EUROPEAN COMMISSION

MEMO

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Capital Requirements - CRD IV/CRR – Frequently Asked Questions

1. CONTEXT

Why was a revision of the Capital Requirements Directive necessary?

The package adopted by Council and Parliament and published in the Official Journal on 27 June 2013 builds on the lessons learnt from the recent crisis that has shown that losses in the financial sector can be extremely large when a downturn is preceded by a period of excessive credit growth. The financial crisis revealed vulnerabilities in the regulation and supervision of the banking system at European and global level. Institutions entered the crisis with capital of insufficient quantity and quality and, in order to safeguard financial stability, governments had to provide unprecedented support to the banking sector in many countries ([i]).

The overarching goal of the new rules is to strengthen the resilience of the EU banking sector so it would be better placed to absorb economic shocks while ensuring that banks continue to finance economic activity and growth.

What lessons have we learnt from the crisis?

First and foremost the crisis revealed an absolute necessity of enforcing the cooperation of monetary, fiscal and supervisory authorities across the globe. Cross border developments were observed too late, cross border impacts were very difficult to analyse.

Secondly, some institutions in the financial system appeared to be resilient and ready to absorb also enormous market shocks. Other institutions, even with similar capital levels, appeared to be unable to protect themselves. The crucial differences between the two were found in: the quality and the level of the capital base, the availability of the capital base, liquidity management and the effectiveness of their internal and corporate governance. These lessons justified amending the Basel agreement, and accordingly replacing the CRD with a new regulatory framework including a Regulation ([ii]) (CRR) and a Directive ([iii]) (CRD IV).

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Thirdly, cross border failures of international financial groups appeared an insurmountable challenge for nationally accountable authorities; as a consequence, several banks needed the intervention of the state in order to stay afloat. The knowledge that banks could have been resolved, also in a cross border context, would have changed the balance of power between public authorities and banks, with the former having more tools at their disposal than just the public purse and the bail-out option, and the latter not being able to enjoy the best of all worlds: privatize gains, socialize losses. This would have put a dent on bank's risk appetite. This justifies the Commission's legislative proposal for bank recovery and resolution adopted on 6 June 2012 (IP/12/570). And this also explains why, during the negotiations, at the initiative of the EP, rules on remuneration were strengthened.

Why did existing rules (including Basel 1/Basel 2) not stop the crisis from happening?

The current EU bank capital framework is represented by the Capital Requirements Directive (CRD) comprising Directives 2006/48/EC and 2006/49/EC and reflecting the proposals of the Basel Committee for the Basel II Framework (Basel II) and Trading Book Review. It covers both credit institutions and investment firms and stipulates the minimum amounts of own financial resources that banks must have in order to cover the risks to which they are exposed.

The financial crisis has unveiled a number of shortcomings of Basel II and necessitated unprecedented levels of public support in order to restore confidence and stability in the financial system. In particulars the following drawbacks of the existing framework were identified: capital that was actually not loss-absorbing, failing liquidity management, inadequate group wide risk management and insufficient governance. In this regard, the G-20 Declaration of 2 April 2009 conveyed the commitment of the global leaders to address the crisis with internationally consistent efforts to, among others, improve the quantity and quality of capital in the banking system, introduce a supplementary non-risk based measure to contain the build-up of leverage, develop a framework for stronger liquidity buffers at financial institutions and implement the recommendations of the Financial Stability Board (FSB) to mitigate the pro-cyclicality.

In response to the mandate given by the G-20, in September 2009 the Group of Central Bank Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee (see below section 2), agreed on a number of measures to strengthen the regulation of the banking sector. These measures were endorsed by FSB and the G-20 leaders at their Pittsburgh Summit of 24-25 September 2009.

In December 2010, the Basel Committee issued detailed rules of new global regulatory standards on bank capital adequacy and liquidity that collectively are referred to as Basel III.

2. BASEL III, CRD IV AND INTERNATIONAL LEVEL PLAYING FIELD

What is the Basel Committee?

The Basel Committee on Banking Supervision (BCBS) has the task of developing international minimum standards on bank capital adequacy. It is based at the headquarters of the Bank for International Settlements (BIS) in Basel, Switzerland. The members 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. The European Commission, the European Banking Authority (EBA) and the European Central Bank are observers.

What is "Basel III"?

The BCBS develops minimum standards on bank capital adequacy. These have evolved over time. Following the financial crisis, the Basel Committee has reviewed its capital adequacy standards (see above section 1). Basel III is the outcome of that review, with the number three coming from it being the third configuration of these standards([iv]).

What is "Basel III" proposing to make banks stronger?

- **Better and more capital**

Several banks appeared to have a capital base on their balance sheet meeting the regulatory standards, which, however, turned out to be not always available when needed for loss absorption. Some contracts restricted the absorption of losses or there were simply no liquid assets mirroring the balance sheet capital figure.

Basel III now prescribes strict criteria ([v]) that must be met by own funds instruments, in order to ensure that they can effectively absorb banks' losses also in times of stress.

- **More balanced liquidity**

A major problem was the lack of liquid assets and liquid funding during the crisis – referred to as "the market dried up". Basel III requires bankers to manage their cash flows and liquidity much more intense than before, to predict the liquidity flows resulting from creditors' claims better than before, and to be ready for stressed market conditions by having sufficient "cash" available, both in the short term and in the longer run.

- **Leverage back stop**

Just in case the calculated risk weights of Basel 2 and 2.5 contain errors, models contain errors, or new products are developed and risk weights are not measured precisely yet, a traditional back stop mechanism limits the growth of the total balance sheet as compared to available own funds. A maximum leverage of 12 used to be a rule of thumb in the days that banks were not regulated yet. Today, given the sophistication of risk weight determination, the leverage ratio will be an additional checking tool for supervisors.

As this tool is new for the international framework, it was agreed that data and experience must be gathered before an effective leverage ratio can be introduced as a binding requirement in each jurisdiction.

- **Capital requirements for derivatives (Counter party credit risk)**

Basel III also enhances the existing capital requirements for bank derivative transactions and the so-called counterparty credit risk that stems from them. A derivative is an instrument whose value depends on another instrument, underlying it. Derivatives are used for good reasons in banks' risk management, but the crisis revealed that exposures and losses could be material, and that a review of the treatment in the supervisory framework was justified.

The framework also includes the treatment of bank exposures to central counterparties (CCPs). CCP is an entity that interposes itself between the two counterparties to a transaction, becoming the buyer to every seller and the seller to every buyer. A CCP's main purpose is to manage the risk that could arise if one counterparty is not able to make the required payments when they are due –i.e. defaults on the deal.

- **Capital Buffers (see section 10 below)**

Do CRD IV and CRR fully implement "Basel III"?

The EU has actively contributed to developing the new capital, liquidity and leverage standards in the Basel Committee on Banking Supervision, while making sure that major European banking specificities and issues are appropriately addressed.

The new rules therefore respect the balance and level of ambition of Basel III. However, there are two reasons why Basel III cannot simply be copy/pasted into EU legislation and, therefore, a faithful implementation of the Basel III framework shall be assessed having regard to the substance of the rules.

First, Basel III is not a law. It is the latest configuration of an evolving set of internationally agreed standards developed by supervisors and central banks. That has to now go through a process of democratic control as it is transposed into EU (and national) law. It needs to fit with existing EU (and national) laws or arrangements.

Furthermore, while the Basel capital adequacy agreements apply to 'internationally active banks', in the EU it has applied to all banks (more than 8,300) as well as investment firms. This wide scope is necessary in the EU where banks authorised in one Member State can provide their services across the EU's single market and as such are more than likely to engage in cross-border business. Moreover, applying the internationally agreed rules only to a subset of European banks would have created competitive distortions and potential for regulatory arbitrage.

These particular circumstances were taken into account throughout the whole process for the transposition of Basel III into the EU legal framework.

What is Europe adding to "Basel III"?

As explained above, the most fundamental change is that, in implementing the Basel III agreement within the EU, we move from an uni-dimensional type of world where you have only capital as a prudential reference, to multi-dimensional regulation and supervision, where you have **capital, liquidity and the leverage ratio** – which is important, because this covers the whole balance sheet of the banks. And even within capital, there is a much cleaner definition and more realistic targets.

In addition to Basel III implementation, the package introduces a number of important changes to the banking regulatory framework.

In the Directive:

- **Remuneration.** In order to tackle excessive risk taking the remuneration framework has been further strengthened with regard to the requirements for the relationship between the variable (or bonus) component of remuneration and the fixed component (or salary). For performance from 1 January 2014 onwards, the variable component of the total remuneration shall not exceed 100% of the fixed component of the total remuneration of material risk takers. Exceptionally, and under certain conditions, shareholder can increase this maximum ratio to 200%.
- **Enhanced governance**: CRDIV strengthens the requirements with regard to corporate governance arrangements and processes and introduces new rules aimed at increasing the effectiveness of risk oversight by Boards, improving the status of the risk management function and ensuring effective monitoring by supervisors of risk governance.
- **Diversity.** Diversity in board composition should contribute to effective risk oversight by boards, providing for a broader range of views and opinion and therefore avoiding the phenomenon of group think. CRDIV therefore introduces a number of requirements, in particular as regards gender balance.
- **Enhanced transparency.** CRDIV improves transparency regarding the activities of banks and investment funds in different countries, in particular as regards profits, taxes and subsidies in different jurisdictions. This is considered essential for regaining the trust of EU citizens in the financial sector.
- **Systemic risk buffer (see section 10 below)**
- **Other systemic institution buffer (see section 10 below)**

Finally, the new rules seek to reduce to the extent possible reliance by credit institutions on external credit ratings by: a) requiring that all banks' investment decisions are based not only on ratings but also on their own internal credit opinion, and b) that banks with a material number of exposures in a given portfolio develop internal ratings for that portfolio instead of relying on external ratings for the calculation of their capital requirements.

In the Regulation:

- **A "Single Rule Book":** For the first time a single set of harmonised prudential rules is created which banks throughout the EU must respect. EU heads of state and government had called for a "single rule book" in the wake of the crisis. This will ensure uniform application of Basel III in all Member States, it will close regulatory loopholes and will thus contribute to a more effective functioning of the Internal Market. The new rules remove a large number of national options and discretions from the CRD, and allows Member States to apply stricter requirements only where these are justified by national circumstances (e.g. real estate), needed on financial stability grounds or because of a bank's specific risk profile. See also IP/10/197.

How is it possible to ensure an international level playing field?

The financial system is global in nature and it is not stronger than its weakest link. It is therefore important that all countries implement international banking standards, including Basel III.

The EU has continuous and constructive discussions with its international partners – most notably the US – regarding their implementation of the Basel agreements in a proper and timely manner and - more in general - on cross-border financial services regulatory issues.

What is the timeline and implementation of CRR and CRDIV and how does it relate to the timelines and implementation in other G20 countries?

