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COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMISSION STAFF WORKING DOCUMENT

Accompanying document to the

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Directives 2006/48/EC and 2006/49/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management

SUMMARY OF THE IMPACT ASSESSMENT

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1. CHANGES: REASONS AND CONSULTATION

The Basel II Framework¹ of June 2004 and the Trading Book Review² of July 2005 were adapted and adopted in the EU in June 2006 as the Capital Requirements Directive (CRD); this comprises Directives 2006/48/EC³ and 2006/49/EC⁴.

Reasons for CRD changes

The CRD came into full effect in 2008. In spite of its nascent implementation, the revision of certain provisions of the CRD has become necessary.

- Amendments in areas ‘left open’ at the time of the CRD adoption in 2006 represent:
 - revisions of rules that were brought forward from previous directives, such as the *large exposures regime* and *derogations for bank networks from prudential requirements*;
 - establishing principles and rules that had not been formalised at the EU level such as the treatment of *hybrid capital instruments* within original own funds.
- Inconsistencies that have been identified during the transposition phase of the CRD need to be addressed to ensure that the effectiveness of the underlying goals of the CRD is not compromised. The majority of these are of a rather technical nature and less materiality and, therefore, are not covered in the impact assessment. However, a couple of more material revisions pertaining to the treatment of *life insurance as eligible collateral* and capital requirements for *collective investment undertakings under the IRB approach*⁵ are covered in the analysis.
- The revision of certain other areas has been prompted by the financial market turbulence that started in 2007 and is aimed at ensuring adequate protection of creditor interests and overall financial stability. In this context, rules related to *capital requirements and risk management for securitization positions* and *home-host supervisory issues and crisis arrangements* were re-examined.

Consultation of interested parties

Consultative work with key stakeholder groups has been conducted to a large extent through the Lamfalussy committees. The European Banking Committee (EBC) and the Committee of European Banking Supervisors (CEBS) have been extensively consulted throughout the project and their views have contributed to the preparation of this impact assessment.

CEBS

The work of CEBS was carried out in response to the Commission's calls for technical advice on *hybrid capital instruments* and *large exposures*. The final advice on both issues was received in April 2008.

¹ <http://www.bis.org/publ/bcbs107.htm>

² <http://www.bis.org/publ/bcbs116.htm>

³ Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions.

⁴ Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions.

⁵ The IRB Approach allows institutions to provide their own ‘risk inputs’ – probability of default, loss estimates, etc – in the calculation of capital requirements.

CRD Working Group

The Commission services also established a CRD working group (CRDWG) with members nominated by the EBC to discuss possible improvements to the current legislative text; the CRDWG met in November 2007, January, February and March 2008.

Other public consultations

In June 2007, the Commission services hosted a conference on the challenges for EU supervisory arrangements in an increasingly global financial environment. Key stakeholders, including industry representatives, supervisors, central bankers and regulators discussed efficiency and robustness of supervisory arrangements and underlined the need to develop a clearer European framework for dealing with cross-border crises. They also agreed that the efficiency of the current supervisory arrangements had to increase.

An online public consultation on proposed draft changes to the current legislation ran from April 16th to June 17th 2008.

Throughout the project, the Commission services have participated in international fora and have closely followed the work of the Basle Committee.

Inter-service steering group

An Inter-Service Steering Group was set up to follow progress and feed in views from other services of the Commission, including Directorates General ENTR, ECFIN, COMP, SJ and Secretariat General. The steering group met in December 2007 and April 2008.

2. PROBLEM DEFINITION

Large exposures

The aim of the large exposures regime is to prevent an institution from incurring disproportionately large losses as a result of the failure of an individual client (or a group of connected clients) due to the occurrence of unforeseen events⁶. The current large exposures regime suffers from the following shortcomings:

- High costs for the industry,
- The lack of clarity,
- Unlevel playing field and
- Higher burden for taxpayers and capital inefficiencies.

Hybrid capital instruments

Hybrid capital instruments (hybrids) are securities that contain features of both equity and debt. The purpose of issuing such instruments is to cover capital needs of banks while appealing to an investor class who is willing to take more risk than in fixed income products and who therefore also expect higher returns. From the banks' perspective, hybrids offer an additional source of funds. They are normally designed in a way that for regulatory purposes

⁶ 'Unforeseen events' are events which are outside the parameters of portfolio capital allocation and, therefore, might trigger unexpected default of an institution or cause it to experience difficulties, regardless of the performance of the rest of the portfolio. Such events include a sudden drying up of market liquidity, internal fraud, government action, loss of a major customer or market and are usually not reflected in *ex ante* credit quality assessments.

they qualify as 'original own funds'⁷. Hybrids are also quite tax efficient as the interest payable is tax deductible.

