Finance for Europe

Association for Financial Markets in Europe

Key Issues under the CRD5/CRR2 Proposals

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Michael Lever, Head of Prudential Regulation, AFME
Jacqueline Mills, Director, Prudential Regulation, AFME

CRD5/CRR2: Background

Global banking reforms

- Post crisis Basel 3 standards for improving banks' resilience
- Key elements:
    - higher quality & level of capital
    - containing leverage
    - liquidity and stable funding requirements
- Part of the Basel 3 standards were implemented in the EU through the CRD4/CRR1 (2013), but more work to be done…

Risk Reduction Measures (RRM) package

- European Commissions proposals of 23 November 2016
- Part of the EC's work to reduce risk in banking sector (towards completion of Banking Union)
- Builds on existing EU rules and implements outstanding global banking reforms
- RRM package updates the following legal instruments:
    - **Capital Requirements Directive (CRD5)**
    - **Capital Requirements Regulation (CRR2)**
    - Bank Recovery and Resolution Directive (BRRD) - 2 proposals
    - Single Resolution Mechanism Regulation (SRMR)

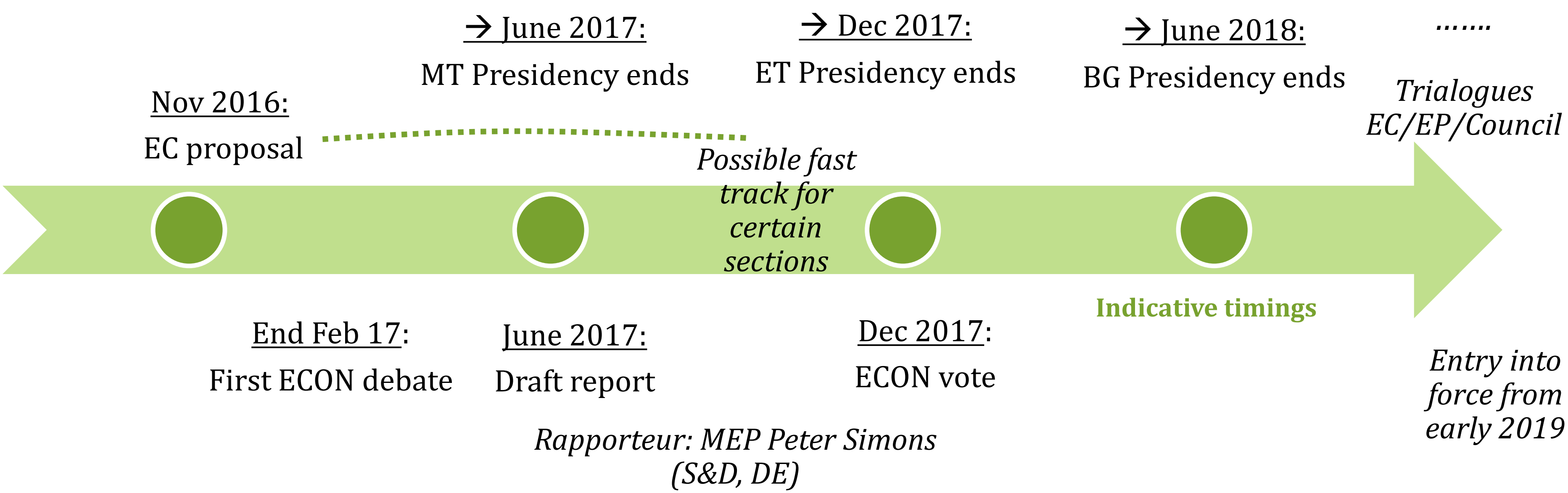
Today's briefing focuses on the **prudential aspects** of the proposals **(CRD5/CRR2)**

CRD5/CRR2: Content

International standards	European issues
Net stable funding requirement (NSFR) Promotes stable sources of funding	**Waivers** From application of capital & liquidity requirements at solo level
Leverage ratio Reduces risk of excessive leverage	**Phase-in of prudential impact of IFRS 9** Deals with effects of the new method for accounting provisions
Fundamental review of the trading book (FRTB) New capital framework for market risk	**Intermediate EU parent undertaking (EU IPU)** Single hold co requirement for 3rd country groups
Revised large exposure framework Update of single name exposure limits	**Pillar 2 framework** New approach to capital for firm-specific risk not covered by Pillar 1
Standardised approach for counterparty credit risk (SA-CCR) Improved non-models-based approach for CCR exposures	**Disclosure** Enhanced proportionality and updates to reflect changes made in Pillar 1
Interest rate risk in the banking book (IRRBB) Enhanced framework	**Remuneration** More proportionate application of certain rules
FSB total loss absorbing capacity (TLAC) standard Sufficient bailinable liabilities	**SME exposures** Extension of supporting factor for SME exposures > EUR 1,5M
Various other updates of int'l standards Treatment of equity investments in funds and CCP exposures	**Infrastructure finance** Scaler for certain physical assets in support of public services

