countries. The EU adopted, inter alia, Directive 2000/12/EC which addressed credit institutions' risks arising from credit-granting activities. Directive 93/6/EEC on the capital adequacy of investment firms and credit institutions extended both the credit risk and market risk rules to investment firms. The existing rules have made a significant contribution to the single market and high prudential standards. However, various important shortcomings have been identified. These include the following:

- crude estimates of credit risks result in an extremely crude measure of risk and is in danger of falling into disrepute;

- scope for capital arbitrage: innovations in markets have enabled financial institutions to effectively arbitrage the mismatch between institutions' own allocation of capital to risks and minimum capital requirements;
- lack of recognition of effective risk mitigation: the present Directives do not provide appropriate levels of recognition for risk mitigation techniques.
- incompleteness of the risks covered under the existing directives, including operational risk, which are not subject to any capital charges.

There is strong consensus that the present situation is unsustainable. Capital requirements and risks would continue to be misaligned resulting in limited effectiveness of the prudential rules and increased risks to consumers and financial stability. The new proposal aims to ensure that financial institutions' capital is more closely aligned with the risks they face and sets out new rules on capital requirements. The framework consists of three different approaches allowing financial institutions to choose the approach most suited to them: simple, intermediate and advanced. The simple and intermediate approaches would be available by end 2006 (but banks could still opt to apply the current rules until end 2007) and the most advanced approaches from end 2007. In addition, specifically designed rules on capital requirements for financing small- and medium-sized enterprises indicate lower capital requirements for lending to such institutions and preferential treatment for certain types of venture capital. The new framework also recognises the lower risks associated with retail lending to individuals – both for general purposes and for house purchasing – by introducing lower capital requirements for these types of lending.

To reduce single market barriers arising from the responsibilities of separate national supervisory authorities, supervisors will be required to work more closely together, including in deciding on applications by financial institutions to use the more sophisticated methodologies. The Committee of European Banking Supervisors will have an important role in promoting consistency of approach between different supervisors.

The new provisions replace the existing solvency ratio requirements for credit risk and introduce two methods to calculate risk weighted exposure amounts. The Standardised Approach is based on the existing framework, with risk weights determined by the allocation of assets and off-balance sheet items to a limited number of risk buckets. Risk sensitivity has been increased by the number of exposure classes and risk buckets. There are lower risk weights for non-mortgage retail items (75%) and residential mortgages (35%). A 150% risk weight for assets which are 90 days past due (100% for residential mortgages) is introduced. The use of credit rating agencies' ratings to assign risk weights where these are available is permitted. The Internal Ratings Based (IRB) approach permits credit institutions to use their own estimates of the risk parameters inherent in their different credit risk exposures. These parameters form the inputs into a prescribed calculation designed to provide soundness to a 99.9% confidence level.

The 'Foundation' Approach allows credit institutions to use their own estimates of probability of default, while using regulatory prescribed values for other risk components. Under the 'Advanced' Approach, credit institutions may use their own estimates for losses given default and their exposure at default. Credit institutions are allowed to use pooled data in the estimation of risk parameter values. This allows smaller credit institutions to apply a more risk sensitive approach to calculating capital requirements.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 14/07/2004

COMMISSION'S IMPACT ASSESSMENT

Further information concerning the context of this issue may be found in the summary of the Commission's initial proposal COM(2004)0486. .

1- POLICY OPTIONS AND IMPACTS

In the context of the Basel process, there are four main options available to the Commission:

1.1- No policy change approach: in the absence of a revision of the present regime for capital requirements in Europe: financial institutions' activities would keep being imposed a misallocation of resources and/or a suboptimal financial structure; capital requirements and risks would continue to be misaligned resulting in limited effectiveness of the rules on MCR; significant capital arbitrage would continue and would increase, with likely serious consequences to the economic and social objectives at which prudential regulation is aimed; the full extent or nature of the risks that some financial institutions are undertaking would keep not being captured by the present requirements; the most sophisticated and most effective risk management techniques would not be actively encouraged or recognised; financial services groups operating in more than one Member State would continue to be subject to disproportionate burdens resulting from multiple layers of regulation and supervision; market forces would keep not being leveraged to strengthen the safety and the soundness of the financial system; the EU would be unable to benefit appropriately from future developments in financial markets and in institutions' risk management practices or from improvements in regulatory or supervisory tools, given the difficulty in speedily updating the current EU regulatory framework; in view of the proposed global implementation of the new Basel Accord at end-2006 (Basel 2), the EU financial services sector would be significantly disadvantaged as compared with its overseas competitors.

