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Comparison between Capital Requirements Directive IV and Basel III

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1 Background and scope

1.1 The Basel III rules, which both amend and supplement the Basel II rules, consist of rules published in:

1.1.1 December 2010 relating to capital (providing for changes to the quality and quantity of capital, new capital conservation and counter-cyclical buffers, tougher counterparty risk rules and a new unweighted leverage ratio);

1.1.2 December 2010 relating to liquidity (providing for the two new liquidity ratios known as the Net Stable Funding Ratio ("NSFR") and the Liquidity Coverage Ratio ("LCR")); and

1.1.3 January 2011 relating to loss absorption (providing for additional Tier 1 capital and Tier 2 capital instruments of "internationally active" banks to include loss absorption mechanisms which are triggered at the point of the relevant issuer's "non-viability").

1.2 The Basel III rules are to be implemented within the European Union through a combination of a new Directive which contains, among other things, the Basel III rules on the new capital conservation and counter-cyclical buffers (the "CRD IV Directive") and a new Regulation which contains, among other things, the Basel III rules on the quality and quantity of capital, counterparty risk rules and liquidity and leverage management (the "CRD IV Regulation"). The CRD IV Directive and the CRD IV Regulation are collectively referred to in this update as "CRD IV". Partly as a result of implementing Basel III, CRD IV effects certain notable amendments to the existing Directives on capital requirements (in part consisting of Directives 2006/48/EC and 2006/49/EC (together the "Existing CRD")) which contain the Basel II-based rules for prudential supervision of, and capital requirements for, banks and investment firms in the European Union.

1.3 This update does not purport to provide a comprehensive summary of CRD IV but instead focuses on some of the key differences between CRD IV and Basel III and between CRD IV and the Existing CRD. This update is based on a provisional draft of CRD IV published by

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the European Commission on 20 July 2011 and as such may need to be updated based on the final published text of CRD IV.

2 Regulation vs. Directive

2.1 As noted above, the Basel II rules are applied in the European Union by way of the Existing CRD. The Existing CRD takes the form of a Directive (which generally requires implementing legislation to be passed by each Member State in order for it to become law) and as such allows Member States to use discretion in the way in which it is implemented at a national level and to impose super-equivalent rules if they consider them necessary (otherwise known as "gold-plating"). A Regulation, in contrast, becomes law in each Member State without further implementing legislation being required.

2.2 The recitals to CRD IV state that the use of discretion by national regulators when implementing the Existing CRD has led to considerable variation between prudential rule books in different European countries and that this is undesirable on the grounds that it distorts competition and fails to deliver a level playing field across the European Union. One of the stated aims of CRD IV, which in significant part takes the form of a Regulation, is to prevent CRD IV from being implemented in different ways at a national level as well as to prohibit "gold-plating". The Financial Services Authority and the Bank of England have expressed concerns with the use of a Regulation, arguing that it interferes with a national regulator's discretion in certain areas. This is a key issue for the UK in that the Independent Banking Commission has recommended that large UK global banking groups are subject to a 10% common equity Tier 1 capital requirement, which is 3% higher than the Basel III/CRD IV requirement. As capital ratios are addressed in the CRD IV Regulation, it is hard to see how the UK can impose a 10% common equity Tier 1 ratio on the UK banks, as this would be super-equivalent to the requirements of the CRD IV Regulation and may therefore be ultra vires.

2.3 Despite significant parts of CRD IV being formulated as a Regulation, there would appear to be at least some scope for national regulators to impose different standards in some cases:

2.3.1 the CRD IV Regulation clarifies that Member States should also have the power to "maintain or introduce national provisions where this Regulation does not provide for uniform rules, provided that those national provisions are not in contradiction with European Union law or do not undermine their application". An example of this is the scope under CRD IV for national regulators to increase the basic risk-weighting applied to exposures secured by real estate having regard to local market conditions;

2.3.2 the CRD IV Regulation states that competent authorities may waive the application of certain core prudential requirements to certain subsidiaries within a supervisory consolidation group provided that certain conditions are met (for example there is no material practical or legal impediment to the prompt transfer of own funds by the parent undertaking);

2.3.3 the CRD IV Directive preserves the ability of national regulators to impose stricter requirements on individual banks where they consider it appropriate to do so in order to address specific risks identified through the supervisory review process; and

2.3.4 EU internal market commissioner Michel Barnier has indicated that CRD IV would permit Member States to impose higher capital ratios through "a much expanded use of the counter-cyclical buffers" for financial stability reasons. Whilst this is consistent with the counter-cyclical buffer requirements being contained in the CRD IV Directive, it is questionable whether the counter-cyclical buffer requirements were ever intended to be a means of achieving super-equivalency on a permanent basis.

