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CRD4 – Maximum Harmonisation but Minimal Harmony?

On 20 July 2011, the EU Commission published a provisional draft of its much-awaited legislation to implement the proposals of the Basel Committee on Banking Supervision, known as "Basel III,"[1] into EU law. It is not, however, light reading. At nearly 700 pages of detailed text, it is likely to be a helpful addition to known cures for insomnia. For those not needing assistance in this area, we have sought to condense the main features of the proposals into just a few (all right, slightly more than a few) pages, focusing particularly on the material differences between Basel III and CRD4.

Scope and Structure

Whereas Basel II and Basel III focus only on internationally active banks, the Capital Requirements Directive in Europe currently applies to all European banks, as well as to European investment firms in general. The proposed CRD4 directive and regulation retain this approach and this gives rise to certain required adaptations of the Basel III proposals.

In addition to implementing Basel III, the Commission's draft proposals (known generally as CRD4) will replace the existing Capital Requirements Directive,[2] along with its subsequent amending directives (known generally as CRD2[3] and CRD3[4]). The Commission proposes to achieve this with the combination of a new directive (which would need to be separately implemented into the national laws of the EU member states in order to have direct effect in those countries) and a new regulation (which would have direct effect on EU regulators and institutions covered by the regulation).

The stated aim of the Commission in presenting the majority of its CRD4 prudential proposals in the form of a regulation is to create a "single banking rule book" for Europe. Unlike the process of implementing a directive into national terms, which can allow individual member states to diverge in their implementation approaches, the regulation mechanism does not allow for any divergence in approach by member states. This therefore means that additional, or more onerous, provisions can generally not be added by individual member states.

[1] See Morrison & Foerster client alert "Basel III: The (Nearly) Full Picture," http://www.mofo.com/files/Uploads/Images/101223-Basel-III-The-Nearly-Full-Picture.pdf.
[2] Directives 2006/48/EC and 2006/49/EC.
[3] Directive 2009/111/EC.
[4] Directive 2010/76/EU.

However, this approach has proved highly politically controversial, with certain member states, including the UK, expressing strong concerns about their lack of ability to impose more onerous requirements on their own national institutions in certain areas—notably minimum capital requirements.

In the UK, the Independent Commission on Banking is due to deliver its final proposals in September 2011 as to restructuring the UK's banking sector, and on the basis of its interim report,[5] the ICB looks likely to recommend minimum capital requirements for the UK retail banking operations of universal banks which are higher (minimum core equity tier one ratio of 10%) than the equivalent Basel III/CRD4 proposals. If the proposed CRD4 regulation were adopted in its current form, it could effectively remove the ability of the UK to implement such higher minimum capital requirements.

In response to the objections raised, Commissioner Barnier has suggested that the countercyclical capital buffer proposals (which are contained in the proposed CRD4 directive, rather than the regulation) could be adjusted by member states to respond to the "potential emerging macroeconomic risks in a flexible manner." However, this is unlikely to represent an adequate solution to the UK's concerns, given that the ICB looks set to recommend a permanent uptick in the minimum capital requirements for UK retail banking. In contrast, the countercyclical capital buffer was always intended by Basel III to be used as a temporary additional buffer to react to certain economic conditions prevailing at a particular time in one or more member states.

The proposed CRD4 directive retains the provisions of the current CRD concerning the freedom of establishment and movement of services and general principles of supervision (such as exchange of information and division of responsibilities between "home" and "host" member state supervisors) and corporate governance. It also contains certain new provisions regarding increased sanctioning powers against institutions and individuals for breach of the CRD4 provisions and enforcing sanctions across different member states, as well as measures aimed at reducing reliance on external credit ratings.

All of the general prudential provisions of Basel III, with the exception of the capital conservation buffer and the countercyclical capital buffer, are proposed to be included in the draft regulation and are to be supplemented by the provisions in the directive regarding supervisory review of each institution. These would therefore take direct effect in member states.

