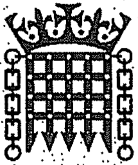

HOUSE OF COMMONS

President José Manuel Barroso
President of the European Commission
European Commission
Rue de la Loi 200
1049 Brussels
Belgium

By email: SG-NATIONAL-PARLIAMENTS@ec.europa.eu

9 November 2011

Dear Mr President,

EUROPEAN UNION DOCUMENT NO. 13284/11: PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL ON PRUDENTIAL REQUIREMENTS FOR CREDIT INSTITUTIONS AND INVESTMENT FIRMS

Com (2011) 452

On 8 November 2011, the House of Commons of the United Kingdom Parliament resolved as follows:

> That this House considers that the draft Regulation on prudential requirements for credit institutions and investment firms (European Union Document No. 13284/11 and Addenda 1 to 4) does not comply with the principle of subsidiarity for the reasons set out in the Annex to Chapter 1 of the Forty-second Report of the European Scrutiny Committee (HC 428-xxxvii); and in accordance with Article 6 of the Protocol on the application of the principles of subsidiarity and proportionality, instructs the Clerk of the House to forward this reasoned opinion to the presidents of the European Institutions.

I enclose the report referred to.

Yours sincerely,

Robert Rogers

Robert Rogers
Clerk of the House

Robert Rogers, Clerk of the House of Commons
London SW1A 0AA T: 020 7219 1310/3758 F: 020 7219 3727

Reasoned Opinion of the House of Commons

Submitted to the Presidents of the European Parliament, the Council and the Commission, pursuant to Article 6 of Protocol (No 2) on the Application of the Principles of Subsidiarity and Proportionality.

Draft Regulation on prudential requirements for credit institutions and investment firms[1]

Treaty framework for appraising compliance with subsidiarity

1. The principle of subsidiarity is born of the wish to ensure that decisions are taken as closely as possible to the citizens of the EU. It is defined in Article 5(2) TEU:

> "Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States, either at central level or at regional and local level, but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level."

2. The EU institutions must ensure "constant respect"[2] for the principle of subsidiarity as laid down in Protocol (No 2) on the Application of the Principles of Subsidiarity and Proportionality.

3. Accordingly, the Commission must consult widely before proposing legislative acts; and such consultations are to take into account regional and local dimensions where necessary.[3]

4. By virtue of Article 5 of Protocol (No 2), any draft legislative act should contain a "detailed statement" making it possible to appraise its compliance with the principles of subsidiarity and proportionality. This statement should contain:

— some assessment of the proposal's financial impact;

— in the case of a Directive, some assessment of the proposal's implications for national and, where necessary, regional legislation; and

— qualitative and, wherever possible, quantitative substantiation of the reasons for concluding that an EU objective can be better achieved at EU level.

The detailed statement should also demonstrate an awareness of the need for any burden, whether financial or administrative, falling upon the EU, national governments, regional or local authorities, economic operators and citizens, to be minimised and to be commensurate with the objective to be achieved.

1 (33052) 13284/11: COM(11) 452.

2 Article 1 of Protocol (No 2).

3 Article 2 of Protocol (No 2).

5. By virtue of Articles 5(2) and 12(b) TEU national parliaments ensure compliance with the principle of subsidiarity in accordance with the procedure set out in Protocol (No 2), namely the reasoned opinion procedure.

Previous Protocol on the application of the principle of subsidiarity and proportionality

6. The previous Protocol on the application of the principle of subsidiarity and proportionality, attached to the Treaty of Amsterdam, provided helpful guidance on how the principle of subsidiarity was to be applied. This guidance remains a relevant indicator of compliance with subsidiarity:

> "For Community action to be justified, both aspects of the subsidiarity principle shall be met: the objectives of the proposed action cannot be sufficiently achieved by Member States' action in the framework of their national constitutional system and can therefore be better achieved by action on the part of the Community.
>
> "The following guidelines should be used in examining whether the abovementioned condition is fulfilled:
>
> - the issue under consideration has transnational aspects which cannot be satisfactorily regulated by action by Member States;
> - actions by Member States alone or lack of Community action would conflict with the requirements of the Treaty (such as the need to correct distortion of competition or avoid disguised restrictions on trade or strengthen economic and social cohesion) or would otherwise significantly damage Member States' interests;
> - action at Community level would produce clear benefits by reason of its scale or effects compared with action at the level of the Member States."[4]

Proposed legislation

7. The content of the proposed Regulation is set out in detail in the Committee's Report, to which this Reasoned Opinion is attached. For these purposes we set out the stated objective of the proposal and the reasons given for EU rather than Member State action.

Objective

8. The Commission's explanatory memorandum describes the objective of the proposal as follows:

> "The overarching goal of this initiative is to ensure that the effectiveness of institution capital regulation in the EU is strengthened and its adverse impacts on depositor protection and procyclicality of the financial system are contained while maintaining the competitive position of the EU banking industry."[5]

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4 Article 5.

5 Para 1.1.2.

9. By contrast, however, the legal base addresses the functioning of the internal market. The legal base has also been used to distinguish the draft Regulation from the related draft Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms:[6]

> "[w]hereas the proposal for Directive [inserted by OP] governs the access to the activity of businesses and is based on Article 53 TFEU, the need to separate these rules from the rules on how these activities are carried out warrants the use of a new legal basis for the latter."[7]

Subsidiarity

10. The Commission's explanation for why the proposal is consistent with the principle of subsidiarity is set out at section 4.2 of the explanatory memorandum. We set it out here in full:

> "In accordance with the principles of subsidiarity and proportionality set out in Article 5 TFEU, the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore be better achieved by the EU. Its provisions do not go beyond what is necessary to achieve the objectives pursued. Only EU action can ensure that institutions and investment firms operating in more than one Member State are subject to the same prudential requirements and thereby ensure a level playing field, reduce regulatory complexity, avoid unwarranted compliance costs for cross-border activities, promote further integration in the EU market and contribute to the elimination of regulatory arbitrage opportunities. EU action also ensures a high level of financial stability in the EU. This is corroborated by the fact that prudential requirements set out in the proposal have been set out in EU legislation for more than 20 years.
>
> "Article 288 TFEU leaves a choice between different legal instruments. A Regulation is therefore subject to the principle of subsidiarity in the same manner as other legal instruments. Subsidiarity must be balanced with other principles in the Treaties such as the fundamental freedoms. Directives 2006/48/EC and 2006/49/EC are formally directed at Member States but eventually addressed towards businesses. A Regulation creates a more level-playing field since it is directly applicable and there is no need to assess legislation in other Member States before starting a business since the rules are exactly the same. This is less burdensome for institutions. Delays with regard to the transposition of Directives can also be avoided by adopting a Regulation."

