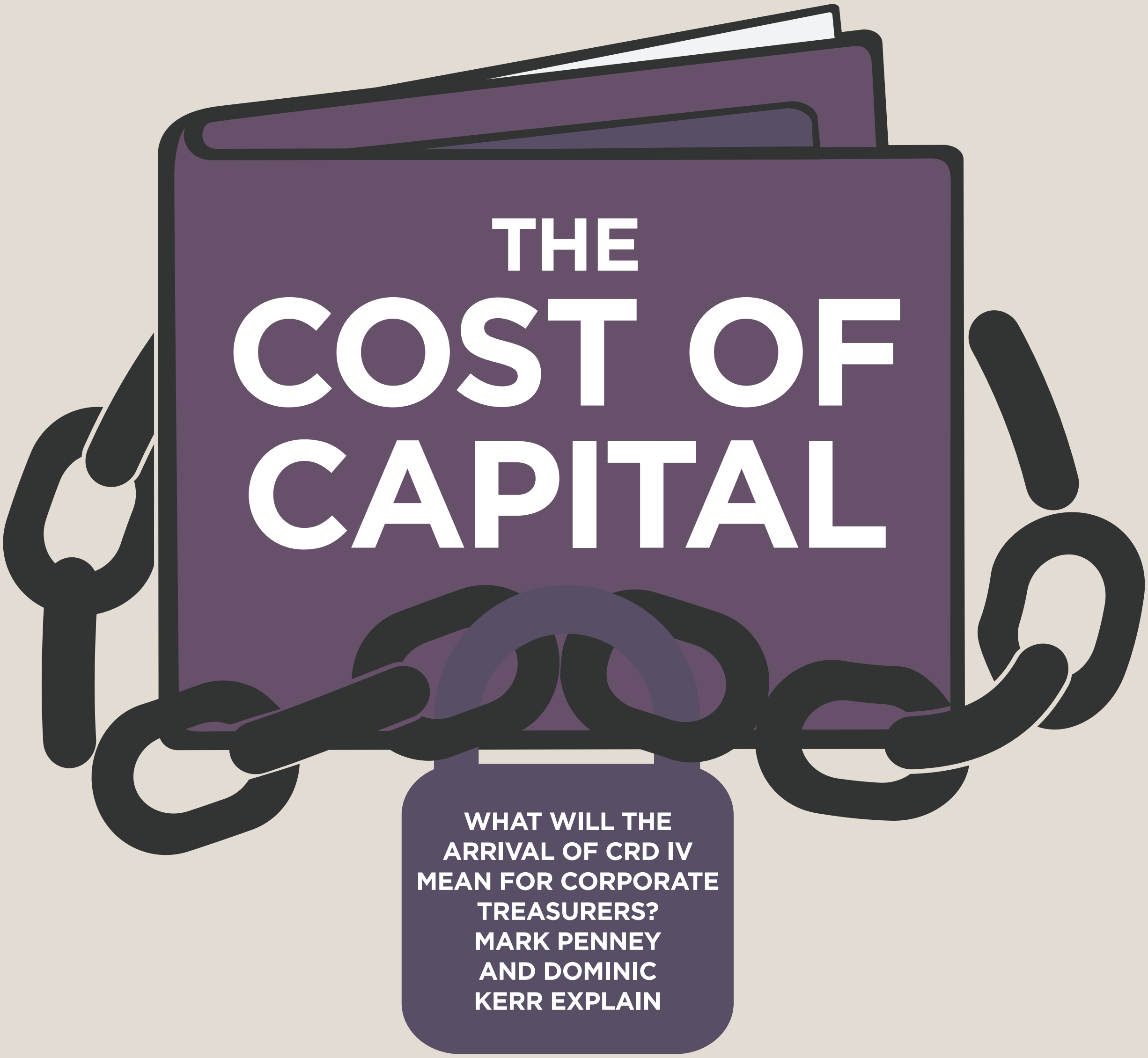

THE COST OF CAPITAL

WHAT WILL THE ARRIVAL OF CRD IV MEAN FOR CORPORATE TREASURERS? MARK PENNEY AND DOMINIC KERR EXPLAIN

The bulk of the rules in the EU legislative package Capital Requirements Directive IV (CRD IV) took effect at the beginning of January. These prudential rules implement the Basel III agreement on bank capital requirements in the EU and they impose strict capital and liquidity restrictions on banks, building societies and investment firms.

CRD IV is unquestionably the biggest regulatory change to affect the banking industry for decades. Its aim is to prevent another crisis by strengthening the resilience of the EU banking sector so that it can better absorb economic shocks while continuing to finance economic activity and growth. But the scale of the changes, which are being phased in between January 2014 and January 2019, means that their effect will be felt not just within the banking industry itself, but also within the wider economy.

While every bank and corporate will have a different experience of CRD IV, all treasurers need to make sure that they understand the main principles of the legislation [see box – CRD IV in brief] and, equally importantly, its implications for financing their business.

CRD IV and corporates

When implementing CRD IV, banks have different starting positions and different pressures. It is likely, however, that the directive will bring long-term, industry-wide changes in the cost and availability of funding to European corporates. So far, low interest rates have been masking the costs of increased bank regulation but if interest rates rise over the next few years, those costs will become more apparent. Capital needs to be paid for and the cost will be partly borne by the customers that use it.