It is also worth noting that the European Commission has stated that Member States are free to anticipate the full implementation of Basel III by imposing the more stringent standards earlier than contemplated by the legislation.

2.4 Looking beyond CRD IV, the Basel Committee and the Financial Stability Board have published papers proposing a requirement for global systemically important banks to hold additional capital beyond the levels specified in Basel III. Under the proposals, qualifying banks would need to hold between 1% and 2.5% of additional common equity Tier 1 capital depending on their systemic importance with the possibility of a further surcharge of 1% if they materially increase their global systemic importance in the future. In the event that these proposals were to become law, then a combination of the minimum common equity Tier 1 ratio of 4.5% under CRD IV, a capital conservation buffer (consisting of common equity Tier 1 capital) of 2.5% under CRD IV and a systemic importance levy of up to 2.5% of common equity Tier 1 capital would bring the rules imposed by the European Union to within 0.5% of the 10% holding of common equity Tier 1 capital proposed by the Independent Banking Commission in the UK.

3 Joint decision process between home and host authorities

3.1 Under the existing consolidated supervision rules, competent authorities are required to do everything within their power to reach a joint decision on the required level of own funds to be maintained by across a European Union banking group. Whilst competent authorities

are able to refer disputes to the Committee of European Banking Supervisors, any resulting advice is not binding on the competent authorities.

3.2 The autonomy of competent authorities has been restricted in CRD IV in that CRD IV provides that disputes may be referred to the European Banking Authority ("EBA") and in that event decisions of the EBA are binding. CRD IV contains similar powers for the EBA to resolve disputes on the level of liquidity requirements and the identification of a liquidity sub-group (including constraints on the location and ownership of liquid assets).

4 Quality of capital and deductions from capital

4.1 One of the main areas of focus of the Basel III rules is to bolster considerably the qualitative requirements for Tier 1 and Tier 2 capital (and to remove the concept of Tier 3 capital). The CRD IV Regulation largely reflects the Basel III rules as to the requirements which capital must fulfil although, unlike Basel III, it does not limit qualifying instruments to ordinary share capital provided that they meet the required set of characteristics. The effect of these requirements on capital instruments is an extensive subject in its own right and is discussed in a separate Linklaters client update. Click here to read more.

4.2 In addition to adjusting the rules on what constitutes capital, Basel III made a number of changes to the rules on deductions from that capital. For the most part, these are replicated in more detailed language in CRD IV, but one notable difference is that, unlike Basel III, CRD IV does not automatically require banks to deduct significant investments in insurance companies and instead leaves it to the discretion of national regulators as to whether banks are allowed to apply rules contained in the Financial Conglomerates Directive which seek to avoid double-counting. The discretion of national regulators to allow this alternative treatment is contained in the Existing CRD, although the FSA chose not to include it when transposing the Existing CRD into national law.

5 Capital conservation buffer

5.1 Basel III provides that banks must maintain a capital conservation buffer (consisting of common equity Tier 1) of 2.5% above the regulatory minimum capital requirement (i.e. 4.5%) and that, where a bank's capital conservation buffer falls below the 2.5% threshold, it will be restricted in its ability to pay dividends, to effect share buy-backs, to make discretionary payments on Tier 1 capital instruments and to pay discretionary bonus payments to staff (with the extent of the restriction increasing according to the extent to which the bank is failing to meet the capital conservation buffer). Where a bank fails to maintain the required capital conservation buffer, Basel III

contemplates regulatory authorities having the ability to impose set time-frames on banks in which the buffer is to be restored in order to prevent banks from routinely operating within the buffer.

