European Bank Coordination 'Vienna' Initiative

Working Group on Basel III Implementation in Emerging Europe

March 2012

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Report to be submitted to the EBCI Full Forum, 12-13 March 2012

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EXECUTIVE SUMMARY AND RECOMMENDATIONS

The European Bank Coordination ‘Vienna’ Initiative (EBCI) originated in early 2009 to help prevent a disorderly unwinding of financial exposures by commercial banks in the countries of emerging Europe subject to IMF/EU financial programmes. At the EBCI meeting as a ‘Full Forum’ in Brussels on 16-17 March 2011 participants decided to establish a Working Group to assess the relevant aspects of Basel III implementation in emerging Europe.

The Working Group benefited from strong participation by commercial banks active in emerging Europe, supervisors from both banks’ home and host countries, the European Commission and a range of international institutions, including the IMF and EIB. EBRD and World Bank staff coordinated the input for the report of the Working Group and chaired the three meetings of the group between May and December 2011. A number of organisations new to the EBCI process also participated in and supported this work, including the European Systemic Risk Board (ESRB), the European Banking Authority (EBA), the Association of Financial Markets in Europe (AFME) and the European Banking Federation (EBF).[1]

Establishing this Working Group was motivated by a concern that the new prudential rules of Basel III, primarily designed for advanced economies in response to the global financial crisis, may have certain unintended negative consequences on both future market development and cross-border relationships that are crucial in emerging Europe.

In the EU, the Commission has adopted a legislative package to amend the current Capital Requirements Directive. The proposal has been developed in the form of a regulation (CRR) and a directive (CRD4). At the time of drafting this report, a review of the texts of CRR and CRD4 by the European Council and the Parliament was already underway. Potential unintended consequences of Basel III type regulation are a particular concern in EU candidate countries and other countries outside the EU, which are deeply affected by the activities of European cross-border banks, though as yet outside formal consultation mechanisms.

The report’s key recommendations refer to Basel III principles as implemented under the Commission proposal for the CRR/CRD4.[2] The report covers the ten new EU member states in central and south-eastern Europe and also the non-member and candidate countries of the western Balkans. The report seeks to provide further input on financial regulation in emerging Europe – both at EU level and within individual host countries of European banks. More prudent financial regulation will require considerable adjustment

[1] For a list of participants see Annex II. The report was coordinated by Lalit Raina (World Bank), and Alex Lehmann (EBRD), with technical support of Hannah Levinger (EBRD).

[2] This has subsequently been overtaken by a compromise proposal issued by the Danish Presidency.

within the financial industry itself, and the recommendations below and the underlying report, are addressed in equal measure at the private sector.

The report is presented as a collective product to which all participating institutions in the Working Group subscribe in principle. The Executive Summary is intended to be made public. As any EBCI-VI product, the recommendations are voluntary and nonbinding. The recommendations are intended to inform market participants, policy makers and the general public about agreed approaches and best practices. As the process of drafting a Basel III implementation within the EU was already quite advanced at the time when the Working Group convened, several institutions have nevertheless taken exception to certain recommendations.

The context for Basel III implementation in emerging Europe

There are three salient characteristics of financial markets in emerging Europe which underline the need for careful assessment and calibration of Basel III implementation in emerging Europe.

- First, financial services are generally provided through the subsidiaries of other European banks. Foreign bank ownership is typically in the range of between 60 to 90 per cent of banking systems assets. Institutions with their home base in large countries, such as Austria, Italy or France, own and control subsidiaries that are systemically important within the host country, while accounting for no more than a minor share of overall group assets. Coordination with the supervisory authorities of the banks' home countries is hence invariably more complex and more central to financial stability than in western Europe.

- Second, maturities of financial liabilities on banks' balance sheets, in both deposits and parent bank funding, are generally shorter than in more mature financial systems.

- Third, and in part as a corollary of the previous constraint, private capital market instruments are generally underdeveloped. EBRD research has emphasised the lack of development of both private sector bond markets and short term money markets.[3] More than in most developed financial markets, credit provision to the private sector is dominated by banks and, in turn, banks have limited options to fund themselves through local bond markets. This presents a considerable constraint in meeting the liquidity standards established by the Basel III package.

Throughout, the working was fully supportive of efforts to safeguard financial stability through the implementation of Basel III type standards within emerging Europe. The agreement, and the Commission draft for implementation within the EU, envisages

[3] EBRD (2010): Transition Report 2010 – Recovery and Reform, London: EBRD.

certain transition periods that will aid in the calibration. Working Group participants expressed their hope that efforts by individual member states to accelerate this implementation should be carefully coordinated between all EU countries, and with the Commission.

KEY RECOMMENDATIONS OF THE GROUP

The Working Group identified concerns in four areas:

- Capital definitions;
- Liquidity requirements;
- Macroprudential instruments; and
- Home-host collaboration.

On capital definitions and capital requirements

The work of the group highlighted that in aggregate, capital ratios of local banks and foreign subsidiaries within the CEE region exceed those in the EU-15. This is due to prudent capital management on the side of banks in the face of volatile credit markets, but also local regulatory requirements. Nevertheless, within the key cross-border bank groups, capital within the CEE countries is typically only a fraction of capital within the consolidated groups overall.

The *quality* of capital within CEE banking systems is typically high. Capital instruments other than what would be considered high quality core-tier one capital under future Basel III type regulation are rare. However, several Working Group members were concerned that within the emerging Europe region a large number of foreign-owned bank subsidiaries are less than fully owned by their strategic investors. This is due to a history of partial privatisations, and in some instances the authorities' interest in developing local equity market liquidity through retaining a certain amount of free float. To the extent these minority participations are not given the same recognition in consolidated group capital this will effectively make capitalisation of subsidiaries more costly. A risk is that this less favourable treatment could create incentives for economizing on capital coverage in less than fully owned subsidiaries.

Additional capital requirements came into effect within the EU under EBA guidance in October 2011, though are only applied on a temporary basis, and therefore do not obviate the need to assess Basel III type provisions. The Working Group was mindful that the risk of asset disposals within bank subsidiaries would raise the need for effective coordination between home and host country supervisory authorities (a topic taken up further below).

The Working Group also considered regulatory measures to deal with the **stock of accumulated foreign exchange loans** directly, which are under consideration or being implemented in a number of countries. Such ‘exit strategies’ could adversely impact bank equity. While not within its remit to consider Basel III implementation, the group expressed its expectation that national authorities will adopt a coordinated approach that involves all relevant stakeholders, avoiding large losses on banks with repercussions for financial stability. Furthermore, risks from foreign exchange lending should be adequately addressed in the directive and regulation, and in ongoing supervision and risks management. There should be no infringements of property rights or of the single market legislation. Banks, for their part, should re-iterate borrowers’ right to convert loans into the currency of the Member State within a reasonable period of time, at a market exchange rate applicable on the day of conversion with the interest rate adjusted accordingly.

A particular concern of the group was the provision of credit to the SME sector, which within the CEE region is almost entirely dependent on banks. There was broad agreement that the need to preserve the flow of credit to SMEs should in no way compromise sound assessment of credit risk under either the standardised or IRB-based approaches to capital weights. That said, this issue seems to warrant close observation, given the economic significance of the sector. A further point of discussion was how systemic risks would be identified for the purposes of additional capital buffers.

> **Recommendation 1.** In the CRR the recognition of **minority interests** at group level covering the *entire* local capital requirement in the host country should be considered, i.e. including that stemming from pillar 2 supervision.
>
> **Recommendation 2. Foreign currency risk** could be recognised explicitly in Art. 77 of the draft Directive, and EBA could develop regulatory and technical standards in this area. Regulators may need to utilise the tools available within the pillar 2 framework of the existing Basel Accord in observation of the specific characteristics of the bank and its credit portfolio (which is already envisaged in recent ESRB recommendations on this topic). Setting supplementary requirements for exposures in foreign currency, such as lower loan-to-value ratios or debt service to income ratios, could be done under pillar two, and possibly under pillar 1. This would also allow to pursue certain objectives for consumer protection.
>
> **Recommendation 3.** While there needs to be an appropriate reflection of risks of each asset class in calculating capital coverage, SME lending warrants particular attention. A study to assess the appropriate risk assessment methodologies under the aegis of the EBA should be undertaken as early as possible as it might pre-empt potentially excessive restrictions. Counter-cyclical capital buffers (CCB) should also be assessed in the light of the impact these tools might have on the SME sector.

Recommendation 4. The group also considered potential further capital charges implemented within the EU and at national level to reflect **systemic risks** emanating from large institutions. In categorising an institution as falling within this group of systemically important banks, the activities financed by an affiliate locally and in local currency should be considered local activities, not cross-border activities. In addition, cross-border transactions between parent and subsidiary should not be treated in the same way as transactions between unaffiliated parties, as the former have proven to be a reliable source of funding, including throughout the recent crisis.

On liquidity requirements

The Working Group was mindful that not withstanding generally sound capital levels within CEE banking systems, the previous financial crisis of 2008-09 exposed liquidity management as a key source of fragility. Risky funding models, evident in excessive dependence on wholesale and parent funding coupled with the need to cover foreign currency mismatches within bank balance sheets in international swap markets, were exposed as a key vulnerability.

The group was hence in principle supportive of the proposed liquidity requirements at the short end (the liquidity coverage ratio, or LCR), and in terms of matching longer term assets and liabilities (in the form of a future Net Stable Funding Ratio, or NFSR, which is to be introduced after an initial observation period).

Under CRR/CRD4, liquidity standards will apply at the level of the individual institution. Only subject to stringent conditions, competent authorities can waive the application to individual institutions and apply requirements at the consolidated level.[4] Currently, legal obstacles and the fact that there is no harmonisation among member states in handling cross-border liquidity problems make this impossible. The national application of liquidity requirements mirrors the fact that liquidity and collateral transfer might be subject to legal or supervisory restrictions. At the same time, this might create idle liquidity pools and hamper the functioning of intra-group transfers of funds.

The inherent constraints within underdeveloped local capital markets, as mentioned above, and the nature of parent group funding to subsidiaries in predominantly foreign owned banking systems needs to be taken into account in the future application of the long-term liquidity ratio (NSFR).

There were wide-ranging discussions on the definition of liquid assets, as some participants felt that the conditions listed in the CRR (Article 404) could be excessively limiting for some CEE countries. Appropriate ‘run-off factors’ (i.e. ratios of funding lost during financial stress) on certain liabilities and a monitoring of the

[4] See the conditions in Art 7(c) of the proposed CRR.

LCR with regard to individual currencies were the key issues of discussion. There were also controversial discussions on the possibility of having a consolidated liquidity framework, possibly based on suitable arrangements for burden sharing of emergency liquidity assistance (ELA).

The Working Group agreed to put forward the following recommendations:

> **Recommendation 5.** With regard to the **definition of liquid assets**, the conditions listed in the CRR (Article 404) seem unduly limiting for some CEE countries, given the fact that certain assets are eligible for national central bank funding and in certain cases even for ECB funding. Against this background, the Working Group recommends that such assets should also be taken into account in the current EBA work on the calculation of liquid assets, if need be with appropriate 'haircuts'. Minimum reserves held at the central bank should also fully count as liquid assets if local regulation allows drawing down those funds in times of distress. The observation period should be used to define the types of assets deemed eligible and the appropriate run-off factors in stress-scenarios.
>
> **Recommendation 6.** With regard to banks' funding, the notion of '**stable operational relationship**' in corporate accounts should better reflect the specific market context in the CEE countries. Competent national authorities should be given sufficient discretion to determine relevant criteria to identify such relationships based on guidance that is uniform across the EU, ideally following EBA standards. Such issues could also be addressed during the observation period. The appropriateness of the run-off factor may need to be revisited.[5] In the same vein, a lower **'run-off factor' for parent funding** should be allowed based on the joint decision of home and host country supervisory authorities.
>
> **Recommendation 7.** The group agreed that **monitoring the LCR with regard to individual currencies** is an important objective. At the same time, the explicit requirement that the currency denominations of liquid assets should correspond to those of potential net liquidity outflows could be unduly burdensome for bank institutions and may not be appropriate from a prudential point of view in all circumstances. A requirement to hold the LCR in a currency other than the domestic currency should hence be left to the discretion of the competent national authorities, who can best take account of

[5] Given the empirical history of liquidity withdrawal from corporate accounts in the region, most participants felt that what is currently set as a 75% run-off factor for *less* stable corporate deposits should rather be about 40%. If an amendment on the definition of an "established relationship" can not be integrated in CRR this may be a more appropriate parameter.

liquidity risk in foreign currencies and of mitigating instruments such as swap facilities at national or international level.[6]

Recommendation 8. Consolidated liquidity supervision is desirable but would require binding decisions, monitoring by the EBA and cooperation among supervisory authorities, and central banks to ensure a proper application of the liquidity requirements. Supervised financial institutions, for their part, will seek a manageable regulatory burden, transparency and predictability of requirements. If legal obstacles are not removed by the time of entry into force of the respective liquidity requirements, then alternative conditions for a waiver of entity-level liquidity requirements for cross-border bank groups should be defined, or mediated, by the EBA.[7]

On the application of macroprudential instruments

The global financial crisis revealed that the missing pillar in the existing financial stability architecture was the macroprudential approach to financial supervision. At the EU level, the importance of this issue was highlighted in the *de Larosière Report* of 2009. The report concluded that the operating arrangements for supervision have not been able to prevent the occurrence of a serious financial crisis. This resulted from the fact that surveillance solutions based on national models were inadequate to the degree of integration of the EU financial markets and the large number of entities operating across borders. Stronger, more complex and opaque interconnections of the financial system with the real economy as well as lack of systemic perspective in conducting financial oversight seem to be the key lessons that come from the experience of that recent financial crisis. Tight linkages between elements of the European financial system had become evident, underlining that systemic risks could result in even greater losses than those within individual institutions. Macroprudential supervision with its systemic perspective must complement the traditional micro-prudential oversight focused on the health of individual financial institutions.