The original Commission proposal followed the timeline as agreed in the Basel Committee and in the framework of the G20: application of the new legislation as from 1 January 2013, and full implementation on 1 January 2019, in line with the international commitments. Given the detailed discussions during trilogues and their impact on the length of the legislative process, the new legislation was published on 27 June 2013 and fully enters into force on 17 July 2013. Institutions are required to apply the new rules from the 1 January 2014 ([vi]), with full implementation on 1 January 2019.

To date, about half of the member jurisdictions of the Basel Committee have adopted the final rules implementing (parts of) Basel III. The remaining jurisdictions are expected to adopt the final rules by the end of this year.

What will the EU do if other jurisdictions do not faithfully implement Basel III?

The EU has an interest in increasing the resilience of its banking system. As Basel III aims to achieve that objective, it is in principle in our interest to implement it. While there is always a short term risk of regulatory arbitrage if one jurisdiction goes further than other jurisdictions, in the longer term it is clearly beneficial as market participants benefit from a stable, safe and sound financial system. Even so, there may be areas where an international level playing field is more important also in the short run (e.g. the new elements of Basel III). The Commission is therefore closely monitoring the consistent and faithful implementation of the pillars of Basel III (i.e. capital, liquidity and leverage requirements) across the globe and would need to draw all the necessary conclusions in due time should other key jurisdictions not follow suit.

3. STRUCTURE OF THE NEW REGULATORY FRAMEWORK

Why are there two legal instruments? Why also a regulation?

The new framework divides the current CRD (Capital Requirements Directive) into two legislative instruments: a directive governing the access to deposit-taking activities and a regulation establishing the prudential requirements institutions need to respect.

While Member States will have to transpose the directive into national law, the regulation is directly applicable, which means that it creates law that takes immediate effect in all Member States in the same way as a national instrument, without any further action on the part of the national authorities. This removes the major sources of national divergences (different interpretations, gold-plating). It also makes the regulatory process faster and makes it easier to react to changed market conditions. It increases transparency, as one rule as written in the regulation will apply across the single market. A regulation is subject to the same political decision making process as a directive at European level, ensuring full democratic control.

Last but not least, this proposal marks a thorough review of EU banking legislation that has developed over decades. The result is a more accessible and readable piece of legislation.

What goes in which legal instrument?

Areas of the current CRD where the degree of prescription is lower and where the links with national administrative laws are particularly important will stay in the form of a directive. This concerns in particular the powers and responsibilities of national authorities (e.g. authorisation, supervision, capital buffers and sanctions), the requirements on internal risk management that are intertwined with national company law as well as the corporate governance provisions. By contrast, the detailed and highly prescriptive provisions on calculating capital requirements take the form of a regulation.

Directive (Strong links with national law, less prescriptive)	**Regulation** (Detailed and highly prescriptive provisions establishing a single rule book)
Access to taking up/pursuit of business	Capital
Exercise of freedom of establishment and free movement of services	Liquidity
Prudential supervision	Leverage
Capital buffers	Counterparty credit risk
Corporate governance	Large exposures
Sanctions	Disclosure requirements

What are regulatory and implementing technical standards?

Binding Technical Standards (i.e. Regulatory and Implementing Technical Standards – BTS) are legal acts which specify particular aspects of an EU legislative text (Directive or Regulation) and aim at ensuring consistent harmonisation in specific areas. BTS are always finally adopted by the European Commission by means of regulations or decisions and they are legally binding and directly applicable in all Member States.

The EBA is mandated to produce a significant number of draft BTS for the implementation of particular aspects of the CRD IV and CRR, as set out in the legislative text.

4. SINGLE RULE BOOK

What is the Single Rule Book?

In June 2009, the European Council called for the establishment of a "European single rule book applicable to all financial institutions in the Single Market." The single rule book aims to provide a single set of harmonised prudential rules which institutions throughout the EU must respect. The Single Rulebook in banking regulation also comprises the BTS which are developed by the European Banking Authority, adopted by the European Commission and applied directly in all Member States. The Single Rulebook will ensure uniform application of Basel III in all Member States. It will close regulatory loopholes and will thus contribute to a more effective functioning of the Single Market. The Commission suggests removing national options and discretions from the CRD, and achieving full harmonisation by allowing Member States to apply stricter requirements only where these are needed on financial stability grounds or because of a bank's specific risk profile.

Why is the Single Rule Book important?

Today, European banking legislation is based on a Directive which leaves room for significant divergences in national rules. This has created a regulatory patchwork, leading to legal uncertainty, enabling institutions to exploit regulatory loopholes, distorting competition, and making it burdensome for firms to operate across the Single Market.

For example:

- Securitisation was at the core of the financial crisis. Previous global and EU standards (Basel II, CRD I) addressed some of the risks by specific capital requirements (including for all liquidity facilities). However, many Member States did not follow, benefiting from a transitional opt-out. In a fully integrated market such as securitisation, it was easy for cross-border groups to issue their securitisation titles in those Member States that opted out rather than in Member States which applied the standards.
- Following the experience with securitisation in the financial crisis, CRD II introduced harmonised rules to tighten the conditions under which institutions could benefit from lower capital requirements following a securitisation (including a harmonised notion of significant risk transfer). But several Member States have not transposed this by the end of 2010 as required.
- The financial crisis has shown that reliable internal risk models are important for institutions to anticipate stress and hold appropriate capital. However, requirements for, and accordingly the implementation of, internal ratings based risk models vary from one Member State to another. As a result, capital requirements for comparable exposures differ, leading potentially to an unlevel playing field and regulatory arbitrage.
- A tough definition of capital is a key element of Basel III. However, experience with CRD I showed that Member States introduced significant variations when transposing the directive definition into national law. In some cases, the Commission was confronted with cases of incorrect transposition and had to open infringement proceedings, taking many years, in order to force these Member States to comply with the directive.

A single rule book based on a regulation will address these shortcomings and will thereby lead to a more resilient, more transparent, and more efficient European banking sector:

- **A more resilient European banking sector**: A single rulebook will ensure that prudential safeguards are wherever possible applied across the EU and not limited to individual Member States. The crisis highlighted the extent to which Member States' economies are interconnected. The EU is a shared economic space. What affects one country could affect all. It is not realistic to believe that unilateral action brings safety in this context. If a Member State increases the capital requirements for domestic institutions, institutions from other Member States can continue to provide their services with lower requirements – and at a competitive advantage - unless other countries follow suit. This gives also rise to regulatory arbitrage. Institutions affected by the higher capital requirements could relocate to another Member State and continue to provide their services in the original Member State by means of a branch.
- **A more transparent European banking sector**: A single rulebook will ensure that institutions' financial situation is more transparent and comparable across the EU - for supervisors, deposit-holders and investors. The financial crisis has demonstrated that the opaqueness of regulatory requirements in different Member States was a major cause of financial instability. Lack of transparency is an obstacle to effective supervision but also to market and investor confidence.
- **A more efficient European banking sector**: A single rulebook will ensure that institutions do not have to comply with 28 differing sets of rules.

What is the role of the European Banking Authority?

The European Banking Authority (EBA) plays a key role in building up the Single Rulebook in banking regulation as it is mandated to produce a number of draft BTS for the implementation of particular aspects of the CRD and CRR, as set out in the legislative texts.

Furthermore, the EBA is in charge of coordinating a **Single Rulebook Q&A process** through which answers are provided to stakeholders on the practical implementation of the CRD IV and CRR, the BTS and guidelines which form part of the Single Rulebook. The process as such is consistent with Article 29 of Regulation (EU) No 1093/2010, which asks the EBA to 'develop new practical instruments and convergence tools to promote common supervisory approaches and practices'. It offers a single point of entry and procedure for addressing questions and thereby provides an efficient tool for dealing with issues that cut across various layers of the Single Rulebook, or concern various areas simultaneously. Peer reviews are expected to play a driving force in ensuring adherence to and compliance with the responses provided in the Q & A process, even though they have no force in law.

Finally, as part of its contribution to a common supervisory culture across the EU, the EBA will review the application of all BTS adopted by the European Commission and propose amendments where appropriate.

Will Member States have the possibility to require a higher basic capital requirement?

The EU in general and the euro area in particular have a very high degree of financial and monetary integration. Decisions on the level of capital requirements therefore need to be taken for the single market as a whole, as the impact of such requirements is felt by all Member States. Financial stability can only be achieved by the EU acting together; not by each Member State on its own.

For example, if EU capital requirements are set too low, an individual Member State cannot escape risks to financial stability by simply increasing requirements for its own institutions. Unless other Member States follow suit, foreign institutions' branches can continue to import risk.

Higher levels of capital requirements in one Member State would also distort competition and encourage regulatory arbitrage. For example, institutions could be encouraged to concentrate risky activities in Member States which only implement the minimum requirements.

Therefore, capital requirements need to be set at a level that is appropriate for the EU as a whole. That is why, according to the political agreement, the capital requirements cannot be increased by national authorities (e.g. 6% CET 1 instead of 4,5%), unless a specific add-on is justified following an individual supervisory review or based on systemic risk or macro-prudential concerns (Systemic risk, Global systemic institutions and Other systemic institutions buffers and Pillar 2, see section 10 below).

Will Member States still retain some flexibility under the Single Rule Book?

Member States will retain some possibilities to require their institutions to hold more capital (see below a table including all possible flexibility options – detailed description of various capital buffers is provided in section 10 below). For example, Member States will retain the possibility to set higher capital requirements for real estate lending, thereby being able to address real estate bubbles. If they do, this will also apply to institutions from other Member States that do business in that Member State. Moreover, each Member State is responsible for adjusting the level of its countercyclical buffer to its economic situation and to protect economy/banking sector from any other structural variables and from the exposure of the banking sector to any other risk factors related to risks to financial stability.

