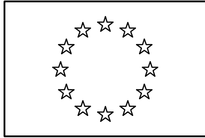

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 13.7.2009
SEC(2009) 975 final

COMMISSION STAFF WORKING DOCUMENT

Accompanying document to the

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

amending Capital Requirements Directive on trading book, securitization issues and remuneration policies

SUMMARY OF THE IMPACT ASSESSMENT

[COM(2009) 362 final]
[SEC(2009) 974]

1. BACKGROUND

The financial crisis has prompted a broad EU and international (G20, the Financial Stability Forum, the Basel Committee) effort to identify the reasons behind the problems and develop effective policies to tackle them head-on. In the buoyant years preceding the turmoil, credit institutions aggressively took risks that turned out to be not adequately captured by capital requirements, including the risks contained in the trading book. In order to achieve higher capital ratios considered appropriate by market participants, banks have had to seek fresh capital in a difficult economic environment that, in turn, led to tightening of their lending standards, exacerbating negative cyclical trends in the real economy.

In tackling another aspect of the high propensity to aggressive risk taking, the Commission has already issued a Recommendation on remuneration policies in the financial services sector explaining the role these arrangements played in precipitating the financial crisis[1]. The Commission Communication[2] accompanying it set out additional steps necessary for their more effective implementation, referring to a need to modify the Capital Requirements Directive[3] (CRD) in order to bring banks' and investment firms' remuneration policies and their link with risk management clearly within prudential oversight laid out under the Directive.

2. STAKEHOLDER CONSULTATION

– The Commission discussed possible improvements to the current legislative text at the CRD working group, whose members are nominated by the European Banking Committee, three times in spring of 2009.

An online public consultation on proposed draft revisions to trading book and securitization provisions ran from March 25 until April 29, 2009. The comments were generally supportive of the objectives of the Commission's draft proposals. With regard to proposed treatment of trading book and securitization activities, throughout the project the Commission has followed and participated in the work of international forums, the Basel Committee in particular.

A separate online public consultation on a proposed draft of remuneration policy provisions ran from April 29 until May 6, 2009. Twenty three responses were received from a wide range of stakeholders including banking, insurance and asset management sectors, national supervisory and regulatory authorities as well as worker trade unions

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[1] Commission Recommendation on remuneration policies in the financial services sector (C(2009) 3159/2)

[2] Communication from the Commission accompanying Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector (COM(2009) 211/2)

[3] Consisting of Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions

3. PROBLEM DEFINITION

3.1. Capital Requirements for Trading Book

Credit institutions and investment firms ('institutions') may calculate their capital requirements for market risk using their internal 'value-at-risk' (VAR) models under Annex V of Directive 2006/49/EC. Market risk is the risk of losses due to price fluctuations of financial instruments in the trading book, the trading book comprising those instruments held for short-term resale or to hedge other financial instruments that are held for short-term resale. Under the current provisions, institutions' VAR models shall provide an assessment of the loss that would not be exceeded with a 99% confidence level if the institution held on to its portfolio over a 10-day horizon.

However, VAR models are based on short periods of historical data which may not capture relevant market stress episodes. In addition, VAR models' assumption of independent returns did not hold at times of market stress when correlations between risk factors increased. Therefore, capital requirements as determined by using VAR models were not robust enough to absorb potential trading book losses and contributed to the sub-optimal level of risk management. Resultant swings in capital position exacerbated procyclicality of bank lending and investment with negative implications for the real economy.

Additional losses were caused by the fact that trading book charge for default risk currently does not capture the credit rating migration risk[4] and by the absence of a robust institutions' internal modelling methodology for default and migration risk for securitization positions in the trading book.

3.2. Capital Requirements for Re-securitization Positions

Annex IX Part 4 of Directive 2006/48/EC sets out the risk weights determining capital requirements for securitisation positions in banks' non-trading books. In most cases, banks will determine capital requirements for securitisation positions by reference to the external rating of the securitisation positions. However, so far, no distinction is being made between normal securitisation positions and re-securitisation positions that have other securitisation positions as underlying assets. As a result, capital required for re-securitizations does not adequately reflect their higher risk compared to 'normal' securitisations.

In April 2008, the IMF estimated that mark-to-market losses on the Collateralized Debt Obligations (CDOs) of US sub-prime and alt-A mortgage backed securities incurred by the euro area and UK banks totalled $32 billion, with losses for banks globally reaching $153 billion[5], assuming on average 60% loss on these instruments since the preceding year. Deterioration in bank capital positions, driven by losses from re-securitizations, exacerbated procyclicality of bank lending with follow-on negative implications for the real economy.