11. The Commission's impact assessment addresses subsidiarity in the following terms:

> "Based on the nature of problems outlined in the above analysis, several major justifications that meet the principle of subsidiarity for action at the EU level become apparent. They include a need to enhance the integration of EU internal banking market (by removing national options, discretions and possibilities to 'gold-plate'), address several market (e.g., in the area of countercyclical policy measures) and regulatory failures (e.g., capital definition and liquidity risk management rules, capital requirements for CCR) that were brought to light by the financial crisis, correct for regulatory arbitrage opportunities which are made possible by the current legislation (due to the availability of certain national options and discretions) and ensure a consistent EU approach for tackling

6 (33053) 13285/11: COM(11) 453.

7 Section 4.1.

various issues covered by the scope of this report, which would do away with the need for MS to pursue individual approaches that risk fragmenting the internal market.

"Most importantly, only a common EU-level approach could be expected to effectively provide for financial stability and tame excessive financial pro-cyclicality, as currently policies that are directed toward these key systemic aspects are either geared to national needs or are absent altogether. With respect to the latter, the crisis clearly demonstrated the ineffectiveness of the national liquidity risk supervision approaches."

Aspects of the Regulation which do not comply with the principle of subsidiarity

12. The House of Commons considers that the draft Regulation on prudential requirements for credit institutions and investment firms does not comply with either the procedural obligations imposed on the Commission by Protocol (No 2) or the principle of subsidiarity in the following respects.

i) Failure to comply with procedural obligations

13. Neither section 4.2 of the explanatory memorandum nor 3.8 of the impact assessment contains a "detailed statement" to make it possible to appraise compliance with the principle of subsidiarity (and proportionality), as required by Article 5 of Protocol No 2, TFEU.

14. The presumption in Article 5 TEU is that decisions should be taken as closely as possible to the EU citizen. A departure from this presumption should not be taken for granted but justified with sufficient detail and clarity that an EU citizen can understand the qualitative and quantitative reasons leading to a conclusion that EU action is justified.

15. The proposed Regulation differs from the Capital Requirements Directive by removing the possibility for Member States to impose stricter prudential requirements when necessary than set out in the Regulation. This is a significant change, leading to "maximum harmonisation" of minimum requirements. To discharge the obligations placed on it by Article 5 of Protocol No 2, the Commission should have prepared a detailed statement outlining the quantitative and qualitative reasons for this change: the relevant sections of the impact assessment and explanatory memorandum fall far short of the detail required.

16. The Commission's approach to the consideration of subsidiarity is matter of concern not only to the House of Commons, but to all national parliaments of EU Member States. We draw its attention to paragraph 2.3 of the Contribution of the XLVI COSAC:

> "In accordance with Article 5 of Protocol 2, COSAC underlines that for national Parliaments to exercise the powers vested in them it is necessary to enable the financial effects of EU draft legislative acts to be evaluated, and, in the case of Directives, the implications for national legal systems also to be evaluated. Moreover, COSAC recalls that EU draft legislative acts should be justified on the basis of qualitative and quantitative indicators. COSAC notes that subsidiarity analyses in the Commission's explanatory memoranda have, to date, not met the requirements of Article 5."

ii) Failure to comply with principle of subsidiarity

17. Compliance of this objective with subsidiarity is appraised in the light of the guidance set out in paragraph 6 above.

18. The House of Commons considers that the objectives of the Regulation could be better achieved without precluding Member States from imposing stricter requirements. We come to this conclusion because it is clear that there continues to be a need for a flexible approach to address prudential concerns at national level. This is reflected by the introduction of Article 443 into the Regulation, in which the Commission proposes that it should be able to adopt delegated acts to impose stricter prudential requirements, for a limited period of time, for one or more sectors, regions, *or Member States*. We do not, however, find there is sufficient evidence to demonstrate that the Commission is better placed than the competent authorities of Member States to address national prudential concerns. Indeed, there is a strong argument to say that national authorities are not only better placed, but can react more quickly than the Commission can by means of delegated legislation, thereby enhancing financial stability. (Nor are we convinced that Article 443 is an appropriate use of the Commission's delegated powers under Article 290 TFEU: prudential requirements are not "non-essential" elements of the proposed Regulation.)

19. In coming to this conclusion we have considered the legal base. In our estimation the functioning of the internal market is at best a secondary objective: it is evident from the Regulation, explanatory memorandum and impact assessment that the predominant legislative objective is prudential supervision. We note that section 3.8 of the impact assessment states that fragmentation of the internal market is only a risk — we think the internal market objective can be put no higher than that. We do not think drawing a distinction between parallel proposals is a sufficient reason for a single market legal base, and we note that the two Directives that make up the Capital Requirements Directive are based on (what is now) Article 53 TFEU. We are not therefore convinced that uniformity within the internal market is sufficient reason for removing Member State discretion to require higher prudential standards in excess of the proposed Regulation.

Conclusion

20. For these reasons given above the House of Commons concludes that this proposal does not respect the principle of subsidiarity.

