

# ALLEN & OVERY



## Capital Requirements Directive IV Framework *Introduction to Regulatory Capital and Liquidity*

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# CRD IV Framework: *Introduction to Regulatory Capital and Liquidity*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV<sup>1</sup> (**CRD IV**) and the Capital Requirements Regulation<sup>2</sup> (**CRR**), replacing the Banking Consolidation Directive<sup>3</sup> and Capital Adequacy Directive.<sup>4</sup> The legislation is highly complex: these briefings are intended to provide a high-level overview of the architecture of the regulatory capital and liquidity framework and to draw attention to the legal issues likely to be relevant to the in-house lawyer.

This briefing is for general guidance only and does not constitute definitive advice.

**NOTE: In relation to the topics discussed in this briefing, CRD IV and the CRR contain a number of discretions for member states in relation to national implementation. The regime may therefore differ across member states in a number of respects. This briefing paper is based on information available as of 17 January 2014.**

## Background and scope

The CRR and CRD IV (together, the **CRD IV Framework**) primarily represent the European Commission's implementation of the revisions to the **Basel Accord** known as **Basel III**. This briefing sets out background to the changes in the regulation of regulatory capital adequacy and introduction of liquidity requirements arising from the implementation of Basel III.

## Sources

CRD IV (*Directive 2013/36/EU*).

CRR (*Regulation 575/2013*).

UK Financial Conduct Authority (**FCA**)  
Policy Statement (*PS13/10*) CRD IV for  
Investment Firms (*December 2013*).

UK Prudential Regulation Authority (**PRA**)  
Policy Statement (*PS7/13*) Strengthening capital  
standards: implementing CRD IV, feedback and  
final rules (*December 2013*).

<sup>1</sup> 2013/36/EU.

<sup>2</sup> Regulation 575/2013.

<sup>3</sup> 2006/48/EU.

<sup>4</sup> 2006/49/EU.

## Background

The Basel Accord is the framework offering standards for establishing minimum capital requirements for internationally active banking organisations prepared by the Basel Committee on Banking Supervision (**BCBS**). Basel III comprises a number of amendments, including the introduction of liquidity standards and a leverage ratio, to the existing framework known as Basel II which is set out in the document: “*International Convergence of Capital Measurements and Capital Standards: a Revised Framework*” (updated November 2005), available at: [www.bis.org](http://www.bis.org)

BCBS published “*Basel III: A global regulatory framework for more resilient banks and banking systems*” in December 2010. The paper was revised in June 2011 and, together with the BCBS’s 13 January 2011 press release entitled “*Basel Committee issues final elements of the reforms to raise the quality of regulatory capital*”, outlines measures – amongst others – to strengthen the quality and quantity of capital and risk coverage provisions of Basel II. Basel III also

introduces liquidity requirements, the leverage ratio, capital buffers and further capital requirements for global systemically important institutions (**G-SIIs**) and other domestic systemically important institutions (**O-SIIs**).

The Basel III rules have been implemented in Europe from the beginning of 2014 (subject to various transitional provisions) by the CRD IV Framework, which recasts and replaces the existing capital requirements regime (2006/48/EC and 2006/49/EC) with a new directive (CRD IV) and a regulation (CRR) – reforming the European rules on capital requirements for credit institutions and investment firms (together, **firms**).

The CRD IV Framework also addresses non-Basel III policy items – for example, changes to remuneration and corporate governance requirements.

The Basel capital framework is founded upon three so-called “pillars”. These are as follows:

PILLAR ONE	PILLAR TWO	PILLAR THREE
<b>Minimum Capital Requirements</b>	<b>Supervisory Review Process</b>	<b>Market Discipline</b>
Pillar One is classical “arithmetical” prudential supervision, involving the allocation of percentage capital requirements for individual asset items.	Pillar Two is the discretionary element of regulation, based on an assessment of the supervisory functions within the institution concerned. Pillar Two in particular looks at the internal control procedures of an institution.	Pillar Three is based on a compulsory disclosure regime, and operates on the principle that if the financial markets are given sufficient information on the position of an institution, then the market price of the risk of that institution would be a useful tool of supervision.

