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EU reform of banking regulation and capital sufficiency

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Articles

Banking & Finance

The financial services sector is one of the most strictly regulated sectors of the economy. In close collaboration with other Practice Groups of Heuking Kühn Lüer Wojtek, the Banking & Finance Practice Group offers its clients comprehensive legal advice. In our articles, we are discussing important new developments, changes of law and the most recent jurisdiction in the field of Banking & Finance.

CRD IV
EU reform of banking regulation and capital sufficiency

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The CRD IV Directive (Capital Requirements Directive IV) and the CRR Regulation (Capital Requirements Regulation) took effect on 1 January 2014 in the European Union. The set of rules to reform banking supervision fulfills the G 20's assignment to permanently strengthen the framework for supervising banks as a reaction to the financial crisis. Even though the content of CRD IV is based on the proposals of the Basel Committee (Basel III), it contains additional details and expanded requirements enacted by the EU.

Direct implementation of Basel III

The harmonization of banking regulation in the EU is a core concern of CRD IV. For this reason, large portions of the Basel III provisions are being implemented through a regulation that is directly applicable. No reconciliation with national law is necessary. However, national laws had to be purged of all provisions that competed or conflicted with the Regulation. In Germany, this primarily applied to the Banking Act [Kreditwesengesetz KWG], the Solvency Regulation [Solvabilitätsverordnung SolvV], and Large Exposure and Million Euro Loan Regulation [Groß- und Millionenkreditverordnung GroMiKV].

CRD IV, which is directly binding on all EU institutions, contains detailed requirements for lending institutions and securities companies and mainly regulates equity capital, liquidity, the maximum leverage ratio, and counterparty risk. The CRR, which leaves some leeway for implementation into national law, contains basic provisions on the prerequisites for engaging in the banking business, freedom of establishment and freedom to provide services, and banking supervision principles. The Directive also contains requirements for corporate governance, sanctions, buffer capital, and improved supervision procedures.

Equity capital and minimum capital

The CRR contains a fully revised definition of regulatory equity capital. This entails three clearly defined categories: hard core capital (CET 1 capital), supplementary core capital (AT 1 capital) and supplementary capital (Tier 2 capital). Tier 3 capital has ceased to exist. The proportion of hard core capital should be 4.5 %, the proportion of supplementary core capital should be 1.5 %, and the proportion of supplementary capital should be 2 %. Then there is buffer capital of up to an additional 10 % for systemic risks, systemically relevant institutions, anti-cyclical hedging, and capital maintenance. In contrast to Basel II, a capital instrument is classified solely on the basis of the criteria in the CRR without regard to the legal form of the particular institution.

Particular significance is placed on hard core capital in the equity capitalization of institutions – in both a quantitative and a qualitative sense. Thus the vast majority of minimum capital is to be represented by hard core capital. In addition, an institution that intends to issue a hard core capital instrument must obtain the consent of the relevant regulatory body.

Jumbo loan provisions

The definition of "jumbo loan" has changed. A jumbo loan is classified as such if a customer or group of customers reaches a credit volume of 10 % of the imputable equity capital (sum of core and supplementary capital) of the lending institution. The reporting threshold, which was EUR 1.5 million is now EUR 1 million.

CCP and CVA Risk

Provisions on Central Counterparty (CCP) Risk mainly relate to large banks with significant over-the-counter (OTC) trading in derivatives and financing through securities. The risk of deterioration in the credit standing of the counterparty must now also be secured by equity capital. Losses from Credit Value Adjustments (CVA) will be recognized to a greater extent than even proposed by Basel III.

LCR and NSFR

The Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) have created an EU-wide liquidity regime to ensure short-term liquidity for 30 days and medium- to long-term liquidity for one year. The LCR describes the ratio of high-quality liquid assets to potential net capital outflows within the next 30 days in a stressed market environment. The NSFR is a measure of adequate, long-term refinancing. It expresses available and necessary stable refinancing as an annual percentage. Both figures were first introduced as observables: The LCR will apply as a binding minimum requirement as of 1 January 2015 and the NSFR as of 1 January 2018.

Leverage ratio

The leverage ratio introduces a risk-independent debt limit for institutions. Through it, the core capital of the institution is expressed as a percentage of the sum of its non-risk-weighted risk position values. So far, the leverage-ratio has only been introduced as an observable and will receive its final review in 2017.

