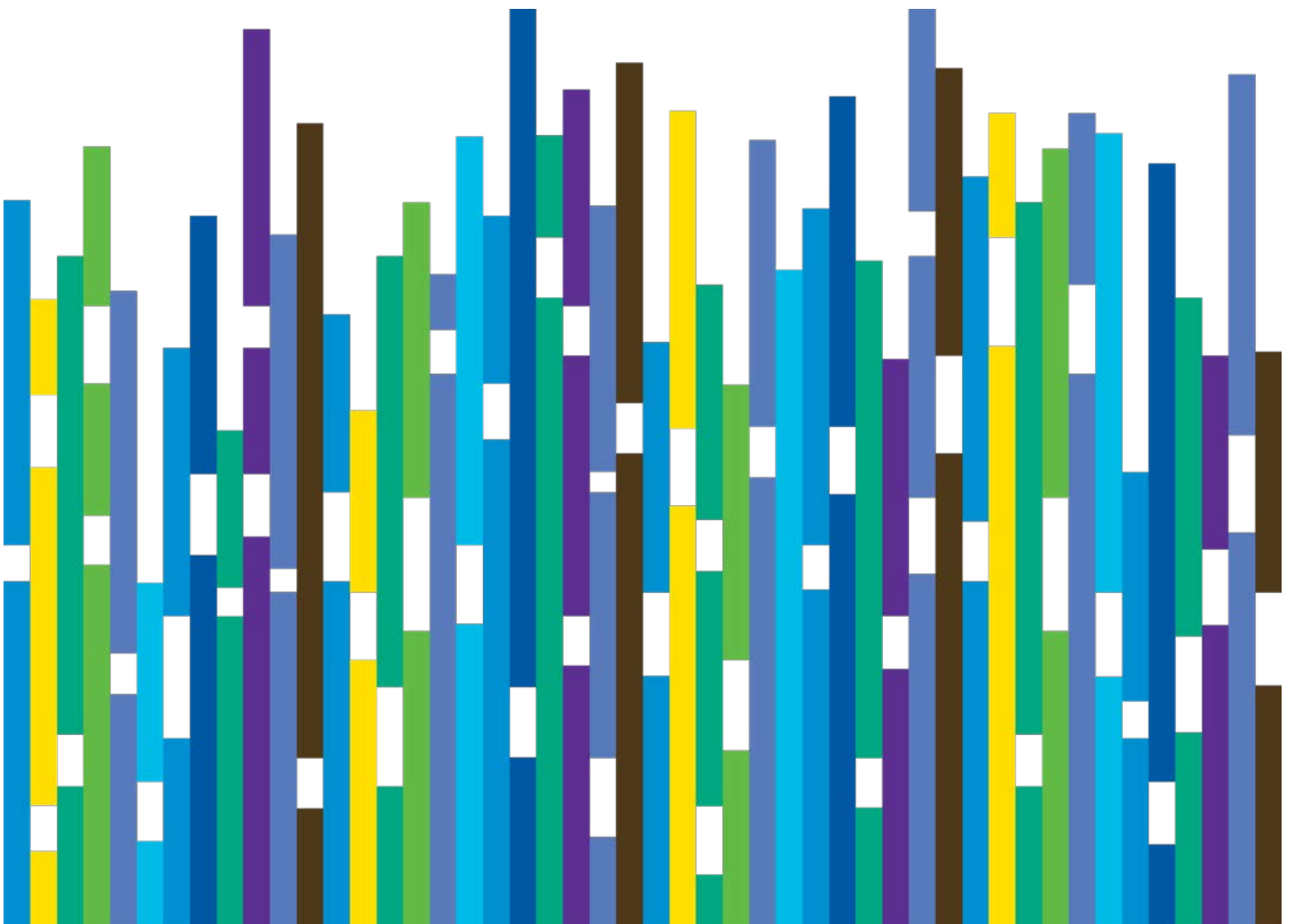


CAPITAL REQUIREMENTS DIRECTIVE (CRD) IV

Issue Brief



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Overview

The European Parliament approved the Capital Requirements Directive (CRD) IV package on 16 April 2013, and it became law after adoption by the European Council and [publication in the Official Journal of the European Union](#) on 27 June 2013. Implementation is set for 1 January 2014.