These are now to be supplemented under Basel III with requirements for various capital buffers, which are

summarised below. Basel III also adds quantitative liquidity and leverage requirements.

# How does it all work?

## Regulatory capital

Quantitative regulatory capital under Pillar One has at its core a simple equation: a firm must maintain at all times

financial resources equal to or greater than a percentage of its risk-weighted assets.

## Financial resources

Financial resources constitute (in broad terms) equity or equity-like instruments (including subordinated debt and instruments with features of equity and debt – ie hybrid instruments), which provide a cushion against losses. These contribute to investor protection and financial stability by mitigating the risk and impact of insolvency, and thereby the risk of depositors or other creditors suffering losses. Financial resources are split into two categories – **Tier 1** and **Tier 2** (Tier 3 capital, a feature of Basel II, has been abolished) – depending on their characteristics and quality as capital.

As part of the calculation of financial resources, certain assets or exposures are required to be deducted from the capital items that constitute financial resources – **deductions**.

Basel III makes various reforms to the quality of capital required to qualify as financial resources, the proportion of higher quality capital required, the quantum of capital required as a percentage of risk-weighted assets and the treatment of deductions.

The calculation of financial resources is described in greater detail in Client Briefing 2 (*Capital and Capital Adequacy*).

## Risk weighted assets (RWAs)

Assets or exposures that are not components of, or deducted from, financial resources are risk weighted. For these purposes, assets may fall into the **banking book** (also known as the non-trading book) or the **trading book**. In broad terms the trading book includes assets held with short-term trading intent (or to hedge such assets). Other assets fall within the banking book.

Assets and liabilities may therefore be required to be accounted for in regulatory capital terms in the following ways:

- as a component of, or deduction from, capital; or
- as a risk weighted asset:
  - in the banking book; or
  - in the trading book.

When looking at the possible treatment of an asset or exposure of a regulated entity, the flowchart set out in Annex 1 may be useful.

## Pillar One

### Credit risk – the banking book

The core requirement of Pillar One remains that an institution's capital must exceed 8% of risk-weighted assets. The purpose of risk-weighting is to ensure that the regulatory capital required for any specific asset is in line with the actual risk profile of that asset.

For credit risk, there is a range of three approaches on which non-trading book assets may be risk weighted:

- Standardised approach;
- Foundation Internal Ratings Based approach (**IRB Approach**); or
- Advanced IRB approach.

Each institution is required to adopt one of these three approaches. The IRB approaches are complex and require considerable resource as well as robust systems and controls. In general, only the most significant institutions will have sufficient resource to use the IRB approaches (most major banks are on advanced IRB).

## Credit risk mitigants – collateral, guarantees and credit derivatives

Credit risk mitigants are assets, such as collateral or the benefit of a guarantee, which may be used to mitigate the credit risk associated with an exposure. Basel III introduces certain changes to the assets which qualify as credit risk mitigants and extends opinion requirements applicable to credit risk mitigants (see Client Briefing 5 (*Collateral: Funded Credit Risk Mitigation in the Banking Book*) and Client Briefing 6 (*Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*)).

## Counterparty credit risk

Counterparty credit risk is the risk of counterparty default on transactions involving bilateral credit risk. Basel III enhances credit risk coverage by the addition of a credit valuation adjustment (**CVA**) charge to take account of the risk of mark-to-market losses as a result of the deterioration in credit quality of counterparties under over-the-counter (**OTC**) derivatives, introducing new requirements for risk-weighting exposures to central counterparties, and strengthening requirements on counterparty credit risk and collateral management (see Client Briefing 8 (*Counterparty Credit Risk*), Client Briefing 9 (*Clearing*) and Client Briefing 10 (*Credit Valuation Adjustment (CVA)*)).

