Finance Watch

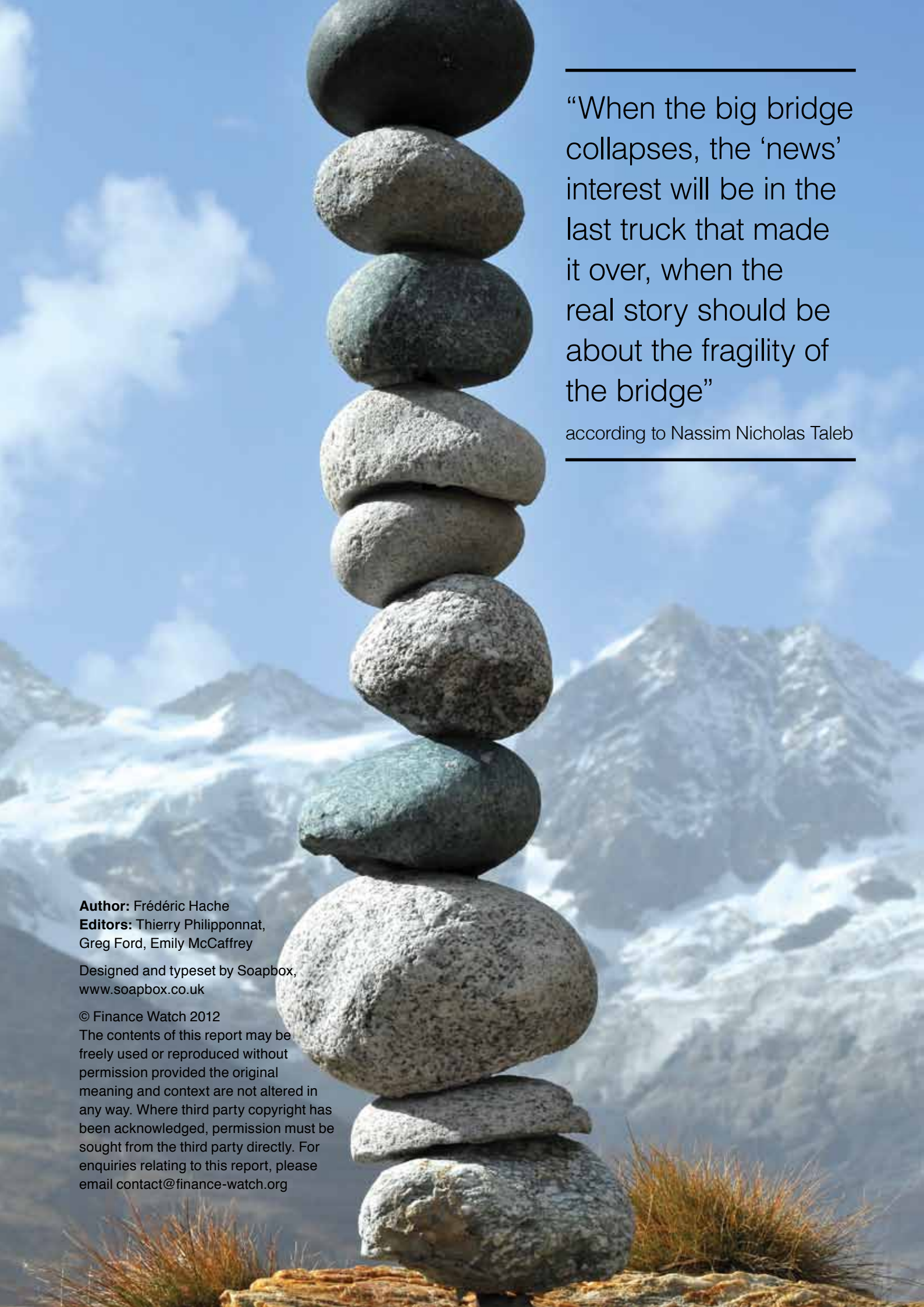
Making finance serve society

Basel 3 in 5 questions:

Keys to understanding Basel 3

Addressing bank capital to strengthen the financial system

May 2012



"When the big bridge collapses, the 'news' interest will be in the last truck that made it over, when the real story should be about the fragility of the bridge"

according to Nassim Nicholas Taleb

Author: Frédéric Hache
Editors: Thierry Philipponnat, Greg Ford, Emily McCaffrey

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This document aims to explain in simple terms the system of bank regulation known as Basel 3, which is intended to make banks stronger and prevent future banking crises.