The overarching goal of the new rules is to strengthen the resilience of the EU banking sector so that it will be better placed to absorb economic shocks whilst ensuring that banks continue to finance economic activity and growth. Although CRD IV represents the implementation of Basel III capital accords, CRD IV does not conform 100% to Basel III.

There are two reasons for CRD IV being different to Basel III. First, Basel III is not a law. It is the latest configuration of an evolving set of internationally agreed standards developed by supervisors and central banks. This set of standards has to go through a process of democratic control as it is transposed into EU (and national) law, being made to fit with existing EU (and national) laws or arrangements. Furthermore, while the Basel capital adequacy agreements apply to “internationally active banks,” in the EU it has always applied to all banks (more than 8,300) as well as investment firms. This wide scope is necessary in the EU where banks authorized in one Member State can provide their services across the EU's single market and, as such, are more than likely to engage in cross-border business on a level playing field.

The CRD IV package includes the Capital Requirements Directive and the Capital Requirements Regulation (CRR). Member States are effectively being given only six months to transpose the Directive and to change any national laws impeding the proper application of the Regulation.¹

Bank Capital

The purpose of CRD IV will effectively implement the Basel III capital accords, including specifically how much and in what form capital must be maintained. Through this mechanism, banks will have to meet Tier 1 capital requirements (going-concern capital) — currently defined as equity capital plus all non-debt, long-term securities — of at least 6% of risk-weighted assets (RWA) by 2015. The highest form of Tier 1 capital is Common Equity Tier 1 (CET 1) capital, which must be at least 4.5% by 2015. Tier 2 capital (gone-concern capital) is designed to ensure that depositors and senior creditors are repaid if the firm fails. Banks must have a total capital-to-RWAs ratio of at least 8% to meet the Basel Tier 2 standard and the CRD IV requirements.

The CRD IV proposals also tighten the definition of common equity, simplify the definition of what amounts to Tier 2 capital, and abolish the use of a Tier 3 capital standard. In line with Basel III, the CRD IV proposals create five new capital buffers: the capital conservation buffer², the counter-cyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer. The CRR introduces two new liquidity buffers: the Liquidity Coverage Requirement, which is intended to improve short-term resilience of the liquidity risk profile of firms and the Net Stable Funding Requirement, which is intended to ensure that a firm has an acceptable amount of stable funding to support its assets and activities over the medium term.

¹ Most provisions apply as of 1 January 2014, although some will enter into force only later, with full implementation in 2019.

² Beginning on 1 January 2016, however, the CET1, T1 and T2 ratios for all banks will increase by 2.5 percent to meet the capital conservation buffer requirement. Compliance will enable institutions to make distributions such as dividends.

Leverage

The CRD IV proposals also introduce a leverage ratio (under the CRR) which has proven to be very controversial. The incorporation of the leverage ratio is to ensure that banks don't circumvent requirements for secure and long-term forms of capital. The leverage ratio is defined as Tier 1 capital divided by a measure of non-risk weighted assets, and whilst the CRR notes the need for a leverage ratio, it does not mention at what level the ratio should be set. The European Banking Authority (EBA) will be studying the riskiness of different institutions over the next two years and thereafter issuing a report on the appropriate ratio levels for different categories of institutions. The European Commission expects to report on the leverage ratio by the end of 2016, producing where necessary a legislative proposal to make it a binding measure as of 2018.

The CRR contains the Pillar 1 (capital, risk coverage, and leverage) and Pillar 3 requirements (market discipline, disclosure requirements), and the CRD contains the requirements for Pillar 2, supervisory review, and the buffers framework. Further details are available [here](#).

Other Parts of CRD IV Package

Besides the capital requirements, leverage ratios, and buffers, there are also new rules on supervision, corporate governance, remuneration, sanctions, counterparty credit risk for derivatives, and reliance on credit ratings under CRD IV.

Corporate governance provisions found in both the CRR and the CRD IV Directive further efforts to reduce excessive risk taking by firms and ultimately the accumulation of excessive risk in the financial system. Among the enhanced corporate governance rules, CRD IV requires diversity in board composition (without gender quotas) and improves transparency of bank activities (profits, taxes, and subsidies in various countries where banks operate). CRD IV strengthens the requirements with regard to corporate governance arrangements and processes. It also introduces rules aimed at improving the status of the risk management function and ensuring its effective monitoring by risk supervisors. Diversity in board composition should contribute to effective risk oversight by boards, providing for a broader range of views and opinion and therefore avoiding the phenomenon of group think.