Governance

The enhanced governance requirements for institutions under CRD IV have resulted in a basic change to some of the provisions of the German Banking Act [Kreditwesengesetz KWG]. Section 25a of the KWG now only contains provisions on management compliance. An upper limit for variable components of compensation and a provision stating that institutions must establish a compliance function were added. For the first time, the KWG now expressly formulates requirements for managing directors and members of the supervisory and administrative bodies (Sections 25c and 25d of the KWG). The new requirements – which range from qualitative requirements for officers to specific obligations in performing the duties of officers, to limitations of powers, and provisions on incompatibility – are intended to counteract the weaknesses in the performance of official duties by managing directors and members of supervisory bodies, which became apparent in the financial crisis. The aforementioned persons must not only be sufficiently qualified, but should also have sufficient time available to conscientiously perform their tasks.

Sanctions

Legislators have taken the opportunity to fundamentally change and supplement the provisions of Section 56 of the KWG on fines. As a result, violations of the code of conduct under the CRR have been included as administrative offenses. At the same time, the level of fines has been significantly increased. The proffered rationale is that fines should exceed the economic benefit that the perpetrator has obtained from the offense. Under Section 60 b of the KWG, the Federal Financial Services Supervisory Authority [BaFin] is even required to publicize any fine that has become final and incontestable. However, the publication may be anonymized in individual cases.

Transitional provisions

The CRR provides that the new equity capital requirements will be introduced gradually. The national regulatory authorities are granted the right to decide how rapidly the transition is to proceed. In setting deadlines, BaFin has basically adhered to the Basel III guidelines. Thus, in the period from 1 January 2014 to 31 December 2014, institutions must maintain a hard core capital ratio of at least 4% and a supplementary core capital ratio of at least 1.5%. More detailed transitional provisions are set forth in Sections 23 et seq. of the (new) SolvV.

Conclusion: The CRD IV package harmonizes European banking regulation law and provides a uniform legal framework for the European single market. At least the regularization dumping, engaged in by some states, is now in the past.

Money-laundering obligations relating to the issuance of e-money are going to be more product-specific in the future

For the first time, BaFin has presented a precise requirements catalogue for applications for exemptions under Section 25 i (5) KWG

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After the Financial Action Task Force (FATF) recently published its guidance on a risk-based approach to monitoring innovative forms of payment for money-laundering, BaFin published an Informational Memorandum on applications for exemption under Section 25i (5) KWG. Therein the Federal Financial Services Supervisory Authority [BaFin] announced that it wished to make the duty of care under money-laundering laws more product-specific. However, it is questionable whether this approach can actually meet the requirements formulated by the FATF.

FATF guide

In June 2013, FATF published its guideline on a risk-based approach to monitoring innovative forms of payment for money-laundering. The document was expected to attract particular attention in Germany, especially with respect to e-money products. The guideline is primarily directed at legislators and regulatory authorities and expressly recommends – in application of the proportionality principle – to avoid applying a uniform requirements catalogue to diverse products in combating money-laundering and terrorism.

Risk-based approach

The better practice, as suggested by FATF is to assess the individual risks associated with a particular product and determine the obligations under money-laundering laws on that basis. As the foundation for such a risk-based approach, FATF recommends the creation of a specific risk-matrix, which includes both the factors that increase risk, such as anonymity, the lack of face-to-face contact with customers, the ability to receive cash, and global application options, as well as counter-measures that reduce risk, such as the introduction of maximum amounts and threshold values.

Statutory framework in Germany

It is interesting that, in making observations about country-specific regulatory approaches, the FATF guideline cites Germany as the only example of a European country with a particularly rigid approach to evaluating e-money products. Specifically, FATF cites Section 25 i KWG, which waives customer identification for cash payout of e-money only if the amount of e-money paid out on a monthly basis does not exceed EUR 100 (although the relevant EU Directive has a threshold of EUR 250).

Informational Memorandum on Section 25i (5) KWG

German regulators seem to have taken full note of these observations. By 16 October 2013, BaFin had already published a new Informational Memorandum on Section 25 i (5) KWG, which enables e-money providers to be exempted from certain duties of care under the money-laundering laws if they file an application. According to BaFin, Section 25 i (5) KWG will play a stronger role in the future to take into account the risk-based approach advocated by FATF. However, BaFin concedes that such applications have often taken a long time to process in the past and were therefore not very practical for the applicant. Consequently, it is necessary to clarify the prerequisites for an exemption application in order to avoid delays in the future.