There were diverging opinions within the Working Group on the use of macroprudential tools, in particular with regard to minimum and maximum harmonisation and reciprocity in the application of the countercyclical buffer. Supervisors from the host countries generally supported the view that national

[6] Article 405 point (g) could hence be deleted, and discretion for competent national authorities limited to the operations under their jurisdictions could be introduced.

[7] Some members of the Working Group proposed to implement a consolidated liquidity framework only under the condition that home and host central banks agree ex-ante on burden sharing should the need for an ELA arise. In their view, such an up-front agreement on respective responsibilities would be in the interest of both competent regulating authorities, central banks, and banking groups. Several central bank representatives, however, argued that broader issues in home-host coordination would need to be resolved first, that ELA can only be granted on a case-by-case basis, and that liquidity support outside the eurozone would be very difficult.

macroprudential authorities should have appropriate macroprudential instruments at their disposal which – in response to local systemic risks – could be used with due discretion (harmonisation of minimum requirements). They were also in favour of home country authorities granting full reciprocity to their decisions when setting the counter-cyclical capital buffer (CCB). Home country supervisors, on the other hand, generally preferred harmonisation of maximum levels of macroprudential instruments, a strong role of the ESRB in evaluating and restraining local decisions, and that reciprocity on CCBs should be limited.

The work of the group highlighted the fact that credit cycles in the CEE region are generally more volatile than in more mature markets, and that national supervisors had already implemented a range of macroprudential tools, including limits to loan-to-value ratios in mortgage lending, or restrictions on dividend distributions. Given close ownership linkages with the CEE banking systems and the risk that host country supervision could be undermined through cross-border or branch-based lending, the group endorsed close coordination of macroprudential instruments in the CEE region, in particular where this entails raising capital requirements further through the counter-cyclical capital buffer envisaged under Basel III.

> **Recommendation 9. Coordination of macroprudential measures.** The ESRB should have a strong role in setting guidelines, principles and recommendations on the capital buffer rates and exercising of national discretion. In the interest of transparency, all decisions to build up the buffer should be reported centrally (to the ESRB and EBA). The Working Group supported the EBA's role in developing draft technical standards to specify the methodology for the identification of the geographical location of relevant credit exposures, as stated in Art. 130 (7) CRD4.
>
> **Recommendation 10.** There should be an appropriate balance between flexibility for national supervisors responding to local risks on the one hand, and sufficient coordination within the single market at the European level on the other hand. In this respect, country-specific measures with cross-border effects, in particular in the macroprudential field, should be implemented based on a regime of tightly **constrained discretion**. Competent authorities should inform the ESRB, the EBA, the European Commission and relevant host country authorities *ex ante* of the measures they plan to implement, giving sufficient time to evaluate the proposed measures. Only in exceptional emergency situations would this be done ex-post. In any event, there should always be well-founded evidence and an objective macro-economic justification for such measures.
>
> **Recommendation 11. Application of the counter-cyclical capital buffer (CCB).** A closer coordination among European authorities is required to avoid uncertainty over the implementation of this important instrument which may affect the effectiveness and efficiency of risk and capital management processes within European banking groups. Once the coordination set out in

the previous recommendation is achieved, national supervisors should consider granting full reciprocity for counter-cyclical capital buffers above 2.5 per cent. This would ensure a level playing field among banks operating within the EU and eliminate arbitrage opportunities through the use of cross-border branches or cross-border lending, as no cost-of-capital advantages or disadvantages would occur. This would support the prudential objectives of the host country authority. Other capital instruments (e.g. contingent capital) should be considered by national supervisors for the purposes of meeting this CCB requirement.

On home-host country issues, and other implementation issues

Basel III was negotiated as a minimum standard approach. By contrast, the CRR/CRD4 draft adopts some maximum harmonisation. Against this backdrop, to assess possible unintended consequences of CRR/CRD4 implementation on both future market development and cross-border relationships in emerging Europe, the overarching question is whether a uniform implementation of the CRR/CRD4 proposal into national law may have different effects from what was intended. Consequently, it remained controversial for some members of the Working Group if CRR/CRD4 were to consider upward flexibility in prudential ratios based on the judgment of the individual country regulators.

Cross-border banks within the EU have contributed to the close integration of the EU's single financial market, which in some regards stretches well beyond the EU into current and future EU candidate countries in the western Balkans region. Still, EU banks operate within regulation that only slowly converges to the close coordination between home and host country supervisors, whose decisions are as yet complicated by fragmented fiscal responsibilities for bank resolution and generally unclear burden sharing arrangements for such cases.

Moreover, the Commission's proposal also clearly states the need for a close monitoring of some new elements introduced by the new Regulation. In particular, the monitoring of the new liquidity measures will be subject to close scrutiny. Given that banks in emerging Europe might face serious challenges from the new liquidity requirements, the EBC 'Vienna' Initiative might furthermore have a role to play in supporting the exchange of information, statistical data and results of analyses among public and private institutions operating in emerging Europe, in order to detect any unintended consequences that might suggest an amendment of the current CRR/CRD4 proposal.

Much progress has been made in establishing the 'single rule book' as a fundamental prerequisite for the integrated market in financial services. Some members of the Working Group thought that lack of upward flexibility in applying certain prudential requirements might create a potential for imbalances between the powers and responsibilities of the national authorities; others thought this would create the risk of regulatory arbitrage between member states.

> **Recommendation 12. Completing the EU's agenda of financial regulation.** EU authorities should continue to press forward with the progressive development of all regulatory initiatives originally envisaged in the 2009 *de Larosière Report* which are also integral to establishing effective European banking supervision, importantly the common EU resolution capacity.
>
> **Recommendation 13. Strengthening the colleges of supervisors and EBA's role within these colleges.** Common legal standards are not enough to strengthen the supervisory structure for European cross-border bank groups. A fully integrated supervision of EU-wide groups is required, resting on a complete pooling of information and the enhancement of the powers of the colleges of supervisors. The participation of CEE countries within existing European supervisory colleges should be strengthened to build up the mutual trust needed to apply consistently the newly harmonised European rules. Such a strengthened role of the colleges – and close involvement of EBA and ESRB – is essential in preventing that concerns over a potential further shift in competences from supervisors in CEE countries towards those in home countries materialise.

The EBCI 'Vienna' Initiative's unique public-private platform can continue to support the work of key international and European institutions by directly participating in the public consultations that EBA will promote before issuing technical standards and by supporting with information and statistical data the analyses performed by the ESRB.

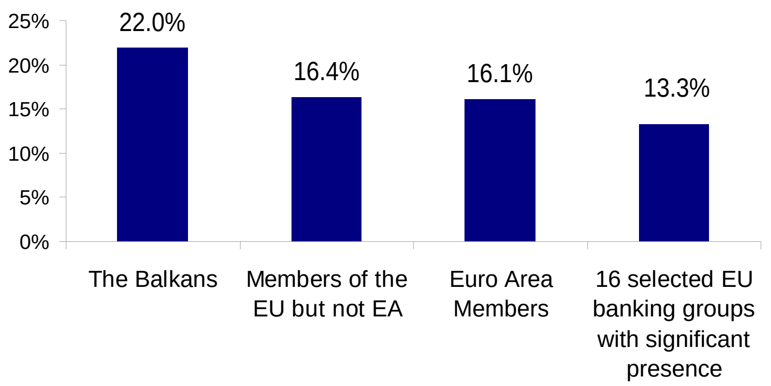
I. Capital definition and requirements

Capitalisation of CEE banks in the context of the EU

In the aftermath of the financial crisis, bank capital ratios in the CEE region look healthy, showing a sizeable cushion over minimum requirements. Notwithstanding the currently comfortable level, banks' capitalisation in the region needs to be considered in the context of the foreign groups to which they mostly belong. By and large, banks in the region are well capitalised with total capital ratios ranging from 15 per cent to 25 per cent across CEE countries. In contrast, the ratios of the major investor bank groups are somewhat lower, i.e. more efficient, mainly as a result of greater capital markets pressure and economies of scale. In particular, the average total capital ratio in CEE was 17.3 per cent as of end-2010, the Balkan countries head the region with a ratio of 22 per cent on average while in other EU member states outside the euro area the total capital ratio was

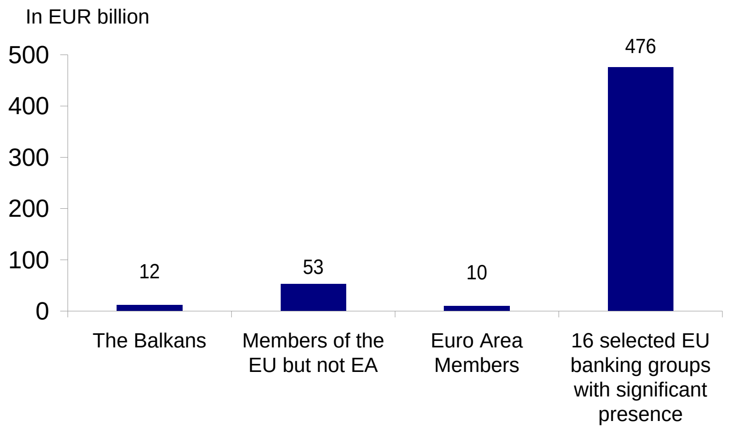
Chart 1. Total capital ratio in CEE countries and EU bank groups with significant presence.

In per cent



Data as of end-2010.
Sources: Bankscope and EBF estimates.

Chart 2. Equity in CEE countries and EU bank groups with significant presence.



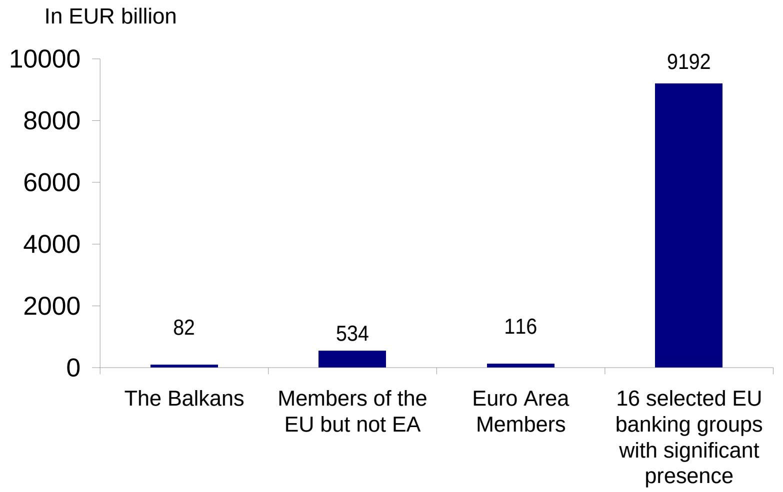
Data as of end-2010.
Source: Bankscope.

slightly above 16 per cent. A cluster of 16 selected western European bank groups[8] with significant presence in the region showed a consolidated capital ratio of 13.3 per cent on average in the same period (Chart 1).[9]

Bank representatives in the Working Group argued that their subsidiaries in the CEE countries represent a longstanding strategic investment. However, the size of their assets in national banking systems in the region represents still a fraction of foreign investors' consolidated portfolios. In absolute terms, the capital available in the region is a small part of the total equity managed by the main investor groups (Chart 2), accounting for only about 13 per cent. This is even clearer in terms of banking sector assets backed by capital (Chart 3).

The relative size of capital and assets held by subsidiaries in the CEE region will become more important as banking groups streamline the use of capital amid the new environment of increased capital requirements. Business lines and geographical investments will necessarily be scrutinised in a general scenario of fiercer competition for capital.

Chart 3. Assets in CEE countries and EU bank groups with significant presence.



Data as of end-2010.
Source: Bankscope.

The remainder of this section will examine four aspects of the regulation of bank capital:

- The treatment of minority interests;
- The foreign currency credit risk;
- The case of small and medium size enterprise financing;
- The definition of the systemic importance buffer.

[8] Alpha Bank, Bayerische Landesbank, BNP Paribas, Commerzbank, Crédit Agricole, EFG Eurobank Ergasias, Erste Group, Hypo Alpe-Adria Bank, Intesa Sanpaolo, KBC Group, Nordea Bank, Raiffeisen Bank International, Skandinaviska Enskilda Banken (SEB), Société Générale, Swedbank and Unicredit.

[9] All ratios refer to Basel II definition and are derived from the Bankscope database.

