"Review of the Capital Requirements Regulation and Directive (CRR/CRD)"

The European Commission published its 'risk reduction' legislative proposals on 23 November. This is intended to reform important aspects of the Capital Requirements Regulation ('CRR') and the Capital Requirements Directive ('CRDIV') and seeks both to facilitate the implementation of international standards from the Basel Committee of Banking Supervision ('BCBS') and the introduction of several separate EU proposals.[1]

The package is therefore another significant piece of the global financial reform programme in Europe and it builds on the achievements of CRDIV/CRR, which had already reduced the likelihood that banks would fail by significantly increasing the quantity and quality of capital they hold, and by making them less leveraged and more liquid.

The EU legislative process is likely to take many months to complete and it will be important that international agreements are respected while taking into consideration European structural characteristics. The diversity of the European banking system needs to be catered for appropriately, while prudential requirements must not hamper banks' financing capacity, the development of market finance, financial stability and sustainable economic growth in Europe.

Scope and Proportionality

While the proposals continue to apply to all banks, their application will be limited to systemically important investment firms which contrasts with the current CRR which applies to banks and all MiFID investment firms. The EC intends to deliver separate proposals for a prudential framework specific to non-systemic investments firms by the end of 2017.

In addition, CRDV / CRR 2 seek to introduce increased proportionality. There are simplified approaches for smaller firms in some areas (market risk and counterparty credit risk calculations) and regulatory reporting and disclosure requirements vary with institutions' nature and scale.

[1] There were also resolution elements to the proposals which comprised amendments to the Bank Recovery and Resolution Directive and Single Resolution Mechanism which for the most part are beyond the scope of this paper. There was an EPFSF briefing which covered standards for bail-in in November 2016.

Main Content

Finalisation of Basel 3 - Implementation of requirements initially envisaged and "tested" in the CRDIV/CRR (as reporting requirements rather than legally binding metrics):

- A Leverage ratio will be introduced as a binding measure at 3% of banks' total exposures. At this level, the ratio is a binding measure for approx. 43% of the largest EU banks.[2] In the proposal, consideration will be given to potentially require GSIB banks to comply with a higher leverage ratio when Basel work in this area is completed. The proposal also changes the way the exposure measure is calculated, mirroring expected changes in the Basel requirements and aligning how exposures are calculated between banks using different accounting standards. Adjustments reducing the exposure measure are introduced for public lending by public development banks, pass-through loans and officially guaranteed export credits.
- The Net Stable Funding Ratio (NSFR) will become a binding requirement, with some changes compared to the Basel NSFR standard to mitigate effects on some capital market transactions, including repos, derivatives and holdings of high quality sovereign securities. The standard is still expected though to have the most impact on repos, derivatives and some types of linked client facilitating transactions such as those involving segregated client assets and securities purchased to hedge client derivative contracts. The possible introduction of requirements to fund assets with reference to the currency of their denomination may have implications for the diversity of banks' funding and be relevant to those operating in smaller markets.

Implementation of other finalised Basel standards:

- Review of the Trading Book (FRTB): the proposal introduces the new Basel market risk framework into EU regulation, with wide-ranging changes to the way market risk is measured, capitalised and disclosed. The FRTB also intends to address broader supervisory concerns regarding model approvals and the boundary between banking and trading book assets. To accommodate further changes, recalibration and clarifications from the international process, the proposal includes a phasing in period over 3 years and several level 2 delegations for the EBA to develop the implementing technical standards. This approach is intended to allow for the flexibility required in EU legislation to adopt any improvements made at global level and its sequencing will be key to ensuring the flexibility of the framework. There are also specific technical details in the EU proposals that appear to diverge from the Basel standards, by for example allowing the EBA to define the liquid currency pairs' lists for FX risk, treating all EU sovereign bonds as highly liquid and by reducing the credit spread charges for covered bonds.

