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Financial Services and Markets

Private Equity Briefing: CRD IV Regulatory Capital Proposal

On 20 July 2011, the European Commission published CRD IV. This note summarises some of the key issues for private equity.

What is CRD IV?

The European Commission's proposal for a new pan-European set of regulatory capital, liquidity and supervisory rules for banks and investment firms. For most banks, the major impact of the legislation will be higher capital requirements, which will be progressively introduced from 2013 to 2019. The European Commission estimates that this will ultimately result in EU banks and other investment firms needing to hold an extra €460 billion of "Core Equity Tier 1" capital ("**CET1**").

CRD IV replaces the existing Capital Requirements Directive ("**CRD**"). It is part of a package of European measures intended to rebuild confidence in the robustness of the EU financial sector.

What is Core Equity Tier 1 capital?

This means "plain vanilla" ordinary shares (or equivalent instruments) plus audited retained profits. One of the post-financial crisis criticisms of the bank capital rules was that they gave banks too much flexibility to rely on other types of capital, such as subordinated debt. CRD IV will require banks to hold more capital, with an emphasis on increasing the bank's CET1 ratio. Pre-crisis, the minimum CET1 ratio for banks was 2% of a bank's risk exposure amount. The minimum CET1 ratio from January 2013 will be 3.5%, rising to 7% by January 2019. National regulators will have discretion to set a higher minimum ratio.

The CET1 ratio is a proportion of CET1 to a bank's risk exposure amount. For a straightforward bank this approximates to total "risk weighted assets", determined by multiplying the value of each asset (e.g. a loan to a corporate) by a risk weighting based on the credit risk posed by the borrower.

Many banks will need to increase their CET1 capital to meet the new requirements, either by raising new share capital or cutting dividends to retain profits. Another approach is for a bank to reduce its risk weighted assets. This could be achieved by reducing lending or by diverting loans away from borrowers which attract a high risk weighting. There is a concern that this will lead to a medium term reduction in lending activity by European banks to SMEs, which attract a higher risk weighting than other bank or large company borrowers.

What is the difference between CRD IV and Basel III?

Basel III is a globally agreed framework for banking capital and regulation, which the G20 member states have agreed to implement for internationally active banks. CRD IV is a package of legal instruments which will implement the Basel III requirements in the European Union, including the requirement to hold additional CET1 capital described above.

The Basel Committee on Banking Supervision is still working on a number of post-crisis proposals for the banking sector, including imposing an additional capital requirement on a small number of global systemically important banks. It is likely that these additional requirements will be inserted into CRD IV during the passage of the legislation through the European Parliament and Council of Ministers.

Does CRD IV implement any other major changes from Basel III?

Yes. CRD IV imposes new EU wide liquidity rules on banks derived from Basel III. Until now, member States have set their own liquidity rules. Banks will also be required to report their aggregate leverage position (without a risk weighting adjustment), which may be a pre-cursor to a maximum leverage ratio.

What else is in CRD IV?

CRD IV contains a number of new requirements which are not set out in Basel III.

First, it sets out new corporate governance rules for EU banks, as well as minimum enforcement powers for national regulators. Significantly it will confer powers on national regulators to take enforcement action against financial holding companies and their boards for breaches by banks and investment firms the first time.

Second, it is not restricted to internationally active EU banks, but as with CRD will apply to all EU deposit takers and to many "investment firms" regulated under the EU Markets in Financial Instruments Directive. Investment firms currently subject to CRD (including securities brokers, investment banks and many investment mangers) will be faced with higher capital requirements and the new governance requirements as a result. This will include those private equity managers who are currently subject to the CRD.

Third, the proposal marks an important step on the road towards a single rulebook for European financial services. Part of the proposals take the form of a "Regulation", which reads very much like detailed regulatory rules. Using a Regulation (compared to the Directive it replaces) significantly restricts the scope for national governments or supervisors to introduce additional local rules. Rule making powers are conferred on the European Banking Authority, which is tasked with completing the single rulebook and acting as a mediator between national supervisors. This reflects the fact that financial services regulatory policy which was once set by member States is increasingly determined at the European Union level. National supervisors will retain flexibility to set bespoke capital requirements for individual institutions as part of their supervisory function.

How does this fit in with the recent European Banking Authority stress tests?

The EU wide stress tests were carried out by the EBA to determine whether any of the 90 subject banks would have CET1 ratios below 5% in a stressed situation. The EBA reported on 15 July that 8 banks failed this test.

Does this have anything to do with AIFMD?

The Alternative Investment Fund Managers Directive will apply to a large number of private equity and venture capital fund managers. That Directive imposes a regulatory capital requirement on the "AIFM" and defines regulatory capital by reference to the current CRD. CRD IV is expected to replace CRD by the end of 2012. Member States are not required to apply the AIFM Directive until July 2013. This means that what counts as "regulatory capital" for an AIFM will almost certainly be determined by CRD IV.

What else does this mean for European private equity and venture capital?

The existing CRD framework treats private equity and venture capital as a "high risk" asset class for which banks must use a high risk weighting. The new framework proposes a hardening of that position. That hardening, combined with an incentive to reduce risk weighted assets in order to improve a bank's CET1 ratio, could increasingly act as a disincentive for banks to invest in the sector. There is a risk that industry opponents may lobby for an even harsher treatment during the passage of this legislation, which could jeopardise the role the industry has to play in supporting Europe's economic recovery. A counterargument to a bank considering reducing their investment in private equity or venture capital is that this eliminates the opportunity of generating a profit from those activities. As noted above, retained profits form part of CET1 capital. To this extent, the bank capital rules continue to recognise the importance of banks supporting well run and profitable businesses.

This isn't really cheering me up. Is there any good news?

CRD IV presents a potential opportunity for private equity funds to invest in European financial services businesses. The €460 billion funding requirement identified by the Commission needs to be met within 8 years.

Another potential opportunity may arise if banks retreat from SME funding in order to reduce their risk weighted assets, thus potentially forcing them to look to other sources of funding to secure their growth.

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