Review of European banking legislation

Green proposals for a strong risk reduction package (CRR 2 / CRD V)

<u>**Proportional treatment of small and less complex banks**</u>

For small and non-complex institutions (CET 1 ratio exceeding 15%, LR exceeding 6%, no use of internal models, assets below EUR 5 billion), **enhance proportionality** in the fields of

- reporting: EBA to develop a common EU reporting framework including statistical data, reduce reporting frequency for data that rarely changes, apply simplified NSFR, dis-apply Additional Liquidity Monitoring Metrics
- disclosure: no disclosure requirements for small non-listed institutions
- market risk: Clarify that good hedging-derivatives for real-world commodity risks are not penalized in the calculation of the small trading book
- remuneration: Increase the threshold for the exemption from deferral and pay-out in instruments to all institutions that are not large, but extend the deferral period from 3-5 to 5-10 years for all other institutions
- interest rate risk: requirement to use the new standardised methodology not automatically but only if competent authority detects deficiencies in the bank-internal risk assessment
- Supervisory Review and Evaluation Process (SREP): reduce SREP frequency from yearly to every three years possibility; subject to approval by the competent authority, waive the SREP requirement in total
- Recovery and Resolution: no reporting on the minimum requirement for own funds and eligible liabilities (MREL); subject to approval by the competent authority, waive the obligation to draw up recovery plans
- Committees: drop requirement to establish a separate risk committee, audit committee, and, subject to approval by the competent authority, remuneration committee; preserve independence of board members

<u>**Eliminate permissive deviations from Basel standards for calculating the Leverage and Net Stable Funding Ratios** (CRR Article 429a-c)</u>

We believe that leverage and liquidity rules must never be weaker in the EU than what is proposed at international level. This is particularly important to avoid overly lax treatment of derivatives and “shadow banking” funding such as “repos” and other volatile short-term funding.

Where the Commission proposal deviates in the detail of calculations from the proposals of the Basel Committee purely to please banks, we have introduced amendments to remove that deviation.

Examples include

- **Leverage ratio:** changes to ensure that collateral (i.e. initial margin and variation margin) received in connection with derivative contracts cannot be used by banks to reduce their own leverage ratio's exposure measure. (CRR 429c)
- **NSFR:** More conservative factors have been introduced in order to penalize banks which finance less liquid assets (derivatives, mortgage-backed securities, etc.) with unstable, short-term funding (i.e. wholesale lending, etc.).

Increase Leverage ratio and enhance supervisory powers over internal models: Decreasing reliance on banks' own models for calculating their shock absorption capacity (CRD Article 78, Article 161);
When the financial crisis hit in 2007/2008 banks all over the world, including Europe, they were found to have ridiculously thin margins (or "capital buffers"), sometimes less than 1%, between the value of their assets and the amount they owed to depositors and investors. That meant that relatively small losses to assets could render them economically bankrupt and the taxpayer was forced to intervene. Part of the blame lies with the fact that banks have for many years been allowed to use their own calculations for establishing the safety margins and always choose models that make them look less risky.

The Commission proposes to put a lower limit of 3% on the safety margin (the "Leverage ratio") in the knowledge that most banks already meet this. Many non-industry analysts recommend much higher limits and the US and Switzerland already impose 6% Leverage Ratio on the bigger banks. The Swiss also give their supervisors greater power over how internal models are translated into risk buffer requirements.

This is why the Greens/EFA Group in the EP proposed in the latest revision of the banking rule book that

- **regardless of what their internal models say, the leverage ratio (asset-liability gap) may not be lower than 10% of assets. Full stop. (CRR Article 92, Article 429ga (new))**
- **the difference between the balance sheet assets as reported in accounts and assets as calculated for the purposes of the Leverage Ratio must be disclosed with explanations (CRR Article 451)**
- **supervisors must have the power to force banks (CRD Article 79)**
  - **to use supervisory risk calculations instead of internal models**
  - **to impose limits on "risk reduction" through changes to such models (either by refusing to approve any model that results in a lower assessment of risk or by requiring that the model cannot lead to a lower risk assessment than a supervisory "standard formula")**
- **the Commission should report on and present legislative proposals to limit variation in internal model estimates that cannot be attributed to variation in actual risk faced (CRD Article 161)**

Limit exposure to systemic banks

The Commission proposed limiting exposures between two globally systemically important institutions (G-SII) to 15% of own funds.

However, G-SIIs will not only pull down other GSIIs if they fail, any bank with significant exposure to a systemic bank could be severely affected. Furthermore, exposures to the category of other systemically important institutions (0-SIIs) as defined in EU legislation, should also be subject to limits.

Hence we propose in CRR 395

- **a limit of 10% of own funds to G-SIIs**
- **a limit of 15% of own funds to O-SIIs**

Limit exposure to shadow banks

The Greens/EFA Group already achieved reporting on the top exposures to entities that perform bank-like activities but are not regulated like banks ("shadow banking" entities).

However, a lot of the inter-linkages and complexities that can affect the banking system arise from its exposure to shadow banking.

For this reason we propose in CRR Article 395

- **a new hard limit of 15% of own funds to any single shadow banking entity**
- **a new hard limit of 25% of own funds to the aggregate exposure to shadow banking**

Limit exposure to banks' home state government debt

Despite all Eurozone sovereign bonds being denominated in the same currency, it is individual states that are responsible for servicing the debt and this means only the biggest economies benefit from high external demand for their bonds. In many other Eurozone countries, the national banking system has been one of the principal purchasers of the governments bonds.

During the crisis this resulted in the so-called "doom-loop" where worries about a country's banks led to worries about the impact on government finances of any possible bail out or economic downturn which in turn reduced the value of the government bonds held by the banks.