Minority interests

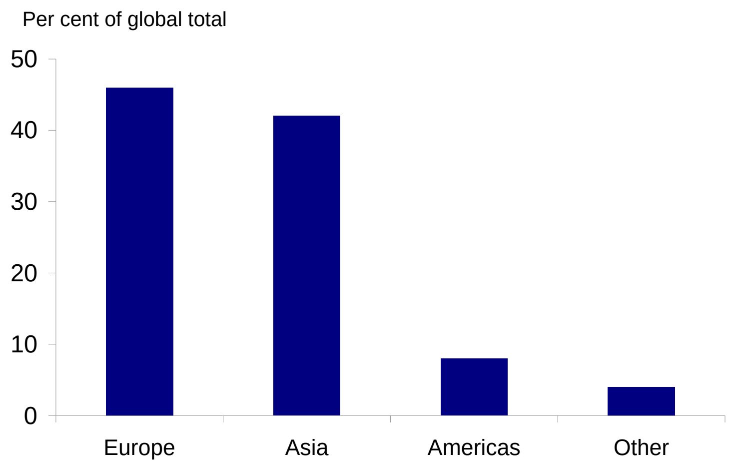
The new international standards foresee that minority interests in banking subsidiaries be only partially recognised at the consolidated group level for solvency purposes. The prudential rationale behind this is that while minority interests support the risks taken by the subsidiary they are not necessarily available to back the risks taken by the group. Consequently, the excess capital above the minimum requirement of the subsidiary is deducted at group level in proportion to the minority interest share. A key point of consideration is the definition of the subsidiary's minimum capital requirement up to which minority interests are recognised at group level:

- Basel III recognises minority interests to the extent that the capital is used to meet capital requirements and the new capital conservation buffer.
- CRR also gives recognition to the countercyclical buffer.

Banking sector participants in the Working Group argued that minority interests bring about greater market discipline (e.g. transparency and valuation) and diversity of capital resources; they also allow for a collaborative business model in which the parent bank contributes to modernisation whereas local partners contribute local expertise. This model is widely used in developing countries. In the CEE region it is estimated that minority interests contribute EUR 95 billion to European bank capital or 46 per cent of the global total of EUR 206 billion (Chart 4).

Disincentives to establish or recapitalise subsidiaries with minority interests could give rise to a move from subsidiaries to branches, ultimately undermining the effectiveness of supervision within the host country jurisdiction. From the perspective of home country supervisors the main concern relates to the questionable loss absorbency of minority interests at group level, and to the potential abuse or arbitrage situations. Prior to finalising the proposals on CRD/CRR an impact study on the capital model and levels in the CEE could be carried out in order to evaluate the effects of different options of recognition of minority interests. In this context, the loss absorbency of the cross-guarantee system used by savings banks with significant presence in CEE should also be studied. With regard to the current legislative drafts, the group proposed:

Chart 4. Bank group minority interests by region.



Sources: HSBC, Bloomberg, Company reports.

Recommendation 1 In the CRR the recognition of **minority interests** at group level covering the *entire* local capital requirement in the host country should be considered, i.e. including that stemming from pillar 2 supervision.

Foreign currency credit risk

The participants in the Working Group uniformly acknowledged that foreign currency lending had been one of the contributing factors to macroeconomic vulnerabilities in CEE ahead of the crisis. This practice created constraints for the proper functioning of monetary policy instruments and exposed households to devaluation and, subsequently, default risk and, consequently, banks to higher credit risk. Foreign currency lending offers apparent gains, yet poses significant systemic risks to all stakeholders: borrowers seek lower interest rates accepting higher exchange rate risk; banks expand their business in foreign subsidiaries as the diversification associated with retail and business segments is overridden by the concentration risk inherent in foreign currency lending; the country as a whole benefits from rapid growth but substantially increases financial vulnerabilities.

Participants in the EBCI previously agreed on principles for foreign currency lending, and priorities for the development of local currency funding in domestic capital markets.[10] Supervisors within the EU are also bound to implement a number of recommendations adopted by the ESRB's General Board.[11]

The Working Group discussed the question whether additional capital requirements to reflect these risks should be set under pillar 1 (across-the-board) or pillar 2 (case-by-case). An automatic mechanism in the first pillar might increase pro-cyclicality since deterioration in the macroeconomic outlook might lead to depreciation of the foreign currency, which in turn would increase capital requirements, ultimately cutting back credit supply. It is important to note that setting additional capital requirements just for this kind of exposure might come on top of specific regulatory requirements that are already in place and thus put further constraints on credit provision to the economy and to banking sector profitability. In contrast, a pillar 2 treatment would grant a higher degree of flexibility when setting the appropriate metrics to measure the foreign lending exposure.

Whatever the solution adopted, collaboration between international institutions, home supervisors and host supervisors is of the essence. Unilateral actions to tackle such a complex issue may not be effective and give way to imbalances. Lack of long-term funding in local currency remains a structural constraint for the development of a

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[10] See the report of the Working Group at this link:
http://www.ebrd.com/downloads/news/local_currency.pdf

[11] Recommendations on lending in foreign currencies, adopted by the ESRB's General Board on 21 September, 2011, available here: http://www.esrb.europa.eu/recommendations/html/index.en.html.

local currency mortgage market. In most cases banks have already discontinued the riskiest forms of foreign currency lending to un-hedged borrowers. If a decision is taken to seriously curtail foreign currency lending, it might lead to a different growth model which ideally would involve the development of long-term debt markets in own currency implying a more balanced growth. To avert risks from foreign currency lending, countries may have to accept lower economic growth, relinquishing part of the benefits of financial integration and convergence.

Enhanced cooperation among home and host supervisors, as already envisaged through the enhanced roles of the ESRB and the EBA, could be an efficient solution to promote sound and consistent management of risks arising from foreign currency lending. Equally, there is a need for consensus between the home supervisor and the host supervisor on the most appropriate solution to particular risks embedded in foreign currency lending, taking account of a variety of products, the segment of borrowers (households or businesses) and their hedging possibilities (e.g. foreign currency income, foreign currency savings). Cooperation and reciprocal recognition should govern the exchange of views and information between host and home supervisors as well as the mutual actions undertaken to mitigate the risk inherent in foreign currency lending. Lack of adequate supervisory coordination would give rise to potential regulatory arbitrage.

> **Recommendation 2. Foreign currency risk** could be recognised explicitly in Art. 77 of the draft Directive, and EBA could develop regulatory and technical standards in this area. Regulators may need to utilise the tools available within the pillar 2 framework of the existing Basel Accord in observation of the specific characteristics of the bank and its credit portfolio (which is already envisaged in recent ESRB recommendations on this topic). Setting supplementary requirements for exposures in foreign currency, such as lower loan-to-value ratios or debt service to income ratios, could be done under pillar two, and possibly under pillar 1. This would also allow to pursue certain objectives for consumer protection.

While not directly linked to Basel III implementation, there was also a discussion on measures for dealing with the *stock* of accumulated foreign exchange loans, as certain EU member states continue to seek an exit strategy from the legacy of foreign exchange lending. Working Group participants agreed that national authorities should adopt a coordinated approach that involves all relevant stakeholders, avoiding large losses on banks with repercussions for financial stability. In designing such an exit programme, there must be no infringement of property rights or of the single market legislation. Banks should acknowledge the right of the consumer to convert the loan into the currency of the Member State within a reasonable period of time, at a market exchange rate applicable on the day of conversion with the interest rate adjusted accordingly.

SME financing

Small and medium size enterprises (SMEs) significantly contribute to economic growth in Europe. In particular, since the economies in CEE are up to 85 per cent financed through classic credit lending by banks, the soundness of the European banking system should be as important as its capacity for consistent funding of SMEs in the region. They depend to a large extent on bank financing given that, particularly in CEE countries, access to local capital markets is limited. Even though SME lending was not associated with the outbreak of the crisis it may have to face significantly larger capital requirements as a result of the new regulatory framework, as currently drafted. In the view of bank representatives in the Working Group, credit risk within SMEs has never been a systemic risk. As regards the appropriate reflection of systemic risk inherent in SME financing, studies showed furthermore that current (i.e. Basel II) capital requirements for loans to SMEs are significantly too high relative to capital requirements for other business lines, in particular the trading business.[12]

Given the vulnerability of SME lending during periods of credit shortage and considering its important economic role within CEE, there is a need to look for a solution that preserves credit supply. Therefore adjustments to the standardised and the IRB-approach such as a reduction of the correlation factor for SMEs, the implementation of a balancing factor and less stringent capital requirements for providing SMEs with products hedging their risks may need to be considered. As it currently stands, the CRD 4 proposal acknowledges the potential negative consequences on lending to SMEs of higher capital requirements though does not introduce any corrective factor.

> **Recommendation 3.** While there needs to be an appropriate reflection of risks of each asset class in calculating capital coverage, SME lending warrants particular attention. A study to assess the appropriate risk assessment methodologies under the aegis of the EBA should be undertaken as early as possible as it might pre-empt potentially excessive restrictions. Counter-cyclical capital buffers (CCB) should also be assessed in the light of the impact these tools might have on the SME sector.

Additional capital buffers for systemically important institutions

For some European banks, capital requirements will be raised further. The Basel Committee on Banking Supervision (BCBS) has put forward a proposal to reduce the probability of default of global systemically important banks (G-SIBs) by increasing their going-concern loss absorbency.[13] According to the methodology, scores are assigned to a sample of global banks on the basis of 5 indicators, namely cross-

[12] i.e. Auswirkungsstudie Basel III, im Auftrag des Deutschen Bundesverband mittelständische Wirtschaft, August 2011, http://www.bvmw.de/fileadmin/download/Bund/basel_III_studie.pdf, S.8.

[13] See 'Global systemically important banks: Assessment methodology and the additional loss absorbency requirement, http://www.bis.org/publ/bcbs207.htm.

jurisdictional activity, size, interconnectedness, substitutability and complexity. Banks are then tiered into ‘buckets’ which are each associated with certain additional capital requirements ranging from 1 per cent to 3.5 per cent of risk weighted assets.

The inclusion of measures of cross-jurisdictional activity is motivated by two factors that could lead to a spillover of systemic effects across countries: first, the fragmentation of regulatory environments that may hinder joint supervision and the implementation of resolution frameworks; second, the global operations of banks which may channel potential instability and systemic effects across countries. In the view of banks, this approach hampers market integration and fails to take into account the positive impact of the international operations of banks on the financial system in terms of efficient capital allocation and diversification as well as increased competition and stability. Some participants suggested that the EBCI could continue to inform the debate on defining and regulating systemically important banks, including at the European level.

Banking sector representatives in the Working Group called for a clear definition of the characteristics which need to be fulfilled for a set of countries to be considered an integrated area for the purposes of identifying G-SIBs (e.g. with respect to resolution frameworks, supervisory practices, burden sharing in case of default and deposit insurance). In their opinion, this would be an important guide for a process of regulatory integration that adequately addresses the potential negative externalities of G-SIBs and the assessment of capital surcharges. Supervisors, however, pointed out that current heterogeneity in a wide range of factors (e.g. macroeconomic peculiarities, different phases of the business-cycle, different foreign exchange regimes and different transmission channels of monetary policy as well as various degrees of financial market development), means that the EU’s financial market cannot, at this stage, be considered a single jurisdiction. Participants agreed that the conditions that are required for the consideration of an integrated area as a single jurisdiction should therefore be clearly defined so that policy targets can be set accordingly.

> **Recommendation 4.** The group also considered potential further capital charges implemented within the EU and at national level to reflect **systemic risks** emanating from large institutions. In categorising an institution as falling within this group of systemically important banks, the activities financed by an affiliate locally and in local currency should be considered local activities, not cross-border activities. In addition, cross-border transactions between parent and subsidiary should not be treated in the same way as transactions between unaffiliated parties, as the former have proven to be a reliable source of funding, including throughout the recent crisis.

II. Application of liquidity requirements

Rationale and transposition of Basel III in Europe

Many European banks experienced difficulties during the financial crisis, adequate capital levels not withstanding, because they did not manage their liquidity risks in a prudent manner. The rapid collapse in market conditions illustrated how quickly liquidity can evaporate and that illiquidity can last for an extended period of time. The banking system came under severe stress, which necessitated central bank action to support both the functioning of money markets and, in some cases, individual institutions. One of the most important lessons from the recent crisis was hence that the banks were holding insufficient liquidity buffers.

In order to strengthen banks' liquidity framework the BCBS developed two minimum standards for funding liquidity, serving separate but complementary objectives. The first minimum standard is the Liquidity Coverage Ratio (LCR). Its underlying objective is to promote short-term resilience of a bank's liquidity risk profile by ensuring that it has sufficient high-quality liquid assets to survive a significant stress scenario over a period of one month. The objective of the second minimum standard, the Net Stable Funding Ratio (NSFR), is to promote resilience over a longer time horizon by creating additional incentives for banks to fund their activities with more stable sources of funding on an ongoing basis. The NSFR has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities.

It should be highlighted that the Basel III liquidity standards establish minimum levels for internationally active banks, as opposed to the European Commission's proposal (CRR) on maximum harmonisation.[14] Consistent with the Basel Committee's capital adequacy standards, national authorities have discretion to require higher minimum levels of liquidity. There are also a number of definitional differences (see Box 1).

This points to a significant tension in the EU implementation of Basel III liquidity rules between, on the one hand, the single rulebook and level playing field concept, and, on the other hand, the pressures to adapt liquidity rules to widely differing financial systems and characteristics of more than 8300 banks in the EU. Upon implementation, European regulators have to reconcile two – in some ways conflicting – aims: they have to take into account the particular circumstances or specificities of the European banking sector when transposing Basel III liquidity rules into EU law, and at the same time ensure the consistency of these new European liquidity rules with Basel III to strengthen the resilience of the global financial system and create a global level playing field.[15] Working Group participants agreed that the

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[14] Based on Basel III: International framework for liquidity risk measurement, standards and monitoring (source: http://www.bis.org/publ/bcbs188.htm).

[15] The new Basel III liquidity requirements apply only to internationally active banks, however in the EU legislation they will be applied to all banks.

main goal of the new EU liquidity regulation should be to define liquidity requirements which fully reflect liquidity risks in both the short and the long term. The regulation should not impose restrictions and incentives that unnecessarily limit the provision of banking services to the real economy.