Member States will also be allowed to impose a specific add-on on banks to cover systemic or macro-prudential risks

Furthermore, Member States would naturally retain current powers under "pillar 2", i.e. the ability to impose additional requirements on a specific bank following the supervisory review process

The Commission will also have the power to increase prudential requirements in all areas subject to specific conditions (see table below)

Pillar 1 Flexibility						
Member States flexibility with regard to increasing capital requirements only				Member States flexibility with regard to increasing requirements on capital / liquidity / large exposures / risk weights		Any prudential requirement
Systemic Important Institution (SII) Buffer	**Systemic risk buffer**	**Counter cyclical capital buffer**	**Capital conservation buffer**	**national macro flexibility**	**Increasing real estate Risk weights and setting stricter criteria, i.e; Loan-To-Value (LTV)**	**Commission delegated Act measures**
CRD 131	CRD 133 and 134	CRD 130, 135-140	CRD art 129	CRR 458	CRR 124	CRR 459
1) Mandatory surcharge for global SIIs applicable from 2016. The surcharge will amount to between 1 and 3.5 % of RWAs depending on the degree of systemic importance of an institution. **2) Optional surcharge** for other SIIs applicable from 2016. The surcharge will amount to up to 2% of RWAs.	**Optional systemic risk buffer on all or a subset of institutions** to cover structural or systemic risks. 1) From 1 Jan 2014 onwards, Member State competent or designated authority can set the buffer between 0-3% subject to notification to Commission, EBA and ESRB. 2) Buffer rate can be set between 3 – 5% from 2015 onwards, notification as above but COM opinion then comply or explain. 3) Above 5% the Setting Member State must be authorized by the Commission through a Commission implementing Act before setting the buffer.	Macro-prudential buffer. Buffer rate based on credit-to–GDP indicator. Institutions established in a Member State different from the one setting the buffer rate have to apply the same buffer rate on exposures towards clients located in the latter Member State. A Member State must require its institutions to recognise the buffer rate set by another Member State up to 2.5%, but can choose to require them to recognise more.	Mandatory capital buffer equal to 2.5% of RWAs.	Setting Member States have to notify and justify more stringent measure to the Commission, EBA and ESRB. The Commission shall adopt an opinion in cases of potential distortion of the Internal Market. Council can overrule the adverse Commission's Opinion. The scope of the measures is broad at includes, for instance, large exposure limits and risk weights.	Based on reported losses on real estate lending competent authorities can set higher risk weights up to 150% and stricter criteria with respect to LTVs.	COM can adopt delegated acts to set temporarily (one year) stricter prudential for specific exposures including the level of own funds, large exposures, disclosure requirements to address risks that affect all Member States.

What is "Pillar 2"? How will it change?

Pillar 2 refers to the possibility for national supervisors to impose a wide range of measures - including additional capital and liquidity requirements – on an individual and on consolidated bases in order to address higher-than-normal risk. They do that on the basis of a supervisory review and evaluation process, during which they assess how institutions are complying with EU banking law, the risks they face and the risks they pose to the financial system. Following this review, supervisors decide whether e.g. the institution's risk management arrangements and level of own funds ensure a sound management and coverage of the risks they face and pose. If the supervisor finds that the institution faces higher risk, it can then require the institution to hold more capital or meet stricter liquidity requirements. In taking this decision, supervisors should notably take into account the potential impact of their decisions on the stability of the financial system in all other Member States concerned. Article 103 of CRDIV clarifies that supervisors can extend their conclusions to types of institutions that, belonging to the same region or sector, face and/or pose similar risks.

How will the new rules affect those Member States that have already decided to go further than Basel III or are planning to do so?

Some Member States (e.g. Spain) have already decided to go above the minimum levels of capital foreseen by Basel III. Some (e.g. Sweden, Cyprus) have indicated their intention to start doing so. Others (e.g. UK) have national processes under way that consider requiring a level of own funds above Basel III from parts of their banking sector. In some instances, Member States have also decided to introduce more quickly the changes foreseen under Basel III that increase the quality of capital as well.

According to the new legislative framework, Member States are free to anticipate the full implementation of Basel III and hence move to the capital requirements foreseen for 1 January 2019 already today, should they so wish. While Member States will not be able to exceed the level of own funds requirement set by the new rules, they can use the instruments of flexibility foreseen by that agreement, namely the counter-cyclical buffer, the systemic risk buffer, the global and other systemic institution buffers, and Pillar 2.

5. CAPITAL

What is bank capital?

Capital can be defined in different ways. The accounting definition of capital is not the same as the definition used for regulatory capital purposes.

For the purposes of prudential requirements for banks, capital is not obtained simply by deducting the value of an institution's liabilities (what it owes) from its assets (what it owns). Regulatory capital is more conservative than accounting capital. Only capital that is at all times freely available to absorb losses qualifies as regulatory capital. Additional conservatism is added by adjusting this measure of capital further by e.g. deducting assets that may not have a stable value in stressed market circumstances (e.g. goodwill) and not recognising gains that have not yet been realised.

What is a capital adequacy requirement?

It is the amount of capital an institution is required to hold compared to the amount of assets, to cover unexpected losses. In the CRR, this is called 'own funds requirement' and is expressed as a percentage of risk weighted assets.

Why is capital important?

The purpose of capital is to absorb the losses that a bank does not expect to make in the normal course of business (unexpected losses). The more capital a bank has, the more losses it can suffer before it defaults. If a firm owes more than it owns (its assets are worth less than its liabilities), it cannot pay its debt and is thereby insolvent. If a bank has less regulatory capital than what it is required, supervisors can take measures to prevent insolvency.

What are risk-weighted assets?

In order to calculate the capital an institution needs to hold, CRR defines how to weigh an institution's assets according to their risk. Safe assets (e.g. cash) are disregarded; other assets (e.g. loans to other institutions) are considered more risky and get a higher weight. The more risky assets an institution holds, the more capital it has to have. In addition to risk weighing on balance sheet assets, institutions must have capital also against risks related to off balance sheet exposures such as loan- and credit card commitments. These are also risk weighed.

What is the difference between Tier 1 and Tier 2 capital?

Capital comes in different forms that serve different purposes. There are two types of capital:

- Going concern capital: this allows an institution to continue its activities and helps to prevent insolvency. Tier 1 capital is considered to be the going concern capital. The purest form is Common Equity Tier 1 (CET1) capital
- Gone concern capital: this helps ensuring that depositors and senior creditors can be repaid if the institution fails. This category of capital includes hybrid capital and subordinated debt. Gone concern capital is named Tier 2 capital.

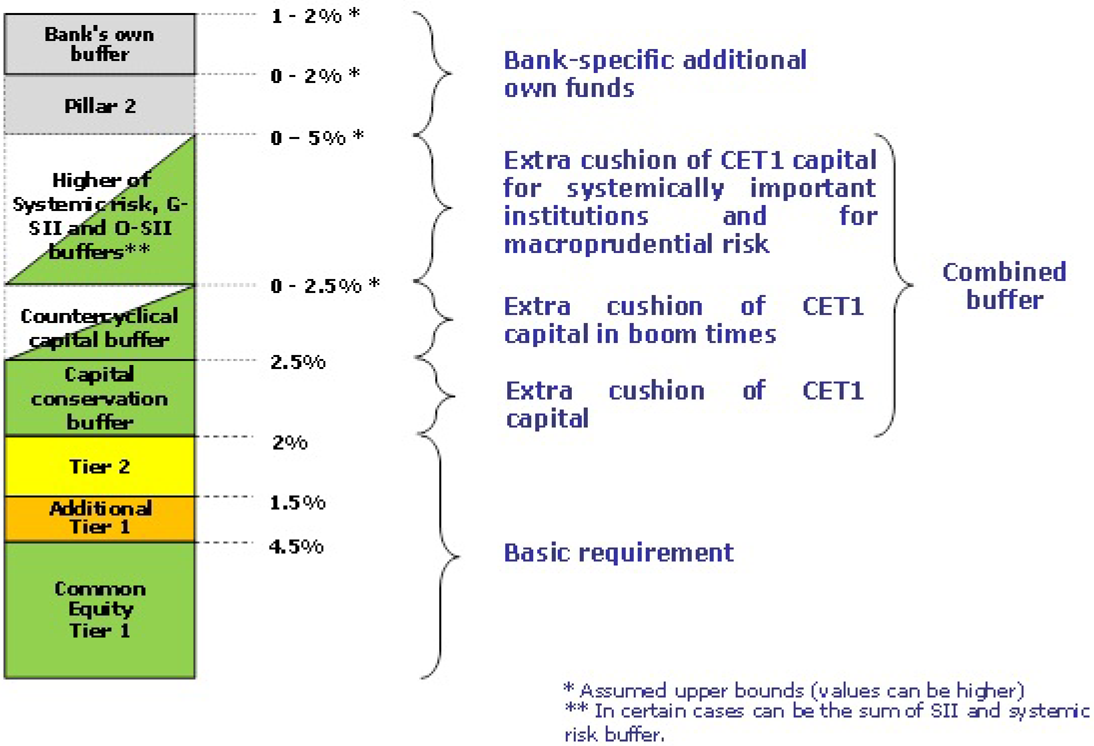
What was the problem with capital during the crisis?

Banks and investment firms did not all have sufficient amounts of capital and the capital they had was sometimes of poor quality as it was not readily available to absorb losses as they materialised. To prevent institutions from defaulting, public funds had to be used to prop up institutions.

How do the new rules increase the quality and quantity of capital?

Under the existing framework, banks and investment firms need to have a total amount of capital equal to at least 8% of risk weighted assets. Under the new rules, while the total capital an institution will need to hold remains at 8%, the share that has to be of the highest quality – common equity tier 1 (CET1) – increases from 2% to 4.5%.

The criteria for each capital instrument will also become more stringent. Furthermore, the proposal harmonises the adjustments made to capital in order to determine the amount of regulatory capital that it is prudent to recognise for regulatory purposes. This new harmonised definition significantly increases the effective level of regulatory capital institutions are required to have. One unit of Basel II capital is therefore not the same as one unit of Basel III capital.



Is the new legislation only going to increase the quality of capital?

No. While the basic own funds requirement stays at 8% of risk-weighted assets, the new rules also establish five new capital buffers: the capital conservation buffer, the counter-cyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer (see section on capital buffers). Naturally, on top of all these own funds requirements, supervisors may add extra capital to cover for other risks following a supervisory review (see question on Pillar 2 above) and institutions may also decide to hold an additional amount of capital on their own.

How can institutions increase their capital ratio to meet the new requirements?

Institutions can increase their capital ratio in two ways:

- **Increase capital**: An institution can increase its capital by either issuing new shares and/or not pay dividends to its shareholders, i.e. to retain profits. These new shares and retained profits become included in its capital base. Provided they do not increase their risk-weighted assets (RWAs), this increases their capital ratio.
- **Reduce risk-weighted assets**: An institution can also cut back on lending, sell loan portfolios and/or make less risky loans and investments, thereby reducing its RWAs, which has the effect of - for a given amount of capital - increasing its capital ratio (capital/RWA).

When will these provisions start to apply?

Basel III foresees a substantial transition period before the new capital requirements apply in full. This is to ensure that increasing the resilience of institutions does not unduly affect lending to the real economy (i.e. to ensure that institutions do not cut back on lending and investments). The provisions related to the level of own funds will accordingly be phased in as of the 1 January 2014.

Capital instruments that will not meet the new, stricter eligibility criteria will be phased out over 8 years in order to help to ensure a smooth transition to the new rules.

Do the new rules allow Member States to implement Basel III faster than foreseen by the Basle timetable?

Basel III foresees a gradual transition to the stricter standards, with full implementation as of 1 January 2019. The CRR foresees the same transition period (except in some well-defined, special cases) but allows Member States to implement the stricter definition and/or level of capital more quickly than is required by Basel III.

Do the new rules depart from the Basel III definition of capital?

