Briefing Note

CRD IV – Capital and Capital Buffers

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Introduction

The European Commission’s proposal for a Directive and Regulation (collectively known as CRD IV) will replace the existing Capital Requirements Directive and implement the Basel III accord in Europe. Capital absorbs unexpected losses for an institution, as well as funding its ongoing activities. Basel III made a number of substantial changes to the minimum level of capital required to be held by institutions and to the quality of instruments that comprise the capital base. In particular:

- An increase to the minimum level of Common Equity Tier 1 to 4.5% of Risk-Weighted Assets (RWAs) and total Tier 1 capital to 6%;
- An increase in the standards for instruments to qualify as Tier 1 capital;
- Harmonisation of Tier 2 capital instruments and the elimination of Tier 3 capital;
- An overhaul of eligible capital deductions and regulatory filters (such as minority interests and deferred tax assets).

On top of the minimum capital requirements Basel III introduces two capital buffers: the Capital Conservation Buffer and the Countercyclical Capital Buffer. The Capital Conservation Buffer is intended to act as a safety cushion to allow institutions to take remedial action if their Common Equity Tier 1 (CET1) ratios fall below 7% (4.5% minimum CET1 plus the 2.5% Capital Conservation Buffer). Where an institution’s CET1 falls below 7% of RWAs it will face various restrictions, including graduated restrictions on making dividend payments depending on the degree to which the buffer is breached.

The Countercyclical Capital Buffer is intended to counter the risks posed by swings in the economic cycle. So, for example, where loan growth is deemed to be excessive national authorities can impose an additional CET1 requirement on institutions of up to 2.5% of their RWAs. Conversely, when economic growth is slowing and loan demand is weakening, the authorities would lower the countercyclical requirement to cushion the impact of such a slowdown. The Countercyclical Capital Buffer acts as an extension of the Capital Conservation Buffer, so if the higher requirements are not fully met, institutions face restrictions on making dividend payments.

A further buffer relating to global systemically important banks (known as G-SIBs) has been proposed by the Basel Committee on Banking Supervision. Under the proposals institutions designated as G-SIBs will face an additional buffer of up to 2.5%.

For more detail on Capital and Buffers under Basel III please see the AFME Briefing Notes on the Definition of Capital and Countercyclical Capital Buffers.
CRD IV Overview

The CRD IV treatment of capital and capital buffers largely follows Basel III, setting the same levels of minimum capital and putting in place both the Capital Conservation Buffer and the Countercyclical Capital Buffer. The G-SIB Buffer is not included in CRD IV.

The European Banking Authority (EBA) has a role to develop technical standards for a number of aspects concerning the definition of capital, including in relation to the CET1 of mutuals and cooperative societies. The EBA is also required to publish a list of the forms of capital instrument in each Member State that qualify as CET1 instruments.

There are a number of differences between the transitional arrangements set out in Basel III and CRD IV. The transitional aspects of CRD IV allow member states to accelerate implementation of CRD IV. While final rules will be met on the same timeline as Basel III, CRD IV provides discretion which means the pace of introduction of the new requirements could vary from country to country.

AFME’s Positions – Capital

Consistency of Treatment of Holding Own Shares*

There are several inconsistencies regarding the treatment of holdings of own shares as compared to holdings of shares in other financial institutions. There seems to be no reason to treat own shares differently from shares of other financial institutions for the purpose of the deductions addressed by CRD IV Regulation (CRR) Art. 33(1)(f) and (h), for example. 1) The limitation that short positions in own shares may only be taken into account for netting purposes if they “involve no counterparty risk” is unfounded. There is no reason to disregard short positions if they entail counterparty risk, as such counterparty risk is already covered in other areas of the regulation. (For example, the short position could be a hedge position that is aiming to convert an existing claim into a senior claim owing to its ranking ahead of the underlying). 2) In addition, netting direct positions in own shares with indirect positions taken through indices should be allowed and this will facilitate consistency in risk management. As an example, an institution which has sold an investment product providing its clients with an exposure on a given stock index will typically hedge itself on the components of the index, including its own shares. In such a situation, the institution will have no net exposure to its own shares. The current wording in the CRR is not clear and could be interpreted as disallowing netting of indirect positions taken through indices against direct positions in own shares.

Significant Investments*

We seek clarity on how CRR Art 42(a) deals with the treatment of ‘relevant entities’, where hedging third-party equity requires a hedge of residual maturity of at least one year. Currently, being long a share and being short the three-month future on the same share will generate a zero market risk position. However, under the proposals, there is a mismatch and therefore the long equity will be taken to the significant investments calculation. We seek confirmation that gross long positions in the CET1 of relevant entities, which by their nature have no maturity, can be netted with short derivative positions and that there should be no maturity restriction for these short positions.

