Prudential requirements for credit institutions and investment firms. Capital Requirements Regulation (CRR)

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The Commission presents a report on the review of the **appropriateness of the definition of "eligible capital"** pursuant to Article 517 of Regulation (EU) No 575/2013 (‘Capital Requirement Regulation’ or ‘CRR’).

To recall, until 31 December of 2013, the capital requirements applicable to investment firms with limited investment services, the prudential treatment of an institution's qualifying holdings outside the financial sector and the definition of institutions' ‘large exposures’ and its limits have been based, on the notion of ‘own funds'.

From 1 January 2014, the ‘own funds’ definition was replaced with the definition of ‘eligible capital’ for the purposes to be used in the above-mentioned fields regulated by the CRR.

The definition of 'eligible capital' was introduced without conducting an impact assessment. For this reason, the implementation of the new regime is subject to a three-year transitional period (ending on 31 December 2016) and it is subject to review before its full implementation. This report reviews the appropriateness of the definition of ‘eligible capital’ being applied for the purposes of Title III of Part Two and Part Four of the CRR. It is based on the opinion issued by the European Banking Authority (EBA) in consultation with national competent authorities.

The difference between eligible capital and own funds: the CRR defines ‘eligible capital’ as the sum of Tier 1 capital and Tier 2 capital. However, the amount of Tier 2 capital recognized as ‘eligible capital’, at the end of the transitional period, **cannot exceed one third of Tier 1 capital.** The concept of ‘eligible capital’ is thus **more constraining than the concept of ‘own funds’** due to the fact that the amount of Tier 2 capital instruments in excess of the one-third threshold cannot be recognized as ‘eligible capital’. On the other hand, there was no limit for the inclusion of Tier 2 capital in ‘own funds’, which simply consisted in the sum of Tier 1 capital and Tier 2 capital.

The notion of ‘eligible capital’ was introduced in the CRR to limit credit institutions and investment firms’ incentives to reduce the regulatory constraints by issuing only Tier 2 capital (e.g. supplementary Tier 2 capital would allow these institutions to increase the size of exposures to their counterparties or the volume of their qualifying holdings in an easier manner than by issuing Tier 1 capital). **The quality of Tier 2 capital is, in fact, lower than the Tier 1 one.** Whilst Tier 1 capital is used to absorb losses in going concern situation, Tier 2 capital can only be used to absorb losses in gone concern situations.

From the 1 January 2014, ‘eligible capital’ has been used as capital base for the purposes of:

- determining the prudential treatment for qualifying holdings outside the financial sector;
- determining the capital requirements for investment firms with limited investment services;
- defining a large exposure – i.e an institution’s exposure to a single counterparty the value of which is equal to or exceeds 10% of the institution’s eligible capital as laid down in Article 392 of CRR;
- setting the maximum amount above which institutions are not allowed to be exposed to a single counterparty (25% of its eligible capital).

The implementation of the ‘eligible capital’ definition is subject to a **transitional regime** of three years which started in 2014. Whilst in 2014, credit institutions and investment firms were still allowed to recognize Tier 2 capital as ‘eligible capital’ up to 100% of Tier 1 capital, from 2015 they are allowed to recognize Tier 2 capital as ‘eligible capital’ up to 75% and in 2016 up to 50% of Tier 1 capital. Once the transitional period is over, the EU system will limit Tier 2 capital recognized as ‘eligible capital’ to one third of Tier 1 capital, approximating Union requirements to the recently issued Basel standards on large exposure, which exclude Tier 2 capital from being considered for the purpose of the application of the large exposure regime.

With regard to the appropriateness of the notion of eligible capital, the report notes that **consultation with the European Banking Authority (EBA) and national authorities has not revealed any particular concern**. The results of the assessment are related, however, to the limited experience gained so far. The new system has applied since 2014 and it will be fully implemented only in 2016. A proper collection of data could be performed only at the end of the transitional period.

Accordingly, **the Commission concludes that it does not appear appropriate at this stage to put forward a legislative proposal amending the current system**. In cooperation with the EBA, it will continue monitoring the application of the new regime and further reflect on whether the definition of 'eligible capital' should be maintained. The experience gained by competent authorities in the implementation of the 'eligible capital' definition during the transitional period will contribute to this reflection.