



Comment Piece

ECOFIN's stance on CRDIV

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On 15th May 2012, the Council of the European Union, through the Economic and Financial Affairs Council (ECOFIN) reached an agreement on the package of measures that will implement Basel III throughout the European Union – commonly known as CRD IV. The next step is with the European parliament and the European Commission to negotiate with the European Council further before it becomes law – however this latest development gives a good indication into what the final outcome could be.

At the heart of the whole process is the need to ensure that the regulatory failures that contributed to the financial crisis are properly dealt with. But more specifically, there has also been the objective to establish a single rulebook in banking in order to create a single uniform market, and to reinforce the ability of the union and member states' ability to protect their economies from potential banking failures.

There were a number of controversial measures that were originally proposed (and consequently disputed) within CRD IV. The final ECOFIN decision was unanimously agreed by all 27 countries. Below outlines what these objections were and what the outcome of each was following the latest ECOFIN meeting:

Freedom to set higher capital and liquidity requirements

Some member states such as the UK, Sweden and Poland proposed the ability to impose higher capital and liquidity requirements than mandated under CRD IV rules. Their argument was that country supervisors are best placed to react to conditions in their respective jurisdictions, resulting in a rulebook set of minimum rather than maximum standards. The counter-argument was that different capital standards could distort the single internal market and consequently, it may allow one jurisdiction to gain a competitive advantage over another.

Outcome: It was agreed in the recent ECOFIN meeting that member countries should be allowed to impose stricter prudential requirements including own funds,

large exposures, public disclosure requirements, liquidity and capital for domestically authorised financial institutions. The outcome will result in a single rule book, but with national supervisors free to impose stricter rules and additional reporting where they deem necessary. The changes recommended by the council represent a minimum rather than an absolute or maximum standard.

Tier one capital determined by each country's national law

It was proposed that items which can be included as part of a firm's Tier 1 capital should be determined by each country's national law rather than if those items adhere to the 14 principles outlined in the Basel III accord. However, in some EU jurisdictions capital instruments are included that would not pass the Basel III tests, namely the ability to be loss absorbing at the point of a bank's failure – some member states argued that this clause signifies a weakening of the requirements. In order to meet the Basel III requirements many banks will need to raise very large amounts of capital or reduce lending. This will be at a time where exposure to Greece and others will make raising capital difficult.

Outcome: Capital will be admissible according to 14 criteria similar to those included in the original accord. This clearly raises the standard of capital that financial firms need to have across Europe. However, it could also adversely impact many financial firms by reducing the number and classes of allowable instruments. Specifically, this rule change could affect several French and German firms, as they have certain legal instruments that would not pass the 14 principles.

Insurance interest incorporated into a bank's capital above the 10% limit

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Outcome: *The inclusion of capital already counted in insurance-related entities appears to have been retained. This is one area where the European rules will be less stringent than those in Basel III. With the tools above, individual regulators may impose higher standards. This measure will benefit some firms with some of the largest bancassurance firms in Europe, such as in France and Germany. However, with all of this in mind, capital standards in Europe will be strengthened considerably even with this concession included.*

Removal of the 80% Basel I minimum on capital requirements

At present, even if capital calculations under Basel II indicate, firms are not allowed to have capital less than 80% of the same calculation under Basel I. During the latest talks, the commission sought the power to grant a permanent waiver from the minimum requirements if certain conditions are met with regards to internal models.

Outcome: *This measure will impact firms' internal model approaches – therefore for most firms the removal of the 80% floor will not have a material impact. However for those who may be affected, the change could potentially be significant. It has not been publically announced if the ability for the commission to grant a waiver on the capital Basel I minimum requirement remains or if it has been removed.*

Clarity on the liquidity asset buffer

At present CRD IV does not explicitly commit the EU to implement to liquidity and leverage ratio measures according to the Basel III timeline. There are also issues regarding which securities are permissible to be included as part a firm's liquidity asset buffer. The commission has been requested to give a solid commitment and to have an approved list of instruments eligible for the liquid asset buffer.

Outcome: *While the liquid asset buffer instrument definition has not been disclosed in the latest press statement surrounding the ECOFIN meeting, the agreement does show solid commitments for liquidity and leverage ratio measures to be in line with the Basel III timelines. This gives clarity and will allow institutions to plan for the introduction of the liquidity and leverage ratios into the rulebook with more certainty.*

In addition, a new macro prudential buffer has been introduced that can be operated for up to two years by the national supervisors and may add up to 3% for all exposures and up to 5% for domestic and third country exposures. This is separate from the other buffers (countercyclical and capital buffers) and will present firms with a further challenge.

Overall the final CRD IV is much closer to the Basel III accord than observers would have predicted, and we have seen a rise in the ability of national supervisors to regulate their markets. The negotiations with the EU parliament will take place, and they are seemingly pushing for higher standards and even closer adherence to Basel III as well as wishing to restrict bonus payments. The EU commission, on the other hand, appears concerned that too much national flexibility has been included. Either way what has been agreed by the ECOFIN ministers will be very close to what will appear in the final rules – therefore financial firms have no excuse not to prepare in earnest.

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