1 Financial services: prudential requirements

(a) (33052) 13284/11 + ADDs 1–4 COM(11) 452, Parts 1–3	Draft Regulation on prudential requirements for credit institutions and investment firms
(b) (33053) 13285/11 + ADDs 1–2 COM(11) 453	Draft Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

Legal base	(a) Article 114(1) TFEU; co-decision; QMV (b) Article 53(1) TFEU; co-decision; QMV
Documents originated	20 July 2011
Deposited in Parliament	29 July 2011
Department	HM Treasury
Basis of consideration	EM of 5 September 2011 and Minister's letter of 3 October 2011
Previous Committee Report	None
To be discussed in Council	Not known
Committee's assessment	Politically important
Committee's decision	Not cleared; more information requested. Recommend debate on Reasoned Opinion

Background

1.1 The Basel Committee on Banking Supervision (commonly referred to simply as the Basel Committee) is a committee of banking supervisory authorities, the aim of which is to enhance understanding of key supervisory issues and improve the quality of banking supervision worldwide. Its members, representative of central banks and, where separate, supervisory authorities, come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.[1]

1.2 The Basel Committee frames guidelines and standards in different areas. In June 2011 the Committee published a slightly revised version of its December 2010 *"Basel III: A global*

1 See http://www.bis.org/bcbs/about.htm.

regulatory framework for more resilient banks and banking systems" (commonly referred to simply as Basel III). The Committee says of Basel III: [2]

> "Basel III is a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision, to strengthen the regulation, supervision and risk management of the banking sector. These measures aim to:
>
> improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source;
>
> improve risk management and governance;
>
> strengthen banks' transparency and disclosures.
>
> "The reforms target:
>
> bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress;
>
> macroprudential, system wide risks that can build up across the banking sector as well as the procyclical amplification of these risks over time.
>
> "These two approaches to supervision are complementary as greater resilience at the individual bank level reduces the risk of system wide shocks."

1.3 Directive 2006/48/EC relating to 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, together known as the Capital Requirements Directive (CRD), introduced a supervisory framework within the EU, designed to ensure the financial soundness of credit institutions (banks and building societies) and certain investment firms, while reflecting the Basel II rules on capital measurement and capital standards. Subsequently two packages of amendments, known as CRD II and CRD III, were adopted in amending Directives 2009/111/EC and 2010/76/EC.

The documents

1.4 The Commission presents this draft Regulation on prudential requirements for credit institutions and investment firms, document (a), and this draft Directive on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, document (b), as a package known as CRD IV. The intention is to replace the Capital Requirements Directive and to partly introduce Basel III into EU law. The Commission explains that the overarching aim of the package is to strengthen the effectiveness of capital regulation in the EU and to contain adverse impacts on depositor protection and pro-cyclicality of the financial system, while maintaining the competitive position of the EU banking industry.

1.5 The Commission suggests that its proposal for a Regulation aims to address regulatory shortcomings related to:

[2] See http://www.bis.org/bcbs/basel3.htm.

- the quality and quantity of capital that banks hold in order to absorb losses effectively as they arise;
- the management of liquidity risk linked to a reliance on wholesale funding with short term maturity instruments;
- the treatment of counterparty credit risk arising from derivatives, repurchase agreements (repo) and securities financing activities; and
- the current divergences between Member States, which prove burdensome for firms operating cross-border, create an uneven playing field and lack legal clarity.

1.6 In relation to its proposal for a Directive, the Commission suggests that it should build on the existing Capital Requirements Directive by introducing four new elements:

- provisions on sanctions to ensure compliance with EU banking rules to protect users of banking services and to ensure the safety, stability and integrity of banking markets;
- preventing overreliance on external credit ratings that has led to financial institutions and institutional investors relying solely or mechanistically on ratings issued by credit rating agencies, while neglecting their own due diligence and internal risk management obligations;
- effective corporate governance and provisions, a lack of which has been partly to blame for the excessive accumulation of risk; and
- addressing the pro-cyclicality of lending, which tends to follow the direction of and amplify the economic cycle.

The draft Regulation

Maximum harmonisation

1.7 The Commission suggests that a maximum harmonised Regulation is necessary to achieve a single EU rule book in banking. Therefore, the Commission proposes re-casting Pillar 1 (minimum capital requirements) and Pillar 3 (disclosure requirements) of the CRD in the form of a Regulation whose provisions are harmonised to maxima. This would prevent Member States from requiring higher prudential standards in excess of the levels set out in the proposed Regulation. It argues that it is uncertain what the potential impacts would be in the case of higher capital requirements in one or more Member States, reasoning that stricter requirements in individual Member States might shift the underlying exposures and risks to the shadow banking sector, or from one Member State to another. In addition, the Commission highlights its concern that allowing Member States to impose higher capital requirements might lead to a "race to the top" mechanism across the EU.

1.8 However, the Commission proposes three possibilities for competent authorities to address macro-prudential concerns at national level, which would allow Member States to:

- apply higher risks weights or stricter criteria to exposures secured by mortgages on immovable property, where appropriate, on the basis of financial stability considerations;

- impose additional requirements on individual credit institutions or investment firms ("institutions") or groups of institutions where justified by specific circumstances under Pillar 2 (supervisory requirements); and
- set the level of the countercyclical capital buffer, reflecting the specific macroeconomic risks in a given Member State.

Additionally, with Article 443, the Commission proposes that:

- it should be able to adopt delegated acts to impose stricter prudential requirements, for a limited period of time, for all exposures, or for exposures to one or more sectors, regions or Member States, where it is necessary to address changes in the intensity of micro-prudential and macro-prudential risks;
- such delegated acts could be adopted in relation to a number of specific areas, in particular including imposing a temporary increase in the minimum level of own funds set out in Article 87; and
- the power would be exercisable in particular upon recommendation or opinion of the European Stability Risk Board.

Definition of capital

1.9 The Commission suggests that the draft Regulation should build upon the changes made in Directive 2009/111/EC (that is the package known as CRD II) to further strengthen the criteria for eligibility of capital instruments. In particular, the Commission's proposal would introduce significant harmonisation of the adjustments made to accounting equity, in order to determine the amount of regulatory capital that it is prudent to recognise for regulatory purposes.