There are, however, a few specific areas where member states will retain some powers to implement national laws and regulations where these do not conflict with directly applicable EU-level laws. These include the ability of national regulators to disapply prudential requirements for subsidiaries within a consolidated regulatory group of companies where certain conditions are fulfilled, such as there being no legal or practical obstacles to the parent of the group transferring capital promptly if required.

More specifically, national regulators will for the first time have the power to increase the risk-weighting of exposures to real estate assets (currently 35% and 50% for residential and commercial real estate, respectively) where local market conditions make this advisable.

In addition, the CRD4 proposals retain the ability that national regulators have enjoyed under the current CRD to impose more onerous requirements on certain national institutions, as part of the regulators' supervisory responsibilities.

[5] See Morrison & Foerster client alert "ICB Interim Report on UK Banking Reform," http://www.mofo.com/files/Uploads/Images/110429-ICB-Report-UK-Banking-Reform.pdf.

Quality and Quantity of Capital

The proposed CRD4 regulation implements very closely the Basel III recommendations as to the minimum levels of different types of capital (Common Equity Tier One, Additional Tier One, and Tier Two) to be held by institutions, the minimum "quality" criteria that financial instruments must possess to be included within specific categories of capital and the regulatory adjustments or deductions that must be made to Common Equity Tier One Capital in respect of certain types of capital before they can be counted as regulatory capital. However, in respect of the regulatory adjustments and deductions, CRD4 provides a much higher degree of detail than Basel III.

Common Equity Tier One Capital

One departure from Basel III is that under the proposed CRD4 regulation, instruments do not have to be common shares in order to be counted as Common Equity Tier One Capital, so long as they meet the extensive criteria laid down in Basel III (and mirrored in CRD4) for qualification as Common Equity Tier One Capital. The European Banking Authority must publish a list, by 1 January 2013, of the forms of capital instrument in each member state which qualify for Common Equity Tier One status.

The new "quality" criteria introduced by Basel III would exclude from regulatory capital certain instruments which were able to be counted under the Basel II regime. The equivalent situation arises under CRD4, compared to the existing CRD. For such newly non-eligible instruments, Basel III specified a "cut-off date" of 12 September 2010, whereby any instrument issued before that date can be de-recognised gradually over a 10-year phase-out period and any instrument issued on or after that date would be fully excluded from the relevant class of regulatory capital from 2013. The proposed CRD4 regulation adopts this same phase-out concept, but sets the cut-off date not as 12 September 2010, but as 20 July 2011.

In terms of regulatory adjustments, as has been the case under CRD, national regulators retain a discretion as to whether significant investments in insurance undertakings need to be deducted from Common Equity Tier One Capital, or instead whether to apply the provisions against double-counting of capital contained in the Financial Conglomerates Directive.[6] In contrast, Basel III only provides for a deduction of such investments from capital.

Additional Tier One Capital

One specific feature of Additional Tier One Capital mandated by Basel III was that the terms of the instrument should provide for a write-down of principal or a conversion of the instrument to equity at a pre-specified trigger point. This is known as "going-concern loss absorption." The CRD4 regulation makes a similar provision and specifies that the trigger point will be the time when the institution's Common Equity Tier One Capital (as a proportion of its total risk-weighted assets) falls below 5.125%, or such higher percentage that the institution may specify in the terms of the instrument.

However, it is worth noting that, whereas Basel III prescribed the going-concern loss absorption only for instruments which are accounted for as liabilities, CRD4 prescribes the same feature for all Additional Tier One instruments, irrespective of how they are accounted for. This is a potentially significant piece of "gold-plating" of the Basel III provisions, given that obtaining liability accounting treatment for Additional Tier One instruments in the future may prove to be more challenging, as a result of those instruments needing to contain more "equity-like" features under CRD4 than under the current regime.

Where conversion into Common Equity Tier One instruments is provided for in the instrument's terms, CRD4 requires the terms to specify either the conversion ratio and a limit on the amount of permitted conversion, or a range within which the instrument will convert into Common Equity Tier One instruments.

[6] Directive 2002/87/EC.

