IMF STAFF COMMENTS ON

EU COMMISSION SERVICES STAFF WORKING DOCUMENT:

POSSIBLE FURTHER CHANGES TO THE CAPITAL REQUIREMENTS DIRECTIVE

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Submission by:

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Please note that the views expressed in this submission are those of the IMF's staff, and not necessarily those of the IMF's management or Executive Board.

Main points

- Regulatory reform in the EU should establish a single rule book that provides the necessary tools to deal with country-specific risks to financial stability. This requires a change in prudential focus from the location of institutions to the location of exposures.

- The EU should base its single rule book on global standards, in order to ensure the integration of its single financial market with the rest of the world. The best way to pursue EU regulatory priorities is to proactively seek their incorporation in global standards.

[1] This contribution has been prepared by the staffs of the Monetary and Capital Markets and European Departments and has been approved by the Directors of these departments. It has benefited from input from the Legal Department.

- As a general principle, liquidity regulation should be applied at the level of legal entities, but integrated liquidity management within groups' intra-EU operations should be facilitated based on solid legally binding mutual support commitments.

- We agree that there is a case to revise the treatment of unrealized gains for regulatory capital purposes.

- We support the introduction of a leverage ratio, but are of the view that this should not be so strict as to replace the risk-based capital framework as the primary regulatory tool.

General considerations

We welcome the opportunity to comment on this working document and wish to compliment the Commission staff for having elaborated such a comprehensive and detailed analysis.

Regulatory reform is a key pillar of building a robust post-crisis financial system. The proposed changes to the CRD are a major step in the right direction. These changes will have costs in terms of financial sector profitability, financing costs for businesses and households, and the viability of some financial sector activities. To a significant degree, these costs are unavoidable: the crisis has underscored the need to put greater weight on financial stability in the balancing act with growth. It has also shown that financial sector excesses can lead to unsustainable and ultimately damaging growth and profit patterns, with short-term gains causing long-term pains for taxpayers. Hence, in designing its regulatory reform strategy, the Commission will need to be guided in the first place by long-term sustainability and public interest considerations.

As much as possible, the regulatory reforms should be shaped not only by the specific problems observed during the crisis but also by broad reflection on the risks the financial system will face in the future and the kind of system that is needed to fuel sustainable long-term economic growth. This is essential to prevent the next crisis, rather than just a recurrence of the present one.

Interaction with global reforms

We appreciate the Commission's strong support of the work that the Basel Committee on Banking Supervision (BCBS) is carrying out to strengthen capital and liquidity requirements while ensuring a global level playing field. Indeed, this work, active EU involvement in it, and the subsequent implementation of the resulting standards in the EU constitute the best avenue toward much-needed global guidelines and supervisory standards and a first-best basis for the EU's single rule book. In this context, we consider the present consultation to be a complementary effort to the one by the BCBS. Our informal input into the latter consultation outlines our basic views on most of the proposals, while this response focuses primarily on EU-specific issues.

To agree on common international standards that strike the right balance between prudence and ensuring the continued availability of credit and financial services, it is crucial to reach a clear understanding of the overall quantitative impact on the banking business of all the proposed reforms. In this regard, the work that the Committee of European Banking Supervisors is carrying out on this matter is of critical importance not only for the European Union but for the international community as a whole. We hope that the results of the Quantitative Impact Study will be made publicly available.

Let us take this opportunity to reiterate some issues that we also raised in the context of the BCBS consultation:

- Simplicity in designing the new regulatory framework would facilitate implementation and consistency across markets, serving both the objectives of effectiveness and achieving a level playing field.

- Regulation per se is insufficient to safeguard financial stability and needs to be accompanied by effective supervision, with appropriate resources, independence and tools.

To be effective in fostering prudent risk management, capital requirements need to be cast within a sound resolution framework. EU-specific considerations [2]

- In the EU, regulatory reforms need to support the single market, including by establishing a single rule book, while also effectively addressing risks to financial stability in this market. Importantly, it needs to provide the means to address country- or sector-specific risks to financial stability. In our view, this requires a fundamental shift in the EU's regulatory approach, whereby the applicable rules are no longer determined by the location of an institution (i.e., the country in which it is licensed) but by the location and nature of the exposures (regardless of which licensed EU institution holds them). We welcome the Commission's reflection on this (as spelled out, for example, in paras. 14, 162, and 172 of the consultation document).