1.10 With Article 24 the Commission proposes assets that may constitute Common Equity Tier 1 instruments:

- capital instruments, provided the conditions laid down in Article 26 are met;
- share premium accounts related to those instruments;
- retained earnings;
- accumulated other comprehensive income;
- other reserves; and
- funds for general banking risk.

In Article 26 the Commission outlines the conditions which capital instruments would have to meet in order to qualify as Common Equity Tier 1, allowing any capital instruments that count as equity under Member States' national law to qualify, as long as:

- they meet the substance of the 14 criteria for Common Equity Tier 1, as agreed by the Basel Committee; and

- they qualify as capital within the meaning of Article 22 of Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions.

1.11 Articles 33–44 would set deductions which institutions should make from Common Equity Tier 1 items. This includes Deferred Tax Assets (DTAs) — assets on a balance sheet that may be used to reduce any subsequent period's income tax expense and that rely on the future profitability of the institution. Article 36 would provide the Basel III exemption that certain DTAs, which do not rely on future profitability (so automatically convert into a claim on the state when a firm makes a loss), would not require deduction.

1.12 Articles 45 and 46 would introduce the Basel III agreement on the deduction of holdings of Common Equity Tier 1 instruments, where a bank has a significant investment in insurance subsidies:

- this would allow 10% of a bank's capital to come from investments in insurance subsidiaries;
- however, the inclusion of Article 46 containing other exemptions from, and alternatives to, deduction where consolidation is applied, would provide an opt-out from the Basel III agreement; and
- this would allow banks to apply three alternative methods for deduction, in accordance with the Financial Conglomerates Directive, Directive 2002/87/EC.

Article 46 provides for the Commission to legislate for any changes that would be necessary to the Financial Conglomerates Directive.

1.13 Articles 87–89 set out the own funds requirements that institutions would be expected to hold at all times. In line with the agreement reached in Basel III, the Commission proposes that banks be expected to hold, as a minimum, own funds expressed as a percentage of the total risk exposure:

- Common Equity Tier 1 capital ratio of 4.5%;
- Tier 1 capital ratio of 6%; and
- Total capital ratio of 8%.

1.14 The Commission sets out conditions for grandfathering (phasing out) of capital instruments that no longer meet the criteria for Common Equity Tier 1, Additional Tier 1 and Tier 2 instruments in Articles 462–469:

- it proposes that instruments should be eligible for grandfathering up until 20 July 2011, the date that the Commission's proposals were published (Article 463);
- so all capital instruments that do not meet the new rules, and which are issued after this cut-off date, would be fully excluded for regulatory purposes from 2013;
- the Commission suggests that this is necessary, since adopting the Basel III agreed date (12 September 2010) would mean applying the Regulation retrospectively, which would not be legally feasible; and

- it was agreed in Basel III that instruments issued by joint stock companies would not be allowed a phasing-out period — however, with Article 464 the Commission proposes that Common Equity Tier 1 instruments issued by joint-stock companies, which would no longer be accepted, should be allowed a ten-year grandfathering period. The Commission suggests that the highest quality instruments issued by joint stock companies that are not common shares, and the related share premium accounts, should be allowed ten-year grandfathering to ensure the consistent treatment of different forms of a company.

Treatment of specific exposures

1.15 Part Three, Title II, Chapter 1–3 of the draft Regulation (Articles 102–187) sets out the two approaches that institutions would be able to take to calculate their risk-weighted exposures:

- the Standardised Approach (Chapter 2, Articles 106–136), which is the accounting value remaining after specific credit risk adjustments have been applied. The application of risk weights are based on both the exposure class to which the exposure is assigned to and its credit quality; and
- the Internal Rating Based Approach (Chapter 3, Articles 137–187), which relies upon an institution's internal assessment of its counterparties and exposures. An institution would require the permission of the competent authority to adopt this approach rather than the Standardised Approach.

Counterparty credit risk

1.16 With Part Three, Title II, Chapter 6 (Articles 266–300), the Commission proposes strengthening the requirements for management and capitalisation of counterparty credit risk, which is the risk that the counterparty to a transaction could default before the final settlement of the transaction's cash flows. The Commission reasons that subjecting institutions to an additional capital charge for possible losses associated with the deterioration in the creditworthiness of a counterparty would promote sound practices in managing this risk and recognise its hedging. This would then allow institutions to mitigate the impact of this capital charge. The Commission sets out the four methods that institutions would be able to use to calculate their exposure:

- the mark-to-market method (Article 269), which determines the replacement cost of all contracts with positive values based on current market values of the contracts;
- the original exposure method (Article 270), which is the notional amount of each instrument multiplied by the corresponding percentage;
- the standardised method (Articles 271–276) for calculating the exposure value for over-the-counter derivatives and long settlement transactions; and
- the internal model method (Articles 277–279) to measure the exposure value of applicable transactions at a net level, if the competent authorities are content that the systems for the management of counterparty credit risk maintained by the institution are sound and properly implemented.

Liquidity

1.17 With Part Six (Articles 400 — 415) the Commission proposes introducing minimum liquidity requirements across the EU, in the form of two instruments:

- a Liquidity Coverage Requirement, which aims to support the short-term resilience of banks to liquidity shocks by ensuring that they have liquid assets to survive a 30 day stress test; and
- a Net Stable Funding Ratio, to ensure that banks fund themselves from medium- and long-term sources of funding in relation to their liquidity risk profiles.

1.18 Articles 404 and 405 set out the reporting and operational requirements of liquid assets eligible for the Liquidity Coverage Requirement, with the Commission proposing that institutions should report a minimum of 60% of liquid assets from:

- cash and deposits held with central banks;
- transferable assets that are extremely high liquidity and credit quality; and
- transferable assets representing claims on or guarantees by a Member State's central government.

The remaining 40% of liquid assets that institutions would have to report on could come from transferable assets of a high liquidity and credit quality. This would allow banks some discretion to identify which assets should be monitored during the observation period of the Liquidity Coverage Requirement, provided they are transferable assets. Following the observation period, the Commission proposes that it have delegated powers to adopt rules governing the precise calibration of the Liquidity Coverage Requirement, in order to avoid the lengthy ordinary legislative procedure.