The EBA is mandated to draft technical standards by 1 January 2013 in respect of procedures and timings for the determination and notification of trigger points and the consequences thereof, and also the procedures and timing of writing down the principal amount or converting the instrument to a Common Equity Tier One instrument. It also has to specify the nature of any such write-down, for instance the extent of the write-down, whether it has to be permanent or can be temporary, and whether it can be subsequently written up.

The EBA's determinations on these points will be crucial in determining the attractiveness of the new breed of subordinated contingent convertible (or "write-down-able") bonds or "CoCos," in terms of whether or not these will be able to be used towards an institution's Additional Tier One or Two Capital requirements. The appetite for such instruments will also be dependent though, among many other factors, on whether the CoCos can satisfy the "point of non-viability" or "gone-concern" loss absorption features proposed by the Basel Committee, discussed below.

The EBA's decisions on these points will also be vital, in many member states, in determining the tax treatment of these Additional Tier One Capital instruments.[7]

Another of the features of Additional Tier One Capital required by both Basel III and CRD4 is that it must not contain any feature that "would hinder the recapitalisation of the institution." However, the CRD4 regulation goes further than Basel III, in stating that so-called dividend pushers, dividend stoppers and alternative coupon satisfaction mechanisms will automatically be considered as features that would hinder a recapitalisation. In contrast Basel III appears to accept that a stopper on dividends on common shares would potentially be a permissible feature of Additional Tier One Capital.

Gone-concern Loss Absorption

The Basel Committee, in January 2011,[8] proposed that all Additional Tier One Capital and all Tier Two Capital should be capable of absorbing losses (by principal write-down or conversion to equity) at the point of the institution's non-viability.

The Basel Committee envisaged that such loss absorption would be effected by the terms of the instrument providing for a competent authority to trigger the loss absorption, unless a peer group review verified that the laws of the bank's jurisdiction already require such instruments to fully absorb losses before taxpayers are exposed to loss.

The CRD4 regulation similarly states in its recitals that "all Additional Tier One and Tier Two instruments of an institution should be fully and permanently written down or converted fully into Common Equity Tier One Capital at the point of non-viability of the institution." However, there is no further CRD4 provision for such loss absorption features in the regulation itself, nor is there provision in the regulation or the directive for any specific future rule-making in this respect.

It is not clear why such provisions have been omitted from CRD4, but one possible reason for this is that provisions for such loss absorption may end up being addressed by the upcoming legislative proposals for a European framework for bank recovery and resolution,[9] which were originally expected in June 2011 but are now expected in the last quarter of 2011. Depending on the terms of these legislative proposals, and how they are implemented into member state laws, these may end up satisfying the Basel criteria for gone-concern loss absorption, without the terms of the instruments themselves needing to contain such provisions.

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[7] See Morrison & Foerster client alert "UK Treatment of Capital Instruments under Basel III–A Taxing Issue," http://www.mofo.com/files/Uploads/Images/110805-UK-Capital-Instruments-Basel-III.pdf.

[8] See Morrison & Foerster client alert "The Minimum 'Bail-in' Criteria for Regulatory Capital," http://www.mofo.com/files/Uploads/Images/110121-Minimum-Bail-In-Criteria.pdf.

[9] See Morrison & Foerster client alert "European Resolution and Recovery Framework for Financial Institutions," http://www.mofo.com/files/Uploads/Images/110217-European-Resolution-Recovery-Framework.pdf.

Capital Buffers

As proposed by Basel III, the draft CRD4 directive prescribes member states to require their institutions to maintain, on top of the minimum capital requirements imposed under the CRD4 regulation, a capital conservation buffer of an additional 2.5% of risk-weighted assets, such buffer to comprise Common Equity Tier One Capital.

It also prescribes member states to require their institutions to maintain an institution-specific countercyclical capital buffer, on top of the minimum capital requirements and the capital conservation buffer, of between 0% and 2.5% of risk-weighted assets. This buffer is designed to build up additional loss-absorption capacity in institutions in times of excessive credit growth in the jurisdictions to which they are exposed. Although the Basel Committee had left open the possibility of this buffer being composed of "fully loss absorbing capital" other than Common Equity Tier One Capital, the draft CRD4 directive clearly mandates only Common Equity Tier One Capital for this buffer.