According to BaFin, domestic credit institutions and e-money institutions are generally entitled to file an application under Section 25 i (5) KWG. Moreover, e-money agents and distribution partners can also apply to be exempted from certain obligations incumbent upon them. In other respects, a separate application must be filed for each individual e-money product.

In its Informational Memorandum, BaFin specifically requires a precise description of the particular e-money-product in any such application submitted. This includes a description of the

- Type of e-money carrier (physical card, online credit, etc.),
- Channels of distribution (online-based, through agents and the like),
- Ability to reload and method of doing so,
- Product features,
- Possible uses and acceptance points,
- Organization of the distribution network,
- Redemption options,
- Monitoring of e-money transactions and
- Measures to minimize risk.

The applicant must also describe with particularity the precise duties of care from which he wishes to be exempted in the future. For example, the applicant may apply to be exempted from the duty to obtain customer identification. It is not possible to be exempted from all the duties imposed by money-laundering laws.

Product risk analysis

In addition, a product risk analysis must be prepared as part of the application. This constitutes the core element of the application. The applicant must state and substantiate why he believes that the particular e-money product is exposed to a low level of risk or why the counter-measures undertaken significantly reduce the risk. This analysis must include all the stations through which the e-money passes, i. e. payout, uploading, distribution network, and acceptance points. In addition, the applicant must attach all model agreements with customers, distribution partners, and acceptance points to the application.

Discretion still accorded to BaFin

In summary, BaFin's Informational Memorandum permitting applications under Section 25 i (5) KWG should be welcomed since applicants now have a precise requirements catalogue to guide them for the first time. However, if one compares the Informational Memorandum with the goals formulated in FATF's guideline, doubts arise as to whether the right to submit an application under Section 25 i (5) KWG is actually sufficient for a risk-based approach to monitoring money-laundering in Germany. It is noteworthy that BaFin has at no time established what characteristics an e-money product must have in order to be granted an exemption as a matter of course. Applicants must thus comply with the very extensive requirements catalogue in the Informational Memorandum without having any guarantee that they will actually be exempted from particular duties of care if they meet certain requirements. The determination of the risk of money laundering and the waiver of related obligations that depends on this determination remain in the sole discretion of BaFin.

Conclusion: In its guideline, FATF advocated a risk-based approach to monitoring e-money products for money laundering. In Germany, this goal is to be implemented through an exemption under Section 25 i (5) KWG, which has been fleshed out for the first time in an Informational Memorandum issued by BaFin. However, exemptions from the duties of care under money-laundering legislation remain in the sole discretion of BaFin and the requirements for submitting an exemption application are anything but minor. Thus e-money providers must still overcome high hurdles to obtain any relaxation of the duties of care under money-laundering laws.

Update on guarantees: Selected decisions of the German Federal Supreme Court [BGH] in 2013

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In practice, guarantees continue to be the most common method of securing personal loans. Two pertinent decisions issued by the BGH in the past year, which are of particular relevance to the banking industry, will be discussed below.

Once again the BGH has had to address the perennial issue of the extreme financial overburdening of a guarantor with the result that its guarantee becomes null and void. In addition, there was also a recent clarifying opinion on the effect of the surrender of collateral, which was provided in addition to the guarantee for the main claim, on claims under the guarantee itself.

BGH on the release of collateral

Under Section 776 of the German Civil Code [BGB], a guarantor is released if the creditor surrenders additional collateral that was provided for the main claim and from which the guarantor could otherwise have sought satisfaction. The meaning of this provision of law is disputed. In its decision, the BGH significantly clarifies its prerequisites and their applicability, particularly the doctrinal meaning of the term "be released".

Problem of the extinguishment of the guarantee through the release of collateral

BGH judgment of 04.06.2013 - XI ZR 505/11

Substance of the decision

Under the circumstances on which the decision is based, the main claim was originally secured by both a guarantee and an (unimpaired) land charge. After a value was set on the main claim and collateral was provided, a portion of the land charge was assigned to a third party. After the main claim was called in, a claim was filed against the guarantor seeking payment of the entire residual claim. The latter defended itself by arguing that the assignment of the land charge deprived him of the ability to obtain satisfaction. If the land charge still existed, it would pass to the guarantor when payment was made (Sections 774, 412, and 401 BGB). This was no longer possible. Therefore, under Section 776 BGB, the guarantor was released in the amount of the assigned land charge.