1.19 Article 481, on the reports and reviews relating to liquidity requirements, would require the European Banking Authority to report to the Commission on whether it would be appropriate to ensure that institutions used stable sources of funding by 31 December 2015. On the basis of that report, a Commission report would follow, as would a legislative proposal, if appropriate, by December 2016. So:

- the Commission's proposal does not necessarily imply implementation of the Net Stable Funding Ratio as a binding measure;
- but the European Banking Authority would be tasked with reporting on whether the Net Stable Funding Ratio should be fully implemented; and
- Recital 76 confirms this by suggesting that the Authority should, based on the reporting required by the draft Regulation, evaluate how the Net Stable Funding Ratio should be designed.

Leverage ratio

1.20 The Commission introduces the concept of a leverage ratio as a new regulatory and supervisory tool for the EU in Part Seven of the draft Regulation (Articles 416 and 417). The Commission:

- indicates that this would be calculated as Tier 1 capital divided by the institution's total exposure;
- explains, however, that this would not be a binding instrument at this stage, but an additional feature that could be applied on individual banks at the discretion of supervisory authorities; and
- Article 487, which references Article 436 on the disclosure of institutions' leverage ratio, proposes that institutions shall disclose information regarding their leverage ratio from 1 January 2015.

Article 482 provides that the Commission should submit a report on the impact and effectiveness of the leverage ratio by 31 December 2016. If the Commission deemed it appropriate, a legislative proposal would accompany its report, to provide for the migration of the leverage ratio to a Pillar 1 measure.

Basel I floor

1.21 The Commission highlights that, compared to Basel I, Basel II required riskier business to hold more capital and less risky business to hold less capital, as it was designed to be more risk sensitive than Basel I. To prevent banks from being subject to inappropriately low capital requirements, Basel II does not allow a lower capital requirement than 80% of the capital that would have been required under Basel I (a capital ratio of 6.4%). Article 476 would reinstate this until 2015, with the competent authorities able, having consulted the European Banking Authority, to waive the application of the Basel I limit to an institution, provided that all requirements for the use of the advanced approaches for credit and operational risks were met.

Commencement

1.22 Articles 487 and 488 suggest that the Regulation would apply from 1 January 2013, subject to prior publication in the Official Journal of the EU.

The draft Directive

Powers of the competent authority of the host Member State in relation to branches

1.23 Articles 40–46 highlight the powers of the competent authority of a host Member State in relation to a credit institution having a branch within its jurisdiction. These articles would provide that:

- responsibility for supervision predominately lies with the home Member State;

- the competent authority of the host Member State would, however, have to inform the competent authority of the home Member State if it believed that the credit institution did not, or was expected not to, comply with national provisions implementing the Directive or with the Regulation;
- the competent authority of the home Member State would then take measures to address the situation;
- the competent authority of the host Member State would have the power to take precautionary measures in emergency situations, pending action by the competent authority of the home Member State, in order to protect the collective interests of depositors, investors and clients in its jurisdiction, as long as those measures were proportionate and non-discriminatory; and
- any disagreements between the competent authorities of the host and home Member States could be referred to the European Banking Authority.

Parliamentary oversight

1.24 Article 60 would:

- provide for transmission of information to other bodies, in particular the communication of information to parliamentary committees;
- require the relevant committees to have a precise mandate under national law and for the information to be kept confidential; and
- require prior agreement from appropriate competent authorities to disclose information that originates from another Member State.

Sanctions

1.25 Article 65 would require Member States to provide their competent authority with appropriate administrative sanctions that were effective, proportionate and dissuasive and to ensure that competent authorities were given the necessary powers to exercise their function. Member States should also ensure that, following a breach, sanctions could be applied to members of the management body and to other individuals who were responsible under national law.

1.26 Articles 66–70 set out provisions relating to the administrative sanctions and measures that should be available to competent authorities in specified cases. Depending on the type of breach, these would include:

- withdrawal of authorisation, cease and desist orders, public statements, dismissal of management and administrative pecuniary sanctions;
- a requirement for the level of administrative pecuniary sanctions to be up to twice the benefit derived from the violation, if that could be determined;
- administrative pecuniary sanctions up to 10% of the total annual turnover of the institution concerned or up to €5 million in the case of an individual;

- the criteria taken into account by competent authorities, when determining the type and level of the sanction to be applied in a particular case, would include benefits derived from the violation or losses caused to third parties and cooperative behaviour of the responsible person;
- a requirement to publish the sanctions and measures applied, unless such publication would seriously jeopardise the stability of financial markets; and
- a requirement for authorities to ensure that effective mechanisms are in place to encourage reporting of breaches within credit institutions and investment firms.

Responsibility of the management body in considering risk issues

1.27 Articles 75–85 contain provisions on the treatment and management of the risk an institution might be exposed to. Article 75 would require:

- competent authorities to ensure that institutions establish a risk committee composed of members of the management body who did not perform an executive function;
- institutions to have a risk management function independent from the operational and management functions, which would be responsible for identifying, measuring and reporting on risk exposures; and
- the head of the risk management function to be an independent senior executive.

1.28 Article 76 sets out that:

- competent authorities should be required to ensure that institutions take appropriate steps to developing Internal Rating Based approaches for calculating own funds requirements for credit risk;
- institutions would be required to develop and use internal models for calculating own funds requirements for specific risks of debt instruments in trading books, default and migration risk; and
- the European Banking Authority would draft regulatory technical standards, for adoption by the Commission, to further define conditions for calculating own funds requirements.

1.29 Article 85 would require:

- competent authorities to ensure that institutions have in place policies and processes to identify, manage and monitor risk of excessive leveraging; and
- institutions to address excessive risk in a precautionary manner by taking into account the risk of excessive leveraging caused by reductions of an institution's own funds.