Box 1. Main differences between Basel III liquidity rules and CRR regulation.

Liquidity coverage requirements

Liquid assets:

- Shares or units in Collective Investment Undertakings (CIUs) may be treated as liquid assets up to an absolute amount of EUR 250 million provided that certain requirements are met and that the CIU, apart from derivatives to mitigate interest rate or credit risk, only invests in liquid assets.[16]
- The denomination of the liquid assets has to be consistent with the distribution by currency of liquidity outflows after the deduction of capped inflows (derogations shall be applied) .

Outflows:

- The Basel III definitions are more precise in the case of credit and liquidity facilities: only committed credit and liquidity facilities are concerned whereas the CRR does not make a difference between committed and uncommitted facilities.
- Competent authorities may grant the permission to apply a lower percentage on a case-by-case basis (Basel III: 100%) if all of the following conditions are fulfilled:
  (a) the depositor is a parent or subsidiary institution of the institution or another subsidiary of the same parent institution;
  (b) there are reasons to expect a lower outflow over the next 30 days even under combined idiosyncratic and market-wide stress scenario;
  (c) a corresponding symmetric or more conservative inflow is applied by the depositor;
  (d) the institution and the depositor are established in the same Member State unless "intra-group treatment" applies.[17]

Inflows:

- Competent authorities may grant a higher inflow on a case by case basis for credit and liquidity facilities (Basel III: 0%) if all of the following conditions are fulfilled:
  (a) there are reasons to expect a higher inflow even under idiosyncratic stress;
  (b) the provider is a parent or subsidiary institution of the institution or another subsidiary of the same parent institution;
  (c) the institution and the provider shall be established in the same Member State unless "intra-group treatment" applies.[18]

Stable funding

The Commission will consider proposing a Net Stable Funding Ratio (NSFR) after an observation and review period in 2018 (only reporting required).

[16] See Commission's Proposal for CRR, Article 127(3).

The p roposals for amendments in detail:

Liquidity coverage requirements – Liquid assets

According to the Commission's proposal, liquid assets have to be listed on a recognised exchange and they have to be tradable on active outright sale or repurchase agreement markets with a large and diverse number of market participants (high trading volume, market breadth and depth). The ongoing crisis has made clear that liquidity can evaporate quickly - even in sovereign bond markets. Therefore, a highly volatile 'market liquidity' parameter should not be taken as a base for liquidity regulation. In addition, the definition of liquid assets builds on the large active markets of EU member states, however in some CEE member states the parameters of 'market liquidity' and the diversity of liquid assets could be considerably different (Chart 5.). Therefore, the conditions listed in the CRR (Article 404) seem to limit unduly the scope of liquid assets in some CEE countries despite the fact that these assets are eligible for national central bank funding and in certain cases even for ECB funding.

Against this background, the Working Group was mindful that these assets should also be taken into account in the calculation of liquid assets with appropriate haircuts. Recognising central bank eligibility as a criterion for liquidity buffer eligibility is not only necessary, but would also help mitigate the systemic risk arising from vanishing market liquidity. According to this proposal, liquid assets should fulfill one of the following conditions: (a) they are eligible collateral for central bank's lending operations (ECB and national central banks), (b) they are tradable on active outright sale or repurchase agreement markets with a large and diverse number of market participants, a high trading volume, and market breadth and depth. For that reason it is essential that national central banks and the ECB accept only a sufficiently prudent range of assets to underlie its open market operations. Minimum reserves held at a central bank should be fully computed as liquid assets if local regulation allows drawing down those funds in time of stress.

Subject to the transferability requirement, there is no reason to additionally demand that liquid assets be located where the liquidity risk is being incurred. This would contradict the necessity to diversify assets, especially if central bank eligibility is required. Restricting the definition of liquid assets could be a disincentive for diversification, and can lead to excessive market concentrations, with potential unwanted externalities.

Assets received in reverse repo and securities financing transactions that are being held for more than 30 days at the bank, have not been re-pledged, and are legally and contractually available for the bank's use can be considered as liquid assets, similar to the Basel Committee's guideline on liquidity risk management (point 27).

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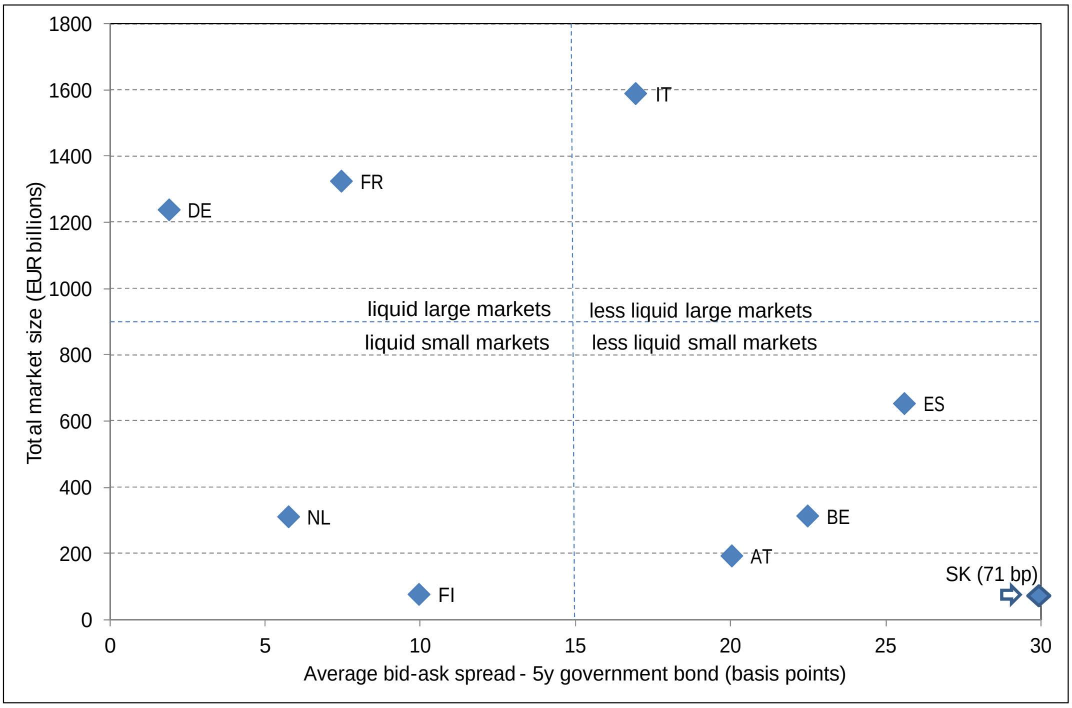
[17] See Commission's Proposal for CRR, Article 18(1)(b).

[18] See Commission's Proposal for CRR, Art. 18(1)(b).

Annex III of the CRR could be deleted as it overly narrowly specifies the definition of liquid assets that the observation period should articulate.

Chart 5. Market size vs. liquidity.



Note: Total market size at October 2011; Average 5y government bond bid-ask spread between January 2011 and October 2011.

Source: Bloomberg.

The monitoring of the LCR by currencies in which there is significant liquidity risk is very important. However, the explicit requirement that the denomination of liquid assets should correspond to the distribution by currency of net liquidity outflows is unduly burdensome for institutions and may not be adequate in all circumstances. The Working Group felt that the requirement to report the LCR in a currency other than the domestic currency should be left to the discretion of the competent authorities who are best placed to decide if there exists a significant liquidity risk in another currency and consequently require that the LCR should explicitly be met on a currency basis. Accordingly, it is proposed to delete point (g) in Article 405 and introduce discretion for competent national authorities limited to the operations under their jurisdictions.

In the view of the Working Group, the key requirement is availability of liquid assets during a crisis. Supervisors should review and validate the internal arrangements, and therefore Article 405(f) i-iii should be deleted.

Recommendation 5. With regard to the **definition of liquid assets**, the conditions listed in the CRR (Article 404) seem unduly limiting for some CEE countries, given the fact that certain assets are eligible for national central bank funding and in certain cases even for ECB funding. Against this background, the Working Group recommends that such assets should also be taken into account in the current EBA work on the calculation of liquid assets, if need be with appropriate 'haircuts'. Minimum reserves held at the central bank should also fully count as liquid assets if local regulation allows drawing down those funds in times of distress. The observation period should be used to define the types of assets deemed eligible and the appropriate run-off factors in stress-scenarios.

Outflows of liabilities

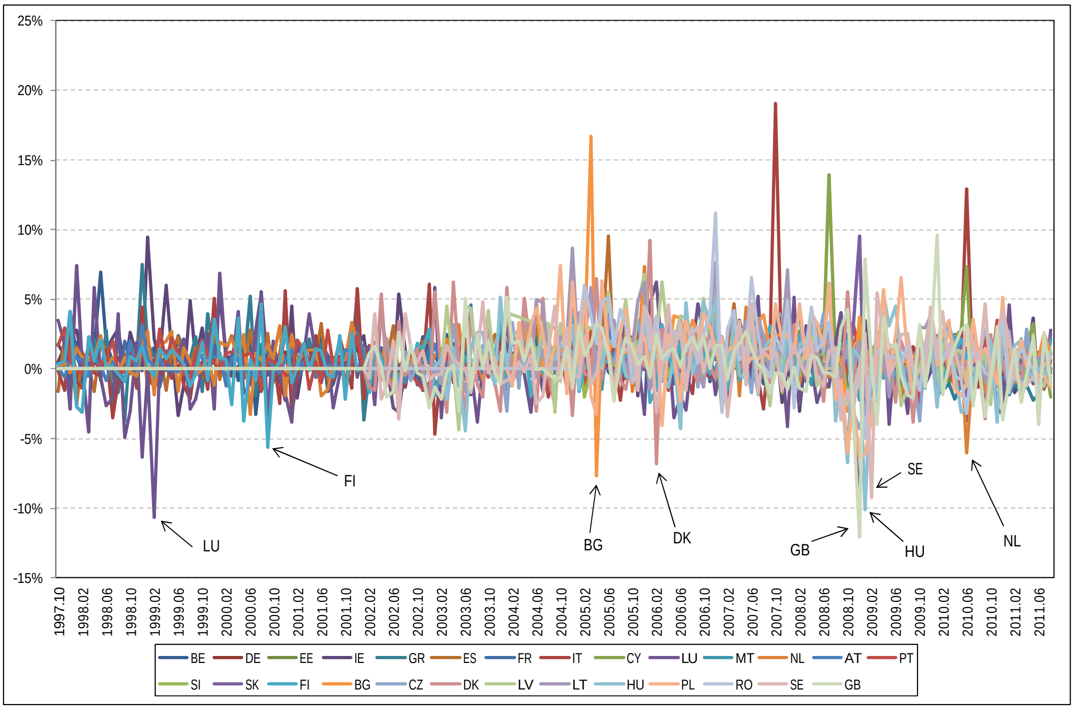
The split between stable and unstable deposits supplied by corporate customers proposed by the Commission is too restrictive. It would almost eliminate the possibility for banks to benefit from the lighter run-off rate of 25 per cent applied on deposits in the context of an operational relationship.[19] It hence denies the commercial ties banks can have with their corporate clients. The definition of "relationship" should, in particular, be consistent with the actual financing model of the European economy which, in contrast to other economies (notably the USA), is not transaction-oriented but rather aimed at accompanying clients over time in their developments in terms of products and/or geography. Therefore, we propose that competent authorities should be given sufficient room for maneuver to determine the relevant criteria to identify deposits with operational relationship, in collaboration with the EBA. Such issues could be addressed during the observation period. The EBA could provide general guidance to competent authorities in identifying deposits with operational relationship.

The 75 per cent run-off factor that is applied to corporate and other non-financial institutions deposits within the framework of the short-term liquidity requirements is extremely punitive to the European banking sector. If the definition of "established relationship" will not be amended in the CRR, the 75 per cent run-off factor could be mitigated by a more sensible 40 per cent run-off factor for corporate deposits. As shown in Chart 6, the maximum outflows of deposits by "other domestic residents" (households, corporates, local governments) within 30 days – even under situations of distress – are significantly lower than 40 per cent. For that reason, it may be justified from a prudential standpoint to apply a 40 per cent run-off factor to less stable corporate deposits.

[19] According to the CRR Article 410(4)(a), clearing, custody and cash management services constitute an operational relationship. However, there are some potential counterexamples, that these services are sometimes inadequate proxies for corporate deposit stability: "Siemens withdrew more than half-a-billion euros in cash deposits from a large French bank two weeks ago and transferred it to the European Central Bank, in a sign of how companies are seeking havens amid Europe's sovereign debt crisis." http://www.ft.com/cms/s/0/dca4cc08-e096-11e0-bd01-00144feabdc0.html

Chart 6. Inflows and outflows of deposits by other domestic residents (households, corporates and local governments).

Per cent, m-o-m



Note: In/out flows were calculated by use of ECB monthly database. Note that this Chart is illustrative only, it shows aggregate data. In/out flows could differ among banks.
Source: ECB

Based on banks' experience, local governments' deposits are stable, and therefore the 75 per cent run-off factor seems to be much higher than it would be in a stress situation. Furthermore, there are important provisions in some CEE countries, which are significantly restricting the run-off rates for these deposits.[20] Based on this background, local governments' deposits should get a more favourable treatment, e.g. the same preferential run-off factor as applied to stable corporate deposits (25 per cent), given the ability to call local governments' deposits is significantly restricted by national law. A more realistic assumption on the run-off factor should also be recognised for SME deposits.

