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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

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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)**

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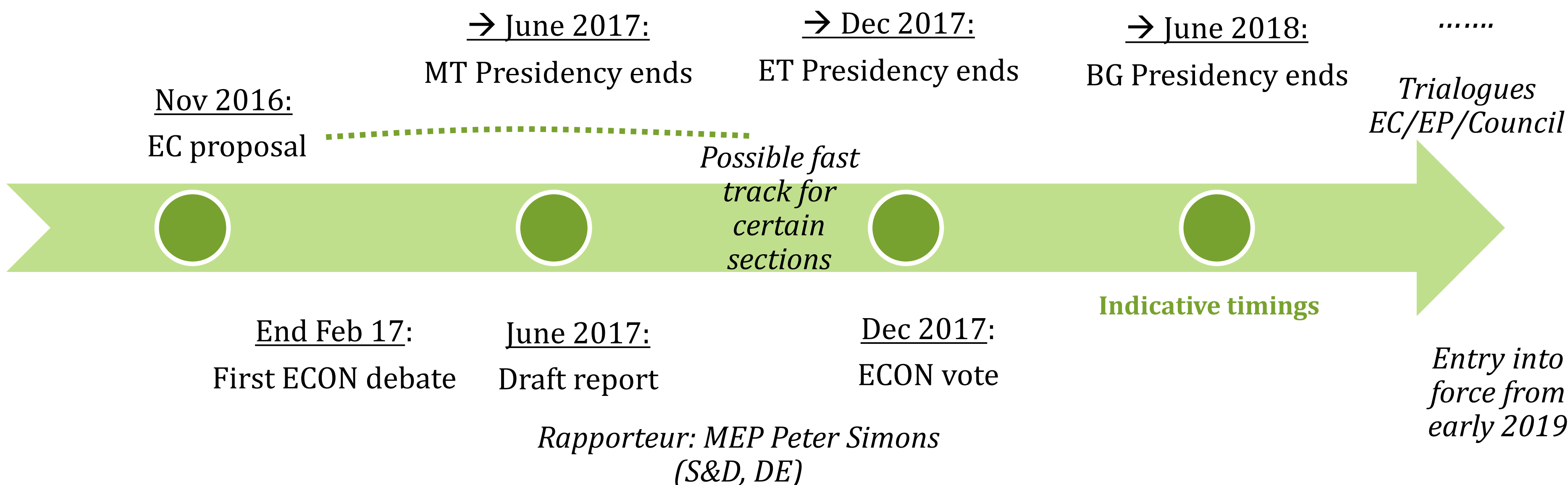
CRD5/CRR2: Content

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)

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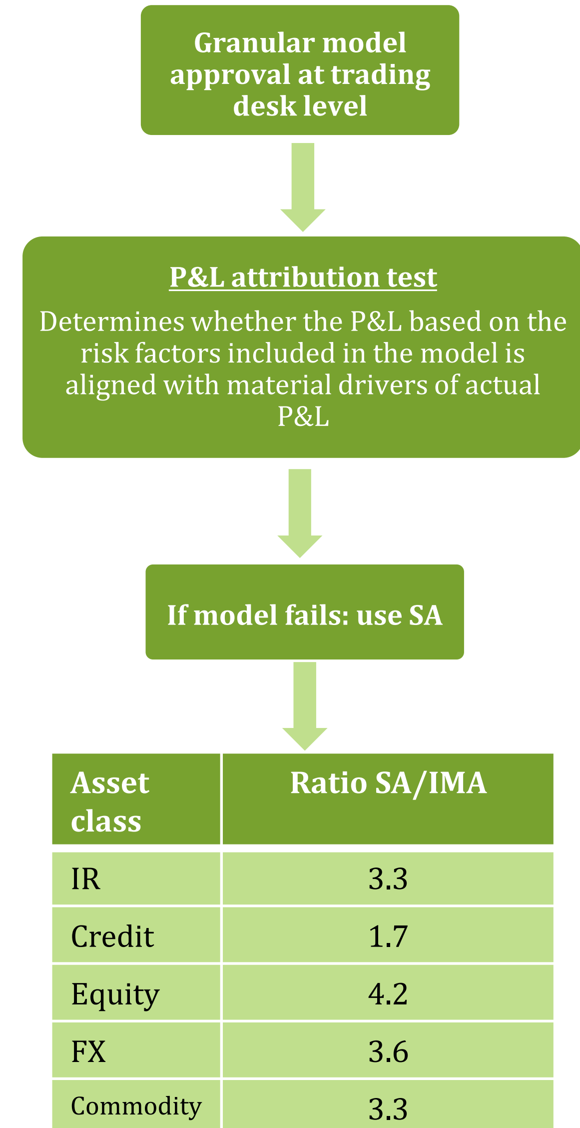
From reporting requirements in the CRR1, to binding metrics in the CRR2

	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

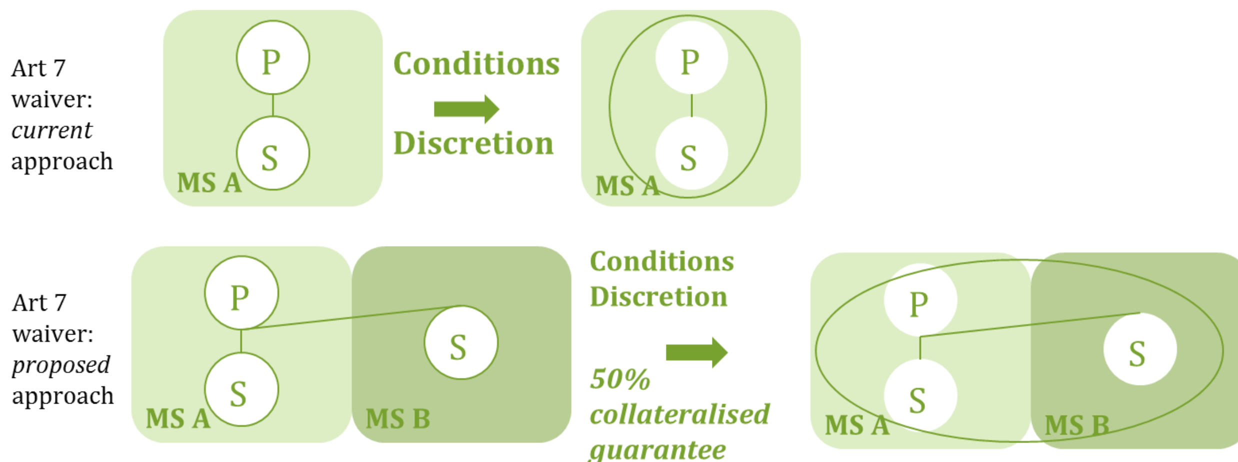
- **What is the FRTB**
  - A new capital framework for banks' market intermediation activities to address deficiencies in the pre-crisis framework and build on improvements already made (Basel 2.5)
  - Key changes include revisions to the boundary between banking & trading books, the internal models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



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
  - Signficant economic benefits to be had from removing obstacles to the free flow of funds



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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

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Other challenges for industry

- **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/

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Any questions?