1.2- The "Basel only" option: no action is taken at the EU level to revise the existing prudential standards framework and banks apply voluntarily the new Basel II accord on the basis of indications by their regulator and / or supervisor. At the same time, banks would continue to apply the EU framework derived from Basel I as prescribed in the Consolidated Banking Directive and in the Capital Adequacy Directive. This option has the benefit of minimizing the workload for EU institutions, but creates a series of very undesirable consequences. First, it does not promote financial stability in the EU as it does not foster the adoption by banks of the most advanced risk management and control methods. Second, it obliges de facto banks acting at the international level to apply a double set of prudential standards, with an important additional regulatory burden. Third, it does not respond to the development of globally agreed prudential standards among supervisors which reflect EU needs and perspectives. Fourth, it puts EU financial institutions at a competitive disadvantage vis à vis their international competitors as they would not be able to benefit from any reduction in capital requirements deriving from the new set of rules. For the above reasons, this option has not been retained by the Commission as a possible working method in developing the new prudential standards framework.

1.3- The "EU only" option: action is taken at the EU level without a close link with the work done by the Basel Committee. The results of the discussions at the EU level would be translated into a new EU prudential framework. This option presents the theoretical advantage of developing a framework tailored on the specificities of the EU financial system, and of ensuring a fully-fledged discussion at all moments of the development of the new rules with all Member States. However, it also presents a series of very serious drawbacks. First, it duplicates the work by EU regulators and supervisors involved in the Basel process. Second, it leads to the creation of double prudential standards for EU banks acting at the international level which would be subject to two completely different sets of rules: those imposed in the EU and those agreed by supervisors in Basel. Third, it does not allow the creation of a level playing field between the EU and the other major actors of the global financial system, such as the US, Japan and Canada. For the above reasons, this option has not been retained by the Commission as a possible working method in developing the new capital requirements framework.

1.4- The "Basel and EU" option: action is taken at the EU level in parallel with the Basel process. Discussions are held at the same time in Basel and in the EU. While the new rules on capital adequacy are agreed by supervisors in Basel, at the same time the development of the discussions is presented in the EU to all Member States so that EU interests and points of convergence can be identified on specific issues and agreed if possible in Basel. If, however, the EU presents the need to pursue a line which cannot be agreed in Basel on selected topics, such a line can still be pursued in the EU. Disadvantages of this option include the use of heavy procedures to make sure that all Member States are informed of the discussions in Basel and the issue that not all Member States are present at the negotiations in Basel. It presents however a series of very important advantages. First, it allows the creation – except for specific topics – of a globally agreed prudential framework which ensures a worldwide level playing field in the financial system. Second, it allows the EU to benefit from the discussions in Basel without the need to replicate an important amount of technical work in order to ensure that the EU financial institutions are subject to a state-of-the-art prudential framework. Third, it allows the EU to influence the Basel process and to arrive at the creation of a broadly single prudential framework (in Basel and in the EU) for European financial institutions with an important limitation in the regulatory burdens they have to sustain. Fourth, it provides the EU with a sufficiently flexible framework for necessary departures from the Basel agreed solutions whenever strong EU reasons require doing so.

CONCLUSIONS: For the above reasons, the **"Basel and EU" option has been retained** by the Commission services as the only possible working method in developing the new capital requirements framework.

2- FOLLOW-UP

There is now a need to adopt a legislative approach and to apply the new capital adequacy rules across all types of EU financial institutions. The proposal is expected to follow normal implementation procedures, i.e. transposition in Member States within 18-24 months.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 14/06/2006 - Final act

LEGISLATIVE ACT: Directive 2006/48/EC of the European Parliament and of the Council relating to the taking up and pursuit of the business of credit institutions (recast).

CONTENT: The Council adopted two directives aimed at introducing new capital adequacy requirements for banks and investment firms, accepting all amendments voted by the European Parliament in first reading (please refer also to 2004/0159(COD)).

The new requirements are intended to contribute to financial stability and strengthened confidence in the financial system by fostering enhanced risk management by financial institutions. The new requirements are part of the EU's financial services action plan, and are aimed at strengthening the competitiveness of the European economy by lowering capital costs for companies.