No. The CRR takes exactly the same approach as Basel III by imposing 14 strict criteria that any instrument would have to meet to qualify, with appropriate adaptation to the criteria for instruments issued by non-joint stock companies such as mutuals, cooperative banks and savings institutions. Therefore the full substance of Basel III has been translated into the European laws. Because of the lack of a common EU concept of "common shares", the legal form of the highest quality form of capital is not restricted to the notion of "ordinary shares". This does not affect the substance as CET1 must meet 14 strict criteria. According to the EU rules, an instrument that, for whatever legal reason, is not called "ordinary share" in a given country law and meets those 14 criteria, is equally loss absorbent than an "ordinary share" and therefore is in substance equivalent to the latter.

What are the conditions capital instruments have to meet to qualify as Common Equity Tier 1 instruments?

Article 28 of the CRR states that capital instrument can only qualify as Common Equity Tier 1 instruments if a number of conditions are met. These can be summarised for joint-stock companies as follows (some special provisions apply for mutual, cooperatives, savings banks and similar institutions):

- they are issued directly by the institution;
- they are paid up and their purchase is not funded by the institution;
- they meet a number of conditions as regards their classification (e.g. they qualify as capital for accounting and insolvency purposes);
- they are clearly and separately disclosed on institutions' financial statements balance sheet;
- they are perpetual;
- the principal amount of the instruments may not be reduced or repaid unless the institution is e.g. liquidated. Moreover, the provisions governing the instruments should not indicate that the principal amount of the instruments would or might be reduced or repaid other than in the liquidation of the institution;
- the instruments meet a number of conditions as regards distributions (e.g. no preferential distributions in time, distributions may be paid only out of distributable items, the conditions governing the instruments do not include a cap or other restriction on the maximum level of distributions, the level of distributions is not determined on the basis of the amount for which the instruments were purchased, etc…);
- compared to all the capital instruments issued by the institution, the instruments absorb the first and proportionately greatest share of losses as they occur, and each instrument absorbs losses to the same degree as all other Common Equity Tier 1 instruments;
- the instruments rank below all other claims in the event of insolvency or liquidation of the institution;
- the instruments entitle their owners to a claim on the residual assets of the institution, which, in the event of its liquidation and after the payment of all senior claims, is proportionate to the amount of such instruments issued and is not fixed or subject to a cap;
- the instruments are not secured, or guaranteed by any entity in the group (e.g. the institution, its subsidiaries, the parent institution or its subsidiaries, etc);
- the instruments are not subject to any arrangement that enhances the seniority of claims under the instruments in insolvency or liquidation.

These conditions ensure that only the highest quality capital instruments qualify as CET1.

Do the new rules recognise only ordinary shares as Common Equity Tier 1 or could other instruments be recognised as well?

To warrant recognition in the highest quality category of regulatory capital, a capital instrument must be of extremely high quality and must absorb losses fully as they arise.

The 14 criteria for Common Equity Tier 1 capital agreed in Basel III are extremely strict by design. Only instruments of the highest quality would be capable of meeting them.

Provided an instrument met those strict criteria - including in respect of its loss absorbency –it would qualify as Common Equity Tier 1 capital.

What are minority interests and what amount of minority interests can be recognised?

Minority interests are capital in a subsidiary that is owned by other shareholders from outside the group. They are particularly important in the EU, as EU banking groups often have subsidiaries that are not fully owned by the parent company but have several other owners.

Basel III recognises minority interests and certain capital instruments issued by subsidiaries (e.g. hybrids and subordinated debt) to be included in the capital of the group only where those subsidiaries are banks (or are subject to the same prudential requirements) and up to the level of the new minimum capital requirements and the capital conservation buffer.

The CRR recognises a higher amount of minority interests, i.e. up to and including capital buffers, the Pillar 2 requirement and other prudential requirements. This is a simple result of the fact that the EU legislation does put at the disposal of the Supervisors several additional capital buffers and allows a degree of flexibility for Member states to set higher requirements (see section 10).

What will the treatment of significant holdings in insurance companies be?

Basel III requires banks to deduct significant investments in unconsolidated financial entities, including insurance entities, from the highest quality form of capital (CET1). The objective is to prevent the double counting of capital, i.e. to ensure that the bank is not bolstering its own capital with capital that is also used to support the risks of an insurance subsidiary.

The CRR allows an updated version of the Financial Conglomerates Directive (FICOD) approach, which allows consolidation of banking and insurance entities in a group, to continue to be used as an alternative to the Basel III deduction approach. The alternative approach is allowed because consolidation is considered to prevent double counting of capital as well

What are Deferred Tax Assets (DTAs) and what will be their treatment?

Deferred Tax Assets (DTAs) are assets that may be used to reduce the amount of future tax obligations. Basel III treats DTAs differently depending on how much they can be relied upon when needed to help a bank to absorb losses. Where their value is less certain to be realised, they must be deducted from capital. However, Basel has subsequently clarified that DTAs that are transformed on a mandatory and automatic basis into a claim on the State when an institution makes a loss would be one of the forms of DTAs for which deduction would not be warranted.

The CRR implements the above Basel rules.

What is the Basel I floor and will its application be prolonged?

Basel II requires more capital to be held by banks for riskier business than would be required under Basel I. For less risky business, Basel II requires less capital to be held than Basel I. This is what Basel II was designed to do: to be more risk sensitive.

To ensure banks do not hold too little regulatory capital, Basel II set a floor on the amount of capital required, which is 80% of the capital that would be required under Basel I.

While the floor required by the original CRD expired by the end of 2009, the CRD III reinstated it until end-2011.

In the light of the continuing effects of the financial crisis in the banking sector and the extension of the Basel I floor adopted by the Basel Committee on Banking Supervision in July 2009, the CRR reinstates the floor in 2014, to be applied until 2017. However, national authorities would be able to waive the requirement under strict conditions.

It also introduces a requirement for a continuous revision of the need for such a floor since it should not be maintained in place longer than is strictly necessary.

What will be the cut-off date for recognising instruments that do not meet the eligibility criteria?

To ensure a smooth transition to the new Basel III rules, instruments that are currently used that do not meet the new rules have to be phased out over a 10-year period, provided they were issued prior to the date of agreement of the new rules by Basel (12 September 2010). Under Basel III, instruments issued after the cut-off date would need to comply with the new rules or would not be recognised from 1 January 2013.

The CRR sets the cut-off date at 31 December 2011 (except for instruments used for the recapitalisation of banks by Member States, where special rules apply). The phase-out period starts in 2014 and lasts for 8 years.

What will be the treatment of instruments no longer eligible as CET1?

The CRR phases them out over a 8-year period. For instruments injected by a government prior to its date of entry into force the CRR allows to fully recognise them in CET1 capital for a 4-year period.

The new rules require institutions to hold more capital against investments in hedge funds, real estate, venture capital and private equity than they have done to up now. Why is that?

The current CRD (points 66-67 of Annex VI, Part 1) states that competent authorities may apply a 150% risk weight to "exposures associated with particularly high risks such as investments in venture capital firms and private equity investments". However, what 'particularly high risks' are has not been defined. The lack of obligation combined with the lack of a clear definition has led to different assessments and risk weights granted to the same type of exposures. On the basis of an advice from CEBS (Committee of European Banking Supervisors, the predecessor of EBA), the CRR now requires banks to assign a 150% risk weight to these types of exposures (investments in venture capital firms, alternative investment funds and speculative real estate financing as well as "exposures that are associated with particularly high risks"). The CRR now also clearly defines the criteria that supervisors should use when an exposure is associated with such risks and requires EBA to develop guidelines in that respect.

What is the role of contingent capital in the new framework?

The CRR requires all instruments recognised in the Additional Tier 1 capital of a credit institution or investment firm to be written down, or converted into Common Equity Tier 1 instruments, when the Common Equity Tier 1 capital ratio of the institution falls below 5.125%. It also allows institutions to issue Additional Tier 1 instruments with a trigger higher than 5.125%. The new rules do not recognise other forms of contingent capital for the purposes of meeting regulatory capital requirements.

What is hybrid capital? What role does it play?

Hybrid capital is a term used to describe forms of capital instrument that have features of both debt and equity instruments. Such instruments in issue during the crisis proved not to be sufficiently loss absorbent. The new rules build upon the improvements made under CRD II to the quality of hybrid Tier 1 capital instruments, introducing stricter criteria for their inclusion in Additional Tier 1 capital. As explained above, this includes a requirement for all such instruments to absorb losses by being written down, or converted into Common Equity Tier 1 instruments, when the key measure of a credit institution or investment firm's solvency - the Common Equity Tier 1 capital ratio - falls below 5.125%.

6. LIQUIDITY

What Rules does the Regulation establish on liquidity buffers?

The crisis has shown that institutions' did not hold sufficient liquid means (e.g. cash or other assets that can be quickly converted into cash with no or little loss of value). When the crisis hit, many firms were short of liquidity. This contributed to the demise of several financial institutions. While a number of Member States currently impose some form of quantitative regulatory standard for liquidity, no harmonised regulatory treatment exists at EU level.

Basel III introduces two new ratios and foresees in each case an observation period in order to identify and address possible unintended consequences. The BCBS will make the necessary changes, if any, before 2015 or 2018, respectively.

Therefore subject to the observation period (see below) the Regulation establishes two new liquidity buffers:

- First, to improve the short-term (over a thirty day period) resilience of the liquidity risk profile of financial institutions, there is a **Liquidity Coverage Requirement** (LCR).
- Second, to ensure that an institution has an acceptable amount of stable funding to support the institutions assets and activities over the medium term (over a one year period), there is a **Net Stable Funding Requirement** (NSFR);

How will the liquidity coverage ratio (LCR) be introduced?

The observation period will start immediately after the entering into force of the Regulation and institutions will be required to report to national authorities the elements that are needed to verify that they have adequate liquidity coverage. They will do this in a uniform way, with standard reporting formats to be developed by the EBA. On the basis of these data, the EBA will prepare reports for submission to the Commission. The Commission will have a delegated power to specify the detailed liquidity coverage requirement for application in 2015.

What is the impact of the Basel Committee decision this January on the LCR?

Many observers including the Commission were concerned that the original calibration of the LCR was too severe. In a time of economic difficulty, there were concerns that implementation of the LCR as originally foreseen by the Basel Committee in December 2010 could have an adverse impact on the real economy by promoting a shift from lending (loan assets) to more liquid assets (e.g. cash, central bank deposits) as institutions prepared to meet the new LCR requirements. For this reason the Commission attaches considerable importance to the observation period after which the detailed LCR will be specified.

These concerns were also recognised by the Basel Committee. On 7 January 2013, the Basel Committe issued the text of a revised Liquidity Coverage Ratio (LCR) which had been endorsed by the governing body of the Basel Committee, namely, the Group of Central Bank Governors and Heads of Supervision (GHOS). This text included a revised timetable (cf below) for the phasing-in of the LCR standard.