- The EU's new supervisory framework (ESFS and ESRB) has the potential to support such a fundamental shift in approach. However, to do so, the regulatory framework needs to provide the new bodies with the right tools and with rule-making flexibility. Notably, means are needed to effectively follow up on ESRB risk warnings within

[2] Many of these considerations are developed further in other published work. We refer in particular to the Fund staff's contributions to the Commission consultations on the proposals of the De Larosière Group, Deposit Guarantee Schemes, and Crisis Management Arrangements, as well as to IMF Working Paper 10/70.

relatively short delays. To facilitate this, we suggest giving consideration to making the CRD more of a framework directive with significantly increased scope for the EBA to set technical standards.

- The ESAs will also need to play a key role in ensuring the consistent implementation of the new rules and a high level of quality in supervision throughout the EU. The objective should be to build a common supervisory culture that delivers this consistent quality and makes supervisors work together to jointly take responsibility for financial stability in the EU as a whole and in each of the member states.[3]

- Cross-border banking in the EU remains to a large extent dependent on banking groups operating through local subsidiaries. For the single market, it is important that these groups can operate as flexibly across the EU's internal borders as within a single country. A clear legal concept of banking group that spells out the rights and obligations of group members would provide a basis to reconcile such operational flexibility with prudential soundness. It would notably provide greater clarity in the application of capital and liquidity standards, by allowing structures, rights and obligations, and arrangements for asset transferability to be aligned with the application of these standards at either the consolidated or the company level.

- It is important that capital and liquidity standards are aligned with crisis management and resolution arrangements, including the rules for asset transferability that the Commission is seeking to develop. As we have argued before, the long-standing tension between increasingly trans-national financial institutions and national crisis management and resolution arrangements needs to be fundamentally addressed.

- Making a single rule book work in a context of interdependence requires good arrangements for enforcement of these rules and to settle conflicts. The ESAs' binding powers are essential for this. Consideration should also be given to the establishment of a specialized financial chamber at the European Court of Justice or the Tribunal of First Instance for such matters.

Section I: Liquidity standards

1. We are in broad agreement with the proposed metrics insofar as they do not diverge from what will be agreed by the BCBS.

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[3] This would align supervisory responsibility with the objectives of crisis management, as outlined in the first of the crisis management principles adopted by the ECOFIN in October 2007.

2. We strongly support the Commission's intention to harmonize liquidity regulations across the EU based on a globally agreed framework. This is important both from a single market and a financial stability perspective, as differences in liquidity rules created significant problems during the crisis.

3. These standards should, to a significant extent, be designed in conjunction with central bank liquidity facilities, as these facilities determine the basic liquidity characteristics of markets and instruments. Therefore, we recommend developing them in close consultation with the ESCB and also favor a clear and direct link with central bank eligibility. As recent experience has shown, the liquidity of well-established markets such as the one for covered bonds can easily evaporate. On the other hand, the flexible collateral policy adopted by the ECB can be viewed as justification for the inclusion of corporate paper and covered bonds into the liquidity buffer, which would help develop those markets and limit the dependence of the banking system on the supply of government paper.

4. In light of the need to establish a single rule book in the EU, we concur with the Commission Services' proposal to deal with country specificities through technical standards set by the EBA (Question 7). However, such differentiation should be based on substantive differences in the nature of products or the conditions that determine their liquidity characteristics and should be based on consistent criteria. The risk should be avoided that the EBA simply ends up setting country-by-country standards at the request of national authorities.

5. As mentioned in our introductory remarks, the liquidity regime should be consistent with the legal and prudential framework, including for asset transferability, crisis management, and insolvency. For this reason, we support the proposed application at both the legal entity and consolidated levels (para. 16 and Question 9). However, efforts should also be undertaken to grant exemptions from this general regime to facilitate the integration of liquidity management in banking groups. The conditions put forward to allow this (para. 17) appear appropriate, except that we reiterate our position that asset transferability should be possible during early intervention but not in insolvency. In our view, solid legally binding mutual support commitments should be sufficient basis to underpin integrated liquidity management. We urge the Commission to seek interim solutions to grant such exemptions while the asset transferability and crisis management work progresses.