## Securitisation

Basel II introduced a new framework for the assessment of risk-weighted assets arising in respect of securitisations and synthetic securitisations – both in the hands of originators and sponsors of such structures (which are required to

ensure that securitisations transfer significant risk in order to recognise off-balance sheet treatment of securitised assets) and in the hands of holders of securitised exposures. These seek to avoid securitisation being used as a means to arbitrage regulatory capital, and to recognise the concentration of credit risk through tranching. Following the financial crisis, the EU has introduced additional prudential requirements for securitisation, including enhanced due diligence and retention ('skin in the game') requirements and additional capital charges for re-securitisations.

## Market risk – the trading book

Market risk rules require capital against items in the trading book by reference to the risk of movements in market price. They establish capital requirements for position risk, counterparty risk and currency risk. Basel III introduces various technical changes to the calculations for capital to be held against such items (see Client Briefing 11 (*Trading Book*)).

## Operational risk

A further area of regulation under Pillar One is quantitative regulation of operational risk. Operational risk (defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk) has not historically been subject to capital adequacy requirements. The Basel Accord sets hard capital requirements for operational risk. Again, there are three approaches that may be taken to the measurement of operational risk capital:

- Basic indicator approach;
- Standardised approach; or
- Advanced measurement approach (**AM approach**).

The basic indicator and standardised approaches use percentages of net income associated with the relevant business as a proxy for operational risk. The AM approach uses more sophisticated means of establishing the operational risk requirement, and again requires significant resource, and robust systems and controls, to implement and maintain.

## Pillar Two

Pillar Two effectively comprises two elements, both of which are retained by Basel III. The first is the requirement for institutions to assess their own capital needs – the individual capital adequacy assessment process (**ICAAP**) – and on regulators to engage actively in the review of

those requirements, systems and controls – the supervisory review evaluation process (**SREP**). The second is the discretion of regulators to impose additional capital requirements on firms following the SREP.

## Pillar Three

Pillar Three constitutes a disclosure regime for institutions. The aim is to provide sufficient transparency for investors so as to ensure that the price which institutions pay to raise capital in the market reflects the level of risk undertaken by them.

The Pillar Three framework is intended to complement bank and investment accounts and is intended to be supplementary to disclosure mandated by accounting standards. The disclosures are not required to be made as part of published financial accounts. In general, disclosures should be made annually.

Pillar Three requires disclosure against a number of separate risk headings, including:

- Scope of regulation
- Capital structure

- Capital adequacy
- Credit risk
- Equities in the non-trading book
- Credit risk mitigation
- Securitisation
- Market risk
- Operational risk
- Interest rate risk in the non-trading book

Basel III introduces the disclosure of certain additional information in respect of capital buffers, unencumbered assets, ‘own funds’, G-SIIs and the leverage ratio (see below).

## Capital buffers

Consistent with Basel III, the CRD IV Framework introduces capital buffers which apply in addition to the Pillar One requirements outlined above and must be met using core equity tier 1 (**CET 1**) capital.

The **capital conservation buffer** requires institutions to hold a buffer of CET 1 capital equal to 2.5% of risk-weighted assets. The buffer aims to limit the ability of institutions to make distributions during periods of stress. When an institution’s holding of CET 1 capital falls below the buffer threshold (7% of risk-weighted assets when aggregated with the Pillar One CET 1 requirements) its ability to make distributions will be limited by incrementally increasing percentages.

The **countercyclical buffer** will be set by the relevant national authority. The relevant national authority may require institutions to hold a buffer of CET 1 capital between 0% and 2.5% of risk-weighted assets – its aim is to require firms to build up a buffer of capital during periods of growth which can be relied upon in downturns. When aggregated with the capital conservation buffer and the Pillar One CET 1 requirements institutions may be required to hold CET 1 capital up to 9.5% of risk-weighted assets. Institutions that fail to meet the countercyclical buffer will be subject to constraints on distribution of earnings.