The Basel accord affects citizens very deeply but, just like its European implementation 'CRD 4', it does not make easy reading. We have therefore boiled down these long and technical documents into the following summary to help readers understand how these rules actually work.

Contents

A 'jargon-buster' appears at the end of the document to explain the words highlighted in blue. If you are reading this online, the explanations should also pop up if you hold your mouse over the highlighted terms.

Introduction

The European Union finds itself in the middle of a crisis that rivals that of 1929. Banking crises are not rare events; there have been thirty since 1985, each leading to very high costs for society.

The 2008 crisis showed that our banks need a lot more capital

The regulators' response, dubbed Basel 3, is therefore a much needed reform to reduce the probability and severity of future crises. Its main element is to require banks to fund themselves with more capital.

Some voices in the banking industry argue that the current economic slow-down is the wrong time to make banks hold more capital. We argue the contrary: the fact that the economy is under stress merely reinforces the need to improve the strength of the financial system, to have sounder and safer banks and to restore confidence.

This will benefit all of us so let's not delay

Contrary to the claims of some in the banking industry, stronger regulation will not penalise banks but will help them return to sustainable long-term value creation. And if you ask shareholders and customers these days, it is likely that most would rather have strong banks that survive and make steady profits than fragile banks that do extremely well for a while and then go bust.

If regulation can also ensure that finance refocuses on its core purpose of allocating capital to productive use in the real economy, it should benefit everyone, from financial system stakeholders to society at large.

Basel 3's core topic is capital requirements for banks: how much minimum capital banks are legally required to fund themselves with.

1. What is Basel 3/CRD 4?

The background to Basel 1, 2 and 3

Basel 3 is the third of the Basel accords, whose core topic is capital requirements for banks: how much minimum capital banks are legally required to fund themselves with, and its main objective is to enhance the stability of the financial system, in order to reduce the probability and severity of future crises.

In 1988 the Basel Committee on Banking Supervision, comprising the world's top banking supervisors, published a set of minimal capital requirements for banks, known as the Basel 1 accord, which was enforced by law in the G-10 countries in 1992.

Basel 1 primarily focused on credit risk and how much capital banks needed among their liabilities in order to deal with losses. Assets of banks were classified in five categories depending on their credit risk, or risk of default, and assigned corresponding risk weights. The general rule was that banks were required to fund themselves with capital equal to 8% of their risk-weighted assets.

Basel 2, the second set of accords published in June 2004, aimed at widening the scope of the risks covered, and at improving the methodology for calculating the risk weights.

In 2010, the Basel Committee on Banking Supervision published the Basel 3 agreement, an updated set of international rules on capital requirements for banks.

CRD 4 – the law implementing Basel 3 in the EU

These rules will now be converted into EU law through a legislative package called CRD 4 (Capital Requirements Directive 4), which is currently being debated by the European institutions.

The package comprises two texts: a directive that requires each Member State to convert it into national law in order to apply it, and a regulation, which is directly applicable at European level.

Some of CRD 4's key elements are:

More bank capital

a. Higher capital requirements: the total capital requirement for banks increases from 8% to 10.5%, plus a countercyclical buffer (see below).

As capital can be composed of several financial instruments (shares, retained earnings, deferred taxes, etc...) and some of them proved to be ineffective in absorbing losses during the crisis, the criteria for deciding which instruments to include as capital are strengthened as well.

More still in a downturn

b. Introduction of a countercyclical capital buffer: a new mandatory capital buffer is created, ranging from 0% to 2.5%, and added to the requirements above: each Member State will estimate on a quarterly basis whether credit creation is excessive and might create a bubble, and based on this assessment decide whether its banks should have additional capital.

The underlying idea is that since credit is cyclical and subject to bubbles, banks would build additional capital in good times, which would tend to slow credit growth during a boom, and provide banks with additional resilience during a downturn.

c. Introduction of a leverage ratio: leverage for banks is like the depth of building foundations for a property developer: the shallower the foundations the bigger the profits but the more fragile the building. This prompts the question: do we want our financial system to weather hurricanes or breezes?

More leverage always means more risk

Bank leverage measures the ratio of total assets to capital. When leverage is high, a bank holds a lot of assets for a given amount of capital. High leverage thus increases the bank's potential profits on its assets but also its potential losses. Other things being equal, more leverage always means more risk.