Corporate Governance

1.30 Articles 86–87 introduce provisions concerning the governance arrangements of management bodies are tasked with overall responsibility for an institution. The Commission

suggests that its proposals for corporate governance should help avoid excessive risk-taking by individual credit institutions and ultimately the accumulation of excessive risk in the financial system.

1.31 Article 87 would require:

- competent authorities to ensure that members of a management body of any institution be of sufficiently good repute, possess sufficient knowledge, skills and experience and commit sufficient time to performing their duties;
- members of a management body not to combine more than four non-executive directorships or one executive directorship with two non-executive directorships at the same time;
- competent authorities to ensure that institutions take into account diversity as one of the criteria for selecting members of the management body;
- institutions to put in place a policy of promoting gender, age, geographical, educational and professional diversity on the management body; and
- the European Banking Authority to develop regulatory technical standards, for adoption by the Commission, concerning the makeup of the management body and in benchmarking diversity practices.

Supervisory review and evaluation process

1.32 Articles 92–104 contain provisions relating to Pillar 2 supervisory requirements. Article 92 would require:

- competent authorities to review the arrangements, strategies, processes and mechanisms implemented by an institution in order to comply with the Directive and the Regulation;
- competent authorities to evaluate the risks to which an institution was exposed and those which it posed to the financial system; and
- this review and evaluation process to be updated at least annually.

Article 95 would provide for a competent authority to apply supervisory measures to a certain type of institution where it determined under Article 92 that a type of institution was exposed to or posed similar risks.

1.33 With Article 97 the Commission proposes that:

- competent authorities be required to carry out annual supervisory stress tests on institutions they supervise, where the Article 92 review and evaluation process showed the need for such tests; and
- the European Banking Authority should issue guidance to ensure that common methodologies be used by the competent authorities when conducting annual supervisory stress tests.

1.34 Article 99 would require competent authorities to require an institution to take the necessary measures, at an early stage, to address problems where it did not meet the Directive requirements or was likely to breach them.

Capital buffers

1.35 Title VII, Chapter 4 would introduce two capital buffers on top of the minimum capital requirements set out in the draft Regulation:

- in Article 123 a capital conservation buffer of Common Equity Tier 1 capital, which would apply at all times, equivalent to 2.5% of an institution's total risk exposure — the Commission suggests that this is aimed at ensuring institutions' capacity to absorb losses in stressed periods that may span a number of years; and
- in Article 124 a countercyclical capital buffer of Common Equity Tier 1 capital, which might be implemented by Member States for macro-prudential purposes, by adjusting the size of the conservation buffer by up to an additional 2.5% — the Commission suggests that this is intended to be used to protect the banking sector and real economy from system-wide risks.

1.36 Article 126 would provide the conditions under which Member States' designated authorities could set the countercyclical capital buffer. For every quarter designated authorities would be required to calculate a buffer guide to determine the countercyclical buffer rate. This would be based on the deviation within a Member State of the ratio of credit-to-GDP from its long-term trend, taking into account both the growth of credit levels and guidance from the European Systemic Risk Board.

Commencement, transposition and repeal

1.37 Article 151 would require Member States to adopt and publish laws, regulations and administrative provisions to comply with this draft Directive by 31 December 2012 and that the provisions of the Directive should apply from 1 January 2013. And Article 152 would repeal the Capital Requirements Directive (Directives 2006/48/EC and 2006/49/EC) with effect from 1 January 2013.

Impact assessments

1.38 Both the draft Regulation and the draft Directive are accompanied by a Commission impact assessment, both with an executive summary.

The Government's view

1.39 In his Explanatory Memorandum the Financial Secretary to the Treasury (Mr Mark Hoban) first discusses the Commission's proposals in terms of subsidiarity, asserting that the Government recognises the importance of ensuring that the principle of subsidiarity is applied to all EU proposals and has constantly emphasised its commitment to upholding UK sovereignty.

1.40 The Minister notes that the Commission suggests that its proposals are in accordance with the principles of subsidiarity and proportionality, as the objectives of the proposed action cannot

be sufficiently achieved by Member States and argues, specifically, that only EU action can ensure that institutions operating in more than one Member State are subject to the same prudential requirements and thereby:

- ensure a level playing field across the EU;
- reduce regulatory complexity;
- avoid unwarranted compliance costs for cross-border activities;
- promote further integration in the EU market; and
- contribute to the elimination of regulatory arbitrage opportunities.

He comments that:

- the Government considers, however, that the proposed maximum harmonisation of the minimum requirements set out in the draft Regulation, particularly on capital, liquidity and leverage (which would prevent Member States imposing stricter requirements in these areas), goes beyond the action which is necessary to achieve the Commission's objectives; and
- the effectiveness of regulating prudential requirements can be sufficiently delivered through harmonising definitions and establishing internationally consistent minimum prudential requirements.

1.41 The Minister continues that:

- the Commission's proposals should not prevent Member States from imposing more stringent rules at national level, as it is not justified and may hinder achievement of the overall objective of greater financial stability, by preventing national authorities from responding flexibly and in a timely manner to systemic risks;
- the inclusion of Article 443 in the draft Regulation, which would allow the Commission to adopt delegated acts to impose stricter prudential requirements, for example, in relation to a particular Member State, is, therefore, inappropriate and goes beyond the objectives of the proposed Regulation;
- this is, furthermore, a significant deviation from the Basel III agreement, in which prudential requirements are only minimum requirements, allowing Member States the possibility to impose higher prudential requirements; and
- the Government remains, therefore, to be convinced that the Commission has provided a sufficiently strong justification that a maximum harmonised Regulation is necessary and that the proposal is compliant with the principles of subsidiarity and proportionality.

The Minister adds that Parliament may, of course, issue a reasoned opinion to the EU institutions on the issue of subsidiarity if it believes that this proposal gives cause for concern.

