Global Counsel

The EU’s new bank capital rules and Europe’s missing banking union

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Summary

- On May 15 European member states adopted their compromise text for European Fourth Capital Requirements Directive/Capital Requirements Regulation (CRD4/CRR). This is the legal instrument by which the new international ‘Basel III’ capital standards for banks will be written into European law.
- This is the cornerstone of the European regulatory response to the 2008 banking crisis and the most important piece of legislation to pass through Brussels this year. It is expected to be approved by the European Parliament with limited changes in July. It will be implemented in phases from January next year.
- In the week in which Spain scrambled into a potentially toxic nationalisation of Bankia, it is worth looking at CRD4/CRR as a product of the unique political economy of banking in Europe. CRD4/CRR bears all the marks of one of the deepest flaws in the Eurozone, and one of the key causes of the current mess.
- The EU set out to write a single prudential rulebook for a European market in which bank failure remains a uniquely national problem. Why it was never likely to ‘harmonize’ practice in Europe tells us a lot about the current problems of the Eurozone. It also explains why any high hopes for a level European – let alone a global – playing field for banking supervision are likely to remain unrealised.

The European Fourth Capital Requirements Directive/Capital Requirement Regulation (CRD4/CRR) is arguably the most important piece of legislation to pass through Brussels in 2012 or indeed this decade, and unless you work in financial services you have probably never heard of it. It is the legal instrument by which the new international ‘Basel III’ capital standards, written and adopted by the Basel Committee of Banking Supervisors in September 2010, will be written into European law. It will set the capital levels, regulatory capital definitions, leverage levels and liquidity levels required of European banks and investment firms in order to ensure their stability. It is the cornerstone of Europe’s regulatory response to the 2008 banking crisis.

After a long and often intemperate debate, European member states agreed a compromise text for CRD4/CRR on May 15. This text will now go into a final three-way negotiation with the European Parliament and the European Commission. The European Parliament wants to add new rules on bankers’ remuneration, and tweak some of the risk weighting for lending to SMEs, but the core detail on prudential capital standards is now probably settled. The European Parliament is expected to adopt a final package in July, which will mark the end of the process.

This Global Counsel Insight suggests that in the week in which Spain scrambled into a potentially toxic part-nationalisation of Bankia, it is worth looking at CRD4/CRR as a product of the unique political economy of banking in Europe. CRD4/CRR bears all the marks of one of the deepest flaws in the Eurozone, and one of the key causes of the current mess. The EU set out to write a single prudential rulebook for the EU. But Europe is a market in which bank failure remains a uniquely national problem. Therein lies the rub.

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Disharmony on harmonisation

The final stages of the debate on CRD4/CRR have hinged on two basic issues. The first is the degree to which capital requirements should be harmonised within and across the EU and the extent to which European states should be able to set higher standards than Basel III requires. The second is the question of whether the EU has come up with rules on defining ‘high quality’ capital that actually fail to meet the Basel standards altogether. Because the EU is the first major jurisdiction to implement Basel III, this raises questions about whether others are likely to follow its example.

Basel III explicitly states that its standards should be regarded as suggested minimums, and that individual regulators should feel free to go above them. The European Commission however took the position that individual European supervisors should not have this freedom – that European capital requirements should be harmonized around a maximum permitted level. Aside from its default-setting defence of a ‘single European rulebook’, the Commission’s argument was that such variation would distort competition, potentially pulling lending out of one EU market to meet higher capital requirements in another. The real issue was that vulnerable French and German banks in particular have no appetite for further large-scale raising of core Tier 1 capital and wanted to head off Spanish, Swedish and British plans to go further than Basel III.

The event that brought the issue to a head was the UK’s signaled intention that it would impose on the UK’s retail banks the 10% core Tier 1 capital requirement recommended by the UK Independent Commission on Banking, which is higher than the standards proposed by Basel III. After an angry debate that included the UK’s misjudged attempt to insert the issue into the debate on the European Fiscal Treaty in December 2011, the British demand for greater flexibility was accepted and codified in the Council proposal on May 15. The new proposed law would allow domestic supervisors to impose stricter standards of up to 500bps over the Basel III levels for domestic banks. Beyond this member states will have to seek EU approval. This gives the UK scope to go its own way in implementing the recommendations of the Independent Commission on Banking. Table 1 sets out the core changes in Basel III and CRD4/CRR.

