FSC Newsletter

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Financial Services Commission

Capital Requirements Directive IV

Capital Requirements Directive IV ("CRD IV") (also commonly known as Basel III) is a package of reforms for prudential requirements introduced by the EU for credit institutions and investment firms.

It will replace the current CRD directives with one regulation and one directive: the Capital Requirements Regulation **No 575/2013** (CRR) and the Capital Requirements Directive IV **2013/36/EU** (CRD IV Directive).

The role of CRD IV is to implement the main Basel III reforms in the EU, with the aim of addressing weaknesses that became apparent during the financial crisis of 2007/8 and to reduce the likelihood of a future financial crisis. The new measures aim to:

- Strengthen the regulation, supervision and risk management of the banking sector.
- Improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source.
- Improve risk management and governance.
- Strengthen banks' transparency and disclosures.

The amending Directive requires transposition at national level and will become local legislation. The EU Regulation will have direct applicability on all credit institutions and investment firms within the scope of MiFID. The provisions currently set out in the Capital Adequacy Directive (CAD) that specifically apply to prudential standards for investment firms will be included in the CRR, together with the prudential standards for credit institutions.

The European Banking Authority (EBA) will now also have the power to impose "Binding Technical Standards" ("BTSs"). It is anticipated that these will range from instructions on how to interpret the treatment of capital provisions, to how national supervisory authorities are required to implement items such as common regulatory reporting.

Throughout 2014, it is expected that the EBA will be drafting over 80 BTSs, of which around 20 are due by 1 January 2014. All firms that are captured by CRD IV will need to become aware of the BTSs that are being implemented which will have direct applicability.

The CRR

As it is an EU regulation, the CRR will be directly applicable and take effect in all EU member states without any further action required by member states. It includes provisions which relate to:

- The definition of regulatory capital
- Capital requirements
- Disclosures made by firms under Pillar 3
- Transitional provisions
- Quality of capital

- Quantity of capital
- Counterparty credit risk (CCR)
- Credit valuation adjustment (CVA) risk
- Leverage
- Liquidity
- Disclosures

The CRD IV Directive

Member states must transpose the CRD IV Directive into national legislation. The Directive contains provisions on issues where the degree of prescription is lower and these include:

- Authorisation of credit institutions
- Passporting rights for credit institutions
- Prudential supervision
- Corporate governance
- Sanctions
- Certain remuneration provisions

The main provisions of CRD IV

The main provisions of CRD IV include the following:

Capital (effective as from 01 January 2014 but will have certain allowances to phase-out the capital instruments that no longer qualify): the criteria to be recognised as regulatory capital will be tightened and common equity will be the main component of Tier 1 capital, and its definition clarified. Tier 3 capital will be abolished. In addition, the minimum ratios for common equity and Tier 1 capital will change, being increased to 4.5% and 6% respectively, with the minimum capital ratio remaining at 8%;

Buffers: two capital buffers will be introduced and these will be additional to the increased common equity and Tier 1 capital ratios. These will be: (i) the capital conservation buffer *(which will be phased in from 2016-2019)*, which will comprise 2.5% of risk-weighted assets and consist of common equity; and (ii) the countercyclical capital buffer *(also to be phased in from 2016-2019)* which will also consist of common equity and which national authorities may at their discretion determine, up to 2.5%;

CRR: capital requirements for counterparty credit risk (CRR) exposures arising from banks' derivatives, repo and security finance activities will be increased and use of central counterparties encouraged;

Leverage ratio (will be applied via the Pillar 2 process until January 2017 and will be migrated to Pillar 1 in 2018): This is likely to be the ratio of Tier 1 capital to total non-weighted assets and off-balance sheet exposures;

Liquidity requirements (will be monitored until 2015 and phased in from then): two new liquidity ratios are anticipated (liquidity coverage ratio and the net stable funding ratio), with the aim of encouraging banks to hold higher levels of unencumbered, high-quality liquid assets;

Remuneration: a 1:1 ratio will be imposed on salary relative to variable pay for certain bankers, though on shareholder approval this could rise to 1:2.

Rules on the disclosure of the number of individuals with a total remuneration over a certain threshold will also be introduced;

Rulebook: a single set of harmonised prudential rules will be produced by the EBA for banks and investment firms. Member states may apply stricter requirements where justified; and

Corporate governance: corporate governance arrangements and processes will be amended, including those dealing with the composition of boards and their role in risk oversight and strategy, and a strengthened risk management function.

Regulatory Reporting

The CRR contains specific mandates for the EBA to develop draft Implementing Technical Standards (ITS) for supervisory reporting. These ITS will help to enhance regulatory harmonisation in Europe, particularly by specifying consistent formats, frequencies and dates of prudential reporting, as well as IT solutions to be applied by firms. The new supervisory reporting framework is composed of Financial Reporting (FINREP) and Common Reporting (COREP). This reporting framework will specify the information firms must report to supervisors in areas such as own funds, large exposures and financial information.

- (COREP) covers the capital requirements and own funds reporting based on Directives 2006/48/EC and 2006/49/EC
- (FINREP) covers Financial Reporting for supervisory purposes based on IAS/IFRS, as endorsed by the European Union.

COREP will become the prudential reporting framework for credit institutions and some investment firms according to the framework established by the CRD IV. The FSC's current reporting format will still apply to some firms and the FSC will also be requesting additional statistical information which is not captured by COREP.

The FSC is currently undergoing a considerable exercise to create a solution for the implementation of COREP; however, investment firms which are within scope and credit institutions, should ensure that they are aware of the level of detail that will be required and are therefore strongly encouraged to review the EBA templates to ensure that the information will be available once the revised reporting is implemented. COREP will become effective as from 1 January 2014 and therefore will be required to be completed by the end of the first quarter. More information on COREP will be published by the FSC in due course.

In accordance with Article 99 of the CRR, common Financial Reporting (FINREP) (due to be in effect as from July 2014) will only need to be supplied by "*Institutions subject to Article 4 of Regulation (EC) No 1606/2002*[1] *and credit institutions other than those referred to in Article 4 of that Regulation that prepare their consolidated accounts in conformity with the international accounting standards adopted in accordance with the procedure laid down in Article 6(2) of that Regulation, shall also report financial information*". Firms and credit institutions are required to assess whether they fall within the scope of FINREP and, if necessary, obtain professional advice.

[1] I.e. consolidated account of publically traded companies

Timeline

With the exception of certain provisions (e.g. liquidity, capital conservation buffer etc.), the CRR will apply from 1 January 2014, and the CRD IV Directive will come into force on 31 December 2013.

Implementation will in the case of some provisions be phased and take up to 2019. Firms should in particular familiarise themselves with CRR Articles 465-499, which outline the requirements with respect to own funds, unrealised gains and losses measured at fair value, deductions and grandfathering of capital instruments as of 1 January 2014.

Summary

CRD IV imposes tougher capital standards which will often require transformation of the business models of some banks. Banks may have significant process and system changes to achieve upgrades in the areas such as stress testing, counterparty risk, and capital management infrastructure.

At a high level, CRD IV will essentially result in:

- More restrictive capital definitions
- Higher risk-weighted assets (RWA)
- Additional capital buffers
- Higher requirements for minimum capital ratios, and
- New liquidity standards that will drive new balance sheet strategies to limit illiquid assets.

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