The BGH determined that assignment of the land charge constituted a surrender of the collateral and that the guarantee was extinguished in this amount. Moreover, the re-transfer of the land charge during the course of litigation had no legal relevance to the claim under the guarantee. In particular, it did not revive the claim. Because of the requirement that the guarantee be in written form, the guarantor's verbal agreement to the assignment did not revive the claim under the guarantee.

Practical implications

In this decision, the BGH for the first time takes a position on certain issues with respect to Section 776 BGB that have been controversial in the literature and clarifies its prerequisites. The Court makes it clear that “be released” means extinguishment of the guarantee. After the collateral has been released, no claim for payment can be asserted against the guarantor. Even the retrieval of the collateral is irrelevant in this regard.

Therefore, in practice, before the release of (unimpaired) collateral for claims that are also secured by guarantees, one should obtain the written consent of the guarantor to this release and the guarantor’s express confirmation that the latter will remain fully liable under the guarantee if one wishes to preserve the right to file a claim under the guarantee. A clause to this effect in a (formulaic) guarantee agreement would violate the laws governing Standard Terms of Business and would therefore be invalid.

BGH on matters violating moral principles

Problem

Maximum amount guarantees: Standard of extreme financial overburdening

BGH judgment of 19.02.2013 - XI ZR 82/11

Despite numerous decisions clarifying legal precedent on the prerequisites for nullification of guarantees between a guarantor and a primary debtor who are in a close personal relationship, there are still some legal questions that are highly relevant in practice and that have not been answered by the highest court. In this decision, the BGH, for the first time, addressed the standard to be used in evaluating the financial capacity of the maximum amount guarantor, i. e. the contractual interest burden based on the amount of the guarantee or the interest burden based on the (higher) primary debt.

The background of the matter is the established legal precedent of the BGH with respect to so-called spousal guarantees, holding that there is a (rebuttable) presumption that the guarantee is void due to the extreme financial overburdening of the guarantor if it is unlikely that the guarantor can pay even the current interest on the secured claim from the garnishable portion of his current income and assets.

Substance of the decision

In the aforementioned decision, the BGH held that, for maximum amount guarantees, the standard of extreme overburdening of the guarantor is the contractual interest burden on the guaranteed amount and not the interest burden on the entire portion of the main claim still outstanding. This takes into account the interests of the parties, particularly the guarantor’s legitimate expectation that his liability is based on the guaranteed amount – not only with respect to the main claim but also with respect to the ancillary claims.

Practical implications

The aforementioned decision makes it easier for creditors to accept guarantees from persons who are in a close emotional relationship with the primary debtor. Having given due consideration to current and future income, a maximum amount guarantee can be accepted without fearing the defense that this violates moral principles. In addition, this clarifying decision changes the evaluation of "old cases".

Conclusion: The aforementioned decisions provide the BGH's rulings on two matters that are highly relevant in practice. In particular, the specific effect the release of other collateral has on guarantees has now been clarified. The guarantee is extinguished. Thus, before making such a decision, one should determine whether one still wishes to make a claim against the guarantor and whether such a claim is likely to be successful. If so, the guarantor must consent to the release in writing. With respect to maximum amount guarantees, the BGH has now determined for the first time that the interest to be paid on the maximum amount is decisive in deciding whether the guarantee is null and void. As a result of this decision, it will likely be more difficult to classify a considerable number of so-called "spousal guarantees" as invalid.

Regulatory classification of transactions with Bitcoins

BaFin has published its first assessment of transactions with Bitcoins

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Bitcoins are growing in popularity and, as a non-governmental substitute currency with a limited money supply, promise to offer an alternative to the currencies issued by central banks. If transactions with bitcoins have so far been characterized by considerable legal uncertainty and have been hardly regulated, the financial supervisory authorities worldwide are now about to bring this area into the regulatory framework. In Germany, BaFin has recently published a paper summarizing the applicable principles for transactions with Bitcoins in Germany.

