ALLEN & OVERY

Capital Requirements Directive IV Framework
Capital and Capital Adequacy

Allen & Overy Client Briefing Paper 2 | January 2014

CRD IV Framework: *Capital and Capital Adequacy*

This briefing paper is part of a series of briefings on the implementation of Basel III in Europe via the Capital Requirements Directive IV[1](**CRD IV**) and the Capital Requirements Regulation[2] (**CRR**), replacing the Banking Consolidation Directive[3] and the Capital Adequacy Directive.[4] 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.

[1] 2013/36/EU.
[2] Regulation 575/2013.
[3] 2006/48/EU.
[4] 2006/49/EU.

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 at 17 January 2014.

Background and scope

Capital adequacy provisions protect depositors and other senior creditors of banks and other regulated entities, help to maintain confidence in the financial systems and promote financial stability.

This briefing paper discusses what is meant by 'capital' and 'capital adequacy' in the context of an EU regulated credit institution or investment firm. It also describes the function of subordinated debt securities as part of a bank's capital.

Sources

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

CRR (*Regulation 575/2013*): Part Two (Articles 25-91) and Part Ten (Articles 465-520).

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

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

PRA Supervisory Statement (*SS7/13*) CRD IV and capital (December 2013) (the **PRA Supervisory Statement on CRD IV and Capital**).

PRA Supervisory Statement (*SS8/13*) The Basel I floor (December 2013) (the **PRA Supervisory Statement on the Basel I floor**).

Introduction

Capital adequacy provisions require a bank[5] to maintain minimum levels of capital, calculated as a percentage of its risk weighted assets. In this context, 'capital' refers to a cushion of cash, reserves, equity and subordinated liabilities available to the bank to absorb losses during periods of financial stress.

The cushion may consist of layers (or 'tiers') of capital, with each layer displaying varying degrees of permanence, flexibility of distributions[6] and subordination.

The EU capital adequacy rules recognise two layers of capital – Tier 1 and Tier 2. Tier 1 is further divided into sub-divisions – Common Equity Tier 1 (**CET 1**) and Additional Tier 1 (**AT1**). CET 1 is the highest quality capital (ie most effective at absorbing losses) and Tier 2 comprises lower quality capital.

A summary of the characteristics of AT1 and Tier 2 instruments are set out in Annex 2.

[5] This briefing refers to 'bank' throughout, although CRD IV and CRR do apply to a broader range of credit institutions and investment firms.

[6] The term 'distributions' is used in this briefing as a generic term covering dividends, coupons and analogous periodic payments.

Background

The Basel Committee for Banking Supervision (**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*", is known as **Basel III**. The Basel III rules have been implemented in the EU from the beginning of 2014. As a regulation, CRR will have direct application in each EU member state, whereas CRD IV will need to be transposed into local laws.

The rules relevant to capital, including those setting out the eligibility criteria for Tier 1 and Tier 2 instruments, are primarily contained in CRR. Some of those rules permit a level of national discretion to be exercised – in relation to capital, these largely relate to capital buffers and the items that must be deducted when calculating a bank's capital. In addition, the European Banking Authority (the **EBA**) is tasked with producing a number of regulatory technical standards (**RTS**) which supplement elements of CRD IV and CRR.

Key changes and points to note

Basel III and the CRD IV framework have made significant changes to the requirements as to the quality and quantum of capital, and also to the international consistency of the treatment of deductions from capital. Key changes include:

- changes to the definition of capital, with a tightening of the eligibility requirements for items to be included as regulatory capital, and the abolition of Tier 3 capital;
- an increase in the overall amount of capital required to be held by institutions, to include various capital 'buffer' requirements;
- changes to the required composition of the capital base, placing an increasing emphasis on CET 1 capital - the highest quality regulatory capital;
- harmonisation of so-called 'prudential filters' (specific treatment of items which varies from their accounting treatment);
- harmonisation and widening of the items required to be deducted from the capital base, and changes to the way in which capital is deducted (again to place more emphasis on CET 1 capital);
- changes to the consolidated treatment of capital raised by subsidiaries; and
- changes to the amount of information institutions are required to report under Pillar Three.

