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Bank bonus compromise bodes ill for the Single Supervisory Mechanism

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The European Parliament has probably won a Pyrrhic victory with its position on bank bonuses. In return, EU member states got what they wanted with Europe's implementation of Basel III: no binding leverage ratio; mortgage risk weightings and capital add-ons to be determined by member states; and no obligatory consolidated capital position for bank-insurance companies. In other words, Banking Union will start out with capital rules that are more like Emmental cheese than a single rulebook. This is a huge encumbrance for a well-functioning Single Supervisory Mechanism (SSM), and makes a single resolution mechanism impossible.

The EU's version of Basel III, or Capital Requirements Directive IV (CRD IV), comprising an EU regulation and a directive, makes the new rules directly applicable in all 27, soon to be 28, EU member states and the three states of the European Economic Area: Iceland, Norway and Liechtenstein. The proposals were debated in the trilogue between the European Parliament, the Commission and with the EU member states in the European Council for almost ten months, after being formally tabled in July 2011. The whole document comprises more than 1,000 pages and is of unparalleled complexity – accommodating a wide diversity of supervisory approaches and banking structures.

The original CRD I of 2005, incorporating Basel II, is widely seen as one of the causes of low levels of capital in the European banking system, and the reason for the lack of a buffer to withstand the shocks we have seen in recent years. This Directive allowed large banks, through internal risk ratings, to have very low absolute capital levels – even more so for the trading book. It had a generous definition of capital and left many implementing options (about 141) open to the member states. Some of these elements had already been corrected in the CRD II and III amendments, however.

CRD IV had to be the EU's incorporation of the global Basel III agreement of the G-20, but even the initial Commission proposal left much to be desired. While CRD IV tightens the definition of capital at EU level and comes to higher capital requirements on a risk-weighted basis, it does not, unlike the Basel III deal, introduce a binding leverage ratio, or a minimum core capital ratio. It also allows member states not to deduct banks' equity participations in insurance operations. Both elements supposedly led the Basel Committee to state that it was non-compliant with the New Accord. In addition, member states came up with special

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demands for their local markets, such as with the risk weightings of mortgage loans, which remain as generous as they were under CRD I, or the determination of capital buffers.

In the context of Banking Union, a dangerous situation is emerging whereby member states' regulators may set different capital buffers for local banks that will be supervised by the ECB. Hence, the ECB will be confronted with a wide array of capital buffers for banks, depending on the home country in question. How to reconcile this with the Single Supervisory Mechanism remains an open question.

The European Parliament probably chose to focus on the easily understandable issue of banking regulation for the benefit of the broader public: bonuses, a symptom of lax capital standards, rather than to win on the causes, i.e. the narrow focus in CRD IV on risk-weighted assets, the zero-risk weighting for local currency denominated government debt, or the many options left to member states. With media coverage in mind, it has now scored an important victory over the European Commission and the EU Council, but it had to accept the many exceptions and exemptions that do not set a sufficiently clear rule for the future of European banking. In addition, it may lead the US to state that the EU is non-compliant with Basel III, at a sensitive time of imminent negotiations on the transatlantic trade pact.

CRD IV will certainly increase the overall levels of capital in the European banking system over time, as is the ambition of Basel III, but with Banking Union in the making it should have been much more homogeneous in its implementation, and more straightforward in its application. Too many backdoors are left open to a standard level of capital to credit, and too many powers are left in the hands of member states. This also makes it impossible to introduce a single resolution mechanism, which is the ambition of the European Council. Twenty years after the start of the single market, there is still a long way to go. Or will the ECB manage to make the difference?