Banks are theoretically constrained on the amount of assets they can have relative to their capital by the 8% capital requirement, meaning they should fund themselves with EUR 8 in capital for every EUR 100 they lend.

Risk-weighting makes assets look smaller

However, under Basel rules the capital ratio is not applied to total assets but to risk-weighted assets, a figure that is adjusted to reflect the riskiness of each asset. Banks can as a consequence invest much bigger amounts in assets considered theoretically less risky than in more risky assets.

For example, assuming an 8% capital requirement, if the risk weight of sovereign bonds is 1% and the risk weight of corporate loans is 100%, how much of each asset could a bank hold for 100 euros of capital?

100 euros / 1% / 8% = 125,000 euros in sovereign bonds
100 euros / 100% / 8% = 1,250 euros in corporate loans

In the example above, a bank seeking to maximise its return on capital would hold only sovereign bonds; sovereign bonds may pay less interest but that doesn't matter if you can hold 100x more of them for the same capital.

In recent years, big banks have been allowed to determine risk-weights themselves using their own internal calculation models, in order to incentivise them to develop robust internal risk management models. As a consequence they can be tempted to attribute lower risk weights to their assets in order to increase their leverage, or the quantity of assets they can have for a given amount of capital.

It is well documented that risk weights for identical assets vary greatly between banks. Some banks can thus have a ratio of assets to capital far greater than others, and consequently be more fragile.

In order to address this issue, Basel 3 plans to introduce a leverage cap that limits the total quantity of assets that a bank can hold relative to its capital.

The leverage cap does not take into account risk weights and is therefore simpler to understand and harder to manipulate.

A limit on leverage

In technical terms the leverage ratio will be calculated as Tier 1 capital (that's mainly equity) divided by total assets (including so-called 'off-balance sheet' assets). The ratio is expected to be capped at 3%, meaning that for every euro of capital it is funded with, a bank can lend up to EUR 33.3.

A leverage ratio will be introduced next year in Switzerland and already exists in the USA and in Canada, where it was credited with helping Canada's banks weather the 2008 financial crisis.

Banks that typically buy a lot of assets that are considered low risk, such as sovereign bonds, criticise the leverage cap on the grounds that it would constrain their activity. Many also oppose the public disclosure of leverage. We find it worrying that banks do not want to disclose their leverage to investors and the general public, and believe that transparency and information for investors and clients are essential.

But 33x is still too much

Also, the proposed leverage limit remains very lax: many hedge funds are considered highly risky with leverage of 10x to 15x, but the current proposal would let banks operate at a much higher leverage of 33x. Finance Watch advocates a stricter leverage ratio.

d. Introduction of liquidity ratios

Explaining liquidity

Traditional banking involves so-called 'liquidity and maturity transformation': borrowing money over the short term through liquid instruments and using it to purchase long-term illiquid instruments. For example, a bank could borrow money for three months in the capital markets and use it to fund 30 year mortgages to its customers.

However, there is a danger that the bank may struggle to renew its short-term borrowing and have to repay it before it can get the money back from its long-term investment. This is called the liquidity risk. In return, banks earn a liquidity premium from the difference between long- and short-term interest rates, which gets bigger (and more profitable for the bank) as the mismatch in maturities increases.

In the years preceding the crisis, some banks tended to push the liquidity and maturity transformation to an extreme, borrowing sometimes over a week to purchase long-term illiquid assets, which significantly increased the risk. As a result several banks found themselves facing a liquidity crisis in 2008 and after.

In order to curb this risk, the regulator decided to introduce two ratios on bank liquidity to ensure that banks keep a minimum cushion of liquidity.

Liquidity ratios

The first, called Liquidity Coverage Requirement, aims at ensuring that banks have enough funding resources available over the next 30 days: it requires banks to have enough liquid assets to cover 30 days of expected net liquidity outflows (cash withdrawals from clients).

The second liquidity ratio, called Net Stable Funding Ratio, aims to ensure that banks have enough funding resources over the next 12 months to cover for the expected funding needs over the same period.

The definitions of what is considered a liquid asset or a stable funding source have been subject to much debate, but the principle is healthy in our view.

We must not forget, however, that liquidity issues are often a symptom of other deeper concerns, such as investors' wariness over a bank's solvency, for example if they think it has insufficient capital.