To smooth the impact of the changes on institutions' regulatory capital balance sheets, the requirements are subject to various transitional provisions.

Key characteristics of capital

Cash and reserves are among the highest quality capital of a bank, since the bank has no payment obligations in respect of those assets and they can be used to absorb losses. Capital securities (ie equity capital and certain types of preferred share and subordinated debt) may also qualify for inclusion in the bank's capital provided they display sufficient degrees of permanence, flexibility of distributions and subordination.

The characteristics of permanence (no obligation on the bank to redeem) and flexibility of distributions (having discretion as to whether to pay distributions) act to absorb losses on a going concern basis by reducing, suspending or cancelling mandatory redemption or distribution payments during periods of financial stress. Subordination protects depositors and other senior creditors on a winding-up since the claims of the holders of deeper subordinated securities are exhausted before more senior instruments are affected.

On the basis of the foregoing, it comes as no surprise that ordinary shares are the highest quality capital securities in a bank's arsenal: the bank has no redemption obligation, dividends are discretionary and non-cumulative, and on a winding-up ordinary shareholders are subordinated to all creditors of the bank. Compare a conventional senior debt instrument, which will usually have a maturity date, mandatory interest payments (with failure to pay triggering default and acceleration) and will rank only behind secured creditors on a winding-up.

However, ordinary shares are dilutive (both in terms of control and participation in surplus assets on a winding-up), and dividends are not ordinarily tax deductible. Hybrid securities[7] are structured so as to qualify as capital without diluting control and, in some jurisdictions, whilst achieving deductibility for tax purposes. They also attract different capital market participants, widening the funding base for the bank.

As a general rule, the more like an ordinary share the hybrid security behaves, the higher it would be expected to fall within the capital layers, as shown in *Features of capital in each tier* below.

[7] The term 'hybrid security' is used in this briefing to describe a form of subordinated debt which is structured to have some equity-like features.

Capital structure

Under the CRD IV framework, a bank must maintain minimum levels of capital calculated by reference to its risk-weighted assets (**RWA**):[8]

- total capital of at least 8% of RWA;
- Tier 1 capital of at least 6% of RWA;[9] and
- CET 1 capital of at least 4.5% of RWA.[10]

Further, banks will be required to hold additional CET 1 capital to meet new capital buffer requirements. Banks will be required to hold 2.5% of RWA in CET 1 capital to meet a new capital conservation buffer requirement, and, further, up to 2.5% of RWA in CET 1 capital to meet a countercyclical buffer requirement.[11] In addition, banks which are considered to be systemically important banks, either globally (known as **G-SIIs**) or domestically (known as **D-SIIs**) may be required to meet even higher CET 1 levels.

In practice, banks aim (and are usually required by their regulator) to be better capitalised than the minimum.

Annex 1 shows diagrammatically the minimum capital of a bank in compliance with CRR and CRD IV, over the implementation period.

[8] For risk weighting of assets, see Client Briefing 3 (*Standardised Approach to Credit Risk in the Banking Book*) and Client Briefing 4 (*Internal Ratings Based Approach to Credit Risk in the Banking Book*).
[9] Under transitional provisions, only 5.5% will be required until 2015.
[10] Under transitional provisions, only 4% will be required until 2015.
[11] For capital buffers, see Client Briefing 14 (*Capital Buffers*).

Features of capital in each tier

The following sets out the key features of each tier of capital.

Tier 1

Tier 1 consists of the highest quality capital, displaying permanence, deep subordination and discretionary and mandatory cancellation of distributions.

Tier 1 can be sub-divided into CET 1 and AT1.

Common Equity Tier 1

CET 1 principally comprises ordinary shares, retained earnings and certain reserves. There are no redemption costs or mandatory payments on these instruments/reserves. On a winding-up, ordinary shareholders can claim only for surplus assets once the bank's depositors and other creditors have been paid in full.

Additional Tier 1

AT1 consists of instruments that are perpetual (in that there is no fixed maturity). These instruments may contain a call option, exercisable at the sole discretion of the bank, and only with regulatory approval, no earlier than the fifth anniversary of the issue date. The call must not be coupled with an incentive to redeem (for example, a coupon step-up). Distributions can be cancelled at the bank's discretion and are non-cumulative.

