CEPS COMMENTARY
Thinking ahead for Europe

EU version of Basel III runs into trouble

Karel Lannoo

11 May 2012

The principal item on the agenda of the May 2nd meeting of the Council of EU finance ministers was the European Commission's proposal for implementing Basel III into EU law, the so-called capital requirements Regulation and Directive (CRD IV). . In expressing his opposition to key elements of the Commission's proposal, the British finance minister reaffirmed his country's traditional role as opponent of further European integration. In defending the single market's core principle of free competition, however, the UK's position on this point is entirely correct, as long as minimum standards are respected. The Commission is proposing a cap on the level of capital that banks can hold, which is in clear violation of these principles. Moreover, the UK also rightly argued that the Basel III rules were being watered down. It is paradoxical that the country that is home to the largest financial centre in the EU, appears to be the one that is least in the hands of the banks.

As the most important post-crisis measure aimed at ensuring sound prudential supervision of the banking sector, CRD IV specifies a stricter definition of capital, sets a minimum of Tier 1 capital that all banks must hold and imposes additional capital buffers. But unlike the proposals of the Basel Committee, its sets no minimum level of core capital, but places a ceiling on risk-weighted capital. Moreover, it does not change the capital requirement for holdings of government bonds and mortgage loans contained in the current rules.

In its present form, the Commission's proposal leaves much to be desired. Firstly, although there is no strong argument in support of limiting the level of capital in a single market as long as minimum levels are respected, the European Commission has done just the opposite: it proposes maximum limits, without formally setting an absolute minimum. Through the risk-weighting of assets to calculate the minimum Tier 1 ratio, banks can mimic the rules through the use of internal models to calculate the levels of capital, or via the zero or low-risk weightings for certain, but very important asset classes, such as government debt or mortgage loans, in the ratings-based approach.

To give the member states some leeway, the Regulation proposes that member states may require banks to hold an additional systemic risk buffer for locally licensed banks, above the Tier 1 and Tier 2 ratios. To make things even more complicated, this facility is limited to up to 3%. Once above 3%, the authorisation of the European Commission is required, which is precisely what the UK government objects to.

This is why a leverage ratio, or a minimum level of core capital to total assets, is all the more important. Such a ratio is, unlike the Tier 1 ratio, easy to calculate and understandable for a broader public. However, the CRD IV proposal does not set a minimum, but leaves the

Karel Lannoo is Chief Executive Officer and Senior Research Fellow at CEPS.

question to be decided at a much later date, if at all. In addition, the definition of capital leaves much to be desired, and allows proportional consolidation of minority interest and double counting of capital in insurance undertakings, contrary to the provisions proposed in Basel III.

The US authorities have for some time applied a leverage ratio and will certainly argue, as soon as the issue is raised in a transatlantic or even a G-20 context, that the EU has not consistently implemented Basel III. Hence it would be better to respect the original spirit of the Basel III proposals, rather than make too many exceptions. Setting correct rules now is all the more important given that the largest part of the proposal is an EU regulation, which means that it is directly applicable to all EU-licensed banks immediately upon adoption by the EU's legislative bodies.