6. Relatedly, we agree that as a basic principle intra-group transactions should be treated as transactions between third parties, with neither positive nor negative discrimination (paras. 21-24 and Question 12). However, as mentioned above, exemptions should be possible to facilitate integrated liquidity management within groups. Such exemptions should be based on clear and legally binding commitments between the members of a group that establish joint and several liability for the relevant commitments.

7. As for the supervisory responsibility for branch liquidity, we agree that the proposed harmonized liquidity regime provides a good basis to give full responsibility for liquidity supervision of branches and cross-border activities to the home Member State authorities, subject to close collaboration with the authorities of the host Member State (paras. 25-28 and Question 13). This would remove the current misalignment in responsibilities, an outcome that is highly desirable. However, it should be complemented by appropriate arrangements at the EU level to match the resulting authority of the home country in the host markets with accountability towards host countries, notably a duty to contribute to orderly liquidity conditions in host markets. The EBA should be mandated to oversee this.

8. We agree that it would be useful to introduce a harmonized set of Monitoring Tools (Question 14). However, we wonder whether this should be done through legislation or—perhaps preferably—through technical standards set by the EBA. In any case, we suggest allowing the EBA and the (colleges of) national supervisors the possibility to use additional monitoring tools at their discretion. The additional monitoring tools outlined in Annex III appear appropriate, but consideration might be given to additional metrics aimed at capturing possible liquidity needs arising from off-balance sheet and contingent exposures.

9. More broadly, the EBA, working with and through the (colleges of) supervisors, should promote a much greater degree of consistency of understanding of risk areas and use of monitoring tools. The implementation of a harmonized reporting system could further enhance consistent monitoring by supervisors.

Section II: Definition of capital

10. We welcome the Commission Services' proposal to revise the CRD in order to increase the quality, consistency and transparency of the capital base in line with what will be agreed by the BCBS.

11. The capital and crisis resolution frameworks need to be closely attuned to each other in function of the overall objective of limiting the probably and cost of bank failures. Within the global standard setting process, the EU needs to think ahead about how the various globally-defined components of capital will function in the context of the EU's future crisis resolution framework.

12. We support the elimination of Tier-3 capital and of the distinction between upper and lower Tier 2 (Question 16). We are also of the view that in order to strengthen bank governance and incentives for banks' prudent management, Core Tier 1 should account for the lion's share of total Tier 1 capital.

13. We note that the eligibility criteria for Core Tier 1 capital outlined in Annex IV are fundamentally inconsistent with the nature of member shares in cooperative banks (notably, criteria 2, 3, 5, and 8). This seems to go against the Commission's declared intention to take

into account non-joint stock companies' specific constitution and legal structure (para. 44). Not all of these criteria are essential to assuring the loss absorption capacity of capital, and most cooperatives have large accumulated reserves that provide a sound buffer against losses. As this has been a recurring issue and the cooperative banking sector is of great importance in Europe, we urge the Commission to work with the sector to establish a separate set of criteria under which cooperative capital and accumulated reserves can be recognized as Core Tier 1 capital. This could be part of a more fundamental exercise aimed at enhancing the ability of cooperatives to manage their capital.[4]

14. As for non-Core Tier 1 capital, staff is of the view that triggers for write/down and conversion of these hybrid instruments should be objectively defined so as to avoid re-introducing elements of complexity and opaqueness in the definition of capital which would make comparability across jurisdictions and individual credit institutions more difficult. In any case, resolution authorities should have the possibility to write down or convert non-Core Tier 1 capital of banks that have been placed under their administration.

15. We agree that there is a case for revising the treatment of unrealized gains (Question 21). These gains have been a major source of volatility, allowing banks to expand their balance sheets or forcing them to contract in function of asset market developments. As a general principle, only gains that are at little or no risk of being reversed and that can easily be realized with little sensitivity to market liquidity should be allowed to count toward regulatory capital.

