Client Alert | Regulatory & Compliance

Transforming bank prudential regulation – Issue 1 of 3

December 2016

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On 23 November 2016 the European Commission published proposed amendments to the Capital Requirements Regulation and Directive, the Bank Recovery and Resolution Directive, and the Single Resolution Mechanism Regulation.

The Commission's aims for these amendments include seeking to increase the resilience of EU institutions and enhance financial stability; measures to improve banks' lending capacity to support the EU economy; and measures to further facilitate the role of banks in achieving deeper and more liquid EU capital markets to support the creation of a Capital Markets Union.

Importantly the Commission is proposing to require third country banking groups that have significant European businesses to establish and obtain authorisation for an intermediate EU holding company. This proposal in particular demonstrates a move away from international harmonisation and mutual recognition of bank prudential standards towards greater international fragmentation and national ring fencing.

The amendments themselves fall into three main categories:

(I) Amendments to capital and liquidity requirements.

(II) Amendments to the resolution framework.

(III) Amendments to improve proportionality.

The Commission does not foresee these amendments going live before Summer 2019 at the soonest.

We are publishing three separate client alerts that cover all aspects of the Commission's proposals.

This first client alert focuses on the following new provisions and proposed amendments:

- Leverage Ratio
- Own Funds and Liquidity requirements
- large exposures
- the Commission's approach to 'proportionality' and
- the treatment of SME exposures
- powers to exempt entities from CRD and CRR

Capital and Liquidity Requirements

(A) Leverage Ratio (CRR Part Seven arts. 429- 430)

The proposal makes adjustments to the existing Capital Requirements Regulation (“CRR”) text and introduces a binding leverage ratio requirement of 3% of Tier 1 capital for all institutions subject to the Capital Requirement Directive (“CRD”). This is to be met in addition to risk based capital requirements.

However, acknowledging that the proposed 3% ratio is not appropriate for all institutions, the Commission has outlined a number of additional adjustments to those already contained in the CRR:

- The leverage ratio exposure measure may be reduced by the amount of pass-through promotional loans and officially guaranteed export credits.
- Institutions are allowed to reduce the exposure measure by the initial margin received from clients for derivatives cleared through qualifying central counterparties.
- Public development banks may reduce their exposure by the amount of lending they provide to finance public sector investments.

The proposal does not contain a leverage ratio buffer for global systemically important banks (“G-SSIs”) but it is envisaged that such a requirement will follow once there is final international agreement on the appropriate leverage ratio buffer for G-SIIs

(B) Net Stable Funding Ratio (NSFR)(CRR Part Six Title IV arts. 428a 428ag-)

Following the financial crisis, Basel Committee on Banking Supervision (“BCBS”), the Commission and others identified over-reliance on short term wholesale funding for long term finance activities as a key issue for the financial system.

Under the current CRR requirements long-term assets must be balanced by a diversity of stable funding instruments. The proposal builds on this with the introduction of the Net Stable Funding Ratio (“NSFR”), which is calculated as the ratio of an institution’s available stable funding needs over a one year horizon. The NSFR is expressed as a percentage and set at a minimum level of 100% to ensure that credit institutions and systemic investment firms have a sustainable stable and funding structure.

The proposals foresee a failure to comply with the NSFR as carrying potential supervisory sanctions.

Under the proposal, the NSFR would come into force two years after the date of entry into force of the proposed Regulation, with implementing standards being drafted by the EBA in the meantime.

(C) Market Risk – Trading Book (CRR mainly Title IV Part 1 arts.325d -325e)

The Commission proposes a specific prudential regime for instruments that banks hold for trading, such as shares, bonds or derivatives (its Trading Book) which are particularly subject to volatility.

This proposal stems from the work that the BCBS commenced in 2009 on the “Fundamental Review of the Trading Book”, which the Commission now proposes to transpose, with some EU specific alterations, into EU law. This would include:

- Establishing clearer and more easily enforceable rules on the scope of application to prevent regulatory arbitrage (e.g. picking the most favourable capital treatment between the trading book and the banking book);
- Improving risk-capture, making requirements proportionate to reflect more accurately the actual risks to which banks are exposed;
- Strengthening the conditions to use internal models to enhance consistency and risk-weight comparability across banks.

In keeping with the spirit of the Commission's proposal however, proportionality would remain a central issue, and certain exemptions are foreseen:

- Banks with small trading books (under EUR 50 million and less than 5% of the institution's total assets) can still benefit from a relaxation of the law, which allows them to apply the treatment of banking book positions to their trading book.
- Banks with medium-sized activities subject to the market risk capital requirements (under EUR 300 million and less than 10% of the institution's total assets) may use the simplified standardised approach, which corresponds to the existing standardised approach.

The rules would come into place two years after the entry into force of the proposal. From that date the proposal allows for a phasing in period of three years during which banks will be allowed to multiply their own fund requirements by 65%, although this will not apply when banks use the simplified standardised approach to calculate them.