In addition, member states will have the possibility of introducing a **systemic risk buffer** of additional CET 1 capital for a financial sector, subset of a sector, or systemically important institutions. A further risk buffer will be mandatory for G-SIIs but at the relevant member state's discretion for O-SIIs.

The capital conservation buffer, the countercyclical buffer and the systemic risk G-SIIs buffer will be phased in from 1 January 2016 and fully implemented by 1 January 2019.

Further detail on capital buffers can be found in Client Briefing 14 (*Capital Buffers*).

## Liquidity requirements: the Liquidity Coverage Ratio and Net Stable Funding Ratio

Also implementing Basel III, the CRD IV Framework introduces (from 1 January 2015) the **liquidity coverage ratio (LCR)** to address short term liquidity. The LCR will require institutions to hold a buffer of unencumbered high quality liquid assets (**HQLAs**) to meet net liquidity outflows under a stress scenario lasting 30 days. The objective of the LCR is to ensure that, during a period of idiosyncratic or market wide stress, institutions will be able to use the buffer to cover outflows. The LCR measures the available HQLAs against net cash outflows arising in the 30 day stress scenario period, institutions are expected to maintain an LCR of at least 100%.

The LCR will be phased in with institutions obliged to hold 60% of their LCR in 2015 with incremental increases on a year on year basis until 2018, at which point institutions will be expected to maintain an LCR of at least 100%.

The **net stable funding ratio (NSFR)** addresses long term mismatches and is aimed at incentivising institutions use

stable sources of funding in the long term. The NSFR will measure the amount of stable funding available to a firm against the required amount of stable funding over a period of a year. The required amount of stable funding will be measured on the basis of the broad characteristics of the liquidity risk profiles of an institution's assets, off-balance sheet exposures and other selected activities.

The NSFR is defined as those types and amounts of equity and liability financing that are expected to be reliable sources of funds over a one-year time period under conditions of extended stress.

The European Commission intends to develop the NSFR, with the aim of introducing it from 1 January 2018.

Client Briefing 15 (*Liquidity Requirements*) discusses the liquidity requirements introduced by Basel III in more detail.

## Leverage ratio

The leverage ratio aims to restrict the level of leverage that an institution can take on to ensure that an institution's assets are in line with its capital. It will also act as a safeguard for the existing risk-based capital requirements. The leverage ratio is a non-risk based measure and is defined as an institution's Tier 1 capital divided by its average total consolidated assets (ie non-risk weighted assets and off-balance sheet exposures).

Institutions will be required to disclose their leverage ratio from 1 January 2015. It is proposed that the date for full implementation of the leverage ratio be 1 January 2018, following review by the European Commission from 2016 on whether or not the ratio should be introduced.

Further detail on leverage can be found in Client Briefing 16 (*Leverage Ratio*).

# Structure and implementation

Basel II was implemented in Europe by two directives applicable to firms (broadly, investment banks, brokers, dealers, asset managers and certain other European regulated firms). As discussed above, Basel III has been implemented

in Europe by CRD IV and the CRR, which supersede the Banking Consolidation Directive and Capital Adequacy Directive (2006/48/EC and 2006/49/EC).

## UK implementation

In the UK, the Basel II standards were implemented by a rewrite of the regulatory capital rules applicable to firms which were substantially replaced by the General Prudential sourcebook (**GENPRU**) and the Prudential sourcebook for Banks, Building Societies and Investment Firms (**BIPRU**). GENPRU and BIPRU are largely superseded by the CRR,

which has direct effect from implementation.

Those aspects of the framework provided for under CRD IV (ie the directive) are implemented by a rewrite of the regulatory capital rules of the UK regulatory authorities. The UK PRA and the UK FCA handbooks have been updated separately.

