

Flash News

CRD IV

Announcement of 20 July 2011: A revised Basel III¹?

1 August 2011

European regulatory context

The draft proposal of the CRD IV issued by the European Commission (in the following “the Commission”) on 20 July 2011 is the formalisation to the expected fundamental revision of the regulation of the European financial system. While the Commission has relied on the standards proposed² by the Basel Committee on Banking Supervision for a significant extent, the selected approach falls short of an outright transposition of these recommendations.

In this context, the Commission provides the following justifications:

- Prior to being transposed into EU and national law, Basel III needs to be aligned with existing laws and regulations;
- In order to avoid competitive distortions and potential regulatory arbitrage, the Commission believes it is essential to extend the scope to all banks as well as investment firms active in the EU, contrary to the Basel III focus on “internationally active banks”;
- The Commission remains committed to the spirit of Basel III, in order to improve the resilience of the global financial system and to ensure a level playing field. In this context, the implementation in jurisdictions across the globe will be closely followed, with action being initiated as necessary.

¹ For more context, please refer to our former Flash News on Basel III:
<http://www.pwc.com/lu/en/risk-management/docs/pwc-risk-291010.pdf>

² <http://www.bis.org/bcbs/basel3.htm>

Unlike what had become the norm in recent EU history, where most prudential regulation was released under the form of Directives, which subsequently had to be transposed into each and every Member State's law, the current draft proposal separates the CRD IV into two distinct legislative instruments, namely a Directive and a Regulation. While the Directive governs the access to deposit-taking activities in areas where the degree of prescription is lower and where the links with national administrative laws are particularly important, the Regulation establishes a single-rule book, specifying a harmonised set of rules applicable for banks and investment firms throughout the European Union. The below table provided by the EU³ gives an overview of the respective contents of Directive and Regulation.

Directive (Strong links with national law, less prescriptive)	Regulation (Detailed and highly prescriptive provisions establishing a single rule book)
Access to taking up/pursuit of business	Capital
Exercise of freedom of establishment and free movement of services	Liquidity
Prudential supervision	Leverage
Capital buffers	Counterparty credit risk
Corporate governance	
Sanctions	

Capital aspects

In line with what it had previously announced, the European Commission is implementing Basel III in a way that it judges faithful to the spirit of the Basel Committee's texts. It is however worth pointing out a few aspects of the proposal that are potentially raising questions or are unexpected.

Silent Partnerships

As already announced on several occasions, one of the main objectives of Basel III has been to reinforce both the quantity and quality of capital that can be used from a prudential standpoint. In contrast with Basel II, particular attention will be given to how well banks meet the so-called Core Equity Tier 1 ('CET1') ratio, which will only consider elements of capital in the strictest sense of the term. To qualify for inclusion in CET1 capital, instruments will have to meet a series of 14 criteria, essentially to do with the instruments' loss

³<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/527&format=HTML&aged=0&language=EN&guiLanguage=en#footnote-4>

absorbency and permanency. What has come as a surprise to some is that the CRD IV proposal does not limit CET1 capital to only 'ordinary shares'. Indeed, it does not rule out the inclusion of so-called 'silent partnerships' (also known as "Stille Einlagen"), an instrument that is very commonly used by German banks, so long as they meet the said 14 criteria. This should therefore come as a positive surprise to those banks which heavily rely on such instruments but less so to some other stakeholders.

In terms of quantity of capital required, the proposal does not, at least as part of Pillar 1, allow individual Member States to set higher requirements than those of CRD IV's. While some countries (notably Spain, the UK or Cyprus to name but a few) have already implemented (or are close to implement) such local measures, the proposal foresees including such extra requirements as part of Pillar 2. In Pillar 2 local regulators would be allowed to require some banks or group of banks to hold above-Pillar 1 capital if they can justify why such bank or group of banks would represent a higher-than-normal risk. It is expected, however, that over time all countries will converge towards similar expectations.

Minority Interests

Also of interest to those Luxembourg banks that have participations in other institutions (i.e. themselves subject to capital requirements at least as restrictive as CRD IV's), minority interests (basically capital in a subsidiary that is owned by shareholders from outside the group), which are particularly important in the EU, would also be recognised to cover the new countercyclical buffer (in a nutshell an extra CET1 capital buffer acting as a cushion in boom times to protect the institutions in rainy days), as it would in practice be used to absorb losses within a group. This came as a surprise to some observers who did not expect minority interests to be eligible to cover this particular buffer. By doing so, the proposal removes a potential risk of regulators having an incentive not to use the counter-cyclical buffer.

Less importance given to Tier 2

An implicit change introduced by CRD IV and Basel III is that the importance given to Tier 2 own funds (typically essentially composed of subordinated debt instruments), which will no longer be limited as a function of Tier 1 capital, will be significantly reduced. Luxembourg banks that rely on such source of own funds should start assessing how well they would cope. This is further compounded by the fact that Tier 2 capital will not be eligible for computing the Leverage Ratio (see further).