The same day, Commissioner Michel Barnier also issued a press release welcoming the revised agreement unanimously reached by the Basel Committee. The package of amendments to the LCR as originally formulated in 2010 including its phasing-in, addressed concerns previously identified by the Commission. However, the final formulation of the LCR is still not fully complete and important work is still continuing under the Basel Committee. Therefore the approach for the final adoption of the LCR under EU law in 2015 is maintained, namely full use of the observation period and adoption of the detailed LCR by the Commission taking account of the EBA Reports and international developments such as the final Basel LCR standard.

What will be the time schedule for implementation of the LCR?

Because of concerns that too rapid implementation of the original LCR could have detrimental impact on the real economy, the text published by the Basel committee on 7th January 2013, proposed a minimum phasing-in of the LCR over 5 years starting with 60% of the LCR in 2015, rising progressively to reach 100% in 2019. However, given the important role liquidity mismatches played in the financial crisis, the Union legislators considered it appropriate to have a somewhat faster implementation schedule than Basel. The Regulation therefore sets the following schedule for LCR implementation:

- 60% in 2015
- 70% in 2016
- 80% in 2017, and
- 100% in 2018.

In other words, under the Regulation, 100% LCR implementation will be reached in 2018, i.e. one year earlier than Basel.

But why does the Regulation phase in the LCR one year faster than Basel?

The financial crisis that started in 2007 showed that liquidity is absolutely key for the resilience of institutions in stress situations. The treatment of liquidity is fundamental, both for the stability of banks as well as for their role in supporting wider economic recovery. Therefore, to highlight this importance, the Union co-legislators decided to advance full implementation of the LCR by one year so that a 100% LCR will already apply in 2018.

However, if appropriate and in the light of a report to be prepared by the EBA taking into account the economic situation as well as European specificities and international regulatory developments, the Commission is empowered to defer the 100% phasing-in of the LCR until 2019 and apply in 2018 a 90% LCR, in line with the Basel schedule.

Is an institution always obliged to have a LCR ratio above 100%?

No. In a stressed situation an institution may be obliged to make use of its liquid assets with the result that its LCR ratio (temporarily) falls below 100%. This point has been specifically recognised in the text published by the Basel committee on 7th January 2013. However, it should be noted that even in this situation, under the Regulation an institution is required to immediately notify the competent authorities and submit a plan for the timely restoration of the LCR ratio to above 100%.

Does that mean there are no new liquidity rules until 2015?

No. Again to underline the importance of avoiding liquidity mismatches, from the date of adoption, the Regulation already establishes a general requirement that institutions need to hold liquid assets to cover their net cash outflows in stressed conditions over a thirty day period. However, this is a general requirement and not a detailed ratio requirement as when the LCR enters into force in 2015.

Will it be possible to accelerate the implementation of the LCR at national level?

Yes. Before the LCR becomes a binding minimum standard in 2015, Member States may maintain or introduce binding minimum standards for liquidity coverage requirements and require LCR levels up to 100% before the LCR is fully introduced at a rate of 100% in 2018.

How does the Regulation implement the 7 January 2013 revised Basel agreement regarding an extended definition of liquid assets and revised outflow rates?

The Commission attaches a special importance to the observation period in order to properly assess the impact of the new liquidity requirements on institutions and financial markets and ensure requirements are defined and calibrated in the most appropriate manner.

This is why the Regulation does not fix at this stage a closed list of liquid assets. Instead, it specifies a minimum list of items that shall be considered as liquid, while the EBA shall report to the Commission by 31 December 2013 on appropriate uniform definition of liquid assets of high and extremely high liquidity and credit quality. In its report, the EBA shall consider a variety of assets, including Retail Mortgage Backed Securities (RMBS) of high liquidity and credit quality, local government bonds, commercial paper, equities listed on a recognised exchange, corporate bonds, and so on.

Pending the uniform definition of liquid assets, institutions shall identify and report themselves in a given currency, assets that are respectively of high and extremely high liquidity and credit quality. At the same time, competent authorities may provide general guidance that institutions shall follow in identifying those assets.

In the same manner, the EBA shall report to the Commission on the calibration of inflow and outflow rates. It should be noted that the EBA shall in particular report on the need for any mechanism to restrict the value of liquidity inflows, e.g. by establishing an appropriate inflow cap; as well as report on any mechanism to restrict the coverage of liquidity requirements by certain categories of liquidity assets, e.g. by establishing a minimum percentage for liquid assets of *extremely* high liquidity and credit quality. Note that in its report, the EBA shall take due account of international regulatory developments. The Commission is empowered to specify the detailed liquidity coverage requirements by delegated act.

When will the net stable funding requirement come into force?

The same basic approach will be followed for the NSFR, namely an observation period, albeit longer, before adoption of the standard into Union law. However, work on the NSFR has not progressed as far as that on the LCR and there is still a very considerable amount of development work to be carried out by the Basel Committee.

Therefore in the light of the results of the observation period and reports to be prepared by the EBA, the Commission will prepare, if appropriate, a legislative proposal by 31 December 2016 to ensure that institutions use stable sources of funding, taking full account of the diversity of the European banking sector.

Does that mean there are no NSFR rules until 2018?

No. several years before any binding minimum standards for net stable funding requirements may be specified under Union law, the Regulation already establishes the general rule from 1 January 2016 that institutions shall ensure that long term obligations are adequately met with a diversity of stable funding requirements under both normal and stressed conditions.

What is the role of covered bonds in the composition of the liquidity buffer?

For the LCR, a particular focus of the observation period will be set on the definition of liquid assets. The EBA will test different criteria for measuring how liquid securities are under stressed market conditions. This will prepare the ground for a decision before 2015 that will ultimately determine the eligibility criteria for the liquidity buffer.

For the NSFR, the Commission will analyse how such a structural requirement plays out across the diverse EU banking sector, notably as regards its ability to provide long-term funding to support the real economy.

7. LEVERAGE

Why reducing leverage in the banking sector?

Leverage is an inherent part of banking activity; as soon as an entity's assets exceed its capital base it is levered. The Commission does not propose to eliminate leverage, but to reduce *excessive* leverage. The financial crisis highlighted that credit institutions and investment firms were highly levered, i.e. they took on more and more on- and off-balance sheet items on the basis of an increasingly thin capital base.

What is the Leverage Ratio?

In line with Basel III, the Commission therefore proposes to start the process of introducing a leverage ratio. The leverage ratio is defined as Tier 1 capital divided by a measure of non-risk weighted on- and off-balance sheet items.

What purpose does the Leverage Ratio serve?

The purpose of the leverage ratio is to have a simple instrument that offers a safeguard against the risks associated with the risk models underpinning risk weighted assets (e.g. that the model is flawed or that data is measured incorrectly). The ultimate aim is also to constrain leverage and to bring institutions' assets more in line with their capital in order to help mitigate destabilising deleveraging processes in downturn situations.

Will institutions be required to have a Leverage Ratio above a certain value?

Since the Leverage Ratio is a new regulatory tool in the EU, there is a lack of information about the effectiveness and the consequences of implementing it as a binding (Pillar 1) measure. It is therefore important to gather more information before making the leverage ratio a binding requirement. In line with Basel III, the Commission therefore proposes a step by step approach:

- Initial implementation of the Leverage Ratio as a Pillar 2 measure;
- Data gathering on the base of thoroughly defined criteria as of 1 January 2014;
- Public disclosure as of 2015;
- Report by the end of 2016 including, where appropriate, a legislative proposal to introduce the leverage ratio as a binding measure as of 2018.

Why institutions should disclose their leverage ratio as of 1 January 2015? Does that not effectively make it a binding requirement in view of market pressure?

Requiring the disclosure of the Leverage Ratio is in line with the EU's push to introduce more transparency in the financial sector in general and in the banking sector in particular. It is also fully in line with Basel III rules. Even in the absence of such a requirement, the market would almost certainly demand institutions to disclose the information on their Leverage Ratio.

How do the new rules address the concerns that the introduction of the Leverage Ratio would have significant negative impacts on trade finance and lending to small and medium enterprises, to name just two areas?

There isn’t currently sufficient information in order to estimate the precise impact of the Leverage Ratio. That is why the Leverage Ratio will not be introduced outright as a binding measure, but rather as a Pillar 2 measure (i.e. the judgement on whether or not the leverage ratio of a particular institution is too high and whether that institution should hold more capital as a consequence will be left to the supervisor of that institution). Furthermore, that is why the proposal foresees an extended observation period during which the necessary data will be gathered, and a review to estimate the impact of the Leverage Ratio based on those data that would then inform the decision on the introduction of the Leverage Ratio as a binding measure.

The Regulation applies lower conversion factors to trade related off-balance sheet items than those initially provided in the Commission's initial proposal. This intends to mitigate the impact of the leverage ratio on trade finance operations and lending to SMEs.

How do the new rules take into account various business models throughout the Union and address the issue of low-risk type of business profiles?

The review of the leverage ratio will include the identification of institutions' business models and whether the level of the leverage ratio should be the same for all types of business models. If deemed appropriate, several levels of the leverage ratio may be introduced in order to reflect the overall risk profile, the business model and size of institutions.

8. COUNTERPARTY CREDIT RISK

What will be the treatment of counterparty credit risk arising from derivatives?

Building on the Regulation on OTC derivatives and markets infrastructures (EMIR) (MEMO/12/232), the new rules increase the own funds requirements associated with credit institutions' and investment firms' derivatives that are traded over-the-counter ("OTC derivatives") and securities financing transactions (e.g. repurchase agreements).

The new rules also amend the current treatment of institutions' exposure to central counterparties (CCPs)([vii]) stemming from those transactions, as well as exchange-traded derivatives transactions, in the following way:

- Unlike under existing rules, exposures to a CCP will be subject to an own funds requirement. The size of the requirement will depend on the type of exposure: trade exposures to a CCP (e.g. exposures due to collateral posted to the CCP) will be subject to a substantially smaller own funds requirement than exposures due to contributions to the CCP's default fund. This is because default fund contributions can be used for mutualising losses due to the default of another clearing member.
- Compared to exposures from bilaterally cleared transactions, exposures to CCPs will be subject to lower own funds requirements as long as the CCP will meet certain requirements (in the specific, they will need to meet the requirements laid down in EMIR or be subject to equivalent rules, in case of a third-country CCP). If the CCP will not meet those criteria, then trade exposures will be subject to the bilateral treatment and default fund contributions will be subject to a high own funds requirement.

How will the new rules affect non-financial corporates and their use of non-centrally cleared OTC derivatives?

The CRR exempts non-centrally cleared OTC derivative transactions between banks and non-financial corporates from the new Basel 3 capital requirement for the so-called Credit Valuation Adjustment (CVA) risk, when such transactions do not exceed relevant thresholds that are specified in EMIR.

