CRR 2/CRD 5: High-level overview of the European Commission Proposals

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Abstract

On 23 November 2016, the European Commission released its proposals to amend the Capital Requirements Regulation (CRR) and the fourth Capital Requirements Directive (CRD 4). Through what is known as CRR2 and CRD5, the Commission is taking a significant step to complete and improve the banking regulatory framework implemented within the EU over the past few years.

The amendments proposed in CRD 5 and the CRR 2 aim to address a number of identified areas of improvements to the CRD 4 package but also implement a number of reforms that have only recently been finalised by the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). These include:

- **A binding leverage ratio,** which will prevent institutions from excessively increasing balance sheet leverage;
- **A binding net stable funding ratio** (NSFR), which will improve institutions' funding profiles and resilience against market and funding stresses;
- **More risk sensitive own funds requirements** for institutions that actively trade securities and derivatives;
- **A revised framework for capturing interest rate risk in the banking book (IRRBB)** which will entail a common approach and supervisory prescribed shock scenarios; and
- **New standards on the total loss-absorbing capacity (TLAC)** of globally systemically important institutions (G-SIIs), which will require more loss-absorbing and recapitalisation capacity.

The proposed amendments **will start entering into force in 2019 at the earliest** and are tightly inter-linked with other provisions in the CRR and the CRD, which have been in effect since January 2014.

This Briefing Note presents an overview of these regulatory developments highlighting areas that banks should carefully evaluate to ensure they can address the requirements in a timely fashion, considering all compliance and associated operational issues.

Introduction

The CRR 2 and CRD 5 reforms implement the remaining components of the original Basel 3 agreement (e.g. NSFR, Leverage ratio) into EU law and also introduce new requirements for determining capital requirements.

These new requirements can be categorised into three areas of change:

i) those affecting RWA, capital management and structure;
ii) those affecting balance sheet structure and liquidity requirements; and
iii) reporting and disclosure impacts.

Although banks are already familiar with most of these topics, the forthcoming incorporation into EU legislation will require them to re-assess the implications of these proposals on their business model, capital and liquidity requirements and associated infrastructure and processes.

Of course, this package is not the end of the banking reform journey, as BCBS has not finalised all the elements on its agenda including the standardised approach to credit risk, capital floors and operational risk capital requirements.

Changes affecting RWA and capital management

Various changes are being proposed that alter the amount and nature of capital that must be held at group and subsidiary levels. The addition of more binding constraints on capital supply including leverage, TLAC, and – in the near future – capital floors on modelled approaches, will present banks with significant optimisation challenges when making capital allocation decisions.

Furthermore, recent quantitative impact studies on the revised capital requirements changes have revealed an expected increase in capital demand for many banks – notwithstanding the intention of regulators of overall capital neutrality.

Waivers from capital and liquidity requirements

At this stage of evolution of the Banking Union, it is proposed that the Competent Authority supervising parents and subsidiaries established in different Member States within the Banking Union will be able **to waive the application of own funds and liquidity requirements for subsidiaries located in other Member States than the parent.** This waiver is conditional on the commitment of the parent to support such subsidiaries for the whole amount of the waived requirement and the guarantee is collateralised for at least half or the guaranteed amount.

Binding leverage ratio

New provisions are introduced and adjustments are made to several articles in the CRR to introduce the **leverage ratio as a binding requirement**, which will complement existing monitoring, reporting and disclosure requirements.

A leverage ratio requirement of **3% of Tier 1 capital** is added to the risk based own funds requirements in the CRR. Note that itutions **might be able to reduce the leverage ratio exposure measure** for specific activities (e.g. public lending, pass-through loans), but also via the initial margin received from clients for derivatives cleared through QCCPs.

Intermediate EU holding companies for large non-EU banking groups

A late addition to the legislative proposals will require large non-EU banking groups to establish an intermediate holding company subject to EU capital, leverage, liquidity and other prudential rules on a consolidated basis. This will have a particularly large impact on overseas banking groups that have significant amounts of their European operations through branches.