All AT1 instruments must either convert into ordinary shares or have their principal amount written down (on either a permanent or temporary basis) if the ratio of the bank's CET 1 to its total RWA falls below 5.125%.[12]

Events of default are limited to non-payment of an amount due and a winding-up of the bank, with the only remedies afforded to the investor being (in the case of non-payment) petitioning for the winding-up of the bank and (in the case of a winding-up of the bank) claiming in the winding-up. The claims of AT1 instruments will rank above ordinary shareholders on a winding-up but will be subordinated to the claims of holders of Tier 2 instruments, senior creditors and depositors.

Tier 2

Tier 2 under Basel III consists of hybrid instruments with a maturity of not less than five years. They will tend to have a longer maturity, however, as regulatory amortisation will apply in the final five years to maturity. They carry a cumulative cost to the bank, with distributions able to be structured as non-deferrable and cumulative. Tier 2 securities are typically in bond format but could be in loan form or issued (in some member states) as a preference share.

The issuer may call the instrument after five years from its issue date, in its sole discretion and with regulatory consent, but there can be no incentives (such as a coupon step-up) for the issuer to redeem.

The capital treatment of the instruments will progressively decay over the last five years of their life (known as **regulatory amortisation**).[13]

Events of default are limited to non-payment of an amount due and a winding-up of the bank, with the only remedies afforded to the investor being (in the case of non-payment) petitioning for the winding-up of the bank and (in the case of a winding-up of the bank) claiming in the winding-up. On a winding-up, claims of the holders of Tier 2 instruments rank above claims in respect of Tier 1 securities.

[12] Under Basel III, all Additional Tier 1 and Tier 2 instruments will also be written-down or converted into ordinary shares at a point of non-viability of the bank. This requirement has not been implemented as a capital eligibility requirement in the CRR and is expected to instead be reflected in the European legislation implementing proposals in relation to bank recovery and resolution (known as the Bank Recovery and Resolution Directive or **BRRD**). Under the BRRD, it is expected that relevant authorities will be given power (from 1 January 2015) to write-down or convert Additional Tier 1 or Tier 2 capital, despite no write-down or conversion provisions being included in the actual terms of the Additional Tier 1 or Tier 2 instrument.

[13] The amount of the instrument eligible for Tier 2 capital treatment is amortised on a straight-line basis over the final five years. If "T" is maturity, then at T-5: 100% of the instrument is eligible for inclusion; at T-4: 80%; at T-3: 60%; at T-2: 40%; and at T-1: 20%.

Deductions from capital

A number of deductions are applied in calculating a bank's levels of regulatory capital. In most cases, these deductions are applied in the calculation of total CET 1. Deductions are made on account of:

– goodwill and other intangibles (excluding mortgage servicing rights);

– deferred tax assets that rely on future profitability of the bank to be realised;

– the amount of the cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet;

– a shortfall of the stock of provisions to expected losses;

– gains on sales related to securitisation transactions;

– cumulative gains and losses due to changes in own credit risk on fair valued financial liabilities;

– defined benefit pension fund liabilities;

– investments in own shares (treasury stock); and

– certain investments in other financial institutions.

EBA technical standards

The EBA is tasked with producing regulatory technical standards (**RTS**) in relation to certain aspects of the CRR provisions relevant to capital adequacy, as set out below:

