Chapter 14
Capital Requirements Directive (CRD) IV: Global Developments

ABSTRACT
Capital requirement directives – as well as their significance in matters relating to implementation – in the European Union in particular, as well as other parts of the globe, are considered under this chapter. The chapter also aims to accentuate the importance of such directives in matters relating to global and financial stability.

INTRODUCTION
According to the European Banking Authority (EBA), “the overarching goal of the Basel III agreement and its implementing Act, the CRD IV package,” is (EBA, n.d.):

To strengthen the resilience of the EU banking sector so that it would be better placed to absorb economic shocks whilst ensuring that banks continue to finance economic activity and growth.

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The CRD IV package, which was introduced in 2013, replaces the Directives 2006/48 and 2006/49, with a Directive and Regulation (EBA, n. d.)\(^1\). The CRD IV entered into force on 1 January 2014, with some phasing in arrangements taking place between 2014 and 2019.

The first consultative paper on a new capital adequacy framework, which was issued by the Basel Committee on Banking Supervision, introduced the “three pillar” model which encompasses the minimum capital requirements, supervisory review, and market discipline—“as a lever to strengthen disclosure and encourage safe and sound banking practices” (BIS, 1999a). As well as the criticism related to the fact that it rewarded risk lending, the fact that “capital requirements were just reasonably related to banks’ risk-taking activities and that the credit exposure requirement was the same regardless of the credit rating of the borrower,” a general criticism of Basel I relates to the fact that it promoted capital arbitrage (Saidenberg & Schuermann, 2003). Such capital arbitrage being attributed to its wide risk categories which provided banks with the liberty to “arbitrage between their economic assessment of risk and the regulatory capital requirements” (BIS, 1999b).

“Regulatory capital arbitrage” a practice which involves banks “using securitization to alter the profile of their book” usually produces the effect of making bank’s capital ratios appear inflated (BIS, 1999b)\(^2\). Four identified types of capital arbitrage are (BIS, 1999b): cherry picking, securitization with partial recourse, remote origination and indirect credit.

The Second Consultative Paper, issued by the Basel Committee in January 2001, introduced the two Internal Ratings Based (IRB) methodologies—the Foundational IRB and the Advanced IRB methodologies. The Internal Ratings Based approach to capital requirements for credit risk, not only relies significantly on the internal assessment carried out by a bank, in relation to counterparties and exposures, but is also geared towards the achievement of two primary goals, namely\(^3\) (BIS, 2001a): “additional risk sensitivity” and “incentive compatibility.”

Basel 2 is premised on a three-level approach which permits banks to select from three models, namely: the basic standardized model, the IRB foundation approach and the advanced ratings approach. According to the Consultative Document on Standard Approach to Credit Risk (BIS, 2001b), capital requirements under the standardized approach are considered to be more synchronized and in harmony with the principal elements of banking risk—owing to the introduction of more differentiated risk weights and a
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