Are CRR provisions on capital requirements for CVA risk in line with Basel 3 rules?

The CRR contains a capital requirement for credit valuation adjustment (CVA) risk, calculated in the manner suggested in the Basel III document. However, in response to concerns about the initial calibration of this requirement for certain counterparties, the EU co-legislators decided to provide for certain exemptions from this requirement. There is a review clause in the agreement connected to the calibration and scope of the requirement. During the democratic process of rule approval co-legislators have become wary of the impact of the requirement on non-financial counterparties in the EU and will approach the required review in an open-minded way, and taking due account of the effective CVA implementation in other jurisdictions. At the same time, the review will also look at those concerns from our international partners, which relate in particular to the extension of exemptions, originally intended to benefit European non-financial firms - including SMEs -, to firms in third countries, and to the preservation of the level playing field.

9. SUPERVISION

How do the new rules strengthen supervision?

Regulation, no matter how good, cannot overcome poor supervision. The financial crisis brought this point on the agenda. As a result, the EU has already taken steps to strengthen supervision, notably with the creation of the three European Supervisory Authorities and the European System of Financial Supervision (MEMO/10/434).

The new rules strengthen banking supervision further by requiring the annual preparation of a supervisory programme for each supervised institution on the basis of a risk assessment; greater and more systematic use of on-site supervisory examinations; more robust standards and more intrusive and forward-looking supervisory assessments.

10. CAPITAL BUFFERS

What the new rules provide for as regards the capital buffers?

On the basis of the Basel provisions the following capital buffers are introduced

Capital conservation buffer

The capital conservation buffer is a new prudential tool introduced by Basel III and implemented by the CRD IV. It is a capital buffer of 2.5% of total exposures of a bank that needs to be met with an additional amount of the highest quality of capital (i.e. CET1 capital). It sits on top of the 4.5% CET1 capital requirement (see Section 5 on capital above). As its name indicates, the buffer's objective is to conserve a bank's capital. When a bank breaches the buffer, i.e. when its CET1 capital ratio falls below 7%, automatic safeguards kick in and limit the amount of dividend and bonus payments a bank can make. The further the bank "eats" into the buffer, the stricter the limits become. This prevents the bank's capital to be further eroded by such payments.

Countercyclical buffer

The countercyclical buffer is another new prudential tool introduced by Basel III. As the name indicates, the purpose of this buffer is to counteract the effects of the economic cycle on banks' lending activity, thus making the supply of credit less volatile and possibly even reduce the probability of credit bubbles or crunches. It works as follows: in good times, i.e. where an economy is booming and credit growth is strong, it requires a bank to have an additional amount of capital (as in the case of the capital conservation buffer, CET1 capital). This prevents that credit becomes too cheap (there is a cost to the capital that a bank must have) and that banks lend too much. If a bank does not have enough capital to fill this buffer, the same restrictions as in the case of the capital conservation buffer kick in.

When the economic cycle turns, and economic activity slows down or even contracts, this buffer can be "released" (i.e. the bank is no longer required to have the additional capital). This allows the bank to keep lending to the real economy or at least reduce its lending by less than would otherwise be the case.

Global systemic institution buffer

The CRD IV includes a mandatory systemic risk buffer of CET1 capital for banks that are identified by the relevant authority as globally systemically important. The identification criteria and the allocation into categories of systemic importance are in conformity with the G-20 agreed G-SIFI criteria and include size, cross border activities and interconnectedness. The mandatory surcharge will be between 1 and 3.5% CET 1 of RWAs, will need to be met with CET1 capital and will apply from 1 January 2016 onwards. The G-SII "surcharge" reflects the cost of being systemically important and is aimed at reducing the moral hazard of implicit support and bail-out by taxpayer money. The Financial Stability Board's provisional list of 28 G-SIFIs includes 14 EU institutions.

Other systemically important institutions buffer

In addition to the mandatory Global SII buffer the CRD IV provides for a supervisory option for a buffer on "other" systemically important institutions. This includes domestically important institutions as well as EU important institutions. In order to prevent adverse impacts on the internal market there is framing in the form of the criteria used to identify O-SIIs, a notification/ justification procedure and an upper limit to the size of the buffer (2% of RWAs). The O-SII buffer is applicable from 2016 onwards but Member States wanting to set higher capital for certain banks earlier can use the systemic risk buffer. The optional O-SII buffer CET1 capital will be recognised for the purpose of meeting the consolidated mandatory G-SII buffer requirement.

In addition to all the capital buffers mentioned above, the new rules provide for a:

Systemic risk buffer

Each Member State may introduce a Systemic Risk Buffer of Common Equity Tier 1 for the financial sector or one or more subsets of the sector, in order to prevent and mitigate long term non-cyclical systemic or macro-prudential risks with the potential of serious negative consequences to the financial system and the real economy in a specific Member State. Until 2015, in case of buffer rates of more than 3%, Member States will need prior approval from the Commission, which will take into account the assessments of the European Systemic Risk Board (ESRB) and the EBA.

From 2015 onwards and for buffer rates between 3 and 5 % the Member States setting the buffer will have to notify the Commission, the EBA, and the ESRB. The Commission will provide an opinion on the measure decided and if this opinion is negative, the Member States will have to "comply or explain". Buffer rates above 5% will need to be authorized by the Commission through an implementing act, taking into account the opinions provided by the ESRB and by the EBA.

11. CORPORATE GOVERNANCE

How does CRD IV improve corporate governance?

The new Directive introduces clear corporate governance arrangements and mechanisms for institutions. These rules concern the composition of boards, their functioning and their role in risk oversight and strategy in order to improve the effectiveness of risk oversight by boards. The status and the independence of the risk management function is also enhanced. Supervisors will play an explicit role in monitoring risk governance arrangements of institutions.

The measures adopted should help avoid excessive risk-taking by individual institutions and ultimately the accumulation of excessive risk in the financial system. The principle of proportionality, taking into account the size and complexity of the activities of the institution as well as different corporate governance models, applies to all measures.

Corporate governance – Does CRD IV impose board diversity?

Diversity in board composition should contribute to effective risk oversight by boards, providing for a broader range of views and opinion and therefore avoiding the phenomenon of group think.

Institutions are therefore required to employ a broad set of qualities and competences when recruiting members to the management body and for that purpose to put in place a policy promoting diversity on the management body. Moreover, the nomination committees of significant institutions are also required to decide on a target for the underrepresented gender on the board and to prepare a policy on how to increase the number of the underrepresented gender.

Institutions must make public their policy on diversity with regard to selection of members of the management body, its objectives and any relevant targets, and the extent to which these objectives and targets have been achieved.

What does CRD IV do to improve transparency regarding the activities of banks and investment funds in different countries?

Increased transparency regarding the activities of institutions which operate on a multi-national basis, and in particular as regards profits, taxes and subsidies in different jurisdictions, is essential for regaining the trust of EU citizens in the financial sector. Under CRD IV, Member States will have to ensure that institutions disclose this type of information to the public, by Member State and by third country in which they have operations. The Commission will, however, first assess the potential impact of some of these disclosure obligations and, if appropriate, make a proposal to amend the scope and/or modalities of disclosure.

Why reforming only CRD IV (banks and investment firms) and disregarding other sectors (insurance, investment funds)?

The corporate governance failings which contributed to the financial crisis occurred mostly in banks. Also, existing rules in the banking sector are of a very general nature as compared to insurance or investment fund legislation where rules on internal organisation and risk management are much more detailed and precise. That is why we started with reforming corporate governance in credit institutions and investment firms. However, for the sake of consistency and in order to avoid regulatory arbitrage between sectors, it will be necessary to review the existing legislation in other sectors (Solvency II, UCITS Directive) to align it, when necessary, to the outcome of the final text of the CRD IV package. Nevertheless, the specificities of each sector should be taken into account, and the rules should not necessarily be identical for banks, insurance companies and investment funds.

12. REMUNERATION

What are the existing rules regarding remuneration?

In order to ensure that remuneration policies do not give incentives to take risks which undermine sound and effective risk management and which exacerbate excessive risk-taking behaviour, CRD III introduced in 2010 a number of technical criteria ([viii]) underpinning the total remuneration policies (including salaries and discretionary pension benefits) of credit institutions and investment firms in relation to categories of staff whose professional activities have a material impact on their risk profile ('material risk takers') ([ix]). These included in particular the following requirements regarding the structure of remuneration:

- a substantial portion, and in any event at least 50 %, of any variable remuneration should consist of equity-linked or other non-cash instruments; and
- a substantial portion of the variable remuneration component, and in any event at least 40 % to 60 % (the latter in the case of a variable remuneration component of "a particularly high amount") should be deferred over a period of not less than three to five years.

While providing that fixed and variable components of total remuneration should be appropriately balanced and that the fixed component should represent a sufficiently high proportion of the total remuneration (allowing the possibility to pay no variable remuneration), it was left to the institutions to set the appropriate ratios between the fixed and the variable component of the total remuneration. CRD III did not set any maximum ratio between the fixed and the variable component.

Institutions also had an obligation to disclose to the public information regarding the remuneration policy and practices for material risk takers ([x]).

What are the new, additional rules introduced by CRD IV?

CRD IV essentially carries over the existing provisions of CRD III ([xi]) relating to remuneration. It also introduces additional transparency and disclosure requirements relating to the number of individuals earning more than EUR 1 million per year.

Furthermore, in order to tackle excessive risk taking the remuneration framework has been further strengthened with regard to the requirements for the relationship between the variable (or bonus) component of remuneration and the fixed component (or salary). The key elements of the new rule, which will apply to remuneration awarded for services and performance from 2014 onwards, are the following:

(i) The variable component of the total remuneration shall not exceed 100% of the fixed component of the total remuneration of material risk takers;

(ii) Member States may allow the shareholders, owners or members of the institution, acting by a qualified majority involving either a minimum representation requirement for shares or equivalent ownership rights of 50 % and a voting majority of two thirds or no minimum representation requirement and a 75 % voting majority, to approve a higher maximum level of the variable component provided that this level does not exceed 200% of the fixed component of the total remuneration. In this context, for the purposes of calculating the maximum ratio, the use of deferred and bail-in-able instruments is specifically encouraged through a provision which allows Member States to permit the application of a notional discount rate to up to 25% of total variable remuneration provided that it is paid in instruments that are deferred for at least five years; and

(iii) The competent authorities are to be informed of recommendations to shareholders and of the result of any shareholder vote, which shall not conflict with institutions' obligations to maintain a sound capital base.

The EBA is called upon to provide further technical guidance as regards the notional discount rate and the Commission will review and report on the application and the impact of the new rules by 30 June 2016.

Do the new rules apply to the remuneration of all staff?

No. The rules apply only for categories of staff whose professional activities have a material impact on their risk profile, such as senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers. The EBA is called upon to develop draft regulatory standards with respect to qualitative and appropriate quantitative criteria to identify these categories of staff.