Large exposures

In the proposal, the large exposures framework is amended:

- The only capital component admissible in the new regime would be Tier 1 capital (i.e. no more Tier 2 capital);
- A lower limit of 15% would be applied for exposures of G-SIIs to other G-SIIs; and
- The SA-CCR would become mandatory to determine exposures to OTC derivative transactions even for banks authorised to use an internal model method (IMM) for counterparty credit risk.

New standards on Total Loss Absorbing Capacity (TLAC)

The TLAC standard (adopted at an international level by the FSB in November 2015) will be formally implemented in the EU via amendments to the CRR, building on the existing framework of the BRRD. It will require EU G-SIIs, to have a sufficient amount of eligible loss absorbing ("bail-in-able") liabilities to ensure smooth and fast absorption of losses and recapitalisation in the event of resolution.

This implies the introduction of a new requirement **for own funds and eligible liabilities composed of a risk-based ratio and on a non-risk-based ratio for EU G-SIIs along with an intragroup requirement for non-EU GSIIs (internal TLAC).**

The Standardised Approach to Counterparty Credit Risk (SA-CCR)

One of the most significant changes introduced relates to the new standardised methodology, known as SA-CCR, for measuring counterparty credit risk exposures associated with OTC derivatives, exchange-traded derivatives and long settlement transactions. The proposed amendments are based on the standard published by BCBS in March 2014 and include:

- The replacement of the mark-to-market method by SA-CCR and removal of the existing standardised approach;
- Addition of a simplified SA-CCR method for exposure calculation along with associated eligibility criteria; and

- Modification of the existing Original Exposure Method (OEM) is also envisaged.

The methodology is **risk-sensitive** and provides a more meaningful recognition of netting benefits. All banks will be required to report it regardless of which method is used to determine capital requirements.

Exposures to Central Counterparties (CCPs)

The proposed CRR 2 includes a range of amendments regarding exposures to CCP, which essentially transposes into EU-law the standard issued by BCBS in April 2014 and amends the EMIR provisions relating to the calculation of hypothetical capital.

Among the notable developments were the following:

- The introduction of a specific treatment of institutions' exposures to a CCPs due to cash transactions;
- The description of the treatment of initial margin and of the single method which would be applicable to the calculation of own funds requirements for exposures to qualifying CCPs (QCCPs); and
- The incorporation of a new method for calculating the hypothetical capital for default fund contributions.

Fundamental Review of the Trading Book (FRTB)

The proposals will implement the new market risk capital requirements emanating from the Fundamental Review of the Trading Book (FRTB) set out in the January 2016 standards adopted by BCBS; including the following key elements:

- A redefinition of trading/banking book boundary;
- The introduction of a new risk sensitive standardised approach that all banks will be required to report;
- The methodology used to calculate own funds will be significantly modified (i.e. expected shortfall method) and the criteria under which institutions will be allowed to use internal models **are strengthened** (e.g. P&L attribution) and will be assessed and approved **per trading desk**. Besides, the methodology to calculate own funds requirement is modified (e.g. expected shortfalls); and
- The default risk charge (DRC) replaces the incremental risk charge (IRC).

Banks are now faced with big decisions on desk structure, systems and reporting upgrades (to cope with the computational complexity) and the cost-benefit dilemma of the IMA vs. SBA decision for their portfolios.

Equity investments in funds

The treatment of equity investment funds is revised in order to achieve a more internationally consistent and risk-sensitive treatment of such exposures, including two methods to calculate own funds requirements: the look-though approach and the mandate-based approach.

SME supporting factor

A new methodology to quantify capital requirements for exposures to SMEs is proposed, further incentivising lending to such counterparties. The current capital reduction of 23.81% for an exposure that does not exceed EUR 1.5 million is maintained and a 15% of reduction for the remaining part above the EUR 1.5 million threshold is introduced.

Treatment of infrastructure exposures

Building on the on-going work carried out in the context of the upcoming reform of the Standardised Approach by the BCBS, it is proposed to grant, under both standardised and IRB for credit risk, a preferential treatment for specialised lending exposures aiming at funding safe and sound infrastructure projects.