A financial crisis occurring every twenty years or so, costing 63% of GDP, is equivalent to losing about 3% of GDP a year (Independent Commission on Banking)

2. Why the need for Basel 3?

The banking crisis of 2007 / 2008 had enormous consequences for society in terms of wealth destruction, rising unemployment and increases in levels of public debt. It also showed that bank capital was, in general, far too low.

In the context of almost continued decline of bank capital over the past century, empirical evidence, academic studies and several leading figures conclude that bank capital needs to be much higher.

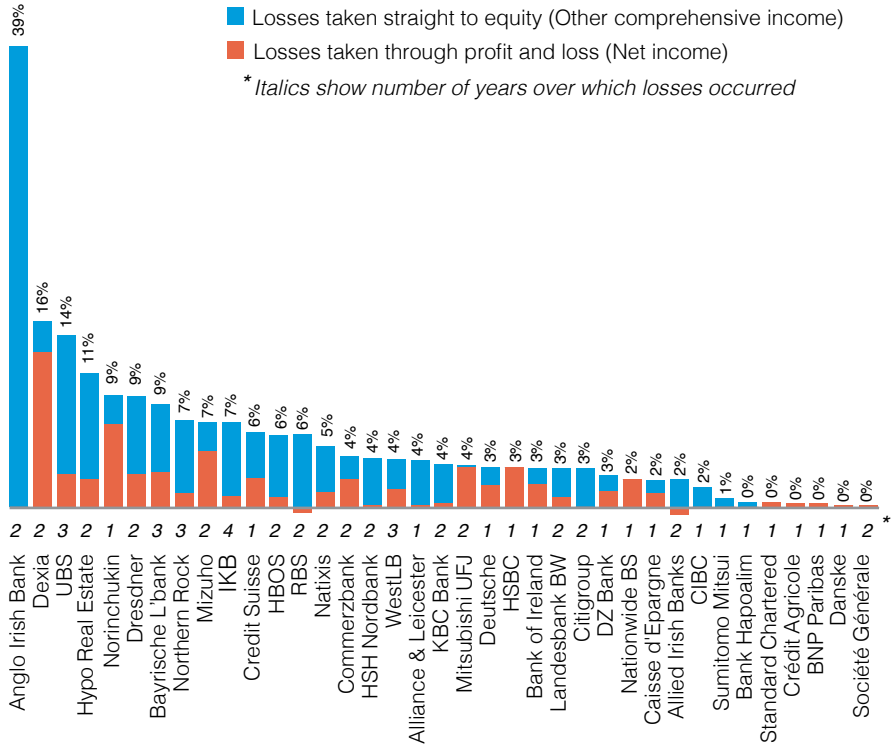
So how high should it have been to absorb the losses?

Calibrating the capital requirement

Studies show that the ***average loss*** in the last crisis was 5% of risk weighted assets. Other studies found "significant marginal benefits" in having capital up to 10% of risk weighted assets, while in the last crisis 16% would have absorbed most individual losses and 24% would have absorbed nearly all the losses from bank crises since 1988. When the wider costs of financial crises are considered, one study calculated that the socially optimal level of capital would be in the range of 16-20% of risk weighted assets.

As it implements Basel 3, the EU is proposing that banks have capital of 10.5% of risk weighted assets (RWA).

Chart 1: Losses suffered by banks in the crisis as a percentage of RWAs (2007-2010)



Source: Bankscope.com, ICB (2011)

Did Basel 2 make things worse?

The role of Basel 2, both before and after the global financial crisis, has been discussed widely, with some people arguing that it did not prevent the crisis but rather amplified its effect. They argue indeed that banks tried to minimise their capital requirements, either through underestimating the true riskiness of their assets or through transferring their assets to non-regulated shadow banking, which ultimately led to much higher losses during the crisis.

Whether Basel 3 will have a similar effect remains to be seen, although it will depend to a large extent on how it is implemented and what other regulations are introduced alongside it.

Compliance with the new capital framework is expected to reduce the stock of loans on average by only 1.8% by 2020-2030 (European Commission)

3. How will it affect the real economy?

a. On bank lending

The myth of expensive bank equity

Banks complain that raising capital (issuing shares) is more costly than debt (borrowing money), as the dividends that the shareholders expect are allegedly higher than interest paid on debt. They argue that this would force them to charge more for their loans and that this would hurt the economy.

However this is mostly untrue, as both returns on equity and the interest on debt are proportional to the risks that banks take: the higher the risks a bank takes, the higher the return that the shareholders will expect and the higher the interest that lenders will require as well.