The Commission could elaborate a more precise definition of retail deposits as regards the inclusion of liabilities to small and medium sized enterprises. The definition could include a reference to the Commission Recommendation No. 2003/361/EC. Without having guidance on assigning SMEs to retail or corporate clients the consistent application of the LCR may not be ensured. The Regulation should be amended accordingly or the implementing technical standard to be issued

[20] An example from Hungary: Government Decree No. 292/2009 (XII.19.) on Manner of operation of public finances. A local government can change its bank account only at the beginning of each month on condition that it notifies the bank 30 days before the change.

by the Commission should provide guidance on this. We suggest, as a unique criterion for the identification of small business customers, the maximum amount of funding be raised for them. Effectively, beyond the customer enterprise's dimension (which can be measured in terms of total assets, turnover, etc.), for operational purposes what really matters is the magnitude of the bank's exposure towards it.

Assets that would be considered liquid but not eligible for liquidity buffer could still be recognised as liquidity in the form of inflows, for instance through the following amendment to Art. 410(3): "Institutions shall multiply liabilities resulting from secured lending and capital market driven transactions as defined in Article 188 by 50 per cent if the assets would not qualify as liquid assets according to Article 404 but they are tradable on active outright sale or repurchase agreement markets with a large and diverse number of market participants, a high trading volume, and market breadth and depth."

> **Recommendation 6.** With regard to banks' funding, the notion of '**stable operational relationship**' in corporate accounts should better reflect the specific market context in the CEE countries. Competent national authorities should be given sufficient discretion to determine relevant criteria to identify such relationships based on guidance that is uniform across the EU, ideally following EBA standards. Such issues could also be addressed during the observation period. The appropriateness of the run-off factor may need to be revisited.[21] In the same vein, a lower **'run-off factor' for parent funding** should be allowed based on the joint decision of home and host country supervisory authorities.

Inflows

For Articles 410/6 and 413/3 the Working Group would recommend the following wording: „Institutions shall take payables and receivables expected over the 30 day horizon from the contracts listed in Annex II on a net basis across counterparties and net of the close out of the hedge and shall be multiplied by 100 per cent in case of a net amount payable. Net basis shall mean also net of collateral to be received that qualifies as liquid assets under Article 404."

Regarding commercial inflows, we would propose to include sight assets, at least partially (e.g. with a 50 per cent associated factor). In some jurisdictions (e.g. Italy), sight assets are the traditional instrument that banks use to finance corporate customers, while in other jurisdictions short term assets are more commonly used in operational practice than sight assets. Effectively, sight assets and short term assets have the same function, from an economic perspective, and the preference towards the

[21] Given the empirical history of liquidity withdrawal from corporate accounts in the region, most participants felt that what is currently set as a 75% run-off factor for *less* stable corporate deposits should rather be about 40%. If an amendment on the definition of an "established relationship" can not be integrated in CRR this may be a more appropriate parameter.

first or the latter depends on each country's operational habits. In order to ensure a common level playing field across countries, there should be an effort that operational peculiarities in specific jurisdictions are duly taken into account and, as a consequence, sight assets be included in LCR commercial inflows.

Parent bank funding

According to the CRR proposal, in the case of parent funding a lower run-off factor could be applied for purposes of the LCR. Working Group participants agreed that the application of a lower run-off factor should be allowed in the case where parent institutions are established in different member states, subject to the joint decision of the supervisory authorities. In the same vein, higher inflows for credit and liquidity facilities should then apply to parent institutions from other member states as well. (paragraph 8 (d) of Article 410 and 4 (c) of Article 413 should be deleted). Intra-group operations should receive a symmetrical treatment.

Reporting and timing

In the Working Group's view, a regular reporting of the LCR to the competent host authorities would be absolutely necessary in the case of both subsidiaries and branches, because the host central bank will in practice be the.lender of last resort. Without regular reporting, host central banks will have less time and less opportunity to mitigate and handle liquidity problems during a stress period.

The CRD IV/CRR observation period is expected to start only from 2013, as reporting instructions will have to be unified. A slightly longer observation period would be beneficial to a successful implementation of the LCR.

Monitoring of currency mismatches

The group agreed that **monitoring the LCR with regard to individual currencies** is an important objective. At the same time, the explicit requirement that the currency denominations of liquid assets should correspond to those of potential net liquidity outflows could be unduly burdensome for bank institutions and may not be appropriate from a prudential point of view in all circumstances.

> **Recommendation 7.** A requirement to report the LCR in a currency other than the domestic currency should be left to the discretion of the competent national authorities, who can best take account of liquidity risk in foreign currencies and of mitigating instruments, such as swap facilities at national or international level.[22]

[22] Article 405 point (g) could hence be deleted, and discretion for competent national authorities limited to the operations under their jurisdictions could be introduced.

Scope of application

The CRR proposes to form liquidity sub-groups based on the current (cross-border) banking groups for the management and reporting of the compliance with liquidity requirements. The conditions for the acceptance of liquidity sub-groups (meaning that these entities are exempted from individual compliance) are the following:

- Consolidated application of the requirements
- Group-wide liquidity management
- Legally binding commitments by group-members for liquidity support

In the case of cross-border groups, relevant supervisory authorities have to reach joint decisions on the level of application of liquidity requirements. Since there is no special process or mechanism determined in CRR for reaching such decisions, the standard EBA mediation process has to be followed should the relevant competent authorities disagree about the joint requirements. Apart from the fact that this could be too time consuming and cumbersome for the EBA it could also lead to serious disturbances to the single market principle.[23] Moreover, some Working Group members had doubts that this procedure would always safeguard financial stability at national level. Since local central banks remain responsible for their countries' financial stability, they would be expected to make decisions on prospective Emergency Liquidity Assistance (ELA) operations with limited access to data and information and limited authority to intervene. Therefore, the Working Group proposes to implement the framework only on the condition that home and host central banks agree *ex ante* on prospective burden sharing should an ELA need arise. Clarifying ex ante about home and host responsibilities in maintaining the liquidity of these sub-groups is in the interest of both competent authorities and banking group.

To recognise liquidity sub-groups covering several member states as the minimum level of compliance with liquidity requirements and to waive compliance for individual institutions requires that "there are no current or foreseen material practical or legal impediments" to the fulfilment of the contracts referred to in Article 7 (1) c. Currently, the existence of legal obstacles and the fact that there is no harmonisation among member states in handling cross-border liquidity problems makes the abovementioned condition impossible to be fulfilled. Therefore, the Working Group reemphasised the importance of the European Commission's work in progress on a crisis management and bank resolution framework that will include sections on cross-border cases. The adoption of such a framework could fill an important gap in the EU legal framework and the Working Group hopes that its adoption could be in time with the coming into force of the CRD IV. Otherwise, alternative conditions upon which

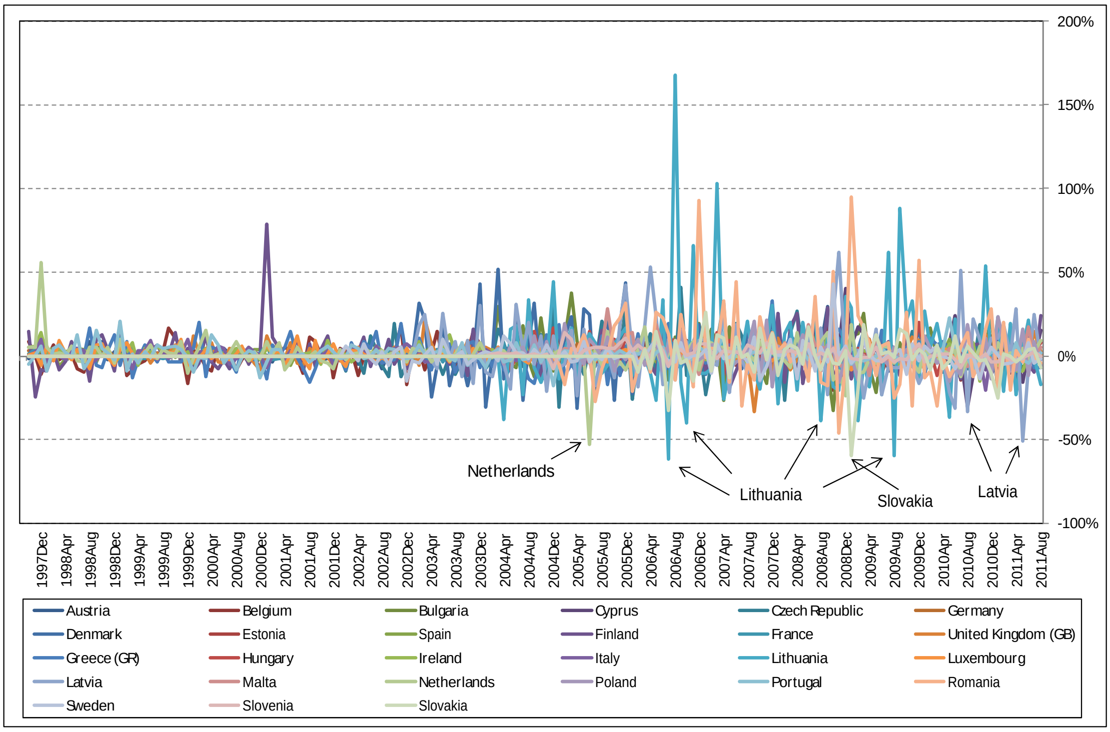
[23] E.g. in the case of Hungary, there are subsidiaries with parent undertakings in 8 different member states meaning that the Hungarian supervisor has to reach 8 different decisions with 8 different home authorities. Should the home authorities take different positions in this respect, 8 different regimes would be in place in Hungary leading to competitive distortions on the one hand and to unmanageable liquidity risk monitoring by Hungarian authorities on the other.

EBA could grant an automatic waiver on entity level requirement to a cross-border group operating in Europe could be defined.

> **Recommendation 8.** Consolidated liquidity supervision is desirable but would require binding decisions, monitoring by the EBA and cooperation among supervisory authorities, and central banks to ensure a proper application of the liquidity requirements. Supervised financial institutions, for their part, will seek a manageable regulatory burden, transparency and predictability of requirements. If legal obstacles are not removed by the time of entry into force of the respective liquidity requirements, then alternative conditions for a waiver of entity-level liquidity requirements for cross-border bank groups should be defined, or mediated, by the EBA.[24]

Chart 7. Total deposits inflows and outflows.

Per cent, m-o-m



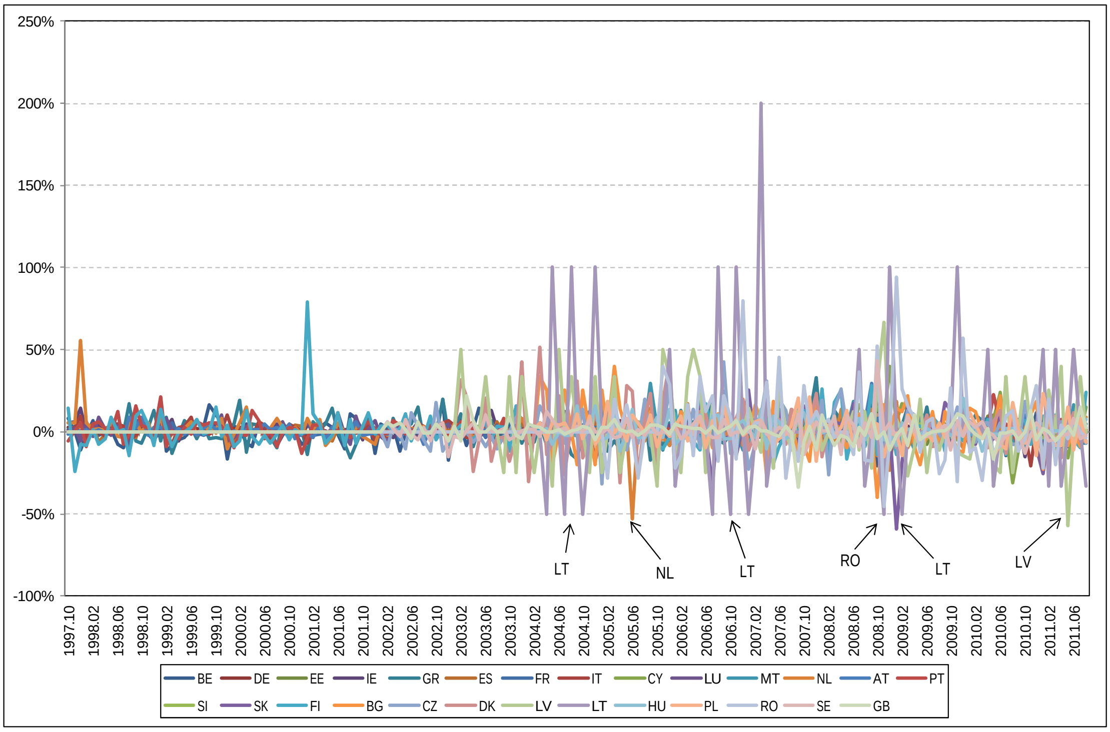
Note: In/out flows were calculated by use of ECB monthly database. Note that this Chart is illustrative only, it shows aggregate data. In/out flows could differ among banks.

Source: ECB

[24] Some members of the Working Group proposed to implement a consolidated liquidity framework only under the condition that home and host central banks agree ex-ante on burden sharing should the need for an ELA arise. In their view, such an up-front agreement on respective responsibilities would be in the interest of both competent regulating authorities, central banks, and banking groups. Several central bank representatives, however, argued that broader issues in home-host coordination would need to be resolved first, that ELA can only be granted on a case-by-case basis, and that liquidity support outside the eurozone would be very difficult.

