



## Bank Regulations: Basel II and the Capital Requirements Directive

The Capital Requirements Directive (CRD) implemented the provisions of the Basel II capital framework in the European Union banking environment. In principle, the CRD requires credit institutions to hold a minimum level of eligible capital or so-called "own funds" calculated in relation to their risk-weighted exposures. Furthermore, Directive 2009/111/EC of 16 September 2009 has amended the CRD with regard to banks affiliated with central institutions, certain fund items, large exposures, supervisory arrangements and crisis management (CRD II). EU Member States must apply the modifications to their national laws by 31 October 2010 and implement them by 31 December 2010.

In particular, the CRD II has revised the definition of eligible capital under Article 57(a) of the CRD and has introduced new criteria under Article 63a for assessing whether certain hybrid capital instruments under Article 57(ca) are eligible to be included in the own funds of credit institutions and the limits of such inclusion.

Further, Article 63a(6) of the CRD II has mandated the Committee of European Banking Supervisors (CEBS) to elaborate on guidelines for the convergence of supervisory practices in relation to (i) the hybrid capital instruments referred to in Articles 57(ca) and 63a and (ii) core capital instruments referred to in Article 57(a) (e.g., equity capital).

Accordingly, following the public consultation on 14

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### Contacts:

[Dr. Andreas Fillmann](#)  
+49.69.17392.423

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June 2010, the CEBS published its final implementation guidelines on instruments referred to in Article 57(a) of the CRD II. In relation to hybrid instruments referred to in Article 57(ca), the CEBS had already published separate guidelines on 10 December 2009.

Article 57(a) of Directive 2009/111/EC amended Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated with central institutions, certain own funds items, large exposures, supervisory arrangements and crisis management. It reads as follows:

"(a) capital within the meaning of Article 22 of Directive 86/635/EC, in so far as it has been paid up, plus the related share premium accounts, it fully absorbs losses in going concern situations, and in the event of bankruptcy or liquidation ranks after all other claims."

Recital 4 of the Directive reads as follows:

"It is therefore important to lay down criteria for those capital instruments to be eligible for original own funds of credit institutions and to align the provisions in Directive 2006/48/EC to that agreement. The amendments to Annex XII to Directive 2006/48/EC result directly from the establishment of those criteria. Original own funds referred to in Article 57(a) of Directive 2006/48/EC should include all instruments that are regarded under national law as equity capital, rank pari passu with ordinary shares during liquidation and fully absorb losses on a going-concern basis pari passu with ordinary shares. It should be possible for those instruments to include instruments providing preferential rights for dividend payment on a non-cumulative basis, provided that they are included in Article 22 of Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, rank pari passu with ordinary shares during liquidation and fully absorb losses on a going-concern basis pari passu with ordinary shares. Original own funds referred to in Article 57(a) of Directive 2006/48/EC should also include any other instrument under a credit institution's statutory terms taking into account the specific constitution of mutuals, cooperative societies and similar institutions and which are deemed equivalent to ordinary shares in terms of their capital qualities in particular as regards loss absorption. Instruments that do not rank pari passu with

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ordinary shares during liquidation or which do not absorb losses on a going-concern basis *pari passu* with ordinary shares should be included in the category of hybrids referred to in Article 57(ca) of Directive 2006/48/EC."

As a consequence thereof, other capital that does not comply with all of the criteria under Article 57(a) and Recital 4 will be treated as original own funds only if they meet the criteria for hybrid Tier 1 capital set out in Article 57(ca), which reads as follows:

"(ca) instruments other than those referred to in point (a), which meet the requirements set out in points (a), (c), (d) and (e) of Article 63(2) and in Article 63a;"

### **CEBS Implementation Guidelines for Article 57(a) Instruments**

Capital instruments defined in Article 57(a) and eligible to be included as capital in the institution's (credit institutions and investment firms) original own funds must have the highest loss-absorption capacity of all capital instruments. The "benchmark" for the Article 57 (a) capital instruments is the capital quality of ordinary share capital issued by joint-stock companies. The CEBS guidelines state that to be eligible for Article 57(a) treatment, the capital instruments must be simple, easy to understand and able to fully absorb losses in going concern situations immediately without any doubt *pari passu* with ordinary shares.

The CEBS guidelines are structured into four categories:

- Definition of capital in the sense of the revised Article 57(a) and Recital 4;
- Permanence;
- Flexibility of payments; and
- Loss absorbency.

In addition, CEBS has defined 10 criteria in relation to these categories.

### **Definition of Capital in Relation to Article 57(a) and Recital 4**

#### *Criterion 1*

The subscription to the capital instrument shall make the investor a shareholder or another proprietor (as defined under national law) or give the investor a deemed equivalent affiliation under national law.

Furthermore, the capital instrument must be recognized as equity capital under the relevant accounting standards and insolvency law.

According to Article 22 of Directive 86/635/EC, only equity capital can be regarded as subscribed capital.

#### *Criterion 2*

The capital instrument must be fully paid up. When the issuer provides any financing to the shareholder or another proprietor to facilitate the subscription of capital, either directly or indirectly, the instrument cannot be considered as capital for regulatory purposes. The instrument shall ensure an effective permanent supply of capital.