The tax system encourages debt over equity

There is nevertheless one factor that makes the costs slightly different, which comes from the fact that debt interest is deductible from bank taxes, whereas dividends are not. Having more capital and less debt would thus increase the amount of taxes that banks pay. This would be a genuine cost to banks but it cannot be considered a cost from society's point of view.

Most European banks have claimed that the implementation of the reform would lead to a significant contraction in lending to companies and individuals. However recent research by academics and experts suggests that higher capital requirements will have little impact on lending levels.

Limited impact on the real economy

According to a European Commission study, compliance with the new capital framework is expected to reduce the stock of loans on average by only 1.8% by 2020-2030.

In terms of the impact on loan rates, most studies conclude that the likely impact will be very limited, adding around 0.15% to the interest rate charged on bank loans.

Since loans to the real economy represent on average about 50% of European banks' assets, it is clear that even a reduction in banking assets does not imply necessarily a reduction in lending. There might be a temptation for some banks to reduce lending rather than their trading assets, as lending can appear less profitable, but as such banks' management decisions would have a big impact on society, we feel that they should be monitored by supervisors.

Finally, some banks might be tempted to transfer some of their activities to the shadow banking system in order to lower their capital requirements. This merely reinforces the case for a comprehensive regulation of the shadow banking system.

b. On bank staff

If there is a need to cut costs, banks can cut bonuses before jobs

A claim made by many bank managers is that the implementation of Basel 3 / CRD 4 will lead to significant layoffs of bank staff.

We appreciate that the proposed package might lead to a redistribution of banking jobs between activities, perhaps from trading to other areas, but we see no reason

why the workforce as a whole should decline automatically as a result of higher capital requirements.

The amount of work that needs doing in a bank will not change simply because the bank is funded with a higher proportion of capital; banks will therefore need, everything else being equal, the same number of employees, and if there is a perceived need to cut costs, banks can always choose to cut bonuses before they cut staff.

Bank layoffs allegedly caused by Basel 3 are therefore management decisions where managers choose to reduce their workforce in order to maintain their return on equity.

c. Banks concerns

We see several reasons why some large banks may object to higher capital requirements.

Banks want to keep their subsidies

The first one is moral hazard, i.e. the fact that most large banks are currently not allowed to fail because governments will bail them out with taxpayers' money: when banks' bankruptcy costs are covered by society (taxpayers) instead of by their shareholders, banks have no incentives to build stronger capital buffers to avoid bankruptcy.

The second reason is the tax deductibility of interest paid on debt, which everything else being equal, makes debt a more attractive source of funding for banks. However, as referred to above, this cannot be considered an advantage from society's point of view.

ROE is a flawed incentive

Finally there is the bias towards return on equity (ROE), defined as profits divided by the capital of the bank. If banks have to increase their capital and hence issue more shares, it follows that banks will display a lower return on equity, everything else being equal, even though the profit remains the same. This is therefore a debatable measure of profitability and performance.

As return on equity is the indicator most commonly chosen to determine bank performance and the management compensation pool, banks try to maximise this indicator. They can increase their ROE either through increasing profits, or more easily through increasing leverage and therefore fragility.

It can therefore be argued that the focus on ROE incentivises banks to minimise their capital and to object to higher capital requirements.

CRD 4 will improve banks' strength on an individual basis, however it does not meaningfully address systemic risk or moral hazard

4. Which issues are not yet addressed?

Systemic risk and moral hazard are still with us

CRD 4 will improve banks' strength on an individual basis through the combination of higher capital requirements, liquidity ratios and leverage ratio, even though it could go further in this direction.

However the reform does not meaningfully address the issues of systemic risk or moral hazard.

Systemic risk can be defined as the risk of collapse of the entire financial system and the related risk of disruption of essential financial services, such as deposit taking and lending to corporations and individuals, leading to massive damage to the real economy.

In our view, several factors contribute to the building of systemic risk and while some of them are addressed in Basel 3, others are not and even in some cases reinforced:

1. The uniformity of asset holdings is the first factor: if a majority of banks acquires similar types of assets, as with the subprime mortgage crisis, this can threaten the stability of the system. It can lead to asset bubbles that can burst violently and trigger downward price spirals as all banks want to get rid of the same assets at the same time.