The remuneration rules and the bonus cap, in particular, were the most controversial elements of CRD IV. Generally speaking, CRD IV carries the existing provisions of the current CRD relating to remuneration (composition and deferral of variable remuneration) apart from the introduction by the European Parliament of a bonus cap. These were agreed by the Council in spite of strenuous U.K. opposition. Under these new rules, the variable component of remuneration (bonus) is capped at 100% of the fixed component for material risk takers. The bonus can be raised to 200% of fixed remuneration with shareowner approval, i.e., if a quorum of shareowners representing 50% of shares participates in the vote and a 66% majority of them supports the measure. If the quorum cannot be reached, the measure can also be approved if it is supported by 75% of shareowners present. In this context and for the purposes of calculating the maximum bonus ratio, the use of deferred and bail-in-able instruments is encouraged through the application of a notional discount factor to up to 25% of total variable remuneration, provided it is paid in instruments which are deferred for more than five years. CRD IV also introduces additional transparency and disclosure requirements for certain individuals that earn more than €1 million per year.

The new requirements apply only to staff whose professional activities have a material impact on risk profile. This includes senior management, risk takers, staff engaged in control functions, and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers. The EBA is developing draft regulatory standards with respect to qualitative and appropriate quantitative criteria to identify such staff.

Finally, the new rules seek to reduce the extent of reliance by credit institutions on external credit ratings by: a) requiring that all banks' investment decisions are based not only on ratings but also on their own internal credit opinion and b) that banks with a material number of exposures in a given portfolio develop internal ratings for that portfolio instead of relying on external ratings for the calculation of their capital requirements.

Hammering out the Level 2 Measures

The CRR effectively creates a single prudential rulebook across the EU, to ensure that Basel III is applied consistently by all the Member States. It will be binding without the need for changes to national law or regulation. However, it is dependent on supplementary ('Level 2') measures of both a political and technical nature, for which the EC and the EBA are primarily responsible. Countries will also have some flexibility in relation to a number of requirements, such as early adoption and options for setting higher capital ratios.

After publication in the Official Journal, there will be much activity from the EBA on Level 2 measures in the remaining six months of 2013 and into 2014. The EBA has already completed much of the necessary preparatory work, but that will have to be reviewed against the final text published in the Official Journal before finalising Level 2.

Transitional measures will need to be addressed quickly, however. The Level 2 process is not simply a matter of the EC or EBA adopting certain rules. The measures will be subject to scrutiny by EU legislators (the European Parliament and the European Council) before adoption. The number of Level 2 measures is substantial and therefore it is likely that those actually in place on 1 January 2014 will be limited with some implementing measures coming later.

Banking Industry Concerns

Banks have been public with their concerns regarding capital increases required by Basel III. European banks have been particularly vocal in their opposition to incorporation of a minimum leverage ratio set at 3% of total managed assets. At the same time, the industry has expressed concerns that CRD IV dilutes the G20's decisions on capital and liquidity reforms. The complexity of implementing legislation across the EU and the creation of national discretions in the CRD IV package are adding to these concerns. The EC argues that flexibility is required because CRD IV will apply to all 8,300 EU banks, not just those banks that are large or internationally active. However, this flexibility is likely to create uncertainty and risks an uneven playing field within the EU.

At the top level it is important to understand the items in CRD IV that are additional to Basel III, such as additional capital buffers, remuneration, and transparency. The national discretions within CRD IV over capital buffers and timing of implementation, for example, mean that cross-border banks need to keep close track of national developments and compliance.

CFA Institute Concerns

CFA Institute considers it of vital importance that banks and systemically important financial institutions meet global minimum capital and leverage ratio requirements, such as the 3% ratio required by Basel III. Without such requirements, the disruption created in the 2008 financial crisis is likely to reoccur with significant effects for the returns and investments of investors.

Minimum risk-based capital requirements should be just that — a minimum. If banks' internal models identify additional risks that require higher capital, firms should be required to raise more equity. To get the necessary capital in place quickly, regulators should prioritize implementing Basel III for the large, internationally active banks first, while strengthening the Basel III leverage ratio to 8%.

Further we have concerns about regulators' willingness to allow large, complex financial institutions to use their own internal models to determine their minimum required regulatory capital. Not only do such models routinely fail in a crisis but their use as a final determinant for regulatory capital purposes can create perverse incentives for risk management and unfairly advantage large firms relative to smaller firms doing the same activity.