(D) Large exposures (CRR arts 390 – 403)

The Commission is proposing to make changes to the "large exposures" regime. Specifically it proposes a change to the quality of capital that can be taken into account when calculating the large exposures limit (only Tier 1 capital), the introduction of a lower limit of 15% for G-SIIs exposures to other G-SIIs, and the imposition of the use of the standardised approach for measuring counterparty credit risk ("SA-CCR") methods for determining exposures to OTC derivative transactions.

In the case of banking groups that are subject to consolidated supervision, article 11 of the re-cast CRR will continue to require parent credit institutions to comply with the large exposures regime on the basis of the consolidated position of the group.

A consolidated group's internal control and reporting framework will need to be able to monitor for these refinements to the large exposures regime.

(E) Pillar 2 (CRD arts 104 -104a)

The Commission is proposing to substitute new provisions in the CRD to clarify and make explicit the current Pillar 2 supervisory review and potential capital add-ons. The CRD outlines conditions in which supervisors can conclude that additional reporting and capital requirements can be imposed. The new CRD provisions are prescriptive about the proportion of any additional capital that must be met with Tier 1 capital and CET1 capital in particular. In addition, to avoid potential clashes with macro-prudential instruments, the proposal provides that Pillar-2 capital add-ons should be confined to address non-macro-prudential concerns. Generally these changes may be seen as constraining desirable flexibility for bank supervisors.

(F) Waivers from capital and liquidity (art 7 CRR)

EU institutions that are subject to consolidated supervision prudential requirements (including own funds and liquidity), can only have applicable provisions waived at individual level for subsidiaries within the same member state that are overseen on a consolidated basis by the same supervisor.

The Commission's proposal is to extend, under certain conditions, the possibility of a waiver to where a competent authority supervises parents and subsidiaries established in different members states. The conditions include the requirement that a parent guarantee is collateralised and the guarantee and financial collateral arrangements should be subject to the law of the member state of the beneficiary institution or institutions. The collateral must be high quality and after the application of haircuts must cover at least 50% of the amount of the guarantee.

These new provisions appear designed to satisfy national authorities with local subsidiaries of banking groups that they will be able effectively to allow consolidated prudential supervision because parental guarantees that will be underpinned by collateral arrangements.

Proportionality

(A) Reporting

The Commission proposes several amendments to streamline and clarify the reporting requirements.

Small institutions, (as defined in a new article 430a) will be required to submit regulatory capital reports less frequently than is the case now while reporting on large exposures will be simplified too.

In addition, the CRD will be amended to clarify the grounds on which competent authorities will be entitled to require additional reporting.

(B) Disclosure

Proposed amendments to the disclosure requirements seek to make them more proportionate; align the disclosure requirements more closely with international standards; and give the EBA the means to develop uniform disclosure formats. Under the proposal the Commission would also be given the power to amend disclosure requirements in order to keep up with international standards on disclosure.

(C) Remuneration

The Commission has proposed changes to the CRD remuneration rules which it noted were not always proportionate. This was particularly the case with the rules on deferral and pay-out in instruments, which are not workable for the smallest and least-complex institutions. It proposed targeted amendment to the remuneration rules to allow listed institutions to use share-linked instruments for meeting the CRD requirements.

(D) SMEs and Infrastructure

In line with the Commission's stated aim of supporting SMEs, the current capital reduction of 23.81% for an exposure to an SME, if it does not exceed EUR 1.5 million, is maintained.

In relation to an SME exposure exceeding EUR 1.5 million, 23.81% capital reduction for the first EUR 1.5 million portion of the exposure; and a 15% reduction for the remaining part of the exposure above the threshold of EUR 1.5 million is now proposed.

(E) Exempted Entities

The Commission proposes a replacement to the current implementing power of the Commission which would allow it to exempt further entities from the CRD where certain criteria are fulfilled. This is designed to allow all Member States to give public development banks and credit unions the possibility to operate only under national regulatory safeguards.

Implications for banks and other institutions subject to CRD and CRR

- The Commission's proposals do not represent the totality of the changes that could arise from changes to the Basel III framework that are due to be announced by the BCBS. In particular the BCBS is expected to recommend further significant changes to banks using internal capital models involving the introduction of capital floors designed to constrain differences in calibration between banks based on assets of the same credit quality.

- Banks will need to monitor the progress of the proposals concerning in particular the leverage ratio, long term liquidity requirements, market risk and large exposures so that they are ready for their introduction in 2019.

Links to the Commission's proposals can be found here:

http://ec.europa.eu/finance/bank/docs/regcapital/crr-crd-review/161123-proposal-amending-directive_en.pdf

http://ec.europa.eu/finance/bank/docs/regcapital/crr-crd-review/161123-proposal-amending-regulation_en.pdf

http://ec.europa.eu/finance/bank/docs/crisis-management/161123-proposal-directive-unsecured-debt-instruments_en.pdf

http://ec.europa.eu/finance/bank/docs/crisis-management/161123-proposal-directive-recapitalisation-capacity_en.pdf

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