2. Interconnectedness is another major factor: if banks are linked to each other through a significant web of contracts then the failure of one bank to honour its obligations will lead to losses at other banks, potentially creating a domino effect that threatens the entire system.

3. The shadow banking system creates additional issues: risks located in unregulated entities cannot be monitored or curbed, and the existence of an unregulated area can incentivise banks to shift some of their assets and activities towards 'the shadows' in order to lower their capital requirements. Also, as the shadow banking system is strongly interconnected with traditional banks, it can create or amplify domino effects.

4.Finally there is still moral hazard, linked to "too big to fail". The current inability to let banks fail is, in our view, a major cause of systemic risk. If a bank should fail, even with higher capital requirements and liquidity buffers, it is still extremely likely that taxpayers' money would be used to prevent either a domino effect or a disruption of essential services.

Structural separation?

The CRD 4 proposal addresses this issue only indirectly by reducing the likelihood of individual banks failing, but it does not address moral hazard directly. To deal with this problem properly we should consider some type of structural reform, such as separating the investment banking arms of big banks from their retail and commercial units.

In view of this, we conclude that ***whilst CRD 4 goes a significant way towards making banks safer on a standalone basis, it does not address systemic risk*** by itself. Additional measures need to be taken to ensure that potential future crises do not impact society and the real economy as dramatically as the most recent one.

It is important for the public to be aware of these issues, and not to leave them only to industry lobbying and governments

5. What happens next?

CRD is in its last stages of becoming law

The Basel Committee on Banking Supervision published the original Basel 3 proposal at the end of 2010.

The CRD 4 proposal was then published by the European Commission in July 2011, and the European Parliament and European Council are currently forming their opinion. If an agreement is reached by the summer of 2012, CRD 4 will become law and the rules will start to have an effect in the EU by the end of 2013.

European Parliament rapporteur Othmar Karas presented his draft report in January 2012. His colleagues in the European Parliament's Economic and Monetary Affairs Committee had until early March to propose amendments, and will now try to find a compromise between political groups. Meanwhile in the European Council, meetings continue with a view to adopting an agreement in May 2012 earliest, so that negotiations between the Council, Commission and Parliament for a final agreement can start.

Our recommendations

Finance Watch has made several recommendations for amending the CRD 4 package, which we hope will be among the many changes proposed as CRD 4 passes through the EU's legislature:

1.Increase the proposed capital requirement from 10.5% to 17.5% of risk weighted assets.

2. Increase the proposed leverage ratio to a flexible cap of 5% in normal times and 3% during crisis, and make it a mandatory measure from 2015.

3. Lower the risk weights for small banks and loans to retail and small companies, which we feel are penalised by the current levels.

4. Introduce a residual capital requirement for certain transfers of credit risk. Excessive credit risk transfer through securitisation has several bad side-effects (as described in the jargon-buster section). Yet banks can be tempted to transfer a significant portion of their loans in order to lower their capital requirements.

In order to curb excessive risk transfer, we therefore propose the introduction of a residual requirement for transferred exposures of 25% of the original risk weight.

This means that if a bank securitises some of its assets, it would still need to have 25% of the capital it would have required had it not done so.

5. Require banks to benchmark their risk weights against a standard loan portfolio. As different banks use different risk weights for the same assets, benchmarking would make it easier for the regulator and people outside the bank to compare the risk weight methodologies used by different banks. If the benchmarking showed that a bank uses excessively low risk weights on certain assets, outsiders could take that into account when assessing the bank's soundness.

6. Require mandatory disclosure of Return on Assets, calculated as profit divided by total assets, as a measure of profitability. This would encourage banks not to focus so much on Return on Equity, which creates issues from society's point of view.

The CRD 4 package, including the proposed changes, and together with other regulatory proposals underway should, in our opinion, be a far reaching and comprehensive reform with a significant impact on enhancing the stability of the financial system and refocusing banks on their core mission to serve the real economy.

Conclusion

Basel 3 will

Increase bank capital
Put a limit on bank assets relative to their capital
Ensure banks have enough liquidity
Make banks stronger on an individual basis

Basel 3 won't

Remove moral hazard
Address systemic risk

As this is an important topic that affects potentially all European taxpayers, we feel that it is important for the public to be aware of these issues, and not leave them only to industry lobbying and governments.