Higher capital ratios	Significant increases in the Common Equity and Tier 1 capital requirements for institutions (see Figure 1)	Phased from 2013
Higher risk weights	Tighter definitions of high quality capital and increased weighting for riskier assets, including derivatives. The ‘riskier’ an institution’s balance sheet, the greater the relative level of required regulatory capital.	Phased from 2013
Capital conservation buffers	2.5% of Risk-Weighted Assets in Tier 1 capital held as a buffer against losses. Institutions breaching conservation buffers will face limits on paying bonuses and dividends on common equity.	Phased from 2013
Countercyclical capital buffers	Additional buffer of 0-2.5% of Risk-Weighted Assets held in Tier 1 capital, applied by national authorities to reflect macroeconomic conditions.	Phased from 2013
Short term liquidity coverage requirements	Institutions required to hold sufficient liquid assets to cover a 30 day liquidity crisis	Tested 2011-2014. Binding 2015
Long term net stable funding requirements	Institutions required to demonstrate stable funding 1 year ahead, measured against stress test scenarios	Tested 2012-2017. Binding 2018
Leverage ratio backstops	Ratio of Tier 1 capital to total balance sheet exposures must be greater than 3%	Binding 2018

Table 1: Key changes to the European prudential framework in CRD4/CRR
Source: CRD4/CRR draft

So far, so true to the Basel spirit. But the CRD4 story has another twist. If the European Commission and the member states have broadly

respected Basel's proposals for higher capital requirements, higher risk weightings for assets including derivatives and new liquidity and leverage requirements, they have arguably weakened it in their agreed definitions of core Tier 1 capital. This is the high quality loss absorbing capital that is intended to be the bedrock of bank balance sheets under the new system.

France gets scope for its *bancassurance* companies to count the capital of their insurance arms as part of their parent capital base - without real clarity as to whether this capital could be genuinely loss absorbing in the event of a crisis. Germany gets a definition of core Tier 1 capital that potentially appears to cover hybrid 'silent' equity injected into both Commerzbank and the *Landesbanken* after the banking crisis, despite the fact that the loss absorbency of this capital is also not clear. These forms of state-injected capital are also subject to long grandfathering periods in the new system, even if they do not meet the technical criteria for high quality capital set out in the CRD4 text. The European Banking Authority will now conduct a consultation to determine exactly what forms of hybrid capital and other assets are deemed to meet CRD4/CRR's standards. But for the moment, questions hang over the Basel compliance of these choices.

Bair, Chairman of the US FDIC is reported as having said last year that US banks and legislators should not take CRD4 as an invitation for similar departures from the Basel III standards when they are eventually implemented in the US. The Commission argues Basel's recommended standards are generic, and focused on international, not domestic, banks, and Europe's laws need to deal with specificities. The Commission's critics say specificities just mean special interests. Europe is the first major jurisdiction to implement Basel III and the perception that it is willing to bend the rules is likely to encourage others to argue for their own specific needs.