1.42 Turning the to the policy implications the Minister first makes several general points, saying that:

- the Government believes that the Basel III agreement on banking regulation and supervision was one of the most important aspects of the internationally agreed response to the financial crisis, with the agreement reached addressing many of the deficiencies of the financial system;

- to protect financial stability, avoid unnecessary international arbitrage and reinforce market confidence in EU banks it is vital that the EU builds upon the G20 agreement to fully and faithfully implement the Basel III agreement through the rules on prudential requirements for credit institutions and investment firms;

- the Commission's proposals significantly deviate, however, from the Basel III agreement in crucial areas, thereby weakening the agreement reached by the Basel Committee;

- in doing so, the proposals risk regulatory arbitrage, diluting the minimum standards agreed internationally for global banks and increasing the taxpayer's potential exposure to future losses;

- establishing minimum prudential requirements for credit institutions and investment firms across the EU presents a valuable opportunity to complete the single rulebook on banking requirements;

- the Commission suggests that a maximum harmonised regulation is necessary to complete the single rule book on banking;

- it is possible, however, to have a set of harmonised definitions and minimum requirements throughout the EU, without preventing Member States from implementing stricter requirements;

- it is important that Member States remain ultimately responsible for financial stability in their jurisdiction;

- the Government is very concerned, therefore, that maximum harmonised requirements will considerably constrain the ability of Member States to respond flexibly and in a timely manner to systemic risks in their jurisdiction or to mitigate fiscal risk, through requiring higher levels, either for the application of system wide macro-prudential policy or for higher prudential standards on a permanent basis;

- a Commission delegated act is an inappropriate vehicle to conduct macro-prudential policy at the Member State level;

- national authorities need the necessary flexibility to use a range of macro-prudential tools in a timely manner and can coordinate through the European Systemic Risk Board — a delegated act would be a time consuming and cumbersome process;

- there are, furthermore, significant overlaps between macro-prudential and monetary policy — Commission involvement in detailed macro-prudential policy decisions would blur significantly the relationship with monetary policy and would therefore be inappropriate;

- over the next year the Government will continue to make the case with other Member States and third countries, including the US, for global implementation of the Basel III agreement;
- in doing so, it will highlight the risks of regulatory arbitrage and a diluting of internationally agreed minimum standards for global banks;
- in discussions with other Member States and the Commission, the Government will seek to understand and respond to the concerns raised on specific issues while promoting consistency with Basel commitments, which have been endorsed by the G20 and the EU; and
- the Government will also work with likeminded Member States, who have also questioned the proposed maximum harmonisation of requirements in the EU, to enable the application of macro-prudential policy without undermining a single rule book on banking regulation.

1.43 In more detailed comments the Minister says that the Government is particularly concerned that the Commission's proposal would dilute significantly the quality of capital that institutions would be obliged to hold at all times in order to absorb losses. He continues that:

- one of the clearest examples relates to the treatment of deductions for capital held by banking groups in insurance subsidiaries;
- Basel III agreed that 10% of a bank's capital can come from investments in insurance subsidiaries but no more, with a lengthy transition period starting from 1 January 2013 to allow institutions time to adjust;
- any investment above the 10% must be subject to the deduction approach — therefore, if a bank invests in the shares of an insurer it is required to deduct that investment from its Common Equity Tier 1 capital;
- the inclusion of Article 46 in the draft Regulation would, however, allow institutions to deviate from the international agreement, which would provide considerable discounts from what would be the minimum Basel III capital requirements for certain institutions;
- this opt-out goes against the concept of a single rule book on banking with consistent minimum standards — it would create the potential for huge deviations in basic minimum standards for global banks with similar business models;
- the Basel Committee and the G20 agreed that instruments that count as Common Equity Tier 1 capital for joint stock companies must meet the legal form of ordinary shares and the 14 substantive criteria;
- the legal form of ordinary shares was chosen because they were the instruments that were proven to be the most loss absorbent and transparent during the financial crisis;
- yet the Commission's proposal would allow anything that counts as equity under national law standards to meet the legal form required of Common Equity Tier 1, as long as they meet the substance of the 14 criteria agreed by the Basel Committee and that they

qualify as capital within the meaning of Article 22 of Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions;

- this approach misses key lessons of the financial crisis; and
- this aspect of the Commission's proposal is also inconsistent with a single EU rule book on banking — it would be possible to have 27 different instruments eligible as Common Equity Tier 1.

1.44 On liquidity the Minister says that:

- as the Commission's draft Regulation does not explicitly define what assets should be monitored during the observation period of the Liquidity Coverage Requirement, the Government is concerned that the observation period will not provide a true test of liquidity buffer requirements;
- the Government believes, therefore, that in order to ensure consistency throughout the EU, and in line with the single rule book, the Regulation should set out clearly the assets that should be monitored during the observation period and this should be based on the definition agreed by the Basel Committee;
- the Government is disappointed that the Commission's proposals do not demonstrate a firm commitment to implement the Net Stable Funding Ratio from 2018, as agreed by the Basel Committee, instead tasking the European Banking Authority to report on whether the ratio should be fully implemented;
- banks funding themselves from unstable sources was one of the key contributors to the financial crisis — when short term inter-bank markets closed in autumn 2008 due to financial turmoil, banks that funded themselves disproportionately from these sources were unable to access funding and quickly suffered acute liquidity problems; and
- this led to a contraction of credit into the real economy and an overreliance on the provision of central bank liquidity.

1.45 In relation to the matter of leverage ratio the Minister says that:

- one of the key characteristics of the build up of the financial crisis was the unsustainable build-up of leverage in the financial system, including in the EU, where on average banks were more highly leveraged than their counterparts in the US and Asia;
- this excessive leverage was enabled by a combination of inaccuracies in the regulatory risk weights attached to the assets held by banks and of insufficient investor and supervisory oversight;
- although there is some commitment to migrate the leverage ratio to a Pillar 1 measure in Recital 68 of the draft Regulation, the recitals by themselves are not legally binding;
- the Government is concerned, therefore, that the Commission's proposals do not contain a firm commitment to migrate to a binding Pillar 1 measure in 2018; and

- the way to demonstrate a clear commitment would be to take a power to introduce the leverage ratio through a delegated act rather than future legislation, as the Commission has proposed for the Liquidity Coverage Requirement.

