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CRD IV: a package of reforms

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What is CRD IV?

CRD IV is a package of reforms for prudential requirements introduced by the EU for credit institutions and investment firms. It will replace the current CRD directives with one regulation and one directive: the Capital Requirements Regulation (CRR) and the Capital Requirements Directive IV (CRD IV Directive).
The role of CRD IV is to implement the main Basel III reforms in the EU with the aim of addressing weaknesses that became apparent during the financial crisis of 2007/8 and to reduce the likelihood of a future financial crisis.

The Basel III reforms were finalised by the members of the Basel Committee on Banking Supervision in December 2010 and included measures concerning the quality and quantity of capital, capital buffers, counterpart credit risk, and new leverage and liquidity ratios.

Implementation will come in phases, aiming for full implementation of the key reforms by 1 January 2019.

CRD IV will apply directly to credit institutions and firms that fall within the scope of MiFID. The provisions currently set out in the CAD that specifically apply to prudential standards for investment firms will be included in the CRR, together with the prudential standards for credit institutions.

The CRR

As it is a regulation, the CRR will be directly applicable and take effect in all EU member states without any further action by member states. It includes provisions which relate to:

- the definition of regulatory capital
- capital requirements
- disclosures made by firms under Pillar 3
- transitional provisions
- quality of capital
- quantity of capital
- counterparty credit risk (CCR)
- credit valuation adjustment (CVA) risk
- leverage
- liquidity
- disclosures

The CRD IV Directive

As a directive, member states must transpose the CRD IV Directive into national legislation and regulation. It contains provisions on issues where the degree of prescription is lower and these include:

- authorisation of credit institutions
- passporting rights for credit institutions
- prudential supervision
- corporate governance
- sanctions
- certain remuneration provisions

What are the main provisions of CRD IV?

The main provisions of CRD IV include the following matters:

Capital:
the criteria to be recognised as regulatory capital will be tightened and common equity will be the main component of their Tier 1 capital, and its definition clarified. Tier 3 capital will be abolished. In addition, the minimum ratios for common equity and Tier 1 capital will change, being increased to 4.5% and 6% respectively with the minimum capital ratio remaining at 8%;

Buffers:
two capital buffers will be introduced and these will be additional to the increased common equity and Tier 1 capital ratios. These will be:
(i) the capital conservation buffer, which will comprise 2.5% of risk-weighted assets and consist of common equity; and (ii) the countercyclical capital buffer which will also consist of common equity and which national authorities may at their discretion determine, up to 2.5%;

CRR:
capital requirements for counterparty credit risk (CRR) exposures arising from banks' derivatives, repo and security finance activities will be increased and use of central counterparties encouraged;

Leverage ratio:
This is likely to be the ratio of Tier 1 capital to total non-weighted assets and off-balance sheet exposures.;

Liquidity requirements:
two new liquidity ratios are anticipated (liquidity coverage ratio and the net stable funding ratio) with the aim of encouraging banks to hold higher levels of unencumbered, high-quality liquid assets;

Remuneration:
a 1:1 ratio will be imposed on salary relative to variable pay for certain bankers, though on shareholder approval this could rise to 1:2. Rules on the disclosure of the number of individuals with a total remuneration over a certain threshold will also be introduced;

Rulebook:
a single set of harmonised prudential rules will be produced for banks and investment firms. Member states may apply stricter requirements where justified; and

Corporate governance:
corporate governance arrangements and processes will be amended, including those dealing with the composition of boards and their role in risk oversight and strategy, and a strengthened risk management function.

Timeline

With the exception of certain provisions, the CRR will apply from 1 January 2014, and the CRD IV Directive will come into force on 31 December 2013.

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November 2013

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