3.3. Disclosure of Securitization Risks

Annex XII of Directive 2006/48/EC sets out disclosure requirements that banks, subject to a materiality threshold, have to make about their risk positions. There is a dedicated section on securitisation risks, however this section currently only requires information on securitisation risks in the banking, not in the trading book.

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4 Risk of losses due to credit rating downgrades

5 IMF, *Containing Systemic Risks and Restoring Financial Soundness* ,Global Financial Stability Report, April 2008

As more and more banks kept posting more and more losses relating to securitisation positions, market confidence in banks' stability declined further and further.

3.4. Remuneration Schemes

The impact assessment accompanying the recent Commission Recommendation on remuneration policies in the financial services sector examined in detail the shortcomings of the remuneration arrangements prevalent in the financial services industry and explained the role these arrangements played in precipitating the financial crisis[6]. These shortcomings were shown to pertain to the structure of remuneration policies and inappropriate corporate governance systems. Furthermore, the ensuing risks to the institutions themselves and, more generally, to financial stability were not subject to adequate oversight by supervisors.

However, since a recommendation is not a legally enforceable instrument, there is a case in the context of prudential supervision for a legally binding EU instrument reinforcing the role of the supervisors and empowering them to assess the remuneration schemes of certain regulated financial institutions in a broader context of sound risk management so that relevant policy objectives are achieved more effectively. There is also a possibility that in the absence of binding EU legislation there might be a potential for regulatory arbitrage, if companies chose to relocate jurisdictions where the Recommendation does not apply.

4. OBJECTIVES

The overarching goal of this initiative is to ensure that the effectiveness of bank capital regulation in the EU, represented by the Capital Requirements Directive, is strengthened and any of its excessive pro-cyclical impacts on the real economy are contained while maintaining the competitive position of the EU banking industry. This translates into the following four general policy objectives to:

– Enhance financial stability;

– Enhance safeguarding of creditor interests;

– Ensure international competitiveness of EU banking sector;

– Reduce pro-cyclicality of the financial system.

In light of the problems outlined, ten operational objectives have been identified to address the problem drivers. Effective realization of such operational objectives should contribute to the achievement of the longer term specific objectives aiming at enhancing adequacy and minimizing cyclicality of capital requirements, eliminating regulatory arbitrage opportunities, reinforcing bank risk management, improving investor understanding of bank risk profile and enhancing legal clarity. In turn, this should facilitate the attainment of the general policy objectives.

5. POLICY OPTIONS, IMPACT ANALYSIS AND COMPARISON

Altogether, fourteen different policy options have been designed, impact-assessed and compared with a view to addressing the various issues identified in the analysis. This section describes the expected impacts of policy measures in each area.

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[6] For more in-depth description and analysis of the problems please see the impact assessment accompanying the recommendation (SEC(2009) 580)

5.1. Trading Book

With respect to capital requirements for bank trading books, the following targeted amendments will be introduced to respond to the individual problems:

– Adding an additional capital buffer based on stress scenario VAR to the ordinary VAR. This change may be expected to roughly double the trading book capital requirements given the current environment.

– Extending the existing charge for default risk in the trading book to capture losses short of issuer default, e.g. rating downgrades, to address in particular the fact that losses on traded debt most of the time did not involve issuers actually defaulting. The overall impact of this change on the capital requirements will depend on how banks portfolios will adjust in terms of composition to the post-crisis environment.

– Basing the charge for securitisation positions in the trading book on the (simple) risk weights that already exist for the banking book, addressing the methodological difficulties of modelling.

Such enhancement of the adequacy of bank capital requirements is of a paramount importance in order to enhance financial stability and minimize any excessive procyclicality of the financial system.

5.2. Re-securitizations

Capital requirements for re-securitization positions of banks will be increased. In line with the approach developed by the Basel Committee, for every credit rating grade, re-securitization positions would be assigned a higher risk weight than other securitisation positions, with such higher risk weights being set in accordance with a higher risk of unexpected impairment losses.

For particularly complex re-securitizations, the proposals would reinforce both the due diligence requirements and the supervisory process to enforce them. The supervisors will have to establish on a periodic basis whether due diligence standards for investments in certain types - as identified in advance by the Committee of European Banking Supervisors (CEBS) - of highly complex re-securitizations have been adequately met. For these instruments, a general deduction from capital requirement would apply unless banks demonstrate that necessary due diligence standards have been met. In instances, where compliance with required due diligence is found to be inadequate, institutions would be debarred from investing in such instruments in the future.

5.3. Disclosure of Securitization Risks

Disclosure requirements would be enhanced in several areas such as securitization exposures in the trading book and sponsorship of off-balance sheet vehicles.

These changes will improve investor understanding of bank risk profile and, by allowing market participants to exert discipline, would also reinforce bank risk management incentives. The incremental administrative burden for the EU banking industry is estimated at €1.3 million per year and is expected to fall mostly on larger institutions with more advanced approaches to risk management.