In line with Basel III proposals, failure to maintain the full required amount of these buffers will result in restrictions being imposed on the institution, in proportion to the degree of its under-capitalisation, in respect of its payment of dividends on Tier One instruments, discretionary bonuses and discretionary pension benefits. It will also oblige the institution to submit a plan to its regulator as to how it proposes to meet the full required buffer.

Institutions will be required to maintain their countercyclical capital buffer at a rate equal to the weighted average buffer rates applicable to jurisdictions in which their exposures are located. Member states are permitted to set their own jurisdiction's buffer rate at a level above 2.5%, in which case other member states may, but are not obliged to, recognise such higher rate in determining the specific buffer levels applicable to institutions regulated by them.

The countercyclical capital buffer rate is to be set quarterly by the relevant authority in each member state, based on the divergence of the current ratio of credit-to-GDP from its long-term average, and on guidance maintained by the European Systemic Risk Board. Where any buffer is determined to be increased, the relevant authority is expected to announce this decision 12 months before the buffer will become binding on banks with credit exposures in that jurisdiction.

Global SIFBs

The Basel Committee has recently released proposals[10] regarding the methodology of determination of global systemic importance of a bank and the consequent additional capital requirements that it considers should be imposed on such bank. The Basel Committee envisages that the additional capital requirements for Global SIFBs, ranging from 1% to 2.5% of risk-weighted assets, would have to be met with Common Equity Tier One Capital, whereas financial sector participants had previously hoped that the Basel Committee would allow more flexibility to use other types of instruments, such as CoCos.

The European Commission, understandably given the early stage of these Basel proposals, has deliberately not sought to include any proposals regarding Global SIFBs in CRD4 and for now the possibility remains open that Europe may allow more flexibility than the Basel Committee in respect of the types of capital eligible to comprise the additional capital requirements.

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[10] See Morrison & Foerster client alert "Defining Global Systemically Important Banks and Additional Loss Absorbency Requirements," http://www.mofo.com/files/Uploads/Images/110812-Loss-Absorbency-Requirements.pdf.

Leverage

In addition to the existing Basel II approach of comparing a bank's capital against its risk-weighted assets, Basel III for the first time introduced the concept of a bank maintaining a maximum leverage ratio, provisionally intended to be set at 3%, based on the amount of its overall Tier One Capital compared to the amount of its total exposures.

The draft CRD4 regulation directs institutions to monitor, and report to their regulators, their leverage ratios from 1 January 2013 to 1 January 2017, as per Basel III, but as yet contains no commitment for institutions to maintain a particular leverage ratio from any future date. The Commission has expressed an intention to introduce such a binding ratio from 2018 and the Commission must submit a report on the impact and effectiveness of a leverage ratio to the European Parliament by the end of 2016, accompanied "where appropriate" by its legislative proposal in this regard. However, under the current CRD4 package, the purpose of monitoring institutions' leverage ratios is at the moment mainly as a tool to aid regulators in performing their supervisory responsibilities.

Liquidity

The CRD4 proposals broadly mirror the Basel III proposals for a liquidity cover ratio, measuring the value of an institution's liquid assets against its projected net outflows for a period of 30 days of stressed market conditions. However, although in most other respects CRD4 provides more detail than Basel III on a particular topic, CRD4 is somewhat less prescriptive than Basel III as to how the LCR would be measured.

In addition, CRD4 currently contains no commitment in respect of the net stable funding ratio proposed by Basel III. The Commission has stated that it is "firmly committed to reaching a minimum standard .... by 1 January 2018," but that it intends to reach a legislative proposal only at a later date during the pre-2018 observation period prescribed by Basel III.

The EBA is charged with reporting to the Commission, by the end of 2015, on whether and how institutions should be required to use "stable sources of funding," and on the basis of this report the Commission must make a report to the European Parliament by the end of 2016, together "if appropriate" with its legislative proposal.