Chart 8. MFIs deposits inflows and outflows.

Per cent, m-o-m



Note: In/out flows were calculated by use of ECB monthly database. Note that this Chart is illustrative only, it shows aggregate data. In/out flows could differ among banks.
Source: ECB

III. Macroprudential Instruments

Background

The global financial crisis revealed that the missing pillar in the existing financial stability architecture was the macroprudential approach to financial supervision. At the EU level, the importance of this issue was highlighted in the report of the Group de Larosière (2009): *The High-Level Group on Financial Supervision in the EU* prepared on a request of the European Commission.[25] The report concluded that the operating arrangements for supervision had not been able to prevent the occurrence of a serious financial crisis. This resulted from the fact that surveillance solutions based on national models were inadequate to the degree of integration of the EU financial markets and the large number of entities operating across borders. Stronger, more complex and opaque interconnections of the financial system with the real economy as well as lack of a systemic perspective in conducting the financial oversight seem to be the key lessons that come from the experience of that recent financial crisis. Tight interdependences between elements of the European financial system had become evident, underlining that effects of the materialisation of aggregated risks could generate even greater losses than those occurring within individual institutions. As a result, monitoring of individual institutions turned out to be insufficient in assessing the condition of the financial system as a whole. Macroprudential supervision with its systemic perspective aiming at safeguarding the stability of the financial system as a whole complements the traditional microprudential oversight focused on the health of individual financial institutions.

The nature of macroprudential instruments

The authority responsible for macroprudential policy should be provided with appropriate tools to be able to effectively respond to the risks arising in the financial system. The toolkit includes both instruments specifically designed to minimise systemic risk (macroprudential instruments) as well as instruments that were originally designed to reduce idiosyncratic risk but after appropriate modifications become part of the macroprudential toolkit (microprudential instruments). Many of the available microprudential instruments can be used to achieve effects of a macro scale and therefore could be applied to address systemic risk (e.g. Loan-to-value ratios or debt to income ratios).

The financial system in the EU as an environment for the operation of macroprudential instruments

The European Union consists of 27 heterogeneous financial systems underlying the Single Market. Significant differences arising across national economies and financial systems within the EU include, for instance: the size and structures of national

[25] *The High-Level Group on Financial Supervision in the EU, Report*, 25.02.2009, Brussels, Chapter 1, p. 7.

banking systems, exchange rate regimes (fully flexible, currency union, currency boards, ERM2), monetary and fiscal policy regimes, economic and asset price cycles, national deposit insurance and supervisory arrangements and practices, assets-to-GDP ratio.

One view that is widely shared among host country supervisory authorities is that to successfully address risks emerging from these heterogeneous national financial systems, local specificities and their potential consequences need to be taken into account when determining the appropriate macroprudential policy and instruments for each country. To this end, national authorities (central banks and supervisory authorities) have the best knowledge about the characteristics and nature of their national financial systems as well as competences and experience to assess the local macroprudential conditions and systemic risks. These issues – because they enable to identify a systemic influence posed by individual institutions – include, inter alia, market characteristics, interlinkages between markets and institutions, risk profile of supervised institutions (e.g. exposure to complex financial instruments), relevant information gathered during on-site inspections, statistical data, legal framework (e.g. taxes). These considerations may lead to the conclusion that national authorities with the mandate for macroprudential policy should evaluate the scale of the problem arising in their financial system and assess both the extent to which they would apply to the EU-level guidelines and to which they would implement country-specific macroprudential instruments.

Furthermore, given the complex and ever-changing nature of the systemic risk as well as the speed and unpredictability with which systemic risks can spread, flexibility of macroprudential policymakers to take remedial actions is of particular importance. Likewise, taking into account that the current experience and work on macroprudential instruments is at a very early stage, both at the EU and national levels, creating scope for policymakers to flexibly adjust macroprudential strategies and instruments, as they gain more knowledge and experience, seems to be the appropriate way forward.

For an effective and efficient conduct of macroprudential policy it seems to be crucial that national authorities would have appropriate instruments at their disposal, allowing them to respond to risks in the financial system flexibly, taking into account country-specific characteristics.

The above position needs to be balanced against the view widely held among home country supervisors, that the EU's integrated market for financial services requires harmonisation of certain maximum ratios and therefore limits to the discretion that can be exercised by host countries. This motivated the dissenting opinion set out at the end of this section.

Countercyclical capital buffers and mutual reciprocity

A key novelty of the Basel III agreement was the introduction of the countercyclical capital buffer (CCB) – the first instrument within EU *acquis* dedicated solely to addressing macroprudential issues. Subsequently, the CCB has been included in the EU draft directive CRD IV. The ultimate goal of the CCB is to protect the banking sector from the formation of imbalances due to excessive leverage in the banking systems in individual member states and in the EU as a whole. In principle, in applying this tool, supervisors will be able to prevent the adverse economic effects of excessive credit developments unwinding, as occurred during the recent financial crisis, and lend support to credit generation as they relax their macroprudential tools.

Key features of the framework for the proposed countercyclical capital buffer

Objective. The aim of the buffer is to enhance the resilience of the financial system in the face of systemic risks stemming from aggregate credit growth. The buffer will comprise high-quality loss-absorbing capital (Common Equity Tier 1).[26]

Setting and transparency. The buffer rate will be set by designated national authorities on a quarterly basis.[27] Each designated authority shall publish the quarterly setting of the buffer rate with a justification.[28]

Mechanism and risks taken into account. The buffer would be built up when aggregate credit growth is judged to be associated with a build-up of system wide risk and released during stressed periods. In setting the rate of the buffer, the following factors will be taken into account: the deviations from the long-term trend of credit-GDP ratio, structural variables, the exposures to any other risk factors related to risk to financial stability as well as guidelines and recommendations issued by the ESRB.[29]

Calculation. The buffer rate will be calculated as a weighted average of the counter-cyclical buffer rates that apply for the countries where banks' credit exposures[30] are

[26] Proposal for *a Directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate*, COM (2011) 453 final, Brussels, 20.07.2011, Article 124 (2).
[27] Ibidem, Article 126 (3).
[28] Ibidem, Article 126 (8).
[29] Ibidem, Recital 58, Article 126 (3).
[30] These exposures include: claims or contingent claims on public sector entities, claims or contingent claims on corporates, retail claims or contingent retail claims, claims or contingent claims secured by mortgages on immovable property, exposures in default, claims in the form of covered bonds, securitisation positions, claims on institutions and corporate with a short-term credit assessment, claims in the form of units or shares in collective investment undertakings ('CIUs'), equity claims, other items. Ibidem, Article 130 (4) and Article 107 (*Exposure classes*) of the Proposal for a *Regulation of*

located.[31] This means that buffers held by banks will reflect the geographical composition of their credit exposures. The buffer rate should normally be between 0 per cent and 2.5 per cent but could be lifted above 2.5 per cent where justified in view of protecting financial stability. Domestically authorised institutions shall apply any buffer rate set by the designated authority.

Mutual reciprocity. International reciprocity obligations concerning the buffer settings depend on the *level of the buffer rate* set by the national designated authority:

- if the buffer rate is set up to 2.5 per cent - the mutual reciprocity is mandatory32 (a designated authority in a Member State B must recognise the buffer rate set by a designated authority in a Member State A, for the purposes of the calculation of the buffer rate by institutions regulated in Member State B whose exposures are located in a Member State A);
- if the buffer rate is set above 2.5 per cent - the mutual reciprocity for the part exceeding 2.5 per cent is voluntary33 (a designated authority in a Member State B may recognise the buffer rate set by a designated authority in a Member State A, but is not obliged to do so).

The rule of reciprocity proposed in the draft CRD IV on 20 of July 2011 has been also conditioned on the *nature of information* that national authorities will consider when determining buffers. According to point *c)* of the Article 126 (3) of the CRD IV, while calculating the buffer rate, national authorities may take into account – apart from the buffer guide and guidance maintained by the ESRB – *any other variables they consider relevant*. These include structural as well as non-cyclical variables. As a consequence to this provision, national authorities must distinguish and publicly quantify those parts of their buffer setting which are based on both cyclical variables or the ESRB guidance and information other than that permitted under the ESRB guidance. Reciprocation of that part of the buffer which reflects the non-cyclical or structural variables or is not consistent with the ESRB guidance by designated authorities from other member states is prohibited.[34]

Role of the ESRB. The ESRB may issue – in the form of recommendations – guidelines and principles on setting the buffer rates that designated authorities should follow, exercising their national discretion which in particular could include: principles when exercising judgement on the appropriate level of buffer rate, guidelines on the measurement and calculation of the buffer rate as well as on variables that might indicate the build-up of system-wide risk in the financial system.

the European Parliament and of the Council on prudential requirements for credit institutions and investement firms, COM(2011) 452 final, Brussels, 20.07.2011.

[31] Proposal for a *Directive…*, op. cit., Recital 57, Article 130 (1).

[32] Ibidem, Article 130 (2).

[33] Ibidem, Article 127 (1).

[34] Ibidem, Articles 126 (4) and 126 (8). However, the proposals by the Danish Presidency have removed this obligation for a decomposition, as also recommended by the ESRB.

The ESRB may also issue a recommendation regarding a given buffer rate set in a specific member state or more than one member state[35].

The draft CRD IV proposal on the CCB constitutes a significant and solid basis for providing EU macroprudential policymakers with an adequate macroprudential instrument to address systemic risks. The main advantages of this proposal are the flexibility and transparency regimes.

- Flexibility regime means that national designated authorities are unconstrained in assessing the sustainability of credit growth as well as the level of system wide risk. This is manifested by the fact that they have been given powers to freely set the level of the buffer rate for both exposures in their own country and, if necessary, for exposures in third countries.
- Transparency regime will ensure that the policymakers would have to explain their reasoning for the decisions to build up a buffer. When the economic conditions will justify the release of the buffer, the public, including market participants, will understand the purpose for which they were accumulated.

However, the CRD IV proposal contains some important rigidities requiring further consideration.

> **Recommendation 9. Coordination of macroprudential measures.** The ESRB should have a strong role in setting guidelines, principles and recommendations on the capital buffer rates and exercising of national discretion. In the interest of transparency, all decisions to build up the buffer should be reported centrally (to the ESRB and EBA). The Working Group supported the EBA's role in developing draft technical standards to specify the methodology for the identification of the geographical location of relevant credit exposures, as stated in Art. 130 (7) CRD4.
>
> **Recommendation 10.** There should be an appropriate balance between flexibility for national supervisors responding to local risks on the one hand, and sufficient coordination within the single market at the European level on the other hand. In this respect, country-specific measures with cross-border effects, in particular in the macroprudential field, should be implemented based on a regime of tightly **constrained discretion**. Competent authorities should inform the ESRB, the EBA, the European Commission and relevant host country authorities *ex ante* of the measures they plan to implement, giving sufficient time to evaluate the proposed measures. Only in exceptional emergency situations would this be done ex-post. In any event, there should always be well-founded evidence and an objective macro-economic justification for such measures.

[35] Ibidem, Article 125 (1).

Reciprocity in the level of the CCB

The system of international reciprocity of CCB constitutes a cornerstone of the instrument, delivering a level playing field for institutions within the EU's single market. By requiring that all banks lending into a given market hold similar buffers against their exposures, it ensures that no bank faces a cost-of-capital advantage. Reciprocity also supports an automated coordinated policy response between supervisors to a given aggregate credit risk. Nevertheless, the CRD IV provision of the mandatory reciprocity applies only to buffers up to 2.5 per cent. Beyond that level reciprocal application is voluntary.

This creates a potential scope for regulatory arbitrage among member states. When a national authority sets a buffer rate above 2.5 per cent but reciprocity by other EU authorities would be mandatory only up to 2.5 per cent, the level playing field in the EU will be affected. Domestic institutions and subsidiaries of credit institutions with exposures in the member state concerned would have to apply the buffer rate at the given level. Therefore they would operate at a cost-of-capital disadvantage in relation to foreign branches of credit institutions and cross-border activities which would have no economic interest in recognising the higher than 2.5 per cent buffer rate. Such an outcome might dissuade national authorities from setting a buffer above 2.5 per cent in the first place, constraining the flexibility of national authorities to take necessary actions and undermining their credibility and the financial system resilience.

> **Recommendation 11. Application of the counter-cyclical capital buffer (CCB).** A close cooperation among European authorities is required to avoid uncertainty over the implementation of this important instrument which may affect the effectiveness and efficiency of risk and capital management processes within European banking groups. Once the coordination set out in the previous recommendation is achieved, national supervisors should consider granting full reciprocity for counter-cyclical capital buffers above 2.5 per cent. This would ensure a level playing field among banks operating within the EU and eliminate arbitrage opportunities through the use of cross-border branches or cross-border lending, as no cost-of-capital advantages or disadvantages would occur. This would support the prudential objectives of the host country authority. Other capital instruments (e.g. contingent capital) should be considered by national supervisors for the purposes of meeting this CCB requirement.

Reciprocity in the nature of information taken into account in setting the CCB

The CRD IV draft provisions introduce a conditional system of reciprocity also with regard to *the nature of information* taken into consideration when setting the rate of the CCB. The European Commission excludes from the reciprocity rule that part of the CCB rate which is associated with structural or non-cyclical variables. In this regard, the prohibition for the member states to reciprocate the CCB constitutes an additional constraint on the principles of the reciprocity system itself. National designated authorities should be obligated to decompose the buffer rate, in particular due to significant practical problems in complying with this task.