Non-Viability Trigger†

The non-viability trigger referenced in the BCBS press release of 13 January 2011 is only referred to in the CRR Recital 27. Clarification is sought in respect of how this non-viability trigger would work in practice and its consequent impact on the exercise of resolution powers in the crisis management proposals. We advocate that the capital eligibility criteria be completely aligned with the Basel III December 2010 release. AFME believes that the point of non-viability loss absorption mechanism (as required by the Basel 13 January 2011 release) is better dealt with via the statutory EU Crisis Management Directive and not through contractual trigger points.
Loss Absorption of Additional Tier 1 and Tier 2 Instruments*

CRD IV does not distinguish between debt or equity for Additional Tier 1 (AT1) instruments which must both have principal loss absorption (CRR Art. 49(1)(n)), in contrast to the Basel III text which only requires specific loss absorption language for “… instruments classified as liabilities for accounting purposes.” CRR Recital 27 states that all AT1 and Tier 2 (T2) instruments should be fully and permanently written down or converted into CET1 at the point of non-viability of the institution. However, when reading the requirements for AT1 instruments (CRR Art. 49) and T2 instruments (CRR Art. 60) this provision is only mentioned in the requirements for AT1 in CRR Art. 49(n) but not included in CRR Art. 60. The CRD IV text needs to be amended to align with Basel III.

Dividend Blockers/Pushers*

CRD IV proposes that AT1 securities should have no provisions that either compel an issuer to pay the AT1 coupon if an ordinary dividend is paid (“pusher”) or blocks the payment of an ordinary dividend if an AT1 coupon is passed (“blocker”). This is super-equivalent to Basel III which only prohibits dividend pushers. Furthermore, the absence of a constraint on ordinary dividends suggests that AT1 holders could be subordinated in the future when AT1 coupons are blocked but ordinary dividends continue to be paid. This position is contrary to the waterfall principals which underpin investment decisions and should be reviewed.

Tax Deductions from Additional Tier 1 Instruments*

CRR Art. 53(f) requires any foreseeable tax to be deducted from AT1 instruments. Depending on how the tax impacts of any permanent write-down are treated, this may preclude the use of AT1 instruments. Thus, consideration should be given to excluding tax impacts of permanent write downs from CRR Art. 53. Ideally, tax treatment for non-equity capital should be agreed across the EU.

Software deduction from Common Equity Tier 1*

Software is classified as intangible assets under IFRS, whilst classified as tangible assets (PPE) under US GAAP and Swiss GAAP. As result, European institutions will have to deduct software from common equity whilst US and Swiss banks will be exempted from doing so. Taking into account that banking software has a value in case of liquidation, and is a key asset in the development of financial activity, it would be justified to exclude it from the intangible assets that need to be deducted.

Minority interests*

The decisions taken by the Basel Committee in the area of minority interests are of special concern to European banks established with subsidiaries in emerging countries. Computing the excess over the capital regulatory minimum established in the Directive could result in deductions that are not fully justified. Instead, the excess should be considered over the effective local regulatory requirement, including Pillar 2 and potential systemic risk surcharges or any other form of additional required capital. Such an approach would avoid penalising capital placed in subsidiaries following higher requirements by host authorities.

Transitional Provisions*

Compared to Basel III, the CRD IV transitional arrangements allow institutions to either accelerate or decelerate their flight path to the full capital requirements expected by 2019. This is one of the main observed differences between CRD IV and Basel III. The risk is that supervisory authorities could demand an accelerated flight path within their jurisdictions as this is allowed under the CRD IV transitional provisions. Individual country acceleration is likely to be transmitted to other countries due to market and investor pressure.
AFME’s Positions – Capital Buffers

*Permanency of the Countercyclical Capital Buffer*

AFME is concerned that, in reality, Countercyclical Capital Buffers may become permanent features if banks are unwilling, due to market or regulatory pressures, to release capital during an economic downturn.

*Type of Capital used for the Countercyclical Capital Buffer*

AFME queries whether CET1 is the right kind of capital to meet the Countercyclical Capital Buffer requirement. To use a permanent form of capital to meet a requirement that should both rise and fall risks thwarting the objective of the Countercyclical Capital Buffer and perhaps other forms of loss absorbing capital might be considered, including Contingent Capital instruments (CoCos). Additionally, consideration should be given potentially to doing away with this buffer. We would prefer better integration within wider macro-prudential policy, through varying risk weights depending on the prevailing amount of risk within the economy, taking into account views of the ESRB and national financial stability bodies such as the UK FPC.

Further Work at Basel

Basel work is still ongoing in his area and the door is still open on some issues. There should be a mechanism for the CRD IV to take into account any further developments at the Basel level.

* CRD IV and Basel III issue
+ Issue specific to CRD IV

Further information

AFME has broken down positions on the key CRD IV issues in more specific briefing notes:

• Overview of CRD IV
• Leverage
• Counterparty Credit Risk
• Liquidity

See also AFME’s material covering Basel III:

• Overview of Capital Requirements Reform

All of these documents are available on the AFME website

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