Reduced Reliance on External Credit Ratings

The Financial Stability Board has previously published principles intended to reduce the reliance of regulators and institutions on external credit ratings,[11] including the aim of removing references to such ratings from financial legislation. In the United States, Section 939A of the Dodd-Frank Act requires the various federal agencies to review their financial regulations and replace references to external credit ratings with other standards of creditworthiness.

The proposed CRD4 directive does not go as far as the Dodd-Frank Act, in that it continues to allow the use of external credit ratings, but it does require that member states ensure that their regulated institutions do not rely solely or mechanistically on external ratings and that they have internal methodologies for assessing creditworthiness. It also implies that where an institution's internal methodology would imply a higher level of capital than that implied by an external rating, the internal methodology should be applied.

[11] http://www.financialstabilityboard.org/publications/r_101027.pdf.

Counterparty Credit Risk

In line with the Basel III proposals, institutions are being encouraged under CRD4 to migrate as much as possible of their over-the-counter derivative, repo, and stock lending activities to clearing through central clearing counterparties. This is to be achieved by making changes to the existing counterparty credit risk regime which subjects institutions to an additional capital charge to cover possible losses that might arise from a deterioration in the creditworthiness of its counterparties in the case of non-centrally cleared trades. In contrast, exposure to CCPs is deemed to subject institutions to a very low counterparty credit risk, and therefore should result in correspondingly low capital requirements in respect of that risk. However, in line with the Basel Committee's recommendations, CRD4 still prescribes a 2% risk-weighting for exposure to CCPs.

These provisions are intended to complement the draft European regulation on OTC derivatives known as EMIR,[12] which is intended, among other things, to mandate the central clearing in Europe of many classes of over-the-counter derivatives trades. The purpose of this draft legislation is to centralise counterparty credit risk for OTC derivative trades to a large extent in CCPs, and introduce transparency obligations, with the aim of making it easier for regulators to monitor and control build-ups of systemic risk in the markets. The final form of the regulation has been significantly delayed, but may materialise before the end of 2011.

Next steps

The Commission intends that the CRD4 regulation and directive (when these are in final form, rather than the current provisional versions) will come into force on 1 January 2013, in line with the Basel III proposals. This will necessarily entail, therefore, a huge amount of work for the EBA over the next 12 months or so in drafting all the relevant technical standards required under the CRD4 package.

As noted above, further legislation will also need to be proposed in other related areas, in particular in relation to the methodologies for determination of global systemic importance of financial institutions, and consequent additional levels of capital requirements, as well as in relation to proposals for loss absorption at the point of non-viability of an institution.

It also remains to be seen over the next few years to what extent the Basel III features not yet fully implemented into CRD4 (in particular as to leverage and liquidity ratios) are introduced into CRD, or to what extent the current lack of implementation reflects a lukewarm attitude of European lawmakers to certain areas of Basel III.

Lastly, whereas Basel III and CRD4 reflect international and European efforts to prescribe prudential requirements designed to ensure that financial institutions are better able to withstand adverse market conditions, international efforts are also progressing in tandem to establish recovery and resolution regimes for financial institutions which end up failing,[13] notwithstanding the best efforts of lawmakers and regulators.

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[12] See Morrison & Foerster client alert "Draft EU Regulation on OTC Derivatives, Central Counterparties and Trade Repositories," http://www.mofo.com/files/Uploads/Images/100920-Draft-EU-Regulation-on-OTC-Derivatives.pdf.

[13] See Morrison & Foerster client alerts "SIFI Resolutions and Living Wills: The Financial Stability Board Proposal (and some U.S. and UK observations)," http://www.mofo.com/files/Uploads/Images/110819-SIFI-Resolutions-Living-Wills.pdf and "'R&R' the Hard Way – the FSA's Consultation on Recovery and Resolution," http://www.mofo.com/files/Uploads/Images/110819-FSA-Recovery-Resolution.pdf.

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