Reducing the risk of bail-out, which is the hope for the bank recovery and resolution legislation in place since 2013, partially addresses this "loop". However, even if there is no bail out, the "loop" can still materialise through the "economic downturn" route.

The Greens/EFA group believes the "doom loop" should be addressed now and not continuously pushed into the long grass. Furthermore, incentives to reduce holdings of the "home" sovereign's debt must be accompanied by incentives to hold the debt of other sovereigns otherwise some Member States would be left with an insufficient market for their debt.

Concretely we propose

- **a limit on exposures to sovereign bonds of the "home" Member States that starts high enough not to be constraining at 200% of own funds but gradually lowers to 100% over 5 years (CRR Article 395)**
- **a thorough review by the Commission of different approaches to break the doom loop while preserving sovereign debt markets accompanied by legislative proposals where necessary (CRD Article 161)**

Give bank supervisors the power to address non-performing loans (NPLs)

Many banks in the EU have accumulated bad loans and had failed to set aside provisions to absorb the expected losses. This has slowed the return to health of the sector and the supervisory arm of the ECB - the Singles Supervisory Mechanism or SSM - has rightly prioritised cleaning up these NPLs.

Although new accounting rules (IFRS 9) coming into force from this year will help ensure provisions are more prudent, there is still some discretion left to banks on how the accounting and prudential statement of NPLs is approached.

We propose two suggestions from the ECB to increase prudence and help avoid such a build-up in future

- **a new "prudential provisioning backstop" setting a minimum level of provisions from the supervisors perspective (CRR Article 34a (new))**
- **new powers to require banks to change their provisioning policy (CRD Article 104)**

Other good suggestions from the Supervisory arm of the ECB

We agree with a number of proposals made by the Single Supervisory Mechanism (SSM) and have proposed to include in CRD/CRR review:

- **an extended list of infringements subject to administrative sanctions to give the supervisor more of a "stick" to force compliance (CRD Article 67)**
- **a requirement that non-EU banks should be required, not only to consolidate all their subsidiaries in the EU under one entity (to improve supervision) but also their branches**

Removing "prudential stimulus"

Encouraging investment in particular sectors of the economy is the job of economic and fiscal policy. Prudential policy should focus only on the stability of the banking system.

For this reason we:

- **remove the Commission's proposal for preferential treatment of infrastructure loans (CRR Article 501a (new))**
- **limit the Commission's proposal for preferential treatment for any size of loan to SMEs to loans below 2.5 million EUR (CRR Article 501)**

Integrating climate and other non-financial drivers of banking risk in banks' risk assessment and disclosure requirements without weakening capital requirements

We oppose the CRR/CRR Rapporteur's proposal for a "Green Supporting Factor" on the same grounds as other "prudential stimulus".

Instead we believe that banks should be required to take stock of environmental, social and governance risks associated with their investments and in line with the EUs Climate Action commitments. Furthermore the public should be informed about how they do this.

For this reason we propose:

- **A new comprehensive mandatory disclosure requirement related to Environmental, Social and Governance (ESG) risks and factors in the CRR framework. This includes an assessment of risks related to stranded carbon assets and the measures undertaken by credit institutions to assess and address these risks. (CRR New Article 449)**
- **A new requirement on supervisors to integrate in the SREP process a supervisory assessment of ESG risks and factors as well as an obligation on EBA and the Commission to develop a methodology for establishing relevant quantitative and qualitative criteria for**

assessing whether credit institutions integrate properly ESG risks and factors as well as for assessing alignment with the Paris objectives. (CRD Article 98)

Enhance supervisory discretion, strengthen soft Pillar 2 Capital Guidance and toughen restrictions on banks' distributions

An overarching aim of our amendments is to enhance supervisory powers on which the Commission's proposal puts severe limitations and to strengthen the consequences of delays in meeting supervisory requirements beyond the bare minimum requirements.

In this spirit we propose the following:

- **deletion of the mandate on EBA to produce RTSs that would result in limiting regulatory discretion in areas where supervisory judgement is needed (assessment of interest rate risk, Pillar II requirements)**
- **transforming the closed lists of reasons on the basis of which competent authorities can impose additional requirements into open-ended ones.**
- **enhancing the discretion for competent authorities to require additional own funds to be met with hard Common Equity Tier 1 (CET 1) instruments and removing the possibility of institutions to use the same capital instruments towards meeting simultaneously multiple capital requirements (Pillar I, Pillar II, Capital Guidance, Combined Buffer Requirement).**
- **re-introducing the ability of supervisory authorities to impose institution specific requirements (Pillar II) to cover systemic risks until the final revision of the macro-prudential toolkit.**
- **avoiding that the introduction of capital guidance encourages supervisors to reclassify Pillar 2 capital requirements as Pillar 2 capital guidance so as to allow distributions by transforming guidance from a vague "regulatory expectation" into a requirement that triggers progressive restrictions on distributions and is also subject to mandatory disclosure.**
- **broadening the scope of profits to be included in the MDA calculation and removing the 6 months grace period for meeting the MREL requirement deleted.**

Additional measures

- **Include conduct risk explicitly in the operational risk category to force banks to ensure protection of consumers, competition in the single market, protection of human rights, tax justice and the avoidance of money laundering**
- **Reduce national options and discretions (ONDs) to achieve a truly single rulebook**
- **Streamline the activation procedures for macro-prudential measures, eliminate overlaps between different capital buffers and make them apply additively**
- **Require a regular review of the macro-prudential framework**
- **Establish a regular review of preferential capital requirements to ensure prudential consistency**
- **Grant banking supervisors the competence to exchange information on money laundering risk**