Conclusions on the application of macroprudential instruments

The draft CRD IV/CRR provides a meaningful and important foundation for the implementation of macroprudential policy at the EU level. However, it should be highlighted that the revised CRD as a package of *a directive* to be discretionary implemented on a national level and *a regulation* which is directly applicable to member states constitutes a legislation in the nature of a maximum harmonisation. Besides the fact that the CRD IV gives national authorities flexibility to determine the level of the CCB, the CRR does not make any allowance for national authorities to tighten calibrations of other prudential instruments for their domestic financial sectors.[36] This raises several concerns with regard to the effectiveness and efficiency of conducting macroprudential policy by the national authorities.

National financial systems constitute a patchwork of differences and specificities at macro- and microeconomic levels. Attempts to pursue a one-size-fits-all macroprudential policy by introducing the same calibrations of instruments for different national financial systems without the possibility of national authorities to react could result in policies that are set too tight for some member states or too loose for others. Subsequently, this could have important consequences for the supply of financial services or could lead to insufficient systemic resilience. Finally, this could – contrary to the policymakers' intentions and objectives of the single market – result in a situation that the stability of both the national and EU wide financial system would not be assured.

Furthermore, the fact that national authorities would not exercise the same powers as the European Commission means that the national policymakers would in fact not be able to carry out their macroprudential mandates. The inability to take necessary remedial actions through the use of prudential instruments when the downturn comes could raise questions about their accountability and responsibility for protecting the financial stability on a national level. As a result, the credibility of macroprudential mandates and powers could be undermined. At the same time, member states are responsible for the stability of their financial systems and bear the fiscal consequences of a potential crisis. To this end, EU–wide regulations should strive to avoid creating the potential conditions that may lead to an internalisation of benefits and nationalisation of losses.

The need for nationally-calibrated policies has been already widely acknowledged. The *de Larosière Report*, for instance, states that: 'A Member State should be able to adopt more stringent national regulatory measures considered to be domestically appropriate for safeguarding financial stability as long as the principles of the internal

[36] The proposal for a *Regulation…*, op. cit., Article 443.

market and agreed minimum core standards are respected'.[37] Likewise, organisations such as the IMF or FSB call for avoiding one-size-fit-all approaches to macroprudential policy and affirm the need for a discretionary use of the instruments and consideration of country-specific circumstances.[38]

The current European Commission's proposal for the revised CRD is more stringent than these recommendations. The Commission has acknowledged the need for flexibility in order to address macro-prudential and systemic risks. However, it has also added some safeguards, like the ESRB *ex-ante* coordination, to reinforce the EU systemic dimension and ensure that the principles of the internal market and the agreed minimum core standards are respected.

Dissenting position on macroprudential instruments

In assessing the appropriate model for minimum or maximum harmonisation, it should be borne in mind that the *de Larosière Report* quoted earlier in this section describes the challenge of bringing together the different standpoints:

"In order to tackle the current absence of a truly harmonised set of core rules in the EU, the Group recommends that:

- Member States and the European Parliament should avoid in the future legislation that permits inconsistent transposition and application;

- the Commission and the level 3 Committees should identify those national exceptions, the removal of which would improve the functioning of the single financial market; reduce distortions of competition and regulatory arbitrage; or improve the efficiency of cross-border financial activity in the EU. Notwithstanding, a Member State should be able to adopt more stringent national regulatory measures considered to be domestically appropriate for safeguarding financial stability as long as the principles of the internal market and agreed minimum core standards are respected."

In support of the EU Commission proposal it could be argued that although there are 27 not totally homogenous financial markets, the intriguing logic of European Integration has always been that convergence of rules leads to convergence of markets, thus enabling companies to fully exploit the advantages of the single market. This premise is particularly relevant in the EU's single market for financial services, as the high degree of interconnectedness between economies demands adequate harmonised or at least coordinated rules. By introducing the CRR, the European Commission provides for a truly harmonised framework, which is why member states do not need unconstrained flexibility to adopt national measures. However, undoubtedly national supervisors should have an adequate toolbox to address

[37] *The High-Level Group on Financial Supervision in the EU,* op. cit., Recommendation 10, p. 29.
[38] *Macroprudential Policy: An Organizing Framework,* IMF, 14 March 2011, p. 30.

macroeconomic country specific issues. The European Commission acknowledged that necessity by providing flexibility to national supervisors concerning Pillar II provisions, the introduction of countercyclical buffers and risk weights for immovable property. It can furthermore change the provisions set in the CRR temporarily in reacting to country specific problems. (Art 433 CRR).

It could be argued that in full compliance with Basel III the CRD IV strikes a balance between the flexibility of host supervisors and the competence of home supervisors by limiting mandatory reciprocity for buffers up to 2.5 per cent and providing for optional *reciprocity for buffers above 2.5 per cent.*

However, there should be no presumption that the home supervisors' decision to grant such reciprocity beyond this level be constrained in any way. The host's decision on the CCB directly addresses exposures which are booked in the home supervisor's jurisdiction. In affecting the capital coverage of the entire stock of loans already booked, the additional capital buffer is among the most potent instruments a supervisor can utilize. That being said, it is certainly not in the home supervisor's interest to allow institutions under its supervision to gain market share in overheated economies. It is therefore likely that, in justified cases, bilateral dialogue and the ESRB's capacity to provide appropriate guidance will be important to ensure the necessary reciprocity.

A possible way forward could be to remove the provisions introducing "other variables" from the legislative text, since they are inconsistent with the architecture of the buffer and increase complexity. Furthermore they jeopardise ESRB's coordinating role in giving guidance on variables that indicate the build up of systemic risk in a financial system (Art 125 (b). Assuming that the ESRB is fulfilling its mandate, there would be no need for using other variables. If other variables nevertheless are permitted, reciprocity should therefore be optional rather than mandatory.

IV. Home-host coordination, pillar II, and other implementation issues

Basel III was negotiated as a minimum standard approach. By contrast, the CRR /CRD4 will follow the concept of maximum harmonisation. Against this backdrop, to assess possible unintended consequences of the implementation of Basel III in the European Union on both future market development and cross-border relationships in Emerging Europe, the overarching question is whether a uniform implementation of the CRR/CRD4 proposal into national law may have different effects from what it is to achieve. Consequently, it is still controversial whether CRR/CRD4 should grant upward flexibility to some extent, based on the judgment of the individual country regulators.

The harmonisation approach in the Commission's proposal for regulation

The European Commission has decided to implement Basel III in Europe separating prudential requirements from authorisation and ongoing supervision - Directives 2006/48 and 49 - that will continue to be in the form of a Directive as part of the overall CRR/CRD4 package. The evaluation of the proposal, and of its potential impact on Emerging Europe, must consider the whole package and in particular the interaction between the elements of the preceding directives and the new elements introduced by the new regulation.

The Commission's regulatory choice of shaping prudential requirements in the form of a Regulation ensures that those requirements are directly applicable to Institutions, thus ensuring a level playing field by preventing diverging national requirements as a result of the transposition of a Directive. It allows harmonising divergent national supervisory approaches by removing options and discretions that were "abundant" in the current European legislative framework and that might have contributed to exacerbating supervisory shortcomings revealed by the financial crisis.

In this regard, consider the pre-crisis management of liquidity risk and capital adequacy. The crisis has shown that existing liquidity risk management practices were inadequate in capturing, measuring and monitoring risks linked to the massive reliance on wholesale short-term funding and to the excessive use of complex financial products. While some member states have had quantitative regulatory requirements for liquidity in place, no harmonised regulatory framework establishing the adequate levels of short-term and long-term liquidity exists at EU level. Different national standards hindered communication between home and host supervisors affecting the effectiveness of the supervision of European cross-border bank groups. The situation was similar on the capital side. At the onset of the crisis many banks didn't hold sufficient amounts of high quality capital to support their overall loss exposure. Insufficient harmonisation in the European definition of capital, coupled with regulatory ratios that did not accurately reflect banks' effective capacity to absorb losses, undermined the ability of the market to assess accurately and consistently the solvency of EU banks.

Maximum harmonisation is thus necessary to achieve a single rule book aimed at further developing a truly harmonised European market by ensuring equal treatment, low costs of compliance and the removal of regulatory arbitrage. Nevertheless common legal standards are not enough to strengthen the supervisory structure for European cross-border banking groups. It requires also an integrated supervision of EU-wide groups, resting on a complete pooling of information and the enhancement of the powers of the colleges of supervisors.

On the other hand, lack of upward flexibility in applying prudential requirements seems to create a potential for imbalances between the powers and responsibilities of the national authorities. Although responsible for addressing increasing risks in the banking sector, national authorities have much lower ability to do so, which calls for readdressing the number of other standards and institutional arrangements with regard to banking supervision and bank resolution framework, especially the Core Principles for Effective Banking Supervision, deposit insurance schemes etc. In this regard, the ESRB and the EU Commission could play an essential role in authorising justified supervisory measures beyond the measures of CRR (so-called 'goldplating').

Banking sectors mirror national economies which are, despite all the efforts on harmonising economic policies, obviously still very different. This can be one of most important reasons why the concept of single rule book, i.e. the uniform implementation of the CRR/CRD4 into national law, might have different effects from what they are designed to achieve. Foreign currency lending, for instance, has to be taken into consideration given its relevance in emerging Europe.

From regulation to supervision

The key feature of the proposal has a twofold target: a single rule book and enhanced supervision entrusted to national authorities. The proposal for a Regulation sets out prudential measures directly applicable to institutions. In the proposal for a Directive remain the general principles of the supervision of institutions which require transposition and the exercise of discretion. For cross-border bank groups, these principles encompass exchange of information, distribution of tasks between home and host country supervisors and exercise of sanctioning powers.

According to the Commission's proposal, the Directive would still contain the provisions governing the supervisory review of banks by the competent authorities. These provisions supplement the prudential requirements set out in the regulation with individual arrangements made by competent authorities as a result of their ongoing supervisory review of individual institutions. The scope of such supervisory arrangements would be set out in the Directive since the competent supervisors should be able to exert their judgment as to which arrangements should be imposed.

Arguably, the CRR/CRD4 framework still leaves considerable scope for national discretion in interpreting regulatory requirements and in implementing the content of the Directive. Namely, the proposals for the Regulation and for the Directive contain provisions for competent authorities to address both micro- and macroprudential concerns at national level:

- Member states could impose additional capital requirements to individual institutions or groups of institutions where justified by specific circumstances under the so called Pillar 2 even for risks that an institution poses to the relevant national financial system (Art 92 CRD) ;
- Member states set the level of the CCB, reflecting the specific macroeconomic risks in a given member state. However, the CCB that can be introduced can in general be set up to the level of 2.5 per cent of risk-weighted assets (RWAs) on Common Tier 1 equity and higher if justified.

These provisions would actually modify either the individual and/or systemic capital requirements to a significant extent.

These discretions are the main argument against the view that CRR/CRD4 lack upward flexibility and hence the ability of national supervisors to tackle national specific risks in the banking sector. But the following questions remain: first, whether less responsible fiscal policy, less efficient or more concentrated real sector, lower financial discipline or households associated with lower financial literacy as compared to the European (weighted) average level should be addressed at the systemic or individual bank level, and second, whether addressing those issues at the individual bank level creates additional imbalances and potential for regulatory arbitrage within the borders of a country.

Single market and similar or same regulations do not necessarily result in similar risks and especially do not warrant the same level of risks, as made clear by the current developments of the eurozone peripheral debt crisis. Prudential regulation should not only ensure adequate safeguards against risks, but should also penalise (make more expensive and therefore less attractive) undesirable market behaviour which creates systemic risks. Considering the differences in bank operations across European economies, the question is whether the one-size-fits-all buffers are sufficient to address the risks at the level of each national economy.

Micro-prudential supervision

To address specific concerns on the implementation of CRR/CRD4 in emerging Europe, local authorities can exploit the powers granted by the European regulation within the Pillar 2 framework. The associated supervisory review process aims at addressing the flaws in risk management practices revealed by the crisis, which in many cases were symptoms of more fundamental shortcomings in governance structures at financial institutions. This is reinforced through reviews of the adequacy of capital buffers above the regulatory minimum to reflect the unique risk profile of a particular institution.

For the supervision and regulation of European cross-border bank groups, Colleges of Supervisors have a key role to play in delivering an effective and efficient implementation of Pillar 2. In fact, Colleges have the potential to considerably enhance consistency in cross-border banks' supervisory assessment arrangements.

The role of European Colleges has been further strengthened by the recent amendments to the European capital requirements legislation (CRD2). Starting this year, European Supervisory Authorities have to share their assessments on risks of both the group and single components and do their best to reach a joint decision regarding the risk assessment and the capital adequacy of European cross-border bank groups (JRAD process).

The new JRAD process, complemented by the guidelines issued by the EBA, is a challenging task for the European Supervisory Authorities, as it needs to demonstrate that, with the lessons from the crisis, the European supervisory framework based on national authorities' powers is still valid for supervising the European cross-border bank groups. In fact, this activity demands considerable efforts on the part of the authorities involved in the supervision of cross-border groups, as they are required to share methodologies, harmonise processes and coordinate activities. A fundamental prerequisite is mutual trust and willingness to cooperate. The CRR/CRD4 proposal confirms the central role of Colleges as many provisions require trustful cooperation among the European supervisory Authorities.