For hybrids to be recognised as 'original own funds', they need to fulfil the criteria of *loss absorption*⁸, *flexibility of payments*⁹ and *permanence*¹⁰. These criteria were agreed at the G10 level and announced in the Sydney Press Release¹¹ as far back as 1998; for various reasons they have still not been transposed into EU directives. The lack of legislation at the EU level has created unlevel playing field conditions and regulatory arbitrage opportunities.

Home-host issues and crisis management arrangements

The supervision of credit institutions is carried out by both home and host MS supervisory authorities although home MS authorities (consolidating supervisor) are responsible for the consolidated overview of the financial health of a financial group, including its parent, branches and subsidiaries.

In pan-European institutions, risk, liquidity and capital management are increasingly executed centrally for all organisational units, and groups are increasingly organized according to business lines. Consequently, it is becoming increasingly difficult to organize supervision on a predominantly national basis. In this context, the following problems were identified:

- Extra compliance costs and unlevel playing field for cross-border financial groups,
- Increased financial stability risks for host MS of systemically relevant branches,
- Sub-optimal effectiveness in cross border crisis prevention,
- Costs to creditors, employees and shareholders of cross-border groups as well as tax payers in case of a bank failure, and
- Potentially higher direct and indirect costs for the industry and EU economy in case of broader crisis.

Derogations for bank networks from certain prudential requirements

Article 3 of Directive 2006/48/EC allows MS to establish derogations, under certain conditions, from certain requirements, including minimum capital requirements, laid down by the directive for domestic credit institutions permanently affiliated to a central body. In order to be eligible for the derogations, credit institutions had to be affiliated to a central body by 15 December 1977 and the regimes implementing it in national law had to be in place by 15 December 1979.

These 'eligibility dates' have not been adapted since 1979 to accommodate later accessions and have resulted in higher than prudentially warranted compliance costs regarding cooperative bank networks in the post-1979 accession MS. Certain MS which acceded to the EU after 1979 have nevertheless implemented the derogations in their national law based on the understanding that the 'eligibility dates' could be interpreted as the date of their accession

⁷ Original own funds is the most reliable and liquid element of a bank's capital. It comprises share capital, retained earnings and hybrid capital instruments which meet the criteria agreed at G10 level. Subject to technical differences, 'original own funds' correspond to the Basel Accord terminology of Tier 1 capital.

⁸ Loss absorption: the instrument must be available to absorb losses, both on a going concern basis and in liquidation, and to provide support for depositors' funds if necessary.

⁹ Flexibility of payments: the instrument must contain features permitting the noncumulative deferral or cancellation of payment of coupons or dividends in times of stress.

¹⁰ Permanence: the instrument must be permanently available so that there is no doubt that it can support depositors and other creditors in times of stress.

¹¹ <http://www.bis.org/press/p981027.htm>

or some other date different from those set out in the article. If the directive provisions are enforced cooperative banks using the derogations would face increase in their compliance costs.

Life insurance as eligible collateral

The CRD allows for life insurance policies pledged to the lending credit institution to be recognised as collateral, thus, reducing the net exposure and hence the capital required for credit risk. Recognition is, however, limited to situations where the life insurer is externally rated in a way that would qualify him for a risk weight of 50% or less under the Standardized Approach¹² OR the equivalent under the Internal Ratings Based (IRB) Approach. Where they are recognised, life insurance policies are treated as if they were a guarantee provided by the life insurance company.

Some life insurance companies, regardless of their actual credit quality, have a competitive disadvantage if they are not rated as required and hence their policies cannot be used as collateral under the CRD. Smaller companies, in particular, are affected as an external credit rating may be prohibitively costly.

Capital requirements for Collective Investment Undertakings under the Internal Ratings Based Approach

For exposures in the form of a Collective Investment Undertakings (CIUs), such as investment funds, in principle, banks should 'look through' to the investments that the CIU has made and apply the IRB approach to them. However, normally banks do not know all individual items in the CIU and, even when they do they are not able to provide internal rating for these items. This exposes them to high compliance costs due to capital requirements disproportionate to risk. Current rules also have negative implications for the CIU managers.

Capital requirements and risk management for securitization positions

The current market turmoil has revealed the need to provide clarifications on certain provisions in the CRD; it has also raised the question on whether more stringent and restrictive capital requirements should be imposed with regard to the 'originate to distribute' model.