CRR SOURCE	TECHNICAL STANDARDS/REPORTS REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
Articles 26(4) (*Common Equity Tier 1 items*), 28(5) (*Common Equity Tier 1 instruments*), 29(6) (*Capital instruments issued by mutual, cooperative societies, savings institutions and similar institutions*), 36(2) (*Deductions from Common Equity Tier 1 items*), 41(2) (*Deduction of defined benefit pension fund assets*), 52(2) (*Additional Tier 1 instruments*), 76(4) (*Index holdings of capital instruments*), 78(5) (*Supervisory permission for reducing own funds*), 79(2) (*Temporary waiver from deduction from own funds*), 83(2) (*Qualifying Additional Tier 1 and Tier 2 capital issued by a special purpose entity*), 481(6) (*Additional filters and deductions*) and 487(3) (*Items excluded from grandfathering in Common Equity Tier 1 or Additional Tier 1 items in other elements of own funds*)	RTS on: – CET 1 capital: foreseeable charges or dividends, features of capital instruments of mutual and similar institutions, indirect funding, limitations on redemption; – AT1 capital: form and nature of incentives to redeem, conversion and write-down/write-up of principal, special purpose entities; – Deductions; – Indirect holdings arising from index holdings, supervisory permission for reducing own funds; and – Transitional provisions for own funds.	28 July 2013.	Consultation on draft regulatory technical standards on own funds – Part one (April 2012) (EBA/CP/2012/02). Final draft regulatory technical standards on own funds (Part 1) (July 2013) (EBA/RTS/2013/01). Commission delegated regulation with regard to regulatory technical standards for own funds requirements for institutions (January 2014).
Article 27(2) (*Capital instruments of mutual, cooperative societies, savings institutions or similar institutions in Common Equity Tier 1 items*)	RTS on conditions for determining qualification as a mutual, cooperative society, savings institution or similar institution.	28 July 2013.	Consultation on draft regulatory technical standards on own funds under the draft Capital Requirements Regulation - Part Two (November 2012) (EBA/CP/2012/11). Final draft regulatory technical standards (RTS) on own funds (Part 2) (July 2013) (EBA/RTS/2013/02).

CRR SOURCE	TECHNICAL STANDARDS/REPORTS REQUIRED	DEADLINE FOR SUBMISSION TO THE EUROPEAN COMMISSION	EBA PUBLICATIONS
			Commission delegated regulation with regard to regulatory technical standards for own funds requirements for institutions (January 2014).
Article 28(5) (*Common Equity Tier 1 instruments*)	RTS on multiple distributions for own funds.	1 April 2014 (see EBA-European Commission Agreement).[14]	Consultation on draft regulatory technical standards on own funds – Part One (April 2012) *(EBA/CP/2012/02)*. Final draft regulatory technical standards on own funds [Part 1] under the Capital Requirements Regulation (July 2013) *(EBA/RTS/2013/01)*. Consultation on draft regulatory technical standards on own funds – multiple dividends and differentiated distributions (Part 4) under the Capital Requirements Regulation (November 2013) *(EBA/CP/2013/43)*.
Article 36(2) (*Deductions from Common Equity Tier 1 items*), Article 73(7) (*Distributions on own funds instruments*) and Article 84(4) (*Minority interests included in consolidated Common Equity Tier I capital*)	RTS on specific deductions from own funds, broad market indices for own funds and calculation of minority interests for own funds.	1 January 2014 (see EBA-European Commission Agreement).[15]	Consultation on draft regulatory technical standards on own funds – Part one (April 2012) *(EBA/CP/2012/02)*. Consultation on draft regulatory technical standards on own funds under Articles 33(2), 69a(6) and 79(3) of the Capital Requirements Regulation (May 2013) *(EBA/CP/2013/17)*. Final draft regulatory technical standards on own funds (Part 1) under the Capital Requirements Regulation (July 2013) *(EBA/RTS/2013/01)*. Final draft regulatory technical standards on own funds [Part 3] as per Articles 36(2), 73(7) and 84(4) of Regulation (EU) No 575/2013 (December 2013) (*EBA/RTS/2013/09*).

[14] http://www.eba.europa.eu/-/revised-deadlines-for-the-delivery-of-eba-technical-standards.
[15] http://www.eba.europa.eu/-/revised-deadlines-for-the-delivery-of-eba-technical-standards.