## PRA's approach

As the CRR is directly applicable in all EU member states without the need for implementation by a national legal instrument, the PRA has not transposed the text of the CRR into its rules. Any pre-existing conflicting UK rules have been deleted. The PRA has deleted BIPRU, as this has been substantially replaced by the provisions of the CRR, with the exception of BIPRU 12 (liquidity rules) which has instead been updated. GENPRU, except for GENPRU 3 which contained the capital rules relating to cross-sector groups, has been disapplied by the PRA as this is also covered by the CRR. Where the PRA is entitled to give effect to CRR discretions and derogations, it has done so through specific rules within existing sourcebooks.

The PRA has, however, transposed CRD IV – including provisions relating to remuneration, supervisory powers and capital buffers – into national law as CRD IV is not directly applicable. Some of these new requirements are implemented by way of amendment to existing sourcebooks, for example by amending the Senior Management Arrangements, Systems and Controls sourcebook (**SYSC**) and the Supervision sourcebook (**SUP**) and other new requirements have been implemented by the introduction of new PRA sourcebook chapters.

## FCA's approach

The FCA has introduced the Prudential sourcebook for Investment Firms (**IFPRU**), an entirely new sourcebook which applies to investment firms subject to the full CRD IV requirements. This sourcebook implements and transposes the relevant provisions of CRD IV as well as implementing discretions afforded to the FCA by the CRR. Firms to which IFPRU applies are given the prudential category of an 'IFPRU investment firm' and are no longer subject to GENPRU or BIPRU. The application of BIPRU is limited primarily to 'BIPRU firms' – a new prudential category for

firms that only execute orders and/or manage portfolios, without holding client money or assets.

The FCA has also updated some of the existing sourcebooks (for example SYSC and the Client Assets sourcebook (**CASS**)) much of which involved incorporating or updating cross references to the CRR, CRD IV or using new defined terms on prudential categories.

The transitional provisions in BIPRU TP 15 have been retained for exempt BIPRU commodities firms.

# To whom does this apply?

The Basel framework is directed at internationally active banks. The CRD IV Framework applies the Basel framework more broadly to ‘institutions’ - this includes banks and (broadly) investment firms which deal as principal in securities or derivatives. Other investment firms are subject to elements of the regime.

It should be noted that the CRD IV requirements do not apply to all firms regulated under the Financial Services and Markets Act 2000 (**FSMA**):

- insurers are subject to a separate set of regulatory capital requirements; and
- some classes of firms which fall outside the scope of the Markets in Financial Instruments Directive<sup>4</sup> (**MiFID**) are not subject to the European regulatory capital regime.

In addition, firms which do not deal on own account or take deposits are subject to capital requirements.

## Further reading

Client Briefing 2 (*Capital and Capital Adequacy*)

Client Briefing 3 (*Standardised Approach to Credit Risk in the Banking Book*)

Client Briefing 4 (*Internal Ratings Based Approach to Credit Risk in the Banking Book*)

Client Briefing 5 (*Collateral: Funded Credit Risk Mitigation in the Banking Book*)

Client Briefing 6 (*Unfunded Credit Risk Mitigation in the Banking Book: Guarantees and Credit Derivatives*)

Client Briefing 7 (*The Securitisation Framework*)

Client Briefing 8 (*Counterparty Credit Risk*)

Client Briefing 9 (*Clearing*)

Client Briefing 10 (*Credit Valuation Adjustment (CVA)*)

Client Briefing 11 (*Trading Book*)

Client Briefing 12 (*Large Exposures*)

Client Briefing 13 (*Operational Risk*)

Client Briefing 14 (*Capital Buffers*)

Client Briefing 15 (*Liquidity Requirements*)

Client Briefing 16 (*Leverage Ratio*)

Client Briefing 17 (*European Additions to Basel III*)

Client Briefing 18 (*Glossary*)

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<sup>4</sup>2004/39/EC.

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# Annex 1

## Determining the treatment of an asset/liability for regulatory capital purposes – *a rough guide*