To read Finance Watch's full position on CRD 4, click here

To see the ideas in this report in cartoon form, click here

Jargon-buster

Asset: an asset can be described as an investment, tangible or intangible, made to make a profit. An industrial company's assets might include factories, machines, and receivables. Bank assets are typically loans the bank makes to customers (mortgages, consumer loans, airplane financing etc.), guarantees, and financial market exposures such as bond and stock purchases for own trading account / investment purposes, etc.

Assets are frequently classified according to their risk, i.e. the probability that they will be reimbursed.

Basel Committee on Banking Supervision: the BCBS is a committee of banking supervisory authorities that was established by the central bank governors of the G-10 in 1985.

Capital: the money a bank receives in exchange for issuing shares and selling them to investors (equity). The investors who purchased the shares are the owners of the bank or shareholders, since shares are ownership titles. Capital is thus the money that the bank funds itself with and that it does not need to reimburse.

Various definitions of capital exist, but we will not get into details, and will refer to capital as equity.

Capital requirements: legal rules that define how much capital in proportion to their assets banks are required to have as a minimum.

Credit risk: risk of loss arising from a borrower not paying back a loan as promised.

Credit risk transfer: (see also, Securitisation). A financial institution transfers to another institution or to investors the risk of non-repayment on a loan it made.

Credit risk transfer can potentially create several issues:

– As banks transfer the risk, they are less incentivised to have sound lending standards and are less accountable.
– The bank that makes the loan will always know more about the risk of non-repayment than the investor who purchases the loan but has not met the client. Therefore credit risk transfer can lead to a decline in the quality of risk assessment.
– As securitisations are often complex products composed of a very large number of loans, investors often do not analyse each underlying loan in the portfolio but rather rely on the rating of the securitised portfolio. Yet the crisis has shown that external ratings could be wrong, so a technique that increases reliance on external ratings is not desirable.
– In some cases the credit risk transfer is flawed, for example when it turns out that the loans have a significantly higher risk than what was agreed between the bank and the investor, and the bank has to take them back. Therefore it is important to

keep in mind that credit risk transfer is not always effective, and that a bank that thought it was no longer exposed to some risks might in effect still be liable.

Leverage: any technique used to multiply gains and losses on investment, through borrowing, use of derivatives or others.

As an example, if you have 100 euros and use them to purchase 100 euros worth of a stock, it is a non-leveraged investment. If the stock goes up 10%, you made a profit of 10, or 10% profit.

Now imagine instead that you borrow 400 euros and purchase 500 euros worth of the stock; if the stock goes up 10%, you earn 50, or 50% profit on your initial 100 euros. That is an investment leveraged 5 times, as you can earn/lose 5 times the rise/decline of the stock.

The higher the leverage the higher the risk, as potential gains but also potential losses are bigger compared to the initial investment.

Liability: a source of bank funding. The liabilities on a bank's balance sheet constitute its financial resources. They are called liabilities because the people who provide these resources have some form of claim on the bank. There are three main types of bank liability:

– Capital: see above.
– Debt: a bank can borrow money from other banks or investors. The difference between debt (borrowed money) and capital is that debt has to be reimbursed at a fixed date and interest has to be paid on it, unlike shares which don't have to be reimbursed and where dividend distribution is discretionary.
– Deposits: deposits that the bank receives from customers are used as well for loans or investments, and constitute a short term financial resource for the bank.

Liquidity: the degree to which an asset can be bought or sold quickly.

A house is less liquid than savings in a money market fund, as it would take far more time to sell the house than to get back the money from the fund.

Liquidity therefore measures the ability to convert an asset quickly into cash. Assets with a low liquidity cannot be sold quickly and are thus more risky.

Liquid instruments include cash, deposits, short-term loans, big companies' stocks, sovereign bonds etc.

Illiquid instruments include real estate, stocks with a low trading volume, complex mortgage based securities etc.

Losses: losses at banks normally arise when one of their assets turns out badly, for example a loan is not repaid or a financial exposure backfires. As long as the losses are smaller than the amount of capital, they can be absorbed. But if the losses exceed the capital, i.e. bank's internal resources, then the bank is unable to pay all its costs/bills without borrowing more money.

When a bank's losses exceed its capital, it goes bankrupt. It follows that the higher the proportion of capital in a bank's funding, the stronger the bank, i.e. the lower the risk that it will go bankrupt.

Moral hazard: situation where an institution takes excessive risks knowing that it will not bear the potential costs. Typically in finance, the situation where banks should go bankrupt but are bailed out by governments with taxpayer money is a moral hazard.