National discretions and UK implementation

The CRR provides competent authorities with certain discretions:

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
Article 27 (*Capital instruments of mutuals, cooperative societies, savings institutions or similar institutions in Common Equity Tier 1 items*)	Competent authorities may determine that a type of undertaking qualifies as a mutual, cooperative society, savings institution or similar institution for the purposes of Part Two.	
Article 36 *(Deductions from Common Equity Tier 1 items)*	A competent authority may set out what it considers to constitute direct, indirect or synthetic holdings which have been designed to inflate the own funds of the institution.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See TP4 (Deductions from own funds) at 4.4, 4.5, 4.6 and 4.7 and Annex 2 (Table with transitional provisions on capital) to the FCA Policy Statement. In respect of PRA authorised firms, see PRA Rulebook Annex C (Definition of Capital) at 11.6, 11.7 and 11.8.
Article 49 (*Requirement for deduction where consolidation, supplementary supervision or institutional protection schemes are applied*)	A competent authority may give permission to a firm not to deduct certain holdings of own funds instruments of financial sector entities for the purposes of calculating own funds on an individual or consolidated basis.	In respect of FCA authorised firms, the FCA has indicated it does not intend to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). In respect of PRA authorised firms, see paragraph 7 (Significant insurance holdings) of the PRA Supervisory Statement on CRD IV and Capital and the PRA Policy Statement at paragraph 6 (Definition of capital).
Article 73 *(Distributions on own funds instruments*)	A competent authority may allow capital instruments for which an institution has the sole discretion to decide to pay distributions in a form other than cash or an own funds instrument to qualify as Common Equity Tier 1, Additional Tier 1 or Tier 2 instruments, provided that the conditions set out in Article 73(2) are met.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)).
Article 76 (*Index holdings of capital instruments*)	A competent authority may give a direction to a firm to allow it to use a conservative estimate of the underlying exposure of the firm to capital instruments included in indices as an alternative to the firm's calculating its exposure to its own or financial sector entities' CET 1, AT1 and T2 instruments included in such indices.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)).

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
	The competent authority may only give this direction where the firm has demonstrated that it is "operationally burdensome" to monitor such underlying exposure.	
Article 79 (*Temporary waiver from deduction from own funds*)	Where an institution holds regulatory capital instruments and subordinated loans in a financial sector entity temporarily, a competent authority may waive on a temporary basis the provisions on deduction that would otherwise apply to those instruments should those holdings be for the purposes of a financial assistance operation designed to reorganise and save that entity.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)).
Article 83 (*Qualifying Additional Tier 1 and Tier 2 capital issued by a special purpose entity*)	Where the competent authority considers the assets of a special purpose entity other than its investment in the own funds of the parent undertaking or a subsidiary thereof that is included in the scope of consolidation pursuant to Chapter 2 of Title II of Part One, to be minimal and insignificant for such an entity, the competent authority may nevertheless allow Additional Tier 1 and Tier 2 instruments issued by that special purpose entity to qualify in the firm's own funds.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)).
Article 84 *(Minority interests included in consolidated Common Equity Tier 1 capital)*	A competent authority may waive the application of this article to a 'parent mixed financial holding company' that satisfies a number of conditions thereto.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). In respect of PRA authorised firms, see PRA Rulebook Annex C (Definition of Capital) at 11.12.
Article 89 *(Risk weighting and prohibition of qualifying holdings outside the financial sector*)	A competent authority must choose to either apply a 1,250% risk weight or to prohibit qualifying holdings outside the financial sector.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See IFPRU 3.2. In respect of PRA authorised firms, the PRA will apply a 1,250% risk weight. See PRA Rulebook Annex C (Definition of Capital) at 3.1.
Article 467 *(Unrealised losses measured at fair value)*	A competent authority must determine the percentage of unrealised losses related to assets or liabilities measured at fair value that an institution can deduct from CET 1 for each year up to the end of 2017.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See TP3 (Gains and losses) at 3.4 (Inclusion of unrealised losses at fair value) and the response to Q11 (on page 17) in the FCA Policy Statement. In respect of PRA authorised firms, the PRA has determined this percentage to be 100% in each year. See PRA Rulebook Annex C (Definition of Capital) at paragraph 11.3 and the PRA Policy Statement at paragraph 6 (Definition of capital).

