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Council adopts new bank capital requirements

The Council today[1] adopted a directive and a regulation amending the EU's rules on capital requirements for banks and investment firms (*14/13* and *15/13*). The decision was taken by a qualified majority of delegations, with the United Kingdom voting against (*10851/13 + ADD1 REV1* and *10853/13 + ADD1 REV1*).

Adoption of the "CRD4" legislation follows agreement reached with the European Parliament at first reading on 28 February, and subsequent approval by the Permanent Representatives Committee, on behalf of the Council, on 27 March.

The proposals set out to amend and replace existing capital requirement directives[2] by two new legislative instruments: a *regulation* establishing prudential requirements that institutions need to respect, and a *directive* governing access to deposit-taking activities.

They are aimed at transposing into EU law an international agreement endorsed by the G20 in November 2010. The "Basel 3" agreement, concluded by the Basel Committee on Banking Supervision, strengthens bank capital requirements, introduces a mandatory capital conservation buffer and a discretionary countercyclical buffer, and foresees a framework for new regulatory requirements on liquidity and leverage, as well as additional capital surcharges for systemically important institutions.

The new rules will apply from 1 January 2014.

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1 At a meeting of the Employment, Social Policy, Health and Consumer Affairs Council, without discussion.

2 Directives 2006/48/EC and 2006/49/EC

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The regulation

Capital requirements

The regulation will be directly applicable in order to prevent divergences in implementation at national level. It will require banks and investment firms to hold common equity tier 1 (CET 1) capital of 4.5% of risk weighted assets (until December 2014 between 4% to 4.5%), up from 2% applicable under current rules. The total capital requirement, which includes tier 1 and tier 2 capital, remains unchanged at 8% of risk weighted assets. The regulation defines CET 1 capital instruments using 14 criteria, similar to those set out in Basel 3, and mandates the European Banking Authority (EBA) to monitor the quality of instruments issued by institutions.

Additional capital requirements in the form of buffers are introduced in the directive (see below).

Liquidity requirements

The regulation will introduce EU liquidity requirements from 2015[1], after an initial observation period.

Institutions will be required to hold liquid assets, the total value of which would cover the net liquidity outflows that might be experienced under gravely stressed conditions over a period of 30 days. During times of stress, institutions would be allowed to use their liquid assets to cover their net liquidity outflows.

The liquidity coverage ratio[2] (LCR) will be phased-in gradually, starting at 60% in 2015 and reaching 100% in 2018. A review[3] in 2016 will enable the Commission to delay the introduction of the 100% ratio, if justified by international developments. Until the LCR is fully introduced, member states may maintain or introduce national liquidity requirements.

The regulation also limits liquidity inflows to 75% of liquidity outflows to ensure that banks don't rely only on expected inflows to meet their outflows and instead hold a minimum amount of liquid assets equal to 25% of outflows.

Net stable funding ratio

To address longer term funding issues, the Commission would submit by 31 December 2016 a legislative proposal[4] aimed at ensuring that institutions use stable sources of funding.

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1 To be introduced by Commission delegated act on the basis of a recommendation by the Basel committee.

2 Unencumbered high quality assets against net cash outflows over a 30 day stress period.

3 In the form of a new delegated act.

4 Based on reporting and assessments by the EBA.

Leverage ratio

The regulation will provide for the introduction of a leverage ratio from 1 January 2018, if agreed by Council and Parliament on the basis of a report to be presented by the Commission by 31 December 2016. This will follow an initial observation period; from 1 January 2015 institutions will be required to disclose their leverage ratio.

The leverage ratio is a non-risk based measure and defined as an institution's tier 1 capital divided by its average total consolidated assets. Different levels will be set for institutions following different business models.