Given the prominent role of cross-border bank groups in the CEE economies, Colleges of supervisors are key in preventing that concerns over a potential further shift in competences from supervisors in CEE countries towards those in home countries materialise.

Against this backdrop, the role of the supervisory Authorities from CEE countries in existing European Colleges of Supervisors should be strengthened to allow building up the mutual trust needed to consistently apply the new harmonised European rules. In some cases – especially when the Colleges of supervisors are established in the form of core Colleges – the participation of these authorities is limited and their contribution only marginal.

Macroprudential supervision

A supervisory framework only based on institution-specific supervisory standards has proved to disregard systemic risks such as those that piled up before the crisis. The introduction of a macroprudential requirement seeking to protect the integrity of the financial system as a whole is a new feature in the Basel framework.

The CCB imposes an additional capital surcharge of up to 2.5 per cent of RWAs on Common Tier 1 equity in jurisdictions where credit growth is deemed excessive and thus may lead to an upsurge of systemic risks (see section IV).

Box 2. Home-host responsibilities with regard to liquidity risk management

With specific reference to liquidity risk management, some CEE supervisors complained that Basel III liquidity requirements imposed at the group level can enable local subsidiaries to operate below the equivalent of the single-bank national requirements, imposing substantial risks of potential refinancing needs on the local central bank which is still the lender of last resort.

In this regard, the proposal of the Commission is apparently balanced. From a home supervisor perspective it seems that it bends towards the host supervisors' demands.

Under the Basel III proposal, liquidity requirements are applied at the level of the consolidated entity. Under CRR/CRD4, by contrast, liquidity standards will in principle apply at the level of every individual institution, as it cannot be taken for granted that they will receive liquidity support from other institutions belonging to the same group if they have difficulties to meet their payment obligations.

Only subject to stringent conditions, competent authorities can waive the application to individual institutions and subject banking groups to consolidated requirements. Those conditions ensure that such institutions are, in a legally enforceable manner, committed to support each other and have the actual ability to do so.

In the case of a group with institutions in several member states, all competent authorities of the individual institutions must, in order for the waiver of individual requirements to be available, agree that the conditions for the waiver are met. In such cross-border situations, there are further conditions requiring that the individual competent authorities must be satisfied with the liquidity management of the group and with how much liquidity the single entities of the group have. In case of disagreement, each competent authority of an individual institution will decide alone about whether the waiver would apply.

There is also the provision that the EBA might mediate in case of disagreement between the competent authorities. The result of the mediation is however only binding regarding the conditions related to the commitment of the institutions belonging to a group to support each other and the actual ability to do so. The individual competent authorities retain the last say regarding the adequacy of the group's liquidity management and the liquidity adequacy of the individual institutions.

The national application of liquidity requirements on the one hand mirrors the fact that liquidity and collateral transfer might be subject to legal or supervisory restrictions but on the other hand might create idle liquidity. Therefore, these provisions require a close cooperation among European Authorities to ensure a proper application of the liquidity requirements and to avoid an increasing regulatory burden on the supervised institutions.

Unlike the micro-prudential requirements that will be translated directly into European regulation, the decision on imposing the CCB will be based only on guidelines issued by the Committee. This will leave considerable discretion to national authorities in determining the factors that trigger such additional requirements and their variance over time. Since it is widely recognised that the excessive credit growth is not the only source of systemic risks, these guidelines should be wide enough to cover all sources of systemic risks specific for each national economy with in the EU (high euroisation, lower financial discipline, higher concentration in the real sector etc.).

Furthermore, in the Basel III framework, the decision to impose the buffer will lie with the host country authorities, making internationally active banks subject to the weighted average of capital requirements in the various subsidiary jurisdictions. On the contrary, the CRR/CRD4 proposal envisages the application of the CCB within the European Union at all levels where capital requirements are applied, that is on the institutional and national level and in the fully consolidated entity.

Uncertainty over the implementation of this standard may affect the effectiveness and efficiency of risk and capital management processes within European bank groups.

Role of European Supervisory Authorities

Basel III implementation within the EU has been preceded by initiatives aimed at significantly strengthening the European supervisory framework.

In particular, a European Banking Authority (EBA) is in charge of improving information-sharing between national supervisors and convergence of supervisory practices based on a single rule book. In more than 50 provisions of the CRR/CRD4 proposal, EBA is requested to submit regulatory and implementing technical standards to the Commission in order to specify the criteria set out in some provisions of the Regulation and in order to ensure its consistent application.

A European Systemic Risk Board (ESRB) will oversee the implementation of macroprudential requirements and identify systemic risks, including those arising from systemically important financial institutions (SIFIs). This will be a crucial function given the aforementioned wide margin for judgement of excessive credit developments that may warrant macroprudential measures.

The EBC "Vienna" Initiative could continue to play an active role by directly participating in the public consultation that EBA will promote before issuing technical standards and by supporting the analyses performed by the ESRB with information and statistical data.

Transitional period

The proposal clearly states the need for a close monitoring of a number of elements to be introduced by the new Regulation. Therefore, in the evaluation of the overall package and of potential unintended consequences on emerging Europe's financial systems, the provisions of the transitional period should be carefully considered.

In particular, the monitoring of liquidity measures will be subject to particular scrutiny on the basis of statistical data, collected according to provisions in the proposal. The Liquidity Coverage Ratio (LCR) will be introduced after an observation and review period in 2015. The Commission will consider proposing a Net Stable

Funding Ratios (NSFR) after an observation and review period in 2018. The monitoring and evaluation will take place both at the European Union level (involving EBA and ESRB) and international level (involving BCBS).

There is preliminary evidence that banks in emerging Europe might face serious challenges from the new liquidity requirements, which are significantly stricter than existing national regulations and are based on more extreme scenarios than historical crisis experience would warrant. Therefore, CEE supervisors ask for further adjustments in the implementation of Basel III and, in general, for greater calibration flexibility at the national level.

It is imperative that the more robust set of prudential requirements be applied consistently across Europe. Nevertheless, liquidity requirements will come into force in three and five-year time giving the opportunity to propose amendments to the current legislation whereas evidence supported by well grounded statistical analyses can be provided of unintended consequences.

The EBC “Vienna” Initiative – given its unique composition – could play a prominent role in supporting the exchange of information, statistical data and results of analyses among public and private institutions operating in emerging Europe with the aim to detect unintended externalities that might suggest amendment of the current CRR/CRD4 proposal to European Authorities. Furthermore the EBC “Vienna” Initiative could promote the development of local funding markets thus facilitating the fulfilment of the CRR.

Conclusions on home-host coordination

The European implementation of Basel III is a key step in addressing the weaknesses that triggered the financial crisis. Given the benefits from financial integration in terms of growth and financial stability, application of Basel III within emerging Europe should be based on sound coordination of prudential regulation and implementation, including in measures directed at systemic risks

In fact, a harmonised regulatory framework is a fundamental prerequisite for effective banking supervision. On the contrary, the CRR/CRD4 proposal might leave excessive discretion to national supervisors in applying the new prudential requirements, especially with regard to liquidity risk, and in imposing additional CCBs. Such flexibility for national application of capital and liquidity standards requires strengthened coordination in the supervision of European cross-border banking groups active in CEE.

Furthermore, common supervisory requirements are not enough to strengthen the supervisory structure for European cross-border bank groups. The focus should shift from regulation to supervision to promote convergence in supervisory practices. This is a much more challenging task. The newly established European Authorities – EBA and ESRB – will have a key role respectively in guiding the implementation of the new standards in national jurisdictions, in identifying systemic risks and proposing appropriate measures.

A single rule book is a fundamental prerequisite for an effective European banking supervision. Nevertheless, lack of upward flexibility in applying prudential requirements might create a potential for imbalances between the powers and responsibilities of the national authorities. It calls for readdressing the number of other standards and institutional arrangements with regard to banking supervision and bank resolution frameworks.

> **Recommendation 12. Completing the EU's agenda of financial regulation.** EU authorities should continue to press forward with the progressive development of all regulatory initiatives originally envisaged in the 2009 *de Larosière Report* which are also integral to establishing effective European banking supervision, importantly the common EU resolution capacity.
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> **Recommendation 13. Strengthening the colleges of supervisors and EBA's role within these colleges.** Common legal standards are not enough to strengthen the supervisory structure for European cross-border bank groups. A fully integrated supervision of EU-wide groups is required, resting on a complete pooling of information and the enhancement of the powers of the colleges of supervisors. The participation of CEE countries within existing European supervisory colleges should be strengthened to build up the mutual trust needed to apply consistently the newly harmonised European rules. Such a strengthened role of the colleges – and close involvement of EBA and ESRB – is essential in preventing that concerns over a potential further shift in competences from supervisors in CEE countries towards those in home countries materialise.

The EBC "Vienna" Initiative could play an active role by directly participating to the public consultation that EBA should promote before issuing the technical standards and by supporting with information and statistical data the analyses performed by the ESRB.

Given that banks in emerging Europe might face serious challenges from the new liquidity requirements, the EBC "Vienna" Initiative might have a role in supporting the exchange of information, statistical data and results of analyses among public and private institutions operating in emerging Europe in order to detect any unintended consequences that might suggest to European Authorities to amend the current CRR/CRD4 proposal.

ANNEX I. ABBREVIATIONS USED

AFME	Association of Financial Markets in Europe
BCBS	Basel Committee of Banking Supervisors
CCB	Countercyclical capital buffer
CEE	Central and eastern Europe
CIUs	Collective Investment Undertakings
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
EBCI	European Bank Coordination Initiative
EBF	European Banking Federation
EBRD	European Bank for Reconstruction and Development
EIB	European Investment Bank
ELA	Emergency liquidity assistance
ESRB	European Systemic Risk Board
IRB	Internal risk based
JRAD	Joint risk assessments and decision guidelines
LCR	Liquidity Coverage Ratio
NSFR	Net Stable Funding Ratio
RWAs	Risk-weighted assets
SIB	Systemically important bank
SIFI	Systemically important financial institution
SME	Small and medium size enterprise

ANNEX II. PARTICIPANTS IN THE WORKING GROUP

WG members		
Participant	**Organisation**	**Title**
Private Sector		
Ioannis Tegopoulos	Eurobank EFG	Head of International Activities Strategic Planning
Rosy Marseglia	Intesa Sanpaolo	Head of Risk Monitoring
Rodolfo Labadie	Intesa Sanpaolo	International Regulatory and Antitrust Affairs
Gyula Barabas	OTP	Head of Asset Liability Management
Georg Lobnig	Raiffeisen Bank International	Director, Capital Planning & Acquisitions
Christine Würfel	Raiffeisen Bank International	
Dorothee Bucquet	Société Générale	Group Treasury - regulatory team
Claudine Billod	Société Générale	Financial officer
Fabio Mucci	Unicredit	Head of CEE Banking Analysis
Micol Levi	Unicredit	Regulatory affairs
Mariana Kühnel	Erste Bank	Head of EU affairs
Gyula Barabas	OTP	Head of Asset Liability Management
Gonzalo Gasos	European Banking Federation	Senior Adviser
Viktorija Proskurovska	European Banking Federation	Adviser, Economic and Monetary Affairs
Home country authorities		
Edith Schiller	Austrian Ministry of Finance	Head of Financial Stabilisation
Elisabeth Ottawa	Austrian Ministry of Finance	Financial Attache
Damiano Guadalupi	Bank of Italy	Head of Banking Groups Supervision Department
Florian Weidenholzer	OeNB	Deputy Head of OeNB’s Banking Analysis Division
Host country authorities		
Piotr Szpunar	National Bank of Poland	Director, Financial System Department
Andrzej Reich	National Bank of Poland	Adviser, Financial System Department
Aniko Szombati	Magyar Nemzeti Bank	Principal Economist, Financial Stability
Martina Drvar	Croatian National Bank	Chief Advisor, Prudential Regulation and Bank Supervision
Mira Erić-Jović	National Bank of Serbia	Vice Governor
Svetlana Gospic	National Bank of Serbia	Director, Banking Supervision

		Department
Djordje Jevtic	National Bank of Serbia	Deputy General Manager of Banking Supervision Department
Péter Fáykiss	National Bank of Hungary	Economist, Financial Stability Department
Cristian Stefan	National Bank of Romania	Deputy Manager, Regulation and Licensing Department
Mirela Dima	National Bank of Romania	Chief of Prudential Regulations Division, Regulation and Licensing Department
Mark Bearman	Association of Financial Markets in Europe	Director, Prudential Policy
Participant Institutions		
Enrica Detragiache	IMF, European Department	Advisor
Christian Moor	EBA	Policy Advisor, Securitisation and Market Risk
Ana-Rita Ribeiro-Mateus	ESRB	
Juergen Kirchhof	European Central Bank	Senior Financial Stability Expert
Sanne Zwart	European Investment Bank	Economist, Economic and Financial Studies
EU Commission		
Andreas Strohm	DG Market	
Corina Weidinger-Sosdean	DG Economics and Financial Affairs	Economic Analyst
Victor-Corneliu Savin	DG Economic and Financial Affairs	Economic Analyst
Peter Lohmus	DG Economic and Financial Affairs	Economic Adviser
EBRD		
Piroska M. Nagy	EBRD	Director, Country Strategy and Policy
Alex Lehmann	EBRD	Senior Economist and Head of Region
Hannah Levinger	EBRD	Economic analyst
World Bank		
Lalit Raina	World Bank	Sector Manager
Katia D'Hulster	World Bank	Senior Financial Economist
Martin Melecky	World Bank	Financial Economist