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
Article 468 *(Unrealised gains measured at fair value)*	A competent authority must determine the percentage of unrealised gains measured at fair value that institutions can deduct from CET 1 for each year up to the end of 2017.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See TP3 (Gains and losses) at 3.5 (Removal of unrealised gains at fair value) and the response to Q11 (on page 18) in the FCA Policy Statement. In respect of PRA authorised firms, the PRA has determined this percentage to be zero in each year. See PRA Rulebook Annex C (Definition of Capital) at 11.4 and 11.5 and the PRA Policy Statement at paragraph 6 (Definition of capital).
Article 471 *(Exemption from Deduction of Equity Holdings in Insurance Companies from Common Equity Tier 1 Items)*	Competent authorities may permit institutions to not deduct equity holdings in insurance companies from CET 1 in the period up to 31 December 2022 if certain conditions are met.	
Article 473 *(Introduction of amendments to IAS 19)*	Competent authorities may permit institutions preparing accounts in conformity with IAS19 certain adjustments to CET 1.	
Article 479 *(Recognition in consolidated Common Equity Tier 1 capital of instruments and items that do not qualify as minority interests)*	Competent authorities shall determine the percentage of items that do not qualify as minority interests that can be included in CET 1 for each year up to the end of 2017.	In respect of FCA authorised firms, the FCA has indicated it intends to exercise this discretion (see Annex 3 (List of national discretions and FCA's approach to their application) to CP 13/6 CRD IV for Investment Firms (July 2013)). See TP5 (Own funds: other transitionals) at 5.4 (Recognition of instruments and items not qualifying as minority interests). In respect of PRA authorised firms, the PRA will not permit any items (ie a zero percentage) that do not qualify as minority interests to be included in CET 1. See PRA Rulebook Annex C (Definition of Capital) at 11.11.
Article 481 (Additional filters and deductions)	During the period from 1 January 2014 to 31 December 2014, competent authorities may require or permit institutions to apply the methods referred to in Article 49(1) where the requirements laid down in points (b) and (e) of Article 49(1) are not met, rather than the deduction required pursuant to Article 36(1). In such cases, the proportion of holdings of the own funds instruments of a financial sector entity in which the parent undertaking has a significant investment that is not required to be deducted in accordance with Article 49(1) shall be determined by a percentage determined by the competent authority. The amount that is not deducted shall be subject to the requirements of Article 49(4), as applicable.	In respect of FCA authorised firms, see TP5 (Own funds: other transitionals) at 5.6 (Additional filters and deductions) and the response to Q11 (on page 17) in the FCA Policy Statement. In respect of PRA authorised firms, the PRA will require a 100% deduction of holdings of own funds instruments of a financial sector entity in which the parent undertaking has a significant investment. See PRA Rulebook Annex C (Definition of Capital) at 11.14.
Article 486 *(Limits for grandfathering of items within Common Equity*	Competent authorities shall determine the percentage of CET 1, AT1 and T2 items that may be grandfathered in each year up	In respect of FCA authorised firms, see TP5 (Own funds: other transitionals) at 5.7 (Limits on grandfathering).