Note: the following are *not included* in the CRD5/CRR2 (Basel standards not yet finalised)
Revision of the credit risk framework To improve risk sensitivity of standardised approach & reduce variability in outcomes of model-based approaches
Revision of the operational risk framework To address weakness in existing framework
A new output capital floor based on revised standardised approaches To mitigate model risk and enhance comparability

CRD5/CRR2: Timetable



- Legislative procedure can take time & several factors may complicate the negotiations
- Proposed application dates for various requirements:
  - TLAC: 1 Jan 2019
  - IFRS 9: on entry into force of the proposals
  - Other aspects of the CRR2 (e.g. FRTB, NSFR, etc.): entry into force + 2 years
  - IRRBB: entry into force + 2 years
  - Other proposals in the CRD5: entry into force + 1 year
- Proposals include level 2 mandates (EC Delegated Acts, EBA RTSs/Guidelines)

From reporting requirements in the CRR1, to binding metrics in the CRR2

	NSFR Available stable funding/Required stable funding ≥100%	**Leverage ratio** Tier1 capital/total exposures (incl on and off B/S items)
What	• NSFR is a longer-term (> 1yr) structural ratio that limits over-reliance on wholesale, short-term funding • Complements the liquidity coverage ratio which requires banks to hold enough high quality liquid assets (HQLA) for a 30 day stress scenario	• Non-risk based requirement designed to act as a back-stop to the risk based framework & contain build up of excessive leverage in the system
CRR proposals	• 0% RSF for Level 1 HQLA • Repos: RSF calibration at 5%/10% • Derivatives: cash and level 1 HQLA count as collateral • Derivatives liabilities: choice of 20% add-on or to- be-defined SA-CCR approach	• Binding 3% requirement • Better treatment of exposures for unsettled trades which avoids artificial grossing up • Exclusion of securitisations when there is significant risk transfer • Recognition of initial margin for cleared derivatives
AFME overvall view	• Studies show that while banks meet the NSFR on average, deficits arise mainly from capital markets activities • Without improvements, the proposal is likely to restrict banks' ability to provide market financing, investing and hedging services	• Support introduction of the LR as backstop • At 3% it is already the binding requirement for 43% of Group 1 EU banks • Weighs heavily on low risk assets like cash & government securities
AFME focus areas	• Repos • Derivatives • Linked transactions	• Intragroup exposures • Central bank deposits • Open repos • Measurement of derivative exposures (SA-CCR)

Fundamental Review of the Trading Book

- **What is the FRTB**
  - A new capital framework for banks’ market intermediation activities to address deficiencies in the pre-crisis framework and build on improvements already made (Basel 2.5)
  - Key changes include revisions to the boundary between banking & trading books, the internal models approach and the standardised approach

- **Expected impact**
  - The Basel FRTB is more impactful than expected: approx 1.8x more capital than Basel 2.5 for GISBs (who play critical role in market intermediation & provision of risk management)
  - This assumes full internal models approval; if models do not pass the P&L attribution test, the impact could be higher (more than 2x)
  - Potential negative consequences for the functioning and liquidity of financial markets, resulting in higher funding & hedging costs for end-users

- **Features of the CRR2 proposal**
  - Phase-in period: a 0.65 multiplier is applied to the capital outcome for the first 3 years of use of the framework
  - Mandates for the EBA to develop important aspects of the framework

- **AFME focus areas**
  - Calibration!
  - Timing of implementation: international work is still ongoing & both banks and supervisors will require sufficient time for model development and approval respectively

Granular model approval at trading desk level

P&L attribution test

Determines whether the P&L based on the risk factors included in the model is aligned with material drivers of actual P&L

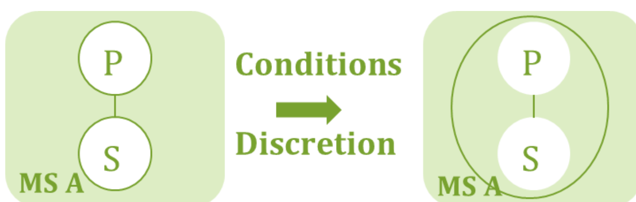
If model fails: use SA

Asset class	Ratio SA/IMA
IR	3.3
Credit	1.7
Equity	4.2
FX	3.6
Commodity	3.3

Capital & liquidity waivers

- **CRR2 proposals**
  - Solo application of capital & leverage requirements can be waived, **across borders**, if;
    - A number of (existing) conditions are fulfilled
    - The parent provides a full guarantee of the sub's own funds & the guarantee is 50% collateralised
    - Supervisory authority in host MS agrees
  - Solo application of LCR and NSFR can be waived across borders if:
    - Existing conditions are fulfilled (liquidity subgroup)
    - No need for a joint supervisory decision if the entities are all supervised by the SSM
    - Parent must guarantee the net liquidity outflows & guarantee is 50% collateralised
    - The supervisory authority agrees
- **AFME view**
  - Step in the right direction, recognising reform & progress made towards Banking Union
  - With new competent authorities (SSM, SRB) & EU recovery & resolution framework in place, proposals do not go far enough:
    - Collateralisation requirements are counterintuitive/ill-defined
    - Continued discretion goes against the single rulebook
  - Significant economic benefits to be had from removing obstacles to the free flow of funds