5.2 CRD IV reflects the quantum and composition of the capital conservation buffer set by Basel III, although in relation to the restrictions which apply in the event of non-compliance, the CRD IV rules:

5.2.1 make explicit that the restriction on discretionary staff bonus payments extends to discretionary pension benefits; and

5.2.2 clarify that discretionary staff payments where the obligation to pay was created at a time when the bank was in compliance with the capital conservation buffer requirement are not prohibited.

5.3 The CRD IV rules also require banks to submit a capital conservation plan within 5 working days of them becoming aware of any failure to meet the capital conservation buffer. The plan must include estimates of future income and expenditure and a forecast balance sheet together with detailed proposals for how and when the bank will restore its buffer. Although such plans are contemplated by Basel III, CRD IV provides greater detail on their terms.

6 Counter-cyclical buffer

6.1 Basel III requires that banks maintain capital buffers (in addition to the capital conservation buffer) during times of excess credit growth which can then act to absorb losses in any ensuing economic downturn. Basel III provides that these buffers will operate both at a national level and at a bank-specific level (the latter having regard to the geographic spread of a bank's operations) and will be capped at 2.5% or such higher amount as a local regulator may elect. Any failure to maintain the required buffer will trigger payment restrictions akin to those outlined above.

6.2 CRD IV provides more detail than Basel III on the factors which member states may take into account when determining the level of any national buffer (such as the ratio of credit to gross domestic product and any specific risks to financial stability) and also requires them to take into account any guidance published by the European Systemic Risk Board. The extent to which that guidance will be treated as binding (and thus the extent to which it will remove discretion from national regulators) remains to be seen.

7 Leverage ratios

7.1 Basel III proposes the introduction of a binding minimum leverage ratio requirement (broadly Tier 1 Capital expressed as a percentage of total exposures) on 1 January 2018. Prior to that date, Basel III contemplates an observation period between 1 January 2013 and 1

January 2017 during which the effect and proper calibration of the ratio (which the Basel III rules provisionally set at 3%) will be assessed, with banks being required to report their leverage ratios from 1 January 2015.

7.2 Whilst the CRD IV Regulation requires banks to calculate their leverage ratios on the basis of guidance provided in the CRD IV Regulation, unlike Basel III it does not propose even a tentative minimum leverage ratio. The explanatory memorandum to the CRD IV Regulation states that the European Commission nevertheless intends to introduce a binding minimum leverage ratio during 2018 with reporting of leverage ratios to commence in 2015. In the interim period, the CRD IV Directive requires national regulators to ensure that banks:

7.2.1 have policies in place to identify and manage excessive leverage (with the leverage ratio calculated pursuant to the CRD IV Regulation being indicative for these purposes); and

7.2.2 address the risk of excessive leverage in a precautionary manner.

8 Liquidity rules

8.1 The Basel III liquidity rules primarily compose two key ratios:

8.1.1 the LCR, which is designed to ensure that banks have sufficient high-quality liquid assets which can be converted into cash to enable banks to meet their liquidity needs over a 30 day period of stress; and

8.1.2 the NSFR, which is designed to promote a more medium and long-term funding profile for a bank's operations with a view to reducing short-term asset and liability funding mismatches.

8.2 Basel III provides that both the LCR and the NSFR will be subject to an initial observation period and that, following any revisions as a result of observations made during that period, the LCR will take effect on 1 January 2015 and the NSFR will take effect on 1 January 2018. CRD IV confirms that a binding LCR will be introduced in 2015, but is less committed as to when the NSFR will be introduced, merely stating that the Commission will consider imposing the NSFR in 2018. This is perhaps a reflection of concerns raised in the market that an NSFR could interfere with the core maturity transformation role of banks.

8.3 Basel III provides formulae for determining both the LCR and NSFR together with relatively detailed guidance on how the variables within them should be completed. CRD IV is less prescriptive than Basel III in that the only quantitative requirements imposed relate to the LCR and these are cast generally as an obligation to hold sufficient liquid assets to address any imbalance of liquidity inflows and outflows

under stressed conditions over a short period. The focus of CRD IV is instead on requiring banks to report on their holdings of qualifying liquid assets and on the maturity profiles of their liabilities, presumably with a view to facilitating the analysis to be conducted by regulatory authorities during the observation periods applicable to both ratios.