Significant holdings in other financial entities like insurance companies

Luxembourg banks that also have insurance companies as part of their group will be pleased to find out that CRD IV, in contrast with Basel III, will not make it mandatory in all cases to deduct such participations from the bank's own funds. The European Commission's justifies this by the fact that the so-called 'bancassurance' is a business model that is very common and peculiar to the EU and that a specific legal mechanism, namely the Financial Conglomerates Directive (FICOD), addresses such risk of double counting of capital across the banking and insurance sectors.

Capital buffers

CRD IV does not introduce any significant changes to either the capital conservation buffer (supposed to be an extra 2.5% CET1 cushion on a permanent basis) or counter-cyclical buffer (save in a boom to protect you in a rainy day) compared to Basel III.

It is however important to note that so-called SIFIs (for "Systematically Important Financial Institutions") will also be subject to extra capital requirements, the extent of which is not finalised yet. A detailed framework will be submitted to the meeting of G-20 leaders at Cannes on 3-4 November 2011 for their decision.

Basel I floor

Since the inception of Basel II, banks that had elected the Internal Ratings Based (IRB) approach to credit risk were subject to a minimum capital requirements floor that was inspired from Basel I rules, which were significantly less risk-sensitive than their successors. CRD IV will reintroduce such floor, at 80% of Basel I level, at least between 2013 and 2015, so as to ensure that banks are not tempted not to hold too little regulatory capital.

Reliance on external ratings

It will be little surprise, in the light of recent developments, that CRD IV proposes to force banks to critically assess the external ratings provided by rating agencies, at least for the exposures that are material. This might therefore be a significant change for smaller institutions that are used to rely exclusively on external ratings.

Implementation timeframe

While the CRD IV sticks to Basel III's suggested implementation timeframe, i.e. a gradual introduction from 2013 to 2019, it leaves the door open for some countries to implement the capital quality or quantity requirements faster, as already started by some countries.

Leverage ratio aspects

While leverage, in essence the fact an entity's assets exceed its capital base, is a perfectly normal and expected part of a bank's balance sheet, Basel III clearly recognises that too much leverage is a bad thing. This is also compounded by the fact that some regions of the world, notably Canada, have had a maximum leverage ratio for some time and that in general these regions seem to have better reacted to the particularly harsh banking crisis of 2008-2009. The European Commission therefore agrees to follow Basel III's leverage ratio recommendations. There are however a few points worthy of attention in CRD IV's proposals:

- First, and in order to ensure that there are no unexpected side effects, such leverage ratio will initially be a Pillar 2 measure;
- Second, starting 2013 (and not 2011 as announced by Basel III), regulators will start gathering data from banks to see exactly where they stand in this respect.

This will be followed by public disclosure expected for 2015 and, finally, if no major side effects have been identified, by a migration to Pillar 1 in 2018.

Liquidity aspects

The Commission clearly affirms its commitment towards fundamentally improving the liquidity risk management regulation as a key aspect of its objective to improve the resilience of the European and global financial system. To this end, the current draft regulation establishes the framework necessary for initiating the observation and review period, including specifications related to operations, regulation and infrastructure.

First of all, the Commission proposes the introduction of a Liquidity Coverage Ratio by 2015, transposing the requirements by the Basel Committee on Banking Supervision to a significant extent but also enacting a number of changes. In this context, the Commission provides the following specifications:

- Institutions will be required to dispose of an adequate liquidity coverage from 2013 onwards;
- During the reporting phase of the observation period, beginning in January 2013, institutions will be required to report to the national authorities the information necessary for the authority to verify the adequacy of the individual institution's liquidity coverage. The European Banking Authority (EBA) will develop unified reporting formats for this purpose;

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- The Commission reserves itself the right to enact amendments to the liquidity coverage requirement on the basis of the results of the observation period as well as international regulatory developments. In particular, the Commission intends to address any issues which could have a significantly adverse impact on the business and risk profiles of European institutions as well as on markets or the economy as a whole.

Regarding the Net Stable Funding Ratio, the Commission does not provide any concrete specifications as to the implementation of this requirement, as it clearly states that it intends to use the extended observation period until 2018 to prepare a legislative proposal. However, the regulation contains specific reporting requirements related to both items providing and requiring stable funding, in order to provide the basis for an assessment during the observation period. In this context, it is to be noted that the Commission specifies five distinct time buckets within which the items are to be reported. This might be an indication that industry concerns regarding cliff effects will be analysed.

Outlining responsibilities and competencies of the new European banking regulator

The regulation provides an outline of the responsibilities which are assigned to the EBA in the context of liquidity risk management. In particular, these responsibilities are centred on two primary focal areas:

- Development of draft technical standards comprising specifications regarding a unified reporting format, additional liquidity monitoring metrics as well as IT solutions allowing for a direct electronic access to an institution's reporting;
- Monitoring and evaluation of reports received during observation period in order to provide the Commission with a report on the appropriateness of the calibration of the liquidity coverage requirement, outlining any potential undesired adverse consequences having been identified.