  Based on feedback from many market participants, the challenge will be to ensure that the EBA has sufficient time to deliver on its technical work for firms to be able to prepare for the application of the requirements on time.
- Standardised Approach for Counterparty Credit Risk (SA-CCR): the proposals will implement the (new) Basel SA-CCR standard, replacing the existing SA measure in the CRR known as the marked-to-market or current exposure method. This has implications for both the leverage ratio and the FRTB calculations, as well as for large exposures.
- Large exposures framework: the treatment of large exposures is more aligned with the revised Basel large exposure framework (which is more restrictive than the current EU framework). Amongst others, the base for determining large exposure limits is limited to Tier 1 capital only (some Tier 2 capital is currently included) and G-SIB to G-SIB exposures will be limited to 15% of this capital base (instead of 25%).The proposal may also restrict large exposure limits to sovereigns in EU Member States in some circumstances. SA-CCR has been imposed in the large exposures framework for determining exposures to OTC derivatives, including for banks that have been authorised to use internal models.
- Total Loss Absorbing Capacity (TLAC): the proposals implement the FSB standard on TLAC in the EU as a pillar 1 MREL[3] for GSIBs only, whilst amending also the pillar 2 MREL framework under the Bank Recovery and Resolution

[2] EBA CRDIV-CRR/Basel III Monitoring, September 2016.
[3] Minimum Requirements for own funds and Eligible Liabilities

Directive (BRRD) and Single Resolution Mechanism Regulation (SRMR). Further to this, the proposals introduce a new class of senior non-preferred debt, which is subordinated to the rest of senior liabilities, to help firms meet their MREL where subordination is required.

- Other: Basel standards on equity investments in funds, exposures to CCPs and new Pillar 3 disclosures are also to be introduced.

The CRDIV/CRR Review proposals do not include any other elements of the so-called Basel 4 package (i.e. changes to the credit and operational risk frameworks, output capital floor, etc.) where work is still ongoing at Basel level. Developments in these areas could however affect the legislative process.

EU specific matters

- Intermediate Holding Company: Third Country G-SIBs and other banks with assets more than €30bn operating in the EU with two or more credit institution or investment firm subsidiaries are required to establish an EU holding company subject to capital requirements.
- Waivers from capital and liquidity requirements: the inclusion of provisions which allow home competent authorities to waive the application of solo capital and liquidity requirements within a Member State, subject to the provision of guarantees/collateral.
- IFRS 9: the impact of the new provisioning requirements will progressively be phased in over a 5-year period beginning 2019. This is inconsistent with the 1st January 2018 application date provided in the Commission delegated act[4] endorsing IFRS9.
- Specialised lending: introduction of preferential treatment for (some/limited types of) specialised lending exposures (e.g. infrastructure finance) under both standardised and advanced credit risk approaches.
- Maximum Distributable Amounts (MDA)/Pillar2 framework: clarification of the stacking order of the different capital requirements and buffers, and their interaction with distribution policy in cases of breach; inclusion of the explicit ability for supervisors to override Pillar 1 measures in most cases.

Timing and resourcing

The length of the negotiation process is of course difficult to predict but is expect to last from 12 to 24 months. At present, it is envisaged that Member States will be required to adopt national laws to implement the provisions of the CRDV one year after the Directive enters into force (two years in the case of the interest rate risk provisions). It is proposed that most of the requirements within the CRR2, which is directly applicable in all Member States and will not require implementing legislation, will come into force two years after the date of publication, although this will be negotiable under the EU legislative process. There seems to be political will at Member States' level to proceed faster on the separate proposal on creditors' hierarchy having in mind the January 2019 application date of the global TLAC requirement.

Nevertheless, it is envisaged that very significant and resource intensive aspects of parts of the proposed standards including the treatment of repos and derivatives under the NSFR, specifications and requirements under the FRTB and large exposure definitions will be passed to the European Banking Authority for further analysis and quantitative work before Delegated Acts are implemented to introduce the relevant aspects of the standards. These Delegated Acts may not be completed for potentially up to 5 years after the publication of the CRR/CRDV in the Official Journal.

Conclusion

CRDV covers a wide range of sometimes very different prudential topics with varying timeframes for implementation. It will be very important that the linkages between aspects of the individual standards and wider parts of the prudential framework, including the SSM and SRM, and their impacts, are thoroughly understood before they are finalised. This will be essential to ensure that the revised prudential standards support the resilience of the European financial sector while also allowing the continued development of market finance, the maintenance of financial stability and sustainable economic growth in Europe.

[4] Commission Regulation (EC) No 2016/2067 of 22 November 2016

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Secretariat or the Chair of the Financial Industry Committee.

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