National flexibility: Macro-prudential powers

The regulation will enable member states to impose, for up to two years (extendable), stricter macro-prudential requirements for domestically authorised financial institutions in order to address increased risks to financial stability. These stricter measures can apply to the level of own funds, liquidity requirements, large exposures requirements, the level of the capital conservation buffer, public disclosure requirements, intra-financial sector exposures, and risk weights for targeting asset bubbles in the property sector. The Council can reject, by qualified majority, stricter national measures proposed by a member state.

The directive

Capital buffers

The directive will be transposed into national law by the member states. It will introduce additional requirements for a capital conservation buffer of CET 1 capital of 2.5% of total risk exposure, identical for all banks in the EU, and an institution-specific countercyclical capital buffer[1] of up to 2.5%.

Moreover, member states will have the possibility to introduce a systemic risk buffer of additional CET 1 capital for the financial sector or one or more subsets of it, or buffers for systemically important institutions.

Member states will be able to apply systemic risk buffers of 1% to 3% for all exposures and up to 5% for domestic and third country exposures, without having to seek prior approval from the Commission. They will be able to impose even higher buffers with prior Commission authorisation in the form of an implementing act. If a member state decides to impose a buffer of up to 3% for all exposures, the buffer has to be set equally on all exposures located within the EU.

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[1] National authorities would be responsible for setting countercyclical buffer rates within their jurisdictions, while financial institutions would have to set their buffer according to their credit exposure to the various jurisdictions.

The buffer requirements specific to systemic institutions will be mandatory for global systemically important institutions (G-SIIs), but voluntary for other (i.e. EU or domestic) systemically important institutions (O-SIIs).

Buffers will apply on a consolidated basis for G-SIIs and on an individual, sub-consolidated or consolidated basis for O-SIIs. The O-SII buffer will be capped at 2%.

G-SIIs will be assigned to one of five sub-categories, depending on their systemic importance. They will be subject to progressive additional CET 1 capital requirements, ranging from 1% to 2.5% for the first four groups, while a buffer of 3.5% will apply to the highest sub-category.

The systemic risk buffer and buffers for G-SIIs and O-SIIs will generally not be cumulative; only the highest of the three buffers will apply. However, if the systemic risk buffer applies to domestic exposures only, it can be added to the SIFI buffer.

Bankers' bonuses

Bonuses will be capped at a ratio of 1:1 fixed to variable remuneration, i.e. no greater than equal to fixed salary. This ratio can be raised to a maximum of 2:1, if a quorum of shareholders representing 50% of shares participates in the vote and a 66% majority of them supports the measure. If the quorum cannot be reached, the measure can also be approved if it is supported by 75% of shareholders present. The first bonuses to be affected will be those paid in 2015 in respect of performance in 2014.

For the purposes of applying this ratio, variable remuneration may include long-term deferred instruments that can be appropriately discounted. The EBA will prepare guidelines on the applicable discount factor, taking into account all relevant aspects, including inflation rate, risk and appropriate incentive structures. Moreover, long-term instruments have to be fully "claw-back-able" and "bail-in-able". Member states may allow institutions to apply the discount rate to a maximum of 25% of total variable remuneration provided it is paid in instruments that are deferred for a period of at least five years.

These provisions will also apply to the staff of subsidiaries of European companies operating outside the European Economic Area and the European Free Trade Area.

The Commission will review and report on the impact of this provision, in close cooperation with the EBA, taking into account its impact on competitiveness and financial stability.

Governance and transparency

From 1 January 2014, institutions will be required to make public the number of employees per institution in group and net banking income.

At the same time, all European G-SIIs and O-SIIs have to report to the Commission on profits made, taxes paid and subsidies received. During 2014, the European supervisory authorities will help the Commission to analyse this data and conduct an assessment looking at the economic impact (i.e. competitiveness, credit availability and levels of investment) and broader financial stability implications of their potential disclosure. From 2015, banks will have to publicly disclose the data unless the Commission, by delegated act, either delays or amends the relevant provisions.

A "sunset" clause provides for expiry of this provision, if/when it has been dealt with in other forthcoming legislation (i.e. accounting directive).