

## EU version of Basel III runs into trouble

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**11 May 2012**

The principal item on the agenda of the May 2<sup>nd</sup> 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 country's opposition to key elements of the Commission's proposal, the British finance minister reaffirmed the UK'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 correct, as long as minimum standards are respected. The Commission is proposing a cap on the minimum level of capital that banks should hold. Moreover, the UK also rightly argued that the Basel III rules were being watered down, despite the fact that it too has participated in this weakening of Basel III by requesting no less than four exemptions.

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, it sets no minimum level of core capital, but places a ceiling on the minimum risk-weighted capital member states can request. Moreover, it does not change the capital requirement for holdings of government bonds and mortgage loans contained in the current rules.

A careful reading of the CRD IV proposals is especially important in light of the fact that the EU legislators were extremely lenient in their review of CRD I (or Basel II) in September 2005. Under pressure from regulators and the industry, all the trading book provisions were added as a single amendment, without a proper full discussion. This failing was partially and belatedly corrected in the CRD II and III of 2009 and 2010, which radically increased capital requirements for the trading book.

Still, in its present form, the proposal leaves much to be desired. Firstly, the European Commission proposes maximum harmonisation of the minimum, 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

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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. The latest compromise would have increased this to 5%.

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 did not set a minimum, but left the matter to be decided at a much later date, if at all. In the Council compromise, a leverage ratio could be decided in 2015, to be applicable from 2018. 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 to make too many exceptions. The comparison with the US practice is also pertinent in another sense, as its approach is to implement these rules in a more principles-based way. In contrast, the EU, in order to find a single rule for its large diversity of banking markets and legal systems, is leaning more towards a rules-based approach. This raises the question of whether a one-size-fits-all approach is appropriate in light of the diversity in Europe's financial markets.