In theory, European banks have until January 2019 to meet the more stringent capital requirements of CRD IV. But, in practice, individual countries are speeding up the process and making their own stipulations. In November 2013, the UK's Prudential Regulation Authority announced that it expects the major UK banks and building societies to meet a 7% common equity tier 1 ratio and a 3% tier 1 leverage ratio from 1 January 2014. This is a stricter requirement than that specified by CRD IV and a five-year acceleration in the

> The aim of CRD is to prevent another crisis by strengthening the resilience of the EU banking sector so that it can better absorb economic shocks

capital process from the original timetable.

Meanwhile, the European Central Bank's Asset Quality Review and accompanying stress testing will affect major eurozone banks in 2014. Eurozone banks will need to pass a threshold of an 8% common equity tier 1 ratio.

Leverage, liquidity and funding

It is not just capital that will affect costs for corporates. The Basel Committee on Banking Supervision is continuing to deliberate the leverage ratio, which is the ratio intended to set the amount of capital that banks need to allocate against their actual or potential financing without any adjustment for credit risk. If the leverage ratio is too low, a bank will either need to hold more capital, or reduce its assets, or both.

In addition, banks are being asked to hold more assets that can be turned into cash quickly and easily. Since these assets don't make a good return, the cost of holding them will be reflected in the overall cost of lending to customers.

Banks are also being asked to improve their mix of funding arrangements, putting greater emphasis on deposit funding and longer-term debt. Both of these are expensive and that cost, too, will be passed on to customers in the long term.

Ring-fencing risks

From 2019, the UK will have retail banks that are ring-fenced from their wholesale counterparts. With this comes the risk that corporates will concentrate their deposits in the retail bank, which will be perceived as safer, while they will want their main relationship to be with the wholesale bank, which can offer a wider product set. This could create further distortion in the funding market.

Consequences of CRD IV

The effect of regulatory change will vary between banks, with each making different deals with their corporate customers. But, overall, costs for corporates are likely to increase. Meanwhile, where banks need to achieve higher capital ratios and want to avoid raising new money, there could be a contraction in supply. This is likely to be where a bank engages in marginal activities or has a small market share in certain countries or business sectors. At some point, it may no longer be efficient for banks to provide expensive funding for their corporate customers. This will make the option of going direct to the capital markets more attractive to companies. Ultimately, it is one of the objectives of CRD IV to rebalance the provision of finance away from banks towards the markets. ◆

CRD IV IN BRIEF

The main principles of CRD IV include:

◆ Enhanced requirements for quality and quantity of capital. A bank's capital is calculated as the value of its capital as a percentage of its risk-weighted assets (RWAs). The riskier the assets, the more capital a firm needs to hold. Some elements, such as deferred tax assets, are being excluded from the calculation of capital. Currently, institutions must have total capital of at least 8% of their RWAs. But under CRD IV, the percentage of tier 1 (high-quality, going concern capital) must increase from 4% to 6%, while the percentage of common equity tier capital within tier 1 (for example, shares and retained earnings) must increase from 2% to 4.5% from January 2015.

◆ **A new liquidity coverage ratio (LCR) and a net stable funding ratio (NSFR). The LCR measures the stock of liquid assets against net cash outflows in a 30-day stress scenario period. It is being phased in between 2015 and 2018. The NSFR will measure the amount of reliable stable funding available to a firm over a one-year period of extended stress against the amount of stable funding that the firm requires.**

◆ Leverage ratio. This is a firm's tier 1 capital divided by a measure of its non-RWAs or exposures. It is not yet a binding requirement although its introduction is expected in 2018.

◆ **New rules for counterparty risk. Modelling of future exposures for derivatives is enhanced to include a stressed period, lengthened margin period of risk and wrong-way risk. A credit valuation adjustment risk is introduced, though most corporate derivatives will be exempt.**

◆ Five new capital buffers. These are: the capital conservation buffer, the counter-cyclical buffer, the systemic risk buffer, the global systemic institutions buffer and the other systemic institutions buffer.

◆ **Enhanced corporate governance rules. The management of a firm has to take greater responsibility for its overall risk strategy.**

◆ Remuneration ratios. The ratio of fixed salary to variable bonus will be 1:1 although the ratio can be raised to a maximum of 1:2 if a majority of shareholders agree.

◆ **Standardised EU regulatory reporting. Banks must report on their risk (Common Reporting Standard or COREP) and financial information (Financial Reporting Standard or FINREP).**

THE EVOLUTION OF THE DEBT CAPITAL MARKETS

◆ **The trend for European corporates to diversify their funding sources away from banks has steadily increased in the years since the financial crisis.**

◆ In the UK, net bank lending to UK corporates has fallen by 20% over the past five years, while bond and private placement issuance has increased by 48% over the same period, according to rating agency Standard & Poor's.

◆ **In many European countries, where banks are relatively less well capitalised and less able to lend, this trend is even more pronounced. In December 2013, the Bank for International Settlements revealed that the bond market had met more than 50% of the funding requirements of euro-area corporates since early 2011.**

◆ In 2013, high-yield bond issuance in Europe reached a record level. By mid December, $110bn had been raised compared with $74bn for all of 2012. Around 75% of the high-yield issuance in 2013 was used for general refinancing, while 25% went to fund acquisitions or dividend payments. Overall, 64% of issuance was from repeat borrowers and 36% from first-time borrowers. Around 30% of high-yield first-time borrowers came from peripheral geographies such as Ireland, Greece, Italy, Portugal and Spain.

◆ **Both the Schuldschein and US private placement markets lent in reduced volumes in 2013 compared with 2012, although investors were liquid and ready to lend. But both markets favour investment-grade borrowers and require covenants that are similar to those demanded by banks. This may explain why covenant-light investment-grade and unrated bond markets have been more attractive to some borrowers.**

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