Bitcoins are a virtual currency. Transactions with bitcoins and bitcoin credits are managed in a decentralized network. In principle, every network user can participate in creating currency through cryptographic calculations. Bitcoins are produced by the users themselves on powerful computers in a process called "mining". Therefore, there is no central bank – which performs this function for real currencies. The users have digital wallets in which to store their bitcoins. Bitcoins can be electronically transferred between participants as they wish. Their allocation is proven by an authorization in the form of a cryptographic key. For this purpose, every transaction is provided with a digital signature, assigned to a certain address, and recorded in a database operated by the entire network. The maximum number of bitcoins is limited to 21 million to protect against inflation.

The users themselves can remain completely anonymous, which is why regulatory authorities worldwide have been increasingly critical of bitcoins. However, no uniform regulatory practice for evaluating transactions with bitcoins has yet been established. This also applies at the European level. While in some countries, such as Great Britain, commercial activities with bitcoins still do not require a license, other countries even prohibit such transactions. Against this background, BaFin has recently published its opinion on the legal situation in a technical paper and thus created some degree of legal certainty for Germany.

Regulatory classification of Bitcoins

From a regulatory perspective, bitcoins are nothing more than so-called "arithmetic units", which are classified as financial instruments under Section 1 (11) Sentence 1 No. 7 of the German Banking Act (KWG). Arithmetic units are units of account comparable to foreign exchange, but – in contrast to foreign exchange – bitcoins are not legal tender, but constitute digital money. Therefore, bitcoins are not a recognized currency, but are rather a substitute currency, which is used as a means of payment in multilateral settlement collectives based on private agreements. Contrary to what might be presumed given the technical background of bitcoins, they are not "e-money" within the meaning of Section 1a (3) of the Payment Services Supervision Act [Zahlungsdiensteaufsichtsgesetz ZAG], since there is no issuer that issues bitcoins by establishing a claim against itself.

Duty to obtain a license

Since bitcoins are classified as financial instruments, any commercial activity with bitcoins must be licensed. However, the mere use of bitcoins – whether it be to make payment as a customer or to receive payment as a dealer – does not constitute an activity requiring a license. The creation of bitcoins, i. e. mining, does not require a license. The decisive factor in whether a license is required is whether a person merely participates in the bitcoin market or actively promotes it. The type of licence needed to operate the business depends on the particular configuration of the relationship with the customer and the technical processes. The type of licence needed determines, in particular, the amount of initial capital necessary.

Financial commission business

The prerequisites needed for licensing as a financial commission business under Section 1 (1) Sentence 2 No. 4 KWG are met if, in buying or selling bitcoins, the platform operator:

- acts in its own name towards the trading partner,
- but actually acts on account of a customer, i. e. the economic benefits and detriments accrue to the customer, and
- the activity is similar to a traditional commission business.

Multilateral trading system

It is however also possible that the operation of a platform meets the prerequisites for the operation of a multilateral trading system under Section 1 (1) (a) Sentence 2 No. 1b KWG. This is the case if:

- a system is operated that brings together numerous persons interested in buying and selling bitcoins,
- there is a uniform set of rules governing membership and bitcoin trading, and
- the contracting parties cannot decide with whom they wish to enter into a contract in an individual case, but rather persons are brought together by software or protocols for the purpose of entering into contracts with each other.

The most important distinguishing criterion from the financial commission business is the fact that the participants themselves become contracting parties.

Proprietary trading

In addition, providers can also directly convert real currencies into bitcoins for their customers. This generally meets the prerequisites for proprietary trading under Section 1 (1) (a) Sentence 2 No. 4 KWG.

Tax aspects

For tax purposes, bitcoins are assets that can be the subject of private sales transactions. Through the conversion of euros into bitcoins, bitcoins are acquired as assets. The reconversion of bitcoins into euros is generally subject to income tax, since the exchange is considered to be income from private sales transactions under Section 22 No. 2 of the Income Tax Act (EStG). In addition, trading in bitcoins is subject to value-added tax. The trade in bitcoins may precisely not benefit from the VAT exemption under Section 4 No. 8b of the VAT Tax Act (UStG), which provides that the sale of legal tender is tax-free, since bitcoins are not legal tender in the opinion of the tax administration.

Conclusion: While the regulatory assessment of bitcoins is still unclear in many European countries, most questions appear to have been clarified in Germany. In Germany, bitcoins are embedded in the existing regulatory regime due to their classification as financial instruments. Therefore, a license from BaFin is required for all commercial activity in connection with bitcoins. Since most operations in this area are start-ups, this constitutes a high hurdle.

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