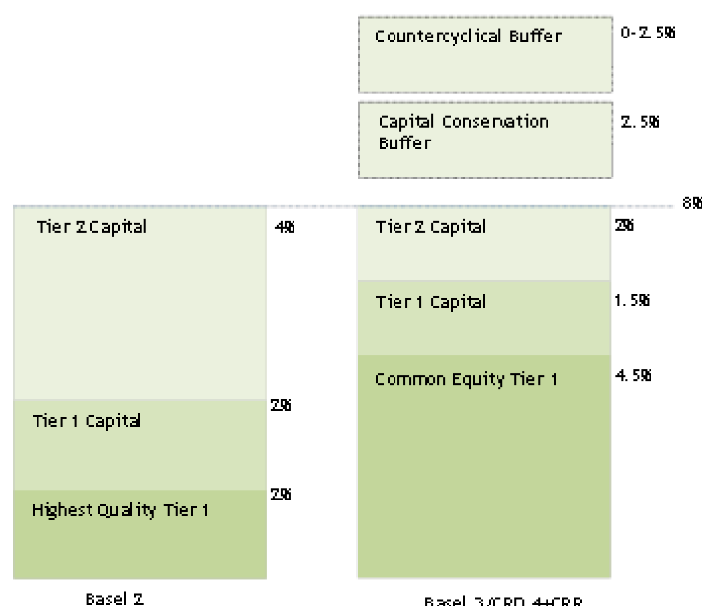

Figure 1: New capital adequacy ratios under CRD4/CRR

Source: CRD4/CRR draft

Europe likes to think that it has a good track record of internationalism on financial services regulation, as on many other issues. That record is based chiefly on the way in which it quickly and comprehensively implemented the previous 2004 Basel II standards in 2006. The CRD4/CRR process suggests that Europe's internationalism and defence of global standards is a bit less principled than it would like to think. A cynical explanation puts this down to horse-trading and special interests. To be sure, European member states can horse-trade with the best of them. But something more fundamental is going on here.

Disunity on banking union

And this is the nub of the issue. Almost everywhere else in the European single market the harmonisation of standards, and a single rule book, is recognised as not just sensible but necessary. Why is banking different? This simple question actually goes to the heart of what is currently going wrong in the Eurozone. The single European market is not a 'banking union'. It has a relatively unified single market for banking services, but national markets for banking rescues or resolutions. The result in many cases is institutions whose balance sheets are not much

smaller than the national states into whose arms they have collapsed. This is of course the arrangement that brought us RBS and the UK, AIB and Ireland, Fortis and Belgium. Bankia and Spain.

As problematic as such national rescues are, while national taxpayers remain on the hook for them, the case for preserving the discretion of national supervisors in Europe to determine what makes a bank safe is pretty hard to deny. This was the political reality that Brussels came up against in trying to impose a single prudential rule book on the single market.

Spain's current problems with Bankia would look different if Bankia could be recapitalized from a central Eurozone pot or taken into pan-Eurozone receivership, rather than being drawn into a toxic nationalisation and recapitalisation process with its already weak sovereign, just as happened in Ireland and elsewhere. Hence Spain's desperate diplomacy this week to secure support for the idea of direct EU-level support for troubled banks, a call which ECB Governor Mario Draghi, and Commission President José Manuel Barosso have seconded.

The big political obstacles to such a banking union are clear enough. The UK, which dominates the EU market for financial services, is outside the Eurozone and allergic to the idea of pan-European banking supervision. In many other European states, local and state banks are often regarded as key parts of the state and social infrastructure, and large flagship banks as national champions whose failure is probably politically inconceivable.

Pooling these political and economic risks, and working out how to capitalise the fund that might handle them, especially if it is raised by taxes on financial institutions, is just a step too far for the EU. The European Commission has been sitting on legislative proposals for bank crisis management and resolution for at least three years, but the dossier has been dogged by resistance from member states. The current scale of vulnerability in bank balance sheets is hardly an incentive for mutualising a rescue mechanism. Although that very weakness may ultimately force the issue in the Eurozone in the months ahead.

The CRD4/CRR debate started with a lot of principled talk about a single European rulebook, but it was quickly held hostage by these idiosyncrasies of the political economy of banking in the EU. Governments heavily exposed to their banks had the somewhat perverse incentive to argue against forcing them to raise new capital, and for a diluting of the standards for that capital. Governments like the UK whose exposure to their banks was and is many times their GDP and who have belatedly come to see this as an existential risk, have an even stronger incentive to assert their own control over prudential standards. Because everywhere in the EU national taxpayers ultimately get landed with the bill, national political prerogative trumped the logic of a single set of rules.

There is no real political appetite in the EU for shrinking banks. So the focus of reform after the banking crisis was always going to be on capital cushions as a guard against failure, and on the means to allow large banks to fail safely. The EU is politically unable to have a serious debate about safe failure, because the risks are large and unevenly spread around the EU, and the EU is not politically ready to pool them. But its inability to do that also made it very difficult to have a serious debate about harmonizing capital levels and capital quality.

The result for banks and financial institutions in the EU? A regulatory and supervisory patchwork. A likely gap between Basel III's interpretation and implementation in the US, EU and potentially Asia. And, at the end of the day, the persistent problem that some of Europe's banks are too big or sensitive to fail, and ruinously expensive for individual European states to save.

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