16. We support the Commission Services' proposal to change the basis of the identification of large exposures from own funds to Tier 1 capital (Question 22), and agree that a concomitant recalibration of the 10 and 25 percent limits may be called for.

17. Similar considerations as for hybrid instruments apply to contingent capital (Question 23). The effective introduction of these instruments should be based on yet-to-be-established global standards and accompanied by harmonization of the relevant legal frameworks through EU level legislation. Certain constraints will need to be tackled, such as pre-emption rights given to shareholders (in certain jurisdictions, for instance, the issuance of share capital on a non pre-emptive basis could be subject to quantitative limits, qualified quorum, temporal or procedural limitations, or substantive justification criteria, all of which may need to be revised or made inapplicable). Also, the legal treatment should be clear as to the mechanisms to fix the conversion price, which may be subject to flexible, but at the same time sufficiently specific, criteria established upon the issuance of such instruments.

[4] For a fuller discussion, see IMF Working Paper 07/159.

18. Contingent capital instruments with automatic write-down could have a greater stability-enhancing effect than instruments with a conversion-into-equity condition, as the latter might give rise to destabilizing trigger point dynamics. Banks near the conversion threshold may see their share price plummeting and find it very hard to raise fresh capital amid the looming threat of dilution.

Section III: Leverage ratio

19. We welcome the proposal of a leverage ratio, and generally support the approach proposed by the Commission. We consider it a useful complement to the risk-based measurement in the supervisory process. As indicated in our comments to the BCBS' proposal, the attempts to agree on a common metric should nonetheless avoid creating a too complicated measure that might impair efforts to apply it consistently across jurisdictions and institutions. Therefore, in principle, we would see merits in a simple and direct correspondence between the methodology used in the risk-based capital framework and the one used to measure the leverage ratio. It is also essential that the impact of accounting differences be fully eliminated.

20. The leverage ratio should not be overly strict. It should not be designed to replace the risk-based capital framework as the main regulatory tool and the binding constraint for most banks. Its main objective should be to serve as a complementary tool that prevents banks from taking on excessive risks through regulatory arbitrage and off-balance sheet exposures (Question 25).

21. In order to comprehensively assess the impact of the leverage ratio and carefully calibrate it, we would support its initial use as a supervisory tool under Pillar II before moving it to Pillar I at a later stage.

22. We agree that the basis for calculation should be the predominant form of Tier 1, as determined in the risk-based approach.

23. As for general measurement principles, one major objective is the achievement of international consistency. While there are arguments on both sides, staff would broadly support the following:

- Exposure – net of provisions and valuation adjustments but physical or financial collateral not allowed to reduce exposure;

- Liquid assets – the leverage ratio should be consistent with maintenance of the Liquidity Coverage Requirement (LCR). The definition and calibration of the leverage ratio, and the weight it is given as an indicator, should not unduly penalize banks that choose to hold a large proportion of assets in liquid (government) paper even if they are relatively highly leveraged. We see much merit in simplicity, but the consistency of incentives needs to be established;

- Repos and derivatives – no-netting approach;
- Credit derivatives and off-balance sheet items – apply a 100 percent conversion factor with the only exception of trade letters of credit, the safer and low risk nature of which should be properly recognized by maintaining the current 20 percent credit conversion factor.

Section IV: Counterparty credit risk

24. We refer to Chapter III of the April 2010 Global Financial Stability Report for an in-depth discussion on counterparty credit risk and CCPs.

25. While in broad agreement with the proposed approach to ensure that sufficient resources are allocated to cover counterparty credit risk, staff would urge a thorough analysis of the relationship between the proposed add-on to capture Credit Valuation Adjustment risk and the stressed component of Expected Positive Exposure since potential double counting could be entailed.

26. We support a thorough review of stress testing approaches and model validation standards (Question 37). In general, such tests are only useful if they are conducted on the basis of sufficiently bold assumptions that take full account of potential correlation and mutual reinforcement among shocks. Excessive reliance on past data, without a complementary forward-looking deductive analysis of potential risk scenarios, has proven to be a major shortcoming as such data often had limited relevance when conditions changed and were subject to various fundamental statistical problems (including peso problems and the inability to capture "black swan" events).