9 Reduced reliance on external ratings

9.1 Under the Existing CRD, banks are permitted to take into account credit assessments provided by approved external rating agencies to determine the risk weight of exposures. The view of the European Commission is that excessive reliance on external ratings has lead to banks failing to conduct their own rigorous assessment of the risks inherent in their investments.

9.2 The CRD IV Directive continues to allow use of external credit assessments but places greater emphasis on the need for banks to take their own assessment of credit risk. National regulators must ensure that:

9.2.1 banks have internal methodologies that enable them to assess the credit risk of their exposures;

9.2.2 banks do not rely solely and routinely on external ratings; and

9.2.3 where own funds requirements would differ according to whether external ratings or internal methodologies are used, this is taken into account in when assessing the level of own funds required (the implication being that the method revealing the more stringent own funds requirement should be used).

10 Exposures secured by real estate property and new reporting requirements

10.1 Under the Existing CRD, exposures secured by residential real estate property can be risk weighted at 35%, and exposures secured by commercial real estate in the home jurisdiction of the bank risk weighted at 50%, provided various criteria are fulfilled.

10.2 These risk weightings continue to apply under CRD IV, although CRD IV provides that national regulators:

10.2.1 must conduct an annual assessment of their appropriateness based on default experience of these exposures and projections of developments in the real estate markets; and

10.2.2 have discretion to apply a higher risk weight or stricter criteria to exposures secured by real estate.

This is a new discretion and one which national regulators may choose to exercise, especially if local market conditions deteriorate.

10.3 CRD IV also introduces some new and particularly onerous reporting requirements related to exposures secured on real estate which are not contained in Basel III. Under CRD IV banks must report:

10.3.1 losses in any given year stemming from lending collateralised by residential real estate up to 80% of market value or 80% of mortgage lending value;

10.3.2 overall losses in any given year stemming from lending collateralised by residential real estate property;

10.3.3 losses in any given year stemming from lending collateralised by commercial real estate up to 50% of the market value or 60% of the mortgage lending value; and

10.3.4 overall losses in any given year from lending collateralised by commercial real property.

11 High risk categories

11.1 Banks using the standardised approach must currently risk weight "high risk items" at 150% subject to the discretion of the competent authorities. The Existing CRD names investments in venture capital firms and private equity investments as examples of high-risk items.

11.2 The CRD IV Regulation builds significantly in this area, by imposing mandatory 150% risk weighting for high risk items (thereby removing the existing discretion of national authorities) and extends the list of named high risk items so as to include investments in shares or units in collective investment undertakings, venture capital firms, alternative investment funds and speculative immovable property financings. Although the list in CRD IV is again not exhaustive, CRD IV provides slightly greater detail than the Existing CRD as to how firms are to identify high-risk investments (e.g. those where there is a high risk of loss as a result of a default of the obligor) and provides that the EBA will issue further guidelines.

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12 Legal review of unfunded credit risk mitigation

12.1 The Existing CRD requires banks to conduct regular legal reviews in respect of certain types of its funded credit risk mitigation arrangements but imposes no explicit review requirement for unfunded credit risk mitigation arrangements. CRD IV imposes a blanket legal review requirement in respect of all unfunded credit risk mitigation arrangements by providing that banks must:

12.1.1 fulfil any contractual and statutory requirements in respect of, and take all necessary steps to ensure, the enforceability of its unfunded credit risk protection under applicable laws; and

12.1.2 conduct sufficient legal review confirming the enforceability of the unfunded credit protection in all relevant jurisdictions and repeat such review as necessary to ensure continuing enforceability.

12.2 The continuing legal review requirement will therefore extend to a much broader range of credit risk mitigation techniques employed by banks. In practice this will require banks to have systems which alert them to legal developments which could impact on their unfunded credit risk mitigation arrangements (for example the Linklaters Blue Flag platform) and to review their existing arrangements in light of any relevant developments.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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