The new requirements follow international guidelines established in June 2004 ('Basel II'agreement) by the Basel committee on banking supervision¹, which formulates supervisory standards and recommends best practice for banking supervisory authorities.

The directive enables financial institutions to choose from three different approaches to capital adequacy - simple, intermediate and advanced - depending on which suits them best. The simple and intermediate approaches may be used from the end of 2006 (although banks may still choose to apply the current rules until the end of 2007), and the most advanced approach from the end of 2007.

The new rules set more precise own funds requirements (i.e. the amount of 'internal' capital which banks and investment institutions must hold in order to cover their risks and protect their depositors) for the financing, amongst other things, of small and medium-sized enterprises. The rules provide for preferential treatment for some types of risk capital.

The two directives recast directive 2000/12/EC on the business of credit institutions and directive 93/6/EEC on the capital adequacy of investment firms and credit institutions, whilst transposing the Basel II agreement into EU law.

ENTRY INTO FORCE: 20/07/2006.

DATE OF APPLICATION: 31/12/2006.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 17/07/2012

The Commission presents its second report on effects of the Capital Requirements Directive (CRD) on the economic cycle. The CRD comprises Directive 2006/48/EC on 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. To recall, the possibility that the CRD may contribute to the pro-cyclicality observed in the financial system under the predecessor Basel I framework led to the inclusion in the CRD of a clause which requires the Commission periodically to examine whether the CRD has significant effects on the economic cycle and to submit a biennial report together with any appropriate corrective measures. This is the purpose of the report, which, like the first report, is based on the analysis of the ECB.

Cyclicality of capital requirements: there is a consistent view among the national supervisory authorities surveyed by the ECB in 2011 that the CRD minimum required capital (MRC) is **more risk-sensitive** and tends to be more cyclical than previous Basel I requirements. The increase of cyclicality in capital requirements is mainly attributed to the higher risk sensitivity of the overall framework, in particular as regards the calculation of capital requirements under the internal ratings based (IRB) approaches.

The ECB quantitative analysis examined the extent to which input risk parameters to IRB models, namely probabilities of default (PDs) and loss given default (LGDs) estimations, and exposures, are correlated with macroeconomic factors, and how much this feeds through into cyclical MRC.

The ECB found some evidence for a cyclical MRC driven by cyclical PDs for larger Group 1 banks using the IRB approach to credit risk, offset somewhat by cyclical exposures (i.e. reduced in a downturn). Although cyclical MRCs are tentatively identified at the portfolio (corporate and retail) level, **this effect seems to be mitigated at the bank level** when the whole sample of banks is considered.

This mitigation is likely to be primarily due to portfolio adjustment concerning the size and composition of banks' overall portfolios. However, the observed reallocations of assets were likely triggered by the financial crisis rather than changes in the underlying risk parameters *per se*. For instance, banks may have targeted a higher amount of assets eligible as collateral in central bank liquidity operations to improve their liquidity position and to be able to benefit from cheap central bank funding. In the absence of the crisis, then, the MRC may have been more cyclical.

Banks using the Standardised Approach may also have a cyclical MRC due to the method's reliance on external CRAs whose ratings are cyclical.

Impact on lending: the ability and willingness of banks to lend depends in part on the degree to which the minimum capital constraints are binding. Although the MRC calculated under the current CRD may have had some impact on actual capital levels held by banks, in addition to several other factors, expectations of stricter future regulatory requirements may have resulted in capital targets set considerably above the MRC, with significant impacts on balance sheets and lending policies. However, this is a driver that is different from the cyclicality of the current legislation.

Impact of credit availability on the economic cycle: quantifying the impacts of MRC changes on lending and GDP remains difficult.

Given all the caveats encountered in the ECB's quantitative analysis of MRC cyclicality, for instance the very limited data available and the impact of the financial crisis both via additional regulatory changes, government interventions and behavioural adjustments, it seems to be too early to make a quantitative estimate of how big the pro-cyclical impact of CRD capital requirements on lending and GDP might be.

Measures to address pro-cyclicality: in July 2011, the Commission proposed a legislative package for the reform of banking regulation, including a **directive** (CRD IV) and a **regulation** (CRR). This follows the Basel III agreement and will meet the key objective of maintaining the credit supply to the real economy in the EU.

