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IMPACT ASSESSMENT

Accompanying the document

Proposal for a Council Directive

on a common system of financial transaction tax and amending Directive 2008/7/EC

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ANNEX 2

REGULATORY MEASURES IN THE FINANCIAL SECTOR

The following regulatory changes should be considered as constituting the baseline scenario from a regulatory perspective. The reforms address a number of problems identified above: reduce risk taking (proposals 1-10), risk surveillance (proposal 2), the definition and creation of proper capital ratios (proposals 1 to 7), misaligned incentives in remuneration schemes (proposal 1), a harmonisation of deposit guarantee schemes and the covering cost of future crisis (proposals 9 and 10), and dealing with Automated Trading (proposal 11). The relevant proposals are briefly summarized here:

(1) The definition of capital under CRD III and CRD IV

Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitizations, and the supervisory review of remuneration policies (so-called CRD III) impose an increase in capital required i) against banks' trading books, ii) for re-securitization positions of banks.

The Commission proposals, so-called CRD IV (Directive and Regulation)[1] to replace Directives 2006/48/EC and 2006/49/EC tighten criteria for eligibility of capital instruments for the different layers of regulatory capital and make extensive revisions to the application of regulatory adjustments.

(2) The revision to the counterparty credit risk under CRD III and CRD IV

The Commission proposals, so-called CRD IV (Directive and Regulation)[2] to replace Directives 2006/48/EC and 2006/49/EC strengthen the requirements for management and capitalization of the counterparty credit risk. The proposals also enhance incentives for clearing over-the-counter instruments through central counterparties. It put in place higher own funds requirements for bilateral derivative contracts in order to reflect the higher risk that such contracts pose to the financial system. It complements other Commission’s regulatory initiatives in this area, in particular the proposed Regulation on OTC derivatives, central counterparties and trade repositories, adopted by the Commission on 15 September 2010.

(3) The treatment of the trading book under CRD III and CRD IV

Regarding the trading book under the so-called CRD III the following changes are of application:

[1] Likely to be adopted in July 2011
[2] Likely to be adopted in July 2011

- Adding an additional capital buffer based on stress scenario VaR to the ordinary VaR.

- Extending the existing charge for default risk in the trading book to capture losses short of issuer default, e.g. rating downgrades, to address in particular the fact that losses on traded debt most of the time did not involve issuers actually defaulting.

Basing the charge for securitization positions in the trading book on the (simple) risk weights that already exist for the banking book, addressing the methodological difficulties of modelling.

(4) The changes related to securitizations under CRD III and CRD IV

Under CRD III capital requirements for re-securitization positions of banks are increased (see point (1)). In line with the approach developed by the Basel Committee, for every credit rating grade, re-securitization positions would be assigned a higher risk weight than other securitization positions, with such higher risk weights being set in accordance with a higher risk of unexpected impairment losses. For particularly complex re-securitizations, CRD III reinforces both the due diligence requirements and the supervisory process to enforce them. The supervisors have to establish on a periodic basis whether due diligence standards for investments in certain types - as identified in advance by EBA - of highly complex re-securitizations have been adequately met. For these instruments, a general deduction from capital requirement would apply unless banks demonstrate that necessary due diligence standards have been met. In instances, where compliance with required due diligence is found to be inadequate, institutions would be debarred from investing in such instruments in the future.

Disclosure requirements are enhanced in several areas such as securitization exposures in the trading book and sponsorship of off-balance sheet vehicles.

(5) The liquidity ratio under CRD IV

CRD IV introduces two liquidity ratios:

- **Liquidity Coverage Ratio** (LCR). It would improve the short term resilience of the liquidity risk profile of financial institutions and require credit institutions to match net liquidity outflows during a 30 day period of acute stress with a buffer of 'high quality' liquid assets.
- **Net Stable Funding Ratio** (NSFR). It would address funding problems arising from asset-liability maturity mismatch and require credit institutions to maintain a sound funding structure over the one-year horizon in an extended firm-specific stress scenario where an institution encounters and investors and customers become aware, for instance, of a significant decline in its profitability or solvency, a potential downgrade in its debt, counterparty credit or deposit rating or a material effect that calls into question its reputation or credit quality.

(6) The capital conservation buffer under CRD IV

Proposals for capital buffers comprise a **capital conservation buffer** and a **countercyclical capital buffer**. The capital conservation buffer of 2.5% of risk-weighted assets is aimed at ensuring banks' capacity to absorb losses in stressed periods that may span a number of years.

Banks would be expected to build up such capital in good economic times. Those banks that fall below the buffer target will face constraints on discretionary distributions of earnings (i.e., dividend payments) until the target is reached.

The countercyclical capital buffer is intended to achieve the broader macro-prudential goal of protecting the banking sector and the real economy from the system-wide risks stemming from the boom-bust evolution in aggregate credit growth. It will be applied by adjusting the size of the buffer range established by the conservation buffer by up to additional 2.5%.

In order to limit an excessive build-up of leverage on credit institutions' and investment firms' balance sheets and thus help containing the cyclicality of lending, the Commission also proposes to introduce, as an element of the supervisory review, a non-risk based leverage ratio. Implications of the ratio will be monitored prior to possibly becoming a generally binding requirement on 1 January 2018.

(7) A calibration of the higher minimum capital ratios, under CRD IV

Under CRD IV, the new higher capital requirements are gradually implemented until 2019. Common equity Tier I has to be at least 4.5% (7% when the capital conservation buffer is added), Tier I capital has to be at least 6%, Total capital has to be at least 8% (same as before but its composition is shifted towards common equity and other better loss absorbing capital)

(8) A harmonised DGS

The draft Directive on Deposit Guarantee Schemes adopted by the Commission on July 2010 introduces a fixed coverage of EUR 100,000. The payout period is decreased to seven days. Ex-ante funding amounts to 2% of eligible deposits over a period of 10 years. Cross-border cooperation between DGS is increased.

(9) The resolution fund

In its Communication on bank resolution funds in May 2010, the Commission is proposing that national funds should be set up on the basis of contributions paid by banks (bank levy) to fund the cost of future resolution measures and ensure that resolving a bank is a credible option.

(10) High Frequency Trading (Algorithmic trading)

This issue will be addressed in the Revision of the Directive on the Markets of Financial Instruments. Notably, instead of levying a tax on all transactions a regulatory measure could be to impose an order to executed transaction ratio by imposing incremental penalties on cancelled orders and setting up minimum tick sizes. In this case market operators would need to ensure that their market participants maintain an adequate order to transaction executed ratio. It would impose that market operators impose a system of incremental penalties for cancelled orders. This would limit the number of orders that can be placed and then cancelled by high frequency traders. This would be beneficial for market efficiency and reduce stress on trading systems as it would prevent excessively large numbers of orders from being sent and then withdrawn and updated. It would also prevent behaviour where participants submit a multitude of orders withdrawing them almost immediately just to gauge the depth of the order book. In addition, the obligation for market operators to set up minimum tick size on their trading venues would prevent excessive arbitrage by HFT as well as unsound competition between trading venues that could lead to disorderly trading.