Do the new rules apply to all institutions and investment firms in the EU?

Yes. Moreover, the rules also apply to i) subsidiaries established outside the EEA of institutions which have their head office in the EEA and ii) subsidiaries established inside the EEA of institutions which have their head office outside the EEA. CRD IV provides that "[t]he application of [the remuneration provisions] shall be ensured by competent authorities for institutions at group, parent company and subsidiary levels, including those established in offshore financial centres" (see Article 92 of CRD IV). This provision already existed in CRD III. The Commission will review the application and the impact of this rule in due course.

13. SANCTIONS

What exactly do the new rules provide for regarding sanctions?

The proposal will require Member States to provide that appropriate administrative sanctions and measures can be applied to violations of EU banking legislation. For this purpose, the Directive will require them to comply with common minimum standards on:

- types and addressees of sanctions,
- the level of fines,
- the criteria to be taken into account by competent authorities when applying sanctions,
- the publication of sanctions,
- the mechanism to encourage reporting of potential violations.

These provisions are without prejudice to the provisions of national criminal law.

Why are provisions on sanctions introduced in CRD?

The "CRD IV" package fundamentally overhauls the substantive prudential rules applicable to institutions. But these rules will only achieve their objective if they are effectively and consistently enforced throughout the EU. This requires that competent authorities have at their disposal not only supervisory powers allowing them to effectively oversee credit institutions but also sufficiently strict and convergent sanctioning powers to respond adequately to the violations (which may nevertheless occur), and prevent future violations.

However, the banking sector is one of the areas where national sanctioning regimes are divergent and not always appropriate to ensure deterrence.

For example, in the banking sector the maximum amount of fines provided for in case of a violation is unlimited or variable in five Member States, more than 1 million euro in nine Member States, and less than 150 000 euro in seven Member States. Those maximum levels, in the latter group in particular, appear to be rather small, especially in view of the large size of the banking groups operating in several of these States. For more examples see MEMO/10/660

Therefore, the new framework provides for the introduction of rules to reinforce and approximate national sanctioning regimes.

Banking supervision is based on supervisory measures to prevent violations and restore banks' viability – why would sanctions be necessary?

When a bank is in distress, the first priority is in fact to save and not to sanction it.

In fact, the new rules are not introducing harmonised sanctions for violations of minimum capital requirements.

But sanctions are key to ensure other rules are respected – for example if banks don't report to supervisors as required, and thereby make supervision ineffective, or if banks act without authorisation.

What is planned to ensure that breaches are actually prosecuted and that appropriate sanctions are actually handed down?

The new rules make sure that all supervisors have the possibility, that is to say are empowered, to impose effective sanctions. National supervisors remain mainly responsible for the actual application of sanctions.

In order to ensure that breaches are actually prosecuted and ensure convergence for sanctions handed down, we require supervisors to put in place whistle blowing programmes to improve detection of violations, and propose convergence on the factors to be taken into account when imposing sanctions in each individual case.

Prosecution is highly case specific and in the realm of national authorities (with the exception of Credit Rating Agencies), so the reach of EU legislative action is limited. Therefore, peer reviews conducted by the ESAs (Art 30(2)(d) of the ESA Regulations explicitly refers to sanctions) are an important tool to ensure further convergence, and once the legislative framework in all Member States on what supervisors can do will have converged following our initiative, we place big hopes on them.

What has happened to the initial idea of criminal sanctions?

Criminal sanctions can have an important deterrent effect in particular on individuals, and can therefore be appropriate in certain instances. Under Art 83(2) TFEU, the EU can take action on criminal sanctions but only under limited circumstances. We will further assess whether EU action on criminal sanctions is necessary for the financial services area as a whole and will decide about appropriate further action on that basis.

List of violations for which sanctioning powers should be available:

- unauthorised banking services;
- requirements to notify authorities in case of acquisition of qualifying holdings;
- governance requirements;
- reporting requirements on capital, liquidity, leverage, large exposure;
- limits on large exposures;
- retention requirements on securitisation;
- general liquidity coverage requirements;
- public disclosure requirements (Basel Pillar III);
- anti-money laundering requirements
- payments of remuneration or dividends in cases prohibited by CRD/CRR
- requirements for members of the management board (in particular limits on multiple board memberships)

14. RELIANCE ON RATINGS

What is the issue?

Capital requirements are meant to be risk-sensitive and therefore require measures of credit risk as inputs. Such measures can either be developed by each bank itself or by a specialised institution whose job is to evaluate risk (credit rating agencies - CRAs).

The financial crisis highlighted that banks had taken on risk without really understanding it and that they relied too much on the risk assessments of external rating agencies, of which there are only a few. Once the crisis started, many of the risk assessments in the securitisation field proved to be wrong. Rating agencies then adapted their risk assessments as a result of which banks tried to exit the markets in question at the same time. This adjustment, while desirable, was so violent that it undermined financial stability.

The Financial Stability Board (FSB) endorsed in October 2010 principles to reduce authorities' and financial institutions' reliance on CRA ratings in standards, law and regulation. The G20 approved the FSB's principles on reducing reliance on external credit ratings (Seoul Summit, 11-12 November 2010).

The FSB principles cover five types of financial market activity: 1) prudential supervision of banks; 2) policies of investment managers and institutional investors; 3) central bank operations; 4) private sector margin requirements; and 5) disclosure requirements for issuers of securities. The goal of the principles is to reduce the cliff effects from CRA ratings that can amplify procyclicality and cause systemic disruption. The principles call on authorities to do this through:

- removing or replacing references to CRA ratings in laws and regulations, wherever possible, with suitable alternative standards of creditworthiness assessment;
- expecting that banks, market participants and institutional investors make their own credit assessments, and not rely solely or mechanically on CRA ratings.

The FSB is currently conducting a peer review in order to tack stock of the progress of FSB Members in implementing the principles mentioned above

The Basel Committee on Banking Supervision is working toward achieving compliance with the G20 and FSB objectives of reducing mechanistic reliance on external ratings, focusing first on the securitisation framework, where such reliance is predominant. It has also proposed to reduce reliance on credit rating agencies ratings in the regulatory capital framework.

How does the new framework reduce over-reliance on external ratings?

This problem has two facets. First, and from a general view point, when it comes to estimating the risk of instruments and activities. Second, when it comes to calculating the amount of regulatory capital.

As regards the first, institutions need to understand the risks of the activities they undertake. However convenient, they should not outsource that judgement fully to an external party such as a credit rating agency. The most problematic overreliance on ratings takes place when institutions invest in rated securities without understanding the risks of these securities. Misguided investment decisions may create bubbles. The most blatant case of such overreliance, in the field of securitisation, has already been addressed by CRD II, which required institutions to carry out a range of analysis for their securitisation investments, even if they are AAA rated.

On top of that, credit institutions and investment firms are required to have their own sound credit granting criteria and credit decision processes in place. This applies irrespective of whether institutions grant loans to customers or whether they incur securitisation exposures. External credit ratings may be used as one factor among others in this process but shall not prevail. In particular, internal methodologies shall not rely solely or mechanistically on external ratings.

As regards the role of ratings in calculating the amount of regulatory capital, avoiding overreliance in this field does not mean making no references to ratings whatsoever. Such references may sometimes be the best available alternative. The systems that are necessary to produce internal ratings are not only costly to implement but also to supervise. Moreover, developing internal ratings may sometimes be impossible for an institution in isolation (e.g. when an institution only has a few material counterparties).

The new rules therefore require institutions that have a material number of exposures in a given portfolio to develop internal ratings for that portfolio. This expresses the EU's preference for using internal rather than external ratings where possible. The new framework will also require institutions using external ratings to benchmark the resulting capital requirements to their internal credit opinions. If that comparison shows that the capital requirements are too favourable compared to the internal credit opinion, then the institution will be required under Pillar 2 to hold additional capital.

In addition, the EBA should every two years publish information on what banks and supervisors have done to reduce overreliance on external ratings and report on the degree of supervisory convergence in this regard.

Why does the EU go for a half-measure; would it not be better to prohibit any reliance on external ratings as done by the US?

Risk sensitive capital requirements require a measure of credit risk. Sometimes external ratings – however imperfect – remain the best solution available. The alternatives (e.g. country based method for banks, internal ratings) may misguide markets, be too costly or lack objectivity.

Removing references to ratings without having alternatives in places could be counterproductive. The US example highlights the difficulty of eliminating ratings. Following the Dodd Frank Act, US authorities have been forced to delete any references to ratings in financial legislation, without having workable alternatives in place. To avoid this inconvenience the package aims to strengthen own credit risk assessments and reduce **sole and mechanistic** reliance on credit ratings.

Rather than scrapping ratings altogether, the new framework encourages the use of internal ratings and strengthens provisions on how external ratings can be used. Furthermore, the CRR introduces supervisory benchmarking to ensure a high level of quality of internal approaches to credit risk assessment.

According to the Regulation CRA III (MEMO/13/571), by 31 December 2015, the Commission shall submit a report to the European Parliament and to the Council on:

(a) the steps taken as regards the deletion of references to credit ratings which trigger or have the potential to trigger sole or mechanistic reliance thereon; and

(b) alternative tools to enable investors to make their own credit risk assessment of issuers and of financial instruments,

with a view to deleting all references to credit ratings in Union law for regulatory purposes by 1 January 2020, subject to appropriate alternatives being identified and implemented.

15. OTHER ISSUES

The new rules will strengthen banking regulation. Will that not encourage activity to migrate to the non-regulated "shadow banking" sector?

Banks are at the heart of the EU financial system. It is accordingly of vital importance that they are safe and sound. That is why the new framework involves an overhaul of EU banking legislation.

At the same time, it is important to ensure that, as a result of this, risk does not simply migrate to other less regulated areas of the financial system. While this is not a reason for refraining from raising the regulatory bar for banks, it is a strong reason for closely monitoring any potential migration. This is an international issue and work is currently on-going at the FSB on 'shadow banking', i.e. when banks are interconnected with non-regulated entities and when non-bank type of institutions provide banking-like services and functions. Two new measures are introduced in CRR to reduce the risks that shadow banking poses to banks:

– banks will report to their supervisors the amounts of their main exposures to unregulated entities as well as exposures arising from repurchase agreements and securities lending transactions;

– by the end of 2014 the European Banking Authority will prepare guidelines to limit banks' exposure to unregulated financial counterparties, while the European Commission will be required to determine, by the end of 2015, whether it is appropriate to establish such limits by considering the work carried out at both European and international level, particularly by the Basel Committee.

The Commission strongly supports the G20-FSB's objectives of monitoring the shadow banking system and developing regulatory proposals. A Green Paper on shadow banking was released last year. For the time being important discussions are still on-going within the FSB working groups and the Commission is actively involved in the finalisation of the recommendations.