1.46 With his letter the Minister sends us the Government's impact assessment of the Commission's proposals, which, he tells us in his Explanatory Memorandum, is based on the Commission's own impact assessments, the Basel Committee's impact assessment of Basel III and analysis conducted by the Financial Services Authority. Highlights of the Government's assessment are:

> "The proposal's primary impact will be on UK authorised credit institutions (approximately 300 in number) and investment firms (approximately 2400). The gross value added (GVA) of financial intermediation in the UK economy was estimated at £117 bn in 2008.
>
> "Second-round effects will occur where the impact on institutions also has an effect on financial markets and products, in particular borrowing by households and corporations. The expectation is that almost all households and firms participating in credit markets will be affected in some way. However, the UK economy and taxpayer will also benefit from the substantial increase in financial stability derived from this legislation.
>
> "The size of the benefits in terms of GDP are found to be large because, on average, systemic banking crises have been very costly, with the net present value of the longer-term losses of output as high as multiples of annual GDP. The benefits may be higher still, as tighter regulatory standards may also lead to smaller fluctuations in lending and output, particularly if counter-cyclical capital buffers are used, and therefore higher welfare even in the absence of banking crises.
>
> "However, the Commission's proposal is in places weaker than envisioned under Basel III. This would result in smaller benefits as the resilience of credit institutions would be undermined, as the probability of a crisis would not be reduced by as much as anticipated in the Basel III agreement, though the exact difference is difficult to quantify.
>
> "Applying these [Commission] figures to UK bank assets suggests one-off costs to UK institutions of approximately £1.2 bn and annual administrative costs to UK institutions of approximately €0.6 bn. However, as the majority of UK bank assets are concentrated within several large institutions that should be able to take advantage of economists of scale, both one-off and annual costs are likely to be lower.
>
> "Stronger prudential requirements for capital and liquidity are expected to pose additional costs to banks, particularly in the short term, Banks are likely to meet the costs of stronger capital requirements in part by passing them on to borrowers, through higher interest rates and a lower quantity of new lending, as well as by retaining earnings, issuing equity and reducing non-loan assets. Stronger liquidity requirements may also result in an initial move towards more liquid assets and a resulting increase in lending spreads.
>
> "Any increase in the cost and decline in the supply of bank loans could have a transitory impact on growth, especially in sectors that rely heavily on bank credit, In the longer term, however, as banks become less risky, both the cost and quantity of credit should recover, reversing the impact on consumption and investment.

"The generous transition path agreed in Basel III will imply that banks have time to adapt their business models and build capital and liquidity buffers organically — through retaining earnings, lowering distributions (bonus payments and dividends) and issuing equity, as well as by reducing non-loan assets.

"The current fragile economic recovery and weak bank lending environment creates concerns for the impact of additional regulation, but the transition period will limit the extent to which any additional costs of prudential regulation result in higher interest rates or a reduced quantity of lending, thereby limiting the negative impact on bank lending.

"The Basel Committee's analysis finds large net benefits of the agreed Basel III package that remain positive for a broad range of capital ratios. For example, with all banks meeting a capital ratio of 7% and the liquidity requirements, and assuming crises have moderate permanent effects, the expected net benefit is 0.76% of the level of GDP per annum.

"Capital Requirements legislation that is weaker than Basel III will likely result in lower net benefits to the UK economy, as the expected cost of crises is likely to be higher without commensurate reductions in the economic costs. This is supported by the Basel Committee's calibration work, which indicates that the net benefits would be smaller if prudential requirements implemented internationally are weaker than the Basel agreement.

"In addition, the proposal currently offers limited scope for national discretion in order to impose additional regulatory requirements, without providing estimates of any benefits that might be derived from harmonisation. The Basel Long-term Economic Impact study was not country-specific and hence the net benefits of regulation might differ from country to country. As demonstrated by the recent financial crisis, the UK's large banking sector can impose significant costs on the real economy.

"More flexible standards for the UK might therefore be appropriate in order to offset a higher expected cost of financial crises, Limited national discretion would prevent the UK from implementing standards that provide benefits over and above those that would be derived from the Basel ill agreement and presents the risk that the UK would be unable to respond flexibly and in a timely manner to adequately address systemic risk.

"The Commission's proposal should facilitate competition cross the EU as a single rule-book will help to ensure a level playing field in terms of the rules and requirements faced by credit institutions and reduce compliance costs for cross-border banks.

"It is not expected that the proposal will impose any significant additional burdens on the UK supervisory authority (the FSA and its successor bodies the FCA and PRA) responsible for enforcement. However, it could have a significant impact on the enforcement policy of the FSA and its successor bodies, in so far as the proposal may impose a positive requirement on supervisory authorities to impose sanctions and it obliges the European Banking Authority to issue guidelines on the types and levels of sanctions with which the supervisory authority will be obliged to make every effort to comply."

Conclusion

1.47 Clearly the proposals in the draft Regulation and the draft Directive have significant shortcomings in relation to Basel III. So we will wish to recommend the documents for debate when we have a clearer idea of what direction Council consideration of the proposals, which we understand has just begun, is taking. And the Government's impact assessment will be relevant to that debate.

1.48 The documents remain under scrutiny. But, meanwhile, we share the Government's concern about whether maximum harmonisation of prudential requirements is consistent with the principle of subsidiarity. Accordingly we recommend that the House adopts a Reasoned Opinion, as provided for in Protocol 2 of the TFEU, as in the annexed draft.

1.49 We would be grateful if the Minister could respond to the concerns we set out in the Reasoned Opinion about the proposed internal market legal base of the Regulation and the legality of delegating powers to the Commission in Article 443 of the Regulation.

1.50 Additionally, we have concerns about Article 60 of the draft Directive. Whatever the merits of the caveats suggested in relation to parliamentary inquiries, it is completely outwith the powers of the EU to attempt to impose rules on national parliaments in the way suggested. We should be grateful for the Government's comments on this aspect of the proposed Directive.