3. OBJECTIVES

The overarching goal of this initiative is to ensure that the effectiveness of the Capital Requirements Directive is not compromised. This implies the facilitation of attaining the following four general policy objectives to:

- Enhance financial stability,
- Enhance safeguarding of creditor interests,
- Ensure international competitiveness of the EU banking sector,
- Further promote the internal banking market integration.

In light of the problems outlined, seventeen operational objectives have been identified to address the problem drivers. Effective realization of such operational objectives should contribute to the achievement of the longer term specific objectives aiming at enhancing legal certainty, supervisory cooperation, level playing field, reducing compliance burden,

¹² Standardized Approach does not require institutions to provide their own estimates of risks in the calculation of capital requirements.

promoting cross-sectoral convergence and reinforcing risk management. In turn, this should facilitate the attainment of the general policy objectives.

4. IMPACT OF PREFERRED POLICY OPTIONS

Altogether, over 60 different policy options have been designed, impact-assessed and compared with a view to addressing the various issues identified in the analysis. This section describes only the preferred policy options in each area and their expected impact on key stakeholders.

Large exposures

An amended limit based backstop regime is considered to be most effective as it is specifically tailored to respond to the identified shortcomings of the current regime. Furthermore, the distribution of costs and benefits among stakeholder groups under this option is the most consistent.

Hybrid capital instruments

A common regulatory European framework would address the shortcomings of the current situation by facilitating convergence between MS and sectors, consequently contributing to stronger level playing field conditions within the single market. Clear EU regulation will improve the quality of capital from an industry and supervisory perspective, while providing more choice and liquidity to investors.

Home-host issues and crisis management arrangements

Colleges comprising authorities supervising group entities in different MS will address potential conflict and supervisory overlap. In crisis situations, stakeholders will benefit from enhanced supervisory cooperation and a clearer allocation of responsibilities. Mediation mechanisms will ensure conflict resolution while regular exchanges will allow for early detection of financial stress.

Derogations for bank networks from certain prudential requirements

It is appropriate to "regularize" the situation in the MS that have implemented derogations under Article 3 in their legal systems after the time limits. For other MS, this may open a possibility for EU bank networks with assets over €11 billion and representing more than 5 million members to qualify for the supervisory treatment under the article.

Life insurance as eligible collateral

The recognition of life insurance collateral irrespective of the existence of an external rating of the insurer would enhance the level playing field for life insurers.

Treatment of Collective Investment Undertakings under the IRB Approach

Applying more targeted increases to the Standardised risk-weights would provide for a sound and risk-sensitive alternative treatment of exposures in CIUs, whereby the percentage increase in risk weights would be lower for well rated exposures and higher for unrated exposures.

Capital requirements and risk management for securitization positions

Clarification and improvements reflecting concrete lessons from the crisis would ensure that banks:

- as lenders, apply more due diligence when granting loans, even if they pass the risk on to investors;

- as investors, are required to improve their understanding of the securitisation investments and their inherent risks;
- as sponsors, improve liquidity risk management with regard to contingent liquidity support to sponsored entities.

5. CUMULATIVE IMPACT OF PROPOSED AMENDMENTS

The proposed improvements aim to render the CRD framework more robust and responsive to market developments.

It is important to note that the CRD framework came into full effect in January 2008. The current turmoil broke out in the summer of 2007, i.e. at a time when full implementation of the CRD was still not in place. Notwithstanding, it is difficult to assume that such turmoil would not have arisen had the framework been fully in place. Turmoil in financial markets is often created as a result of irrational exuberance and over optimism in up-turns.

The proposed changes would result in improvements in risk management, quality of capital and greater competitiveness of small banks in co-operative structures. A level playing field and the removal of arbitrage opportunities within the EU will allow for more consistency and would eventually benefit institutions as well as the stakeholders such as clients, borrowers and other counter parties.

For cross-border groups, it is important that supervisors co-operate with each other and remain sensitised to developments in jurisdictions that go beyond their frontiers. This is a proposal that takes due account of the current functioning of supervisory practice in the EU and endeavours to render the process more 'collegial' and 'co-operative' to eventually enhance the financial stability of the system and the interests of the consumer and tax payer.

6. MONITORING AND EVALUATION

It is expected that the proposed amendments to the Capital Requirements Directive will enter into force in 2010. Since they are tightly inter-linked with other provisions of the CRD, that are already in effect since 2007/2008, a preliminary assessment of impact of some of the proposed amendments could be carried out at the time of the evaluation of the CRD (comprised of Directives 2006/48/EC and 2006/49/EC), which is required by 1 January 2012.

The Commission, in co-operation with Member States will monitor the effectiveness of the proposals once implemented. It will also take account of the macro-prudential indicators already developed and utilized by the ECB to monitor the stability of the banking sector.