While the FSB will present its final policy recommendations for endorsement by the G20 in September 2013, the Commission intends to adopt a Communication on shadow banking in the coming weeks.

Will the new rules make trade finance more costly?

Trade finance and export credits are important financial instruments for EU export and contribute to growth and job creation.

Trade finance is not part of the Basel III agreement but following a specific G20 request the Basel Committee proposed in October 2011 two changes to reduce capital requirements in relation to trade finance: 1) using the actual maturity (> 1 day) of the trade exposure instead of a one year maturity floor, which will result in lower capital requirements and 2) waiving the 100% sovereign floor for short term exposures to banks in Low Income Countries that are unrated (and apply instead the favourable approach for unrated banks). The new framework transposes both measures into EU legislation (see Article 162 and Article 121 of CRR).

A more favourable treatment in terms of capital charges will also be introduced in relation to certain trade finance instruments (tender and performance guarantees) through a reduction of their 'exposure value' as a result of changing their ranking in the CRR classification of off-balance sheet items (see Annex I to CRR).

The new liquidity rules should not make the provision of trade finance more expensive. On the contrary, the reporting requirements for liquidity outflows for trade-finance off balance sheet related products are subject to a maximum outflow of 5 per cent, in line with the Basel III requirements. However, national competent authorities may apply a lower outflow percentage. In addition, as part of the observation period, the EBA shall report to the Commission, among others, on whether the LCR has a material detrimental impact on trade financing, including lending under official export credit insurance schemes.

What is proposed to increase banks' lending to small and medium-sized enterprises (SMEs) to help EU economic recovery?

SMEs are one of the pillars of the European economy given the fundamental role they play in providing employment and creating economic growth.

Taking into account the limited amount of alternative sources of funding, in order to ensure an appropriate flow of credit to SMEs in the current difficult economic context, Article 501 of CRR introduces a reduction in the capital charges for exposures to SMEs – up to EUR 1.5 million - through the application of a supporting factor equal to 0.7619, thus providing credit institutions with an appropriate incentive to increase the available credit to EU SMEs. To achieve this objective credit institution should effectively use the capital relief produced through the application of the supporting factor for the exclusive purpose of easing lending conditions for EU SMEs and provide an adequate flow of credit to the real economy.

Supervisory Authorities will monitor periodically the amount of exposures to SMEs of credit institutions in relation to the total amount of capital deduction and other factors including the developments in the economic cycle.

After 3 years from the date of application the CRR, i.e. by 2017, the Commission will have to report on the impact of the supporting factor on lending to small and medium-sized enterprises and shall submit this report to the European Parliament and the Council, and, if appropriate, a legislative proposal.

You propose to continue considering sovereign debt as risk free. Isn't the risk of such debt amply illustrated by current events in the euro area?

The CRR and CRD aim at a risk-sensitive treatment of all exposures, including those to central governments. However this should be achieved by instruments which go beyond risk weights for credit risk. The legislation stresses that banks and investment firms should address and control all concentration risks, including from public sector exposures. Given the size of these exposures that banks hold for various reasons, including liquidity risk management, addressing concentration risk is key and more effective than risk weighting them, as risk weights are typically calibrated to absorb losses on a well-diversified portfolio of small exposures.

The difficulties with risk weights for central government exposures are recognised both in the CRR and in the Basel Accord by allowing exemptions from risk weighting (i.e. risk weights of zero) for domestic, and in our case, European, central government exposures.

What will the impact on the real economy of the new rules be?

Results of the Commission's impact assessment indicate that the impact of the proposed measures in the whole EU will be by far lower than the estimates presented by the industry (as they typically consider only costs, but no benefits). In our view, the concerns expressed by the industry about an excessive impact of the reform on banks' lending and the economy are therefore exaggerated.

More importantly, the transition period to the new capital and liquidity requirements is very generous. This will allow institutions to reach the new targets in an organic way, without putting a lot of pressure on capital markets. It will also reduce the impact of the nominal credit shock on the real economy (via price adjustments).

How do the new rules relate to the bank resolution legislative proposal?

The two frameworks complement each other. The CRDIV/CRR package strengthens the prudential requirements and supervision related to banks and investment firms. The legislative proposal on bank resolution contains measures on how to address a banking crisis at an early stage and if the crisis develops further resolve a failing bank in an orderly manner without damaging the financial system and by extension, the real economy. While the CRD IV/CRR package reduces the probability of banks failing, the proposal reduces the impact of such failures and will therefore work as a backstop for bank failures. It contains legislative provisions related to preparatory measures, early intervention measures and resolution powers and tools.

How will the common rule book contribute to the establishment of a Banking Union?

CRDIV is the backbone of the single rule book and, together with harmonized deposit protection schemes (see IP/10/918) and a European recovery and resolution framework (see IP/12/570 and IP/13/674), they form the core components of a stronger financial framework common to the 28 Member States (see MEMO/13/679).

Building on this stronger regulatory framework, the European Commission has taken an inclusive approach by proposing a roadmap for the Banking Union. It includes a number of steps for the 18 Euro Area Member States, and potentially also open to all 28 Member States should they wish to participate. Two major steps have been taken with the Single Supervisory Mechanism (see IP/12/953) and the Single Resolution mechanism (see IP/13/674 and MEMO/13/675).

What's the interaction between the Single Supervisory Mechanism and the CRDIV/CRR on the use of macro-prudential tools?

The CRD/CRR package defines the macro-prudential toolkit, rules and procedures to be applied by the relevant authorities in all Member States.

Article 4a of the draft SSM regulation as reflected in the agreement reached between the European Parliament and the Council on 19 March 2013 allows: 1) national competent or designated authorities to act on own initiative to apply macro-prudential tools; 2) the ECB to impose higher requirements or to act in consultation with the relevant competent authority in each participating Member State; 3) a reciprocal consultation process to ensure that both the national authorities and the ECB act in a consistent and coordinated manner.

In any event, the allocation of the competence to exercise macro-prudential tools between the ECB and national authorities in the SSM are fully consistent with the coordination procedures provided for in the CRD/CRR texts which will apply to all 28 Member States. As consistently defended by the Commission, prior coordination procedures for macro-prudential action are necessary to avoid negative spill-over effects on other Member States and to safeguard the internal market.

What are the new rules for the exposures in defaults?

For banks using the internal rating based approach for credit risk, the Regulation allows competent authorities to replace the 90 days with 180 days for exposures secured by residential or SME commercial real estate in the retail exposure class, as well as exposures to public sector entities (PSEs). The 180 days shall not apply for the purposes of standardised approach.

Key Numbers mentioned in the 2011 Impact Assessment

Process and public consultations:

- One public hearing and four online public consultations between 2009-2011,
- Nearly 300 responses to online consultations,
- EU quantitative impact study on a sample of 246 banks holding 70% of capital of the whole EU banking sector.

Crisis costs:

- Crisis-related losses incurred by European banks between 2007 and 2010: almost €1 trillion or 8% of EU GDP (IMF)
- EU GDP contraction in 2009 due to the economic recession induced by the financial crisis: 6% (Eurostat)
- Approved state aid measures between October 2008 and October 2010: €4.6 trillion or 39% of EU GDP (Commission)
- State aid measures effectively used in 2008 and 2009: more than €2 trillion (Commission)
- Examples of companies where inadequate management of liquidity risk largely contributed to their failure: Northern Rock (UK), HBOS (UK), Bradford and Bingley (UK), Bear Sterns (US), Lehman Brothers (US)
- Examples of companies whose (mostly hybrid) capital instruments did not live up to the expectations as regards their loss absorption, permanence and flexibility of payments capacity (which had to be reinforced through Commission state aid decisions): RBS (UK), Bradford and Bingley (UK), KBC Group (BE), Bayern LB (DE), Commerzbank (DE), Lloyds (UK), Allied Irish Banks (IR), Bank of Ireland (IR), Cajasur (ES)

Short term impact, ignoring benefits of the new measures:

- Estimated Common Equity Tier 1 (CET1) shortfall to meet the new minimum requirements and the conservation capital buffer, based on 2009 capitalisation levels:
- Immaterial in 2013 (binding only for 3 banks in the EU QIS sample) – due to transitional provisions;
- €84 billion in 2015 – due to transitional provisions;
- €460 billion in 2019 – full implementation.
- Limited impacts till 2019(after this period a superior increase in EU GDP is expected, please refer to the figures below):

- Decrease of only 0.14%-0.17% in EU GDP for each percentage point increase in CET1 capital ratio (Basel Committee, Commission services)
- Decrease of only 0.42%-0.49% in EU GDP for the above €460 billion CET1 capital shortfall (Basel Committee, Commission services)

Long-term economic impact (after 2019), considering both benefits and costs of the new measures:

- Average decrease of only 1.8% in stock of loans for 2020-2030 (Commission services)
- On Average an increase of only 0.29 percentage points in loan rates for 2020-2030 (Commission services)
- Net economic benefits (i.e., benefits less costs) increase of 0.3% - 2% in EU GDP, stemming from reduction in expected frequency of systemic banking crises (Basel Committee, Commission services)
- Reduction in the probability of systemic banking crises: within the range of 29% to 89% when banks recapitalise to a total capital ratio (including buffers) of at least 10.5% (Commission services, Basel)
- Additional systemic benefits in terms of stemmed pro-cyclicality and reduced severity of any future banking crises not captured in the above estimates.

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[i] According to the IMF estimates, crisis-related losses incurred by European banks between 2007 and 2010 are close to €1 trillion or 8% of the EU GDP

[ii] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 published in the Official Journal of the European Union L 176, volume 56, of 27th June 2013.

[iii] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC published in the Official Journal of the European Union L 176, volume 56, of 27th June 2013.

[iv] http://www.bis.org/publ/bcbs189.pdf

[v] http://www.bis.org/publ/bcbs189.pdf, pages 14-15

[vi] See Article 521 of CRR and Article 162 of CRDIV.

[vii] A CCP is an entity that interposes itself between the two counterparties to a transaction, becoming the buyer to every seller and the seller to every buyer. A CCP's main purpose is to manage the risk that could arise if one counterparty is not able to make the required payments when they are due –i.e. defaults on the deal.

[viii] The principles set out in CRD III were in line with the internationally agreed and endorsed Financial Stability Board (FSB) Principles and Standards for Sound Compensation Practices and the principles regarding sound remuneration policies set out in the Commission Recommendation of 30 April 2009 on remuneration policies in the financial services sector (OJ L 120, 15.5.2009, p. 22).

[ix] See Article 22 and points 23 and 24 of Annex V of Directive 2006/48/EC of 14 June 2006, as amended by, among others, Directive 2010/76/EU of 24 November 2010.

[x] Article 145 of Directive 2006/48/EC.

[xi] It is recalled in this context that CRD IV repeals Directive 2006/48/EC together with its successive amendments.