CRR SOURCE	NATURE OF DISCRETION	FCA/PRA APPROACH
Tier 1, Additional Tier 1 and Tier 2 items)	to the end of 2021.	In respect of PRA authorised firms, the PRA will adopt the maximum percentages permitted for these purposes. See PRA Rulebook Annex C (Definition of Capital) at 11.15.
Article 493 *(Transitional provisions for large exposures)*	Competent authorities may fully or partially exempt certain exposures from the application of Article 395(1) until 31 December 2028.	See IFPRU and IPRU(INV).
Article 495 *(Treatment of equity exposures under the IRB Approach)*	Until 31 December 2017, competent authorities may exempt from the IRB treatment certain categories of equity exposures held by institutions and EU subsidiaries of institutions in that Member State as at 31 December 2007.	In respect of PRA authorised firms, the PRA does not intend to exercise this discretion (see PRA CP5/13 Strengthening capital standards: implementing CRD IV (August 2013) at paragraph 7.28).
Article 496 *(Own funds requirements for covered bonds)*	Until 31 December 2017, competent authorities may waive in full or in part the 10 % limit for senior units issued by French *Fonds Communs de Créances* or by securitisation entities which are equivalent to French *Fonds Communs de Créances* laid down in points (d) and (e) of Article 129(1), provided that certain conditions are fulfilled.	In respect of PRA authorised firms, the PRA does not intend to exercise this discretion (see PRA CP5/13 Strengthening capital standards: implementing CRD IV (August 2013) at paragraph 7.14).
Article 499 *(Leverage)*	During the period from 1 January 2014 to 31 December 2017, competent authorities may permit institutions to calculate the end-of-quarter leverage ratio where they consider that institutions may not have data of sufficiently good quality to calculate a leverage ratio that is an arithmetic mean of the monthly leverage ratios over a quarter.	In respect of FCA authorised firms, see TP6 (Leverage). In respect of PRA authorised firms, see the PRA Policy Statement at paragraph 14 (Reporting and disclosure) at 14.9 (Leverage).
Article 500 *(Transitional provisions – Basel I floor)*	The competent authorities may permit the amount referred to in point (b) of paragraph 1 to be replaced by a requirement to hold own funds which are at all times more than or equal to 80% of the own funds that the institution would be required to hold under Article 92 calculating risk weighted exposure amounts in accordance with Part Three, Title II, Chapter 2, and Part Three, Title III, Chapter 2 or 3, as applicable, instead of in accordance with Part Three, Title II, Chapter 3, or Part Three, Title III, Chapter 4, as applicable. The competent authorities may, after having consulted EBA, waive the application of point (b) of paragraph 1 to institutions provided that all the requirements for the Internal Ratings Based Approach set out in Part Three, Title II, Chapter 3, Section 6 or the qualifying criteria for the use of the Advanced Measurement Approach set out in Part Three, Title III, Chapter 4, as applicable, are met.	The FCA does not expect that it will waive the application of the Basel 1 floor as contemplated in Article 500(2) of the EU CRR. See IFPRU at 3.3 (Basel I floor). See the PRA Supervisory Statement on the Basel I floor. The PRA does not expect that it will waive the application of the Basel 1 floor in accordance with Article 500(5).

Further reading

Client Briefing 1 (*Introduction to Regulatory Capital and Liquidity*)

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 14 (*Capital Buffers*)

Contacts

Kate Sumpter
Partner
Tel +44 20 3088 2054
kate.sumpter@allenovery.com

Etay Katz
Partner
Tel +44 20 3088 3823
etay.katz@allenovery.com

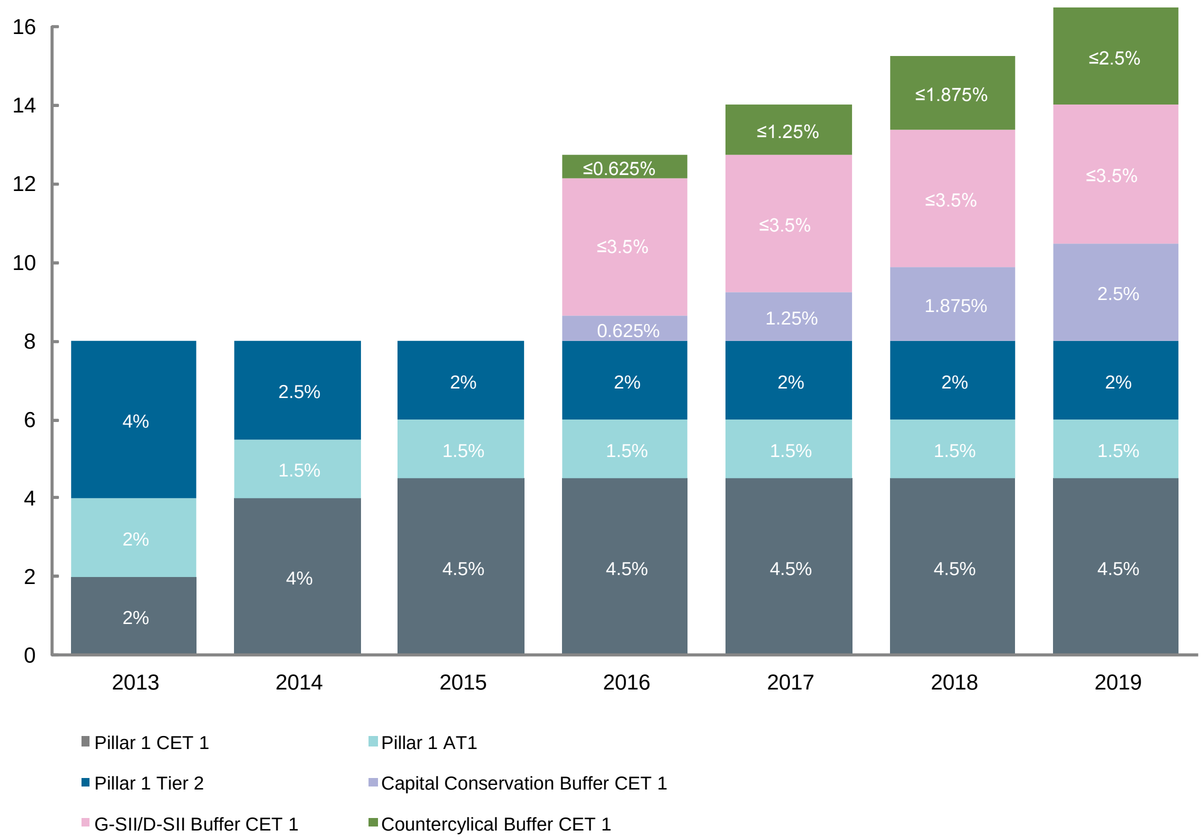
Damian Carolan
Partner
Tel +44 20 3088 2495
damian.carolan@allenovery.com