5.4. Supervisory Review of Remuneration Policies

The proposed amendments will impose a binding obligation on credit institutions and investment firms to have remuneration policies that are consistent with effective risk management. The relevant principles will be set out in the CRD, but will be closely aligned with those set out in the Recommendation on remuneration policies in the financial services

sector. For the practical application of this binding obligation, the guidelines on sound remuneration polices developed by CEBS will be also highly relevant. All national supervisors will be able to apply both financial and non-financial sanctions against firms that fail to satisfy supervisors that they comply with the relevant principles in a way that is appropriate to their internal structure and business model.

Making the relevant principles of the Recommendation binding will enhance compliance with them at a company level; therefore, there might be an impact on attracting or retaining talent at the overall sector level which might have negative short-term implications for the international competitiveness position of EU firms. It is essential to underline, however, that a more effective implementation of the relevant principles of the Recommendation certainly implies a trade-off that includes long-term benefits for the industry stemming from improved risk management outcomes and, more importantly, broader benefits in terms of a more stable and less procyclical financial system.

5.5. Cumulative Impact of Proposed Amendments

An estimated $1.4 trillion could be lost in asset writedowns by European banks as a result of the current crisis. These losses together with ensuing negative consequences for the real economy will be shouldered – to a varying degree – by different stakeholder groups, ranging from shareholders of financial institutions to taxpayers. In light of the lessons learned, it is crucial to review certain aspects of bank regulation so that the risk of losses of this scale occurring in the future is contained. Such containment constitutes the overarching and the most material expected benefit (or cost saving) of the proposed amendments and by far outweighs the costs that accompany them.

The improvements that are being proposed aim to render the CRD framework more robust, leading to more effective risk management incentives and practices, more adequate and less volatile bank capital requirements and enhanced disclosure of bank risk positions to the market participants. At the level of individual stakeholder groups and systemic concerns, the expected benefits of the proposals are as follows:

– Enhancements to the regulatory capital framework - in terms of more adequate and less cyclical capital requirements together with strengthened public disclosure requirements - should provide the EU banking industry with appropriate incentives for improving their risk management as well as their internal governance and control systems and procedures. As a result, not only the long-term viability of EU banks but also their competitive position vis-à-vis their international peers in the long run would be enhanced.

– The proposed revisions will enhance the effectiveness of supervisors' monitoring of the risks that financial institutions are exposed to by providing more legal clarity on banks' obligations with respect to managing risks stemming from inappropriate remuneration policies; by eliminating regulatory arbitrage opportunities allowing banks to apply lower of the banking or the trading book capital charges and streamlining the regulatory treatment of securitization positions in banks' trading book.

– Protection of banks' creditors, including depositors, will be enhanced as improved effectiveness of the framework and its supervision will lead to a reduction of bank default risk.

– Borrowers, including SMEs, will benefit from a less cyclical nature of bank financing allowing them to engage in projects that are profitable and vital for the economic growth and prosperity.

– Importantly, by improving the adequacy and curtailing the cyclicality of regulatory capital requirements as well as enhancing risk management incentives for the EU banking institutions, the proposed amendments will strengthen financial stability and mitigate any excessive pro-cyclical effects of bank regulation, indirectly yielding substantial benefits to the wide range of social stakeholders, including bank employees (via improved financial soundness of their employers), households (e.g., via less cyclical availability of credit and restored trust in their banks) and taxpayers (via reduced likelihood of bank bailouts in the future).

The overall cumulative impact on compliance costs for the industry is expected to be chiefly driven by the cost of capital which would have to be raised in order to comply with revised rules. To the extent that, as a result of their internal capital planning or credit rating agencies' requirements, banks hold capital levels exceeding regulatory requirements, the impact might be partially mitigated by the resultant capital buffers.

Introduction of proposals that have a direct bearing on the amount of capital that banks are required to hold will have to be carefully timed so that any unintended pro-cyclical impacts on the credit supply and, hence, the real economy are avoided or cushioned in the short-term.

6. MONITORING AND EVALUATION

It is expected that the proposed amendments will enter into force in 2011. The amendments are tightly inter-linked with other provisions of the CRD, that are in effect already since 2007-2008, and that will come into effect following CRD revisions that have already been adopted by the Council and the European Parliament in 2009 or are foreseen for adoption by the Commission later in 2009.

Measuring the progress of reaching specific policy objectives will be aided by the Commission's participation in the working group of the Basel Committee and the joint task force on the impact of the new capital framework, established by the ECB and CEBS, that are monitoring the dynamics of bank capital positions under the Basel II framework globally and in the EU, respectively.