On-balance sheet – off-balance sheet assets: there is an accounting distinction between assets that are on-balance sheet, i.e. that are recorded in the end of year picture of a company's assets and liabilities, and assets that are not recorded on this picture, called off-balance sheet. Off-balance sheet assets include guarantees and client assets under management, among other things.

An asset will as a rule be on the balance sheet if it is an asset that the company owns.

Rapporteur: in the European legal context, a rapporteur is a person appointed to investigate a topic or legislative text. Their report can become the official negotiating position of an institution such as the European Parliament.

Risk weight / risk weighted asset: financial regulators require banks, when calculating how much capital they are required to have, to apply a weight percentage to each of their assets, which is supposed to reflect the degree of risk of the assets.

Let's take as a fictional example a bank that lends 100 euros to a start-up company and another 100 euros for an individual mortgage.

The total assets of the bank are 100 +100 = 200 euros.

Let's imagine that the regulator has decided that mortgages have a higher probability of being repaid than loans to start-up companies and therefore attributed risk weights of 50% to mortgages and 90% to start-up loans.

The risk weighted assets of the bank are 100*50% + 100*90% = 140 euros.

The risk weighted assets are the basis used for calculating how much capital banks need to have under Basel regulation.

If banks need for example to have 8% of their risk weighted assets in capital, that means in our example that the bank needs to have 8%*140=11.2 euros in capital.

That means that out of the 200 euros that the bank lent, 11.2 must be funded with capital, and the rest, i.e. 188.8 euros can be money that the bank borrowed.

Securitisation: financial technique where a financial institution pools together a portfolio of various types of loans and issues bonds against this portfolio that it sells to investors. Investors get their money back when the underlying loans get reimbursed.

This technique is used to transfer credit risk to investors: banks that have lent money 'sell the loans' to investors through this technique, and the investors then bear the risk of non-repayment of the loans.

Shadow banking: all the entities and activities that are part of the credit intermediation chain, but are outside the scope of the regulator.

Up until recently the regulators monitored only financial institutions collecting deposits from clients, i.e. banks, as they felt that ensuring the safety of clients' deposits was sufficient from a prudential point of view.

But other types of financial companies also provide credit or asset management such as mortgage brokers, hedge funds, money market funds, that are outside the scope of the bank regulator, hence the term 'shadow'. It means that they are not required to abide by the same rules of safety and careful management as banks. The shadow banking system is estimated to represent 25%-30% of the financial system today.

CRD 4 – Summary and Timeline

The European Union proposes to revise its rules on bank capital through an updated Directive and a new Regulation, collectively known as the Capital Requirements Directive 4 (CRD 4).

CRD 4 translates the international Basel 3 standards package as endorsed by the G20 into European legislation. The Commission's official goal of the new rules is to '*strengthen the resilience of the EU banking sector while ensuring that banks continue to finance economic activity and growth*'. The proposal also includes the Basel recommendations from December 2010 on Credit Value Adjustments and Counterparty Credit Risk. The Basel recommendation for additional requirements for large international banks ('SIFI surcharge') may be inserted through a later amendment to the CRD.

In addition to the implementation of the Basel 3 agreement, CRD 4 also introduces a 'single rulebook' in order to reduce national divergences in the way that the CRD is implemented.

The CRD 4 proposal was published by the European Commission in July 2011. The European Parliament and European Council are currently forming their opinions with the goal of reaching a common agreement by the Summer of 2012, with the new rules coming into effect by the end of 2013 at the earliest.

Indicative timeline of the legislative process (as at April 2012):

July 2011 – CRD 4 proposal published by the European Commission

January 2012 – European Parliament rapporteur Othmar Karas (EPP, Austria) presents draft report

27 February 2012 - Deadline for MEPs in the Economic and Monetary Affairs Committee to table amendments

25 April 2012 (more likely mid-May) – Economic and Monetary Affairs Committee adopts its position

22 June 2012 – Danish Presidency plans to reach agreement amongst Finance Ministers ('General Approach')

June-July 2012 – Compromise negotiations between the institutions

3-5 July 2012 – European Parliament plenary vote

July 2012 – Compromise endorsed by Finance Ministers

About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting citizen advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large section of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, and that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

Finance Watch

Finance Watch
Square de Meeûs 38/40
1000 Bruxelles
Tel: + 32 (0)2.401.87.07

www.finance-watch.org