The proposal includes a number of measures that may mitigate pro-cyclicality in banking lending:

- a single rule book;
- a countercyclical capital buffer;
- the introduction of a leverage ratio;
- reduced dependency on credit rating agencies for prudential requirements, and
- scope to undertake further measures to enhance loan availability for small and medium sized enterprises.

Where appropriate, the implementation of measures will be phased in over time in order to avoid pro-cyclical effects.

Credit institutions: taking up and pursuit of the business. Recast

2004/0155(COD) - 18/12/2012 - Follow-up document

The Commission presents a report on the application of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions, to microcredit. It recalls that in November 2007, the European Commission published its Communication "[A European initiative for the development of microcredit in support of growth and employment](#)" in order to promote a more favourable environment for microcredit provision. More recently, the Commission has been directly engaged with both the microcredit sector and national public authorities to identify obstacles microcredit providers face in deploying their services throughout the EU and to consider how these might be overcome and whether there is a need for regulatory action at national or EU level.

The report notes that the Commission is very active in this area notably with the JEREMIE and JASMINE initiatives and the [European Progress Microfinance Facility](#) launched in 2010 to increase the availability of microcredit for alleviating unemployment amongst young people.

The report clarifies what is meant by microcredit with a special focus on microlenders. It gives an overview of the prudential supervision of microlenders across the EU and identifies the effects of the prudential requirements on microcredit activities resulting from the application of the Directive 2006/48/EC.

The Commission **does not consider that the prudential requirements, as laid down in Directive 2006/48/EC, impede the development of microcredit activities.** The prudential rules do not seem to penalise microcredit in the EU, partly because a large portion of microcredit providers are exempted from the application of prudential requirements laid down in the Directive 2006/48/EC. For those not exempt, several factors tend to mitigate the impact of the prudential requirements laid down in Directive 2006/48/EC on microcredit activities:

- access to public guarantee schemes enables microcredit providers to significantly reduce the level of own funds required to cover the credit risk to which they are exposed;
- given the small size of microcredits, most microcredit can be exempted from the large exposure limit designed to limit concentration risk (25% of the regulatory own funds of the banking microcredit providers);
- the Directive's requirements in terms of risk management help the banking microlenders to mitigate their risks;
- Directive 2006/48/EC requires that banking institutions, including microlenders, have sound liquidity management strategies, policies and processes to identify, measure, monitor and control liquidity risk on a day-to-day basis, and contingency plans for handling liquidity problems;
- the Directive may involve high administrative burdens which may reduce the attractiveness of microcredit as a banking business. However, some prudential requirements, especially those related to prudential reporting, the risk assessment process and capital adequacy can be commensurate with the smaller size and complexity of these institutions, which helps to alleviate the administrative burden.

Since prudential rules do not penalise microcredit, this precludes the need to tailor them to the particular features of microcredit activities. Moreover, microcredit brings together a wide range of actors who are not subject to similar rules and is dealt with in a diversity of ways across Member States depending on the policy framework and the legislation in place. Given this heterogeneous situation combined with the lack of a consistent definition of microcredit, any action to modify the prudential and regulatory framework would require careful consideration to ensure that microcredit activities are effectively promoted.

It might also be argued that no prudential reform needs to be undertaken if the development of microcredit is driven to a large extent by non-prudential factors. That does not mean that prudential regulation has no impact on the development of such activities, but that **prudential factors do not play a critical role in the development of microcredit**, making any prudential reforms unnecessary. A number of areas outside of the prudential sphere could instead be the focus of reforms:

- one way to foster the supply of microcredits may be to create a more favourable general environment for institutions specialising in microcredit by facilitating their access to financial resources. This development might be promoted through a **wider provision of loan guarantees**, encouraging closer cooperation between banks and non-banks or more financial transparency;
- the **development of voluntary codes of conduct** such as those which have been issued by the microcredit industry itself in recent years, or more recently by the Commission, can help to provide a higher degree of recognition and credibility to those microcredit providers adhering to them;
- a review of the **consumer protection environment** for microcredit, which is outside the remit of Directive 2006/48/EC, and any appropriate improvements, may also have positive effects on microcredit activities;
- greater attention to the **institutional framework for self-employment and microenterprises** could also increase chances of success and make microcredit more profitable.

Lastly, the report suggests fostering measures to **simplify legal and administrative regimes** or to smooth the transition between unemployment or social welfare dependence and self-employment.