CRD 4: Introduction of New Regulatory Requirements for the Quality of Tier 1 and 2 Capital

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The Basel 3 framework is intended to increase the resilience of the banking sector, amongst others by strengthening the quality and quantity of regulatory capital. In the European Union the proposed Capital Requirements Directive and Capital Requirements Regulation (referred to as "CRD 4" and "CRR 4", respectively) will implement the Basel 3 requirements from 1 January 2013. The combined CRD/CRR 4 proposal also provides a mandate to the European Banking Authority ("EBA") to develop binding Regulatory Technical Standards ("RTS") relating to the quality of Tier 1 and 2 capital, also known as the regulatory capital base (hereafter referred to as "own funds").

On 4 April 2012, the EBA published a consultation paper relating to regulatory requirements for own funds ("CP12/02"). CP12/02 details proposed requirements covering Common Equity Tier 1 capital ("CET1"), Additional Tier 1 capital, deductions from CET1 and own funds generally.

Background

CRD 4 will introduce Basel 3 within the EU, as well as a significant number of other changes to European banking regulation, aimed at achieving greater harmonisation across the EU.

Amongst other requirements, CRD 4 will raise both the quality and quantity of own funds. The new regulatory requirements on own funds, applicable to credit institutions and investment firms, shall be effective from 1st January 2013, subject to some transitional arrangements (grandfathering).

CP12/02 provides further clarification for both institutions and competent authorities regarding CRD 4 regulatory requirements relating to the quality of own funds. Besides this it also adresses specific questions to industry stakeholders. EBA intends to publish a further consultation paper in the second half of 2012, which will address a number of CRD 4 own funds requirements not covered by CP12/02.

Some of the Main Features of the New Regulatory Requirements on Own Funds

Dividends deducted from profits within CET1 – meaning of 'foreseeable'

Dividends are required to be deducted from profits included in CET1 and own funds. CP12/02 (Article 24(2) of the CRR) provides a uniform approach on the application of 'foreseeable' when determining dividends to be deducted from profits, as follows:

- Where an institution's management body has formally proposed the dividend distribution, this amount shall serve as the dividend deduction.
- Prior to proposal of dividend distribution, the dividend deduction shall be calculated as the amount of interim or year-end profits multiplied by dividend payout ratio.

The dividend payout ratio is determined according to the institution's dividend policy. In the absence of a dividend policy, the dividend payout ratio is based on the highest of the following:

- average of preceding three years dividend payout ratios; and
- preceding years dividend payout ratio.

As a result, institutions without a formal dividend policy may wish to consider the implications of the new proposals on their anticipated own funds, as well as consider the benefits of introducing a formal dividend policy to prevent swings in their capital base and maintain investors confidence.

Capital instruments of mutuals and cooperative societies recognised within CET1

Mutuals and cooperative societies are usually required to make distributions to instrument holders even in periods of severe market stress, casting doubt on their going concern status and therefore implying that such instruments are not loss absorbent. CP12/02 and

Article 25 of the CRR set out that where a capital instrument includes a cap on maximum distributions, such instrument is considered fully loss absorbent and included within CET1.

In addition, the abilities of mutuals and cooperative societies to limit, defer or even refuse redemptions of own funds instruments may be prohibited under applicable national law. Article 27(6) of the CRR states that the provisions governing the instruments which allow limitations/refusals shall override such prohibitions, therefore allowing instruments to be included within CET1. Note that the extent of such limitations is determined based on "the overall financial, liquidity and solvency situation of the institution."

Additional Tier 1 capital elements

CP12/02 contains several proposals aimed at increasing loss absorbency features of, and introducing uniform approaches for, Additional Tier 1 capital (Article 49(2) of the CRR). The main proposals are as follows:

- Form and nature of incentives to redeem – guidance on an instrument's features that provide an expectation that such instrument is likely to be redeemed (e.g., call option combined with investor option to convert to CET1, if the call is not exercised).
- Conversion or write-down of principal amounts – requirements to ensure the timely activation of loss absorbency mechanisms for hybrid instruments, when the CET1 ratio falls below minimum required level.
- Use of special purpose entities for indirect issuance of own funds instruments – requirement that capital instrument must not receive recognition as capital of a higher quality than the lowest quality of the capital issued to the special purpose entity and the capital issued to third parties by that special purpose entity.

Deductions from CET1 and own funds in general

CP12/02 contains proposals for uniform approaches concerning the following deductions from own funds (Article 33(2) of the CRR):

- Capital instruments of financial institutions – deductions for holdings of capital instruments of financial institutions, including subordinated instruments, with some exceptions.
- Losses of current year – deduction for losses to be recognised according to financial report if finalised; if not, to be determined as the net figure once income and expenses are "prudently estimated".
- Deferred tax assets ("DTA") – DTA deducted from CET1 that rely on future profitability can be reduced by the amount of associated deferred tax liabilities
- Defined benefit pension fund assets – deduction for such assets can be reduced where there is "immediate and unfettered access" to the assets.

Supervisory consent for reducing own funds

CP12/02 (Article 73(3) of the CRR) provides that institutions wishing to reduce own funds (via redemptions, reductions, or repurchases) must apply for the consent of the relevant regulatory body prior to announcing to instrument holders.

Conclusion

Based on the draft CRD/CRR 4 and the technical requirements in CP12/02, it is clear that regulatory capital requirements will be more stringent under CRD and CRR 4. We recommend that firms evaluate the impact of the regulatory changes with regards to their capital base and assess the proposed technical standards in particular. CP 12 is open for consultation until 4 July 2012.

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