Section V: Countercyclical measures

27. From a general point of view, there is an overarching need to strike a delicate balance between the prudential goal of ensuring the buildup of adequate cushions against expected losses in bad times and the investor protection objective of preserving a fair view of the true financial position of an institution. This is an area that calls for enhanced attention to guarantee that regulators and investors are enabled to assess and compare information on loan loss provisioning across jurisdictions and institutions.

28. If this balance cannot be adequately achieved through the accounting regime, prudential concerns will need to be addressed otherwise, e.g., through prudential filters and/or separate prudential reporting.

29. We look forward to the results of the technical working group of Member States experts on credit loss provisioning.

30. We also see a need for further analysis in order to reconcile the through-the-cycle provisioning framework with the downturn-approach used in the regulatory capital framework to determine expected losses and loss-given defaults.

31. While staff agrees with the basic features of the proposals to mitigate cyclicality and excessive credit growth (through provisioning and the dual structure of capital buffers), it might be difficult, if not impossible, to perfectly calibrate all the parameters involved. This implies that while these metrics can be used as valuable benchmarks, it remains a fundamental responsibility of supervisors to ensure that sound provisioning and capitalization are effectively applied by banks.

32. The proposals to establish a Capital Conservation Buffer and a Counter-cyclical Buffer are welcome. If implemented in the EU, the benchmark buffer requirements should be set in function of conditions in individual national markets and/or sectors, and apply EU wide as proposed in the document. However, they should be set on the basis of clear criteria, with input from the ESRB, and be endorsed by the relevant ESA. Such buffers could become important tools of macro-prudential policy. To realize this potential, we suggest allowing the ESAs—acting on ESRB advice—significant scope to define the details and adjust the parameters of the regime.

33. We agree that the elements proposed for being the subject of distribution restrictions appear appropriate (para. 160 and Question 41). We particularly agree that discretionary bonus payments should be included. In addition, parts of large pay packages could be made discretionary for this purpose.

34. Suitable macro-variables for use in the counter-cyclical buffer (Question 43) include the stock and growth rate of credit expressed as a percentage of GDP; sectoral balance sheet and income leverage ratios, and house price dynamics. However, regulators should also retain some discretion to respond to risks/imbalances not reflected in simple headline figures and country-specific factors (such as the trend rate of financial deepening and nonlinear relationships). In some countries it may be prudent to look at less aggregated variables, such as regional growth rates.

Section VI: Systemically important financial institutions

35. We support the Commission in seeking ways to reduce the financial stability risks related to systemic institutions, which may require more stringent capital and liquidity requirements for such institutions.

36. As indicated in a recent IMF Board paper (SM/09/245; September 10, 2009), three key criteria that are helpful in identifying the systemic importance of institutions (but not only) are:

- Size – the volume of financial services provided by the individual institution;
- Substitutability – the extent to which other institutions can provide the same services in the event of a failure; and
- Interconnectedness – linkages with other components of the system.

37. However, the assessment is likely to be time-varying depending on the economic environment. It will be also be conditioned by the financial infrastructure and crisis management arrangements, and their capacity to deal with failures when they occur.

38. While it is tempting to aim for market-based measures, these pose significant challenges, e.g., with respect to updating systemic (sur)charges over time. In fact, once such (sur)charges are in place, an institution's original systemic importance can no longer be inferred from market statistics. To the extent that a satisfactory measure of systemic risk cannot be found and full internalization of systemic externalities proves elusive, it becomes even more important to ensure low probabilities of bank default in general, notably through strict capital and liquidity requirements.

Section VII: Single rule book

39. As mentioned in our introductory comments, we see a single rule book as essential for the single market. Therefore, we encourage the minimization of national discretion, while moving to a system in which national risks are dealt with EU-wide rules and tools established and managed through the ESAs. The capital buffers discussed in Section 5 and variations in risk weights could be key tools in this regard. This system should help to address procyclicality in real estate lending (Question 52), but should be more generally applied to all sectors. We also support the Commission in its endeavor to explore more targeted measures for the real estate sector.

40. In this regard, the role that the newly established EBA and the college of supervisors can play is critical.

41. In our view, the CRD should be viewed not as a "minimum" but as a "maximum" harmonization Directive in as many areas as possible.