Art 7 waiver: *current* approach



Art 7 waiver: *proposed* approach

Prudential impact of IFRS 9

- **The issue**
  - IFRS 9 addresses the "too little, too late" flaws of IAS 39 by moving from an incurred loss model to a forward looking expected credit losses framework
  - Accounting provisions under IFRS 9 are expected to be higher than under IAS 39 and this is likely to impact capital ratios
  - Applicable from 1 Jan 2018

- **Expected impact**
  - According to EBA, IFRS 9 may result in a 20% - 30% increase in accounting provisions
  - This amounts to a reduction of 59 basis points on average for CET1 ratios
  - Although firms' risk profiles will not have changed, another reduction in capital resources may restrict lending capacity into the market and pricing will need to be adjusted accordingly

- **The CRR2 proposal**
  - Add back excess provision to CET 1 capital
  - Phase-out neutralisation over over 5 years
  - Date of application: entry into force

- **AFME focus areas**
  - Given IFRS 9 implementation date, this issue needs to be dealt with asap
  - Full neutralisation until end-state prudential treatment of accounting provisions is defined
  - Neutralisation should be dynamic

Key changes in the Directive (CRD5)

	New Pillar 2 framework	EU Intermediate Parent Undertaking proposal
CRD proposals	• Clarification that P2 should not cover macroprudential risks • Introduction of Pillar 2 requirements and Pillar 2 guidance, with clear stacking order: *P2G – combined buffers – P2R – P1* • If buffers are breached, preference is given to AT 1 distributions over other distributions within MDA framework	• Non-EU GSIB, or 3rd country firm with B/S above EUR 30 billion, with two subs or more in the EU must create a holding company
AFME overall view	• Clarification of stacking order and how these relate to the MDA framework is helpful • Welcome intended separation between micro and macro pru tools	• No AFME position • Impacts will be group specific
AFME areas of focus	• More work must be done to ensure that there effectively no duplication of requirements for the same risk • P2R should not override policy choices in L1 • Composition of P2R • Disclosure	• Proposal could benefit from amendments to make it more operational • Allow alternative structures e.g. when a single IPU would conflict with 3rd country structural requirements • Allow more time for implementation

afme/ Other challenges for industry

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- **Consistency with CMU objectives**
  - FRTB, NSFR, leverage ratio may all have disproportionate impacts on capital market activities and hence clients
  - The prudential framework should not hinder the development of capital markets, particularly in light of the EU's Capital Markets Union project

- **Sequencing is tricky when implementing international standards**
  - EU is a first mover in certain cases (FRTB, replacement of internal models with SA-CCR in Large Exposure framework)
  - Recalibration of Basel standards is necessary in many areas (e.g. FRTB, SA-CCR)
  - Basel is still considering important aspects of the FRTB (e.g. P&L attribution test, non-modellable risk factors) & NSFR (e.g. treatment of derivatives liabilities)

- **EU going beyond international standards**
  - Pillar 3 disclosures (e.g. hypothetical standardised disclosures)
  - Banking/trading book boundary

- **Home/host considerations**
  - Continue to stall treatment of EU as a single market or Banking Union as a single jurisdiction

- **Lack of equivalence remains an issue**
  - Recognition of AT1 & T2 instruments issued by subs in 3rd countries
  - Recognition of minority interests in non-banks

For more information

- For our detailed positions and non-technical notes, visit AFME’s website:
    - Prudential aspects of the RRM package
      https://www.afme.eu/en/divisions-and-committees/regulation/crd5-and-crr2/
    - Resolution aspects of the RRM package
      https://www.afme.eu/en/reports/publications/afme-views-on-the-resolution-aspects-of-the-eu-risk-reduction-measures-package/

Any questions?

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Offices

The Association for Financial Markets in Europe advocates stable, competitive and sustainable European financial markets that support economic growth and benefit society.

London
Level 39
25 Canada Square
London EC3V 9DH
United Kingdom

+44 (0)2 0382 82700

Brussels
Rue de la Loi 82
1040 Brussels
Belgium

+32 (0)2 788 3971

Frankfurt
Skyper Villa
Taunusanlage 1
60329 Frankfurt am Main
Germany

+49 (0)69 5050 60 590

www.afme.eu