Only paid-up capital is eligible under Article 57(a). Financing structures under which the issuer returns capital to its shareholders or proprietors must be closely monitored to prevent any improper distribution of capital.

#### *Criterion 3*

The capital instrument must be directly issued. The capital shall not be issued using a special-purpose vehicle.

### **Permanence**

#### *Criterion 4*

The capital instrument shall be perpetual, and no terms shall enable redemption by the issuer outside liquidation (except for discretionary repurchases or other discretionary means of capital reduction in a manner permitted under national law). The shareholder or proprietor shall not have the right to require a redemption.

The holders of such capital instruments shall not have a put option towards the issuer. In this context, existing rights under national law for shareholders to return their shares to the issuer are not considered by the CEBS as put options, where the issuer has the option of rejecting the holder's request in particular with regard to the prudential situation of the institution.

#### *Criterion 5*

Neither the contract nor marketing conditions shall provide any expectation that the capital instrument will

be bought back. Buy-backs shall be subject to prior approval by the competent authorities.

In case of a buy-back, the issuer shall submit an application to the competent authorities as soon as he or she has made a decision to buy back the instruments. The competent authorities shall have the possibility to refuse the buy-back intention.

## **Flexibility of Payments**

### *Criterion 6*

Holders of capital instruments do not have the right to claim distribution.

Like any ordinary share, the capital instrument shall:

- Ensure full discretion. The issuer must have full discretion to decide whether to pay a dividend and how much dividend to pay (if any);
- Permit the issuer to preserve cash by not paying out dividends, without triggering an event of default. Consequently, nonpayment must not be an event of default;
- Have no Alternative Coupon Satisfaction Mechanisms or similar mechanism that obliges the issuer to substitute the payment of dividend with payment in kind; and
- Have no dividend pushers (which oblige the issuer to pay a dividend on the instrument if it has paid it on another instrument) or dividend stoppers (which oblige the issuer not to pay dividends on ordinary shares if the dividend on the instrument is not being paid).

### *Criterion 7*

Payments of dividends must be made out of distributable items and must not be cumulative. The level of distribution is not in any way tied or linked to the amount paid at issuance.

The amount or level of distribution must be based on the amount of distributable items as defined under national law. Furthermore, the payment must be fully discretionary, and there shall be no pre-indication of the amount that could be paid.

## **Loss Absorbency**

### *Criterion 8*

The instrument takes the first and proportional share of any losses as they occur *pari passu* with other instrument included under Article 57(a).

Capital instruments must fully absorb losses to enable the institution to continue as a going concern *pari passu* with ordinary shares. As such, it must take the first share of any losses as they occur like ordinary shares of a joint stock corporation.

#### *Criterion 9*

Capital instruments must rank *pari passu* among themselves and have the most subordinated claim in liquidation. They are entitled to a claim on the residual assets that is proportional to their share of capital and not a fixed claim for the nominal amount.

The holders of such capital instruments must have no priority in liquidation and shall rank after all claims. The claim must be limited to the residual amount in proportion to their share of capital and not to a fixed claim for the nominal amount of their holding.

#### *Criterion 10*

Capital instruments must not be provided with guarantees, pledges or other credit enhancements that legally or economically enhance their seniority.

Shareholders or proprietors must not have any guarantees, pledges or other credit enhancements.

### **Next Steps**

#### *Europe*

Member States must transpose the Article 57(a) guidelines into their national legal framework by 31 October 2010 and implement them no later than 31 December 2010 so that the new rules will be applicable for institutions' reporting obligations in 2010. Furthermore, the CRD III rules have to be implemented partly into national law by 1 January 2011, and the remaining rules by 31 December 2011.

However, the new Basel III rules are also expected to be finalized by 31 December 2010 and implemented starting on 1 January 2011. Consequently, further changes to the CRD III-IV rules or to the CEBS guidelines for national regulators will likely be needed later this year to ensure conformity with Basel III. In particular, Basel III will define in detail the capital

instruments to be included in the own funds (Tier 1) and the supplementary capital (Tier 2).

### *Germany*

Nevertheless, Germany is determined to implement the Directive by 31 December 2010 through the *Entwurf eines Gesetzes zur Umsetzung der geänderten Bankenrichtlinie und der geänderten Kapitaladäquanzrichtlinie*, despite some signals from the EU Committee that EU Member States will be allowed more time. The new rules primarily relate to regulatory capital and will introduce changes to the German Banking Act (*Kreditwesengesetz*) with regard to:

- Standardized principles for the acceptance of hybrid capital as core capital;
- The regulations on securitizations and resecuritizations and stricter rules on disclosure requirements;
- The revision of large credit regulations and risk mitigation;
- The consolidation of cooperation among regulatory authorities within the European Union; and
- Remuneration policies.

The new regulations would go into effect on 31 December 2010 and apply to Germany-based banks' final reporting duties for 2010.

### *G20 Summit*

Furthermore, in September 2010 regulators worldwide will meet in Basel, Switzerland again to try to come to consensus on new capital and liquidity rules for banks, in an effort to prevent a repeat of the financial crisis. In particular, representatives of France, Germany, Japan and the United States have become involved in the discussion, as the outcome is expected to affect major financial institutions. Such negotiators will try to draft details of the new rules during the mid-September meeting and then offer the Group of 20 nations' leaders a package to approve at their November summit.

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