Moreover, the EBA is to report to the Commission by the end of 2015 on whether and how to ensure that institutions rely on stable sources of funding, including an analysis of the potential impacts on institutions, markets and the general economy.

Scope of application

While the regulation regarding liquidity is in principle applicable to institutions on a single-entity basis, the Commission provides for the possibility of derogation to this principle, distinguishing between two cases:

- All institutions appertaining to the same “liquidity sub-group” are authorised in the same member state, in which case the waiver shall be applied by the competent authorities in the respective member state;
- Institutions appertaining to the same “liquidity sub-group” are authorised in several member states, in which case the waiver can be granted subject to an agreement being reached between the competent authorities of the individual member states, where necessary supplemented by mediation on behalf of the EBA.

One aspect that should receive attention is that the regulation clearly specifies that electronic reporting facilities must be put in place to grant specified authorities (including EBA, the European Central Bank [ECB] and the host member state competent authorities) direct and immediate electronic access to all reporting submitted by a specified institution upon request.

Intra-group exceptions

Differing from the Basel III requirements, the EBA has provided for possible derogations in case of liquidity flows between intra-group entities. Provided specific conditions are met, the respective competent local authority may grant the permission to apply different percentages to liquidity in- and outflows on a case-by-case basis. The regulation explicitly states that these derogations may also extend to credit and liquidity facilities.

The above provisions have potentially far-reaching implications for the structure of group treasury operations, in particular regarding the location of liquidity buffers and the organisation of liquidity contingency planning. However, the regulation highlights that any potential constraints to the transferability of liquidity would have to be clearly identified and accounted for in an institution’s liquidity management framework.

Asset liquidity

The Commission has specified a number of criteria for identifying liquid assets for purposes of the liquidity coverage requirement. However, while these criteria are similar to those specified in the Basel III requirements, they diverge in several key aspects.

First of all, the proposed regulation does not comprise a clear definition of level 1 and level 2 assets⁴ for purposes of quantifying the liquidity coverage requirement. Instead, the EBA is assigned the task of developing criteria for an appropriate uniform definition of high and extremely high liquidity and credit quality of transferable assets. As EU Commissioner Michel Barnier has in the past repeatedly questioned the dependence on rating agencies for the purpose of determining asset liquidity, this might be perceived as an indicator for an attempt at reducing the extent of this dependence.

Pending issuance of specifications regarding asset liquidity, competent authorities may issue guidance as to the identification of transferable assets of high, respectively extremely high, liquidity and credit quality in different currencies. In the absence of any such guidance, institutions are required to define transparent and objective criteria to this end, drawing upon criteria the regulation states the EBA will analyse in developing the uniform definition.

A second point of importance is that the proposed regulation addresses concerns regarding the criterion of “central bank eligibility” in assessing asset liquidity. One of the conditions for classifying assets as liquid is that “they are eligible in normal times for intraday liquidity needs and overnight liquidity facilities of a central bank in a member state or if the liquid assets are held to meet liquidity outflows in a currency of a third country, of the central bank of that third country”.

Furthermore, the definition of liquid assets has been slightly extended, as shares or units in collective investment undertakings (CIUs) may be treated as liquid assets up to an absolute amount of € 250 million, provided certain criteria set forth in the regulation are met.

Operational specifications

While the operational specifications related to the liquidity coverage requirement largely mirror those specified by the Basel III requirements, the proposed regulation comprises an article explicitly addressing the oft-stated criticism of a missing guideline on how to deal with a breach in the liquidity coverage requirement.

Notably, an institution incurring or expecting to incur a breach in its liquidity coverage requirement is required to immediately notify its competent authority and submit a plan for a timely restoration of compliance. Until this has been achieved, the institution will be required to report to the competent authority on a daily basis. The authority has the right to grant a lower reporting frequency and to extend or protract the time period until compliance has been restored.

⁴ The proposed regulation does not refer to “level 1” and “level 2” assets, instead referring to “transferable assets that are of extremely high liquidity and credit quality” and “transferable assets that are of high liquidity and credit quality”.

Contacts:

Emmanuelle Henniaux	Partner, Regulatory & Compliance Leader	+352 49 48 48 2549	emmanuelle.henniaux@lu.pwc.com
Thierry López	Partner, Risk Management Services Leader	+352 49 48 48 4011	thierry.lopez@lu.pwc.com
Alexandre Lambin	Director, Basel II/III Expert	+352 49 48 48 2628	alexandre.lambin@lu.pwc.com
Jean-Philippe Maes	Senior Manager, Basel II/III Expert	+352 49 48 48 5719	jean-philippe.maes@lu.pwc.com

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