Investment firms review

At the request of the Commission, the EBA is conducting additional work to propose a more proportionate capital regime for investment firms. The EBA published a consultation on the new prudential regime for investment firms on 4 November 2016, which is open until 2 February 2017. The final outcome is expected to be delivered in June 2017 and the Commission intends to present legislative proposals setting-up **a specific prudential framework for non-systemic investment firms by the end of 2017**.

Changes affecting balance sheet structure and liquidity requirements

Interest Rate Risk in the Banking Book (IRRBB)

The proposals include transposing into EU rules the standard issued by BCBS in April 2016 incorporating a common standardised approach to IRRBB. Outlier tests and disclosure requirements are also strengthened. The EBA is mandated to specify the details of the standardised methodology (including the IRRBB framework, the six supervisory shock scenarios, the outlier test). This formalises a currently inconsistent approach taken by banks to this critical risk factor affecting pillar 2 capital requirements. It also presents a significant data challenge for banks in coping with the scenario-based approach; especially for products with contractual optionality that rely on data evidencing historical customer behaviour in certain circumstances.

Binding Net Stable Funding Ratio (NSFR)

Various adjustments to existing liquidity rules are proposed to introduce a binding Net Stable Funding Ratio (NSFR) for financial institutions (already reported and disclosed in most cases). Among the proposals, certain treatments are clarified, including:

- The netting of secured lending and capital market-driven transactions; and
- **A risk-sensitive approach** adjusted compared to the BCBS NSFR is introduced to capture the future funding risk of derivatives (e.g. the use of the SA-CCR for margined derivatives contracts).

Changes affecting reporting and disclosure

Disclosure and regulatory reporting

Various amendments are proposed, including:

- A more proportionate disclosure framework taking into account the relative size and complexity of institutions; and
- Enhancements to proportionality and reduced costs for institutions in complying with the overall regulatory reporting framework.

The Commission also mandates the EBA to establish a report to evaluate the cost of regulatory reporting by 31 December 2019 and provide mechanisms to simplify reporting for small institutions.

The EBA published its final guidance for pillar 3 disclosures on 14 December 2016. This does not change the existing disclosure requirements enshrined in CRR, but is aimed at implementing the revised pillar 3 regime published by BCBS in January 2015, ensuring consistent application across the EU through prescribed presentational formats (for use in 2017 by the largest institutions).

IFRS 9

A new article is added to phase in the new incremental provisioning requirements for credit risk under IFRS 9 to mitigate the financial impact on institutions. This is critical for banks as IFRS 9 introduces a fundamental change in credit loss estimation with a potentially huge impact on regulatory capital. Adding to the challenge of adopting this standard is the anticipation of the requirement to estimate credit losses in regulatory stress testing scenarios under IFRS 9 standards.

Conclusions

This is a wide-ranging package of reforms to banks' prudential requirements. Much of it has been long anticipated by banks that have already conducted quantitative impact studies on the Basel proposals. However, as with all such reforms, the devil is in the detail so there is no substitute for a detailed impact analysis to ascertain the precise requirements and challenges from the perspective of policy choices, infrastructure, processes, controls and underlying data.

Given that more reforms are on the way, once BCBS finalises the items remaining on its agenda, it makes sense for firms to plan ahead and consider the likely outcome of these big changes as well.

About Avantage Reply

Avantage Reply (a member of the Reply Group) is a pan-European specialised management consultancy delivering change initiatives in Risk, Compliance, Finance (Capital Management and Regulatory Reporting), Treasury and Operations within the Financial Services industry.

Within our core competencies, we have extensive experience in implementing changes driven by:

- Industry-wide legislative and regulatory initiatives (e.g. CRD IV, BRRD, MiFID);
- Mergers, Acquisitions & Divestments (e.g. business combination, separation and flotation); and
- Business improvement and optimisation agendas (e.g. risk appetite and capital allocation).

We are available to discuss in more detail the new legislative package and its implications on your organisation.

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