CEPS COMMENTARY
Thinking ahead for Europe

The Commission's CRD IV requires a deeper reading

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31 January 2012

The European Parliament and EU Council need to undertake a more thorough review of the draft Capital Requirements Directive IV (CRD IV), which implements Basel III in EU law, with a view to streamlining and tightening the proposal. The most important amendments to consider are the introduction of risk-weighting on sovereign exposures within the EU and the related application in the large exposures regime, a review of the generous risk-weighting afforded to real estate, and the full application of the leverage ratio.

CRD IV is the most substantial of all the post-crisis regulatory measures entertained to date and touches upon the core problem of the EU financial system, namely the overall low levels of bank capital to absorb losses. Mario Draghi, in his former capacity as Chairman of the Financial Stability Board, called the loopholes in Basel II "one of the major factors of the crisis".[1] Since this is the first time the proposal has been subjected to review by legislative bodies, it is important for the EU to make a very close examination. The EU is the only jurisdiction codifying Basel III in EU law for application and implementation in the national law of 30 states, whose banking systems collectively represent about one-half of the world's banking assets. Other jurisdictions leave this responsibility to the discretion of national supervisory authorities.

The Commission's proposal is hugely complex, composed of a Regulation consisting of 488 articles and 4 annexes and a Directive consisting of 154 articles and 1 annex – in total good for about 220,154 words![2] Its size alone makes it a monster for the EU's legislative bodies. The European Parliament in particular should be reminded of its lenient review of CRD I (or Basel II) in September 2005, when, under pressure from regulators and the industry, all the trading book provisions were added as a single amendment, without a proper discussion. This failing was partially and belatedly corrected in the CRD II and III in 2009 and 2010, which radically increased capital requirements for the trading book.

As elaborated below, the EP should take a strong position on five key points of CRD IV: 1) the maximum harmonisation approach; 2) the maintenance of current risk-weighting of assets regime and, the zero risk weighting for EU government debt; 3) the limited role for the

[1] Conference on Financial Integration and Stability, organised by the European Commission and the ECB, Brussels, 2 May 2011 (http://ec.europa.eu/internal_market/economic_analysis/conference20110502_en.htm).
[2] For comparison, the MiFID and MiFIR drafts total 85,397 words.

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leverage ratio; 4) the reliance on credit ratings in the external credit ratings-based approach 5) and the reduced risk weightings for real estate exposures.

- The **maximum harmonisation** approach has already been criticized by some member states, but it has not been changed so far by the European Parliament's initial report. While the European Commission follows the same approach adopted in other recent EU proposals, it is difficult to maintain in the context of capital. The European Commission argues that it wants to avoid a 'race to the top', but it is difficult to argue in favour of a maximum limit on capital. Capital regulation is never perfect, as the crisis has demonstrated, but why would a bank not be allowed to compete on the basis of higher levels of capital? This would also make the financial system safer.
- The EP and EU Council should give the **leverage ratio** a much more central role in the capital adequacy assessment of banks than the European Commission has done, which is only indicative and subject to review (Art. 416). The almost unique reliance on risk-weighted core tier 1 ratio, as also the European Banking Authority (EBA) continues to do in its stress tests, gives a misguided view about the health of the European banking sector, as was demonstrated again with the failure of the Belgian-French bank Dexia. The latter had a core tier-1 ratio well above 9%, thanks to substantial sovereign holdings, but a tangible equity ratio of less than 2%.
- Contrary to some reports in the media, the European Parliament has not changed the **sovereign risk-weighting** in its initial report. It only asks the European Commission to submit a report to the European Parliament and the Council proposing options to adjust "that risk weight accordingly as soon as possible" (Amendment 9 EP). The zero-risk weighting thus remains in effect (Art. 109). The same applies to limits on large exposures, which do not apply for governments and local authorities (Art 389). The drawback of this method is that it unduly penalises banks with exposures to the 'real economy', as the latest EBA stress test demonstrated.[3] The current system builds in strong disincentives to lend to SMEs as compared to sovereigns, for example.
- The **role of ratings agents** in the assignment of risk categories has also not been addressed. While the European Commission is correcting the regulatory reliance on ratings agents in the latest amendment to CRA Regulation, ratings agents continue to have a central role in the determination of the risk weights, under the external ratings-based approach. They thus continue to have a regulatory role in the current proposal.
- Exposure to **real estate** continues to benefit from a more favourable risk-weighting than other exposures, which and is left to the discretion of the member states (in contradiction with the maximum harmonization approach). The bias towards real estate investments, with the well-known result, is maintained, with a risk-weighting of half (or even less) of the real exposure, even for commercial property (Art. 391). Real estate exposure must be assessed on the basis of its real cost.

An examination of the European Parliament's initial review of the proposed legislation in a post-crisis context suggests that the institution is being excessively timid. Even more so than in 2005, the EP will likely come under pressure from governments and regulators to adopt its reading as soon as possible. But even the heads of state and government are capable of changing parameters rapidly, as they did in October 2011, when they decreed that the 9% tier 1 ratio should be met by all banks by June 2012. In pointed contrast, CRD IV states that this only needs to be 6% by 2014. In short, the European Parliament should do its job responsibly on CRD IV and not bow to outside pressure or shy away from flexing its muscles.

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[3] See by the same author, "Placing EU Banks under Undue Stress", CEPS Commentary, December 2011 (http://www.ceps.eu/book/placing-eu-banks-under-undue-stress).