Stephen Miller
Partner
Tel +44 20 3088 2815
stephen.miller@allenovery.com

Abigail Boyd
Counsel
Tel +44 20 3088 3238
abigail.boyd@allenovery.com

Annex 1

Capital Structure of a bank under CRD IV and CRR[16]



[16] Note that the authorities in an individual jurisdiction may seek to impose capital requirements in addition to these CRD IV/CRR *minima* (known as "Pillar Two capital requirements").

Annex 2

Comparison of features of Additional Tier 1 and Tier 2 instruments

	Additional Tier 1	Tier 2
Coupon	– Discretionary – Non-cumulative	– Mandatory – Cumulative
Maturity	– Perpetual – First issuer call: – ≥ 5 years – with regulatory approval – no incentive to redeem	– Minimum 5 years – First issuer call: – ≥ 5 years – with regulatory approval – no incentive to redeem
Early calls (prior to 5 years)	– Change in tax treatment – Change in regulatory treatment – Only with regulatory approval	– Change in tax treatment – Change in regulatory treatment – Only with regulatory approval
Ranking	– Above ordinary shares – Below Tier 2 – Not a liability for insolvency test	– Above Tier 1 – Below depositors and senior creditors
Events of default	– Non-payment (only if due) – Winding-up	– Non-payment – Winding-up
Regulatory amortisation	– N/A	– 20% reduction in capital recognition in each of 5 final years to maturity
Loss absorption	– Write-down (permanent or temporary) or conversion into ordinary shares – Trigger: below 5.125% CET 1	– N/A

FOR MORE INFORMATION, PLEASE CONTACT:

London

Allen & Overy LLP
One Bishops Square
London
E1 6AD
United Kingdom

Tel +44 20 3088 0000
Fax +44 20 3088 0088

GLOBAL PRESENCE

Allen & Overy is an international legal practice with approximately 5,150 people, including some 525 partners, working in 43 offices worldwide. Allen & Overy LLP or an affiliated undertaking has an office in each of:

Abu Dhabi
Amsterdam
Antwerp
Athens (representative office)
Bangkok
Beijing
Belfast
Bratislava
Brussels
Bucharest (associated office)
Budapest
Casablanca
Doha
Dubai
Düsseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Istanbul
Jakarta (associated office)
London
Luxembourg
Madrid
Mannheim
Milan
Moscow
Munich
New York
Paris
Perth
Prague
Riyadh (associated office)
Rome
São Paulo
Shanghai
Singapore
Sydney
Tokyo
Warsaw
Washington, D.C.
Yangon

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. The term **partner** is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings.