REGULATION

New package of banking reforms

Regulation & Public Policies

The European Commission has presented today a new legislative package aimed at amending both the current banking prudential and resolution frameworks. The revision includes the implementation of several international standards into the EU law (some regulatory pieces adopted by the Basel Committee after 2010 and the TLAC standard) and the introduction of a package of technical improvements (mainly identified as unintended consequences of the regulation in the Call for Evidence launched by the Commission). In parallel, a legislative proposal to harmonise creditor hierarchy of senior debt across the EU has also been released. The publication of these proposals is only the first step in the legislative process of the European Union. A negotiation period of approximately one year can be expected before a final text is agreed.

Content and timing of the proposal

The European Commission has presented today a new comprehensive package of reforms to further strengthen the resilience of European banks. The package of risk reduction measures includes the implementation of outstanding international standards (some regulatory pieces adopted by the Basel Committee after 2010 but not those pieces which are currently under discussion in Basel and the TLAC standard) and at the same time certain amendments to take into account European specificities or unintended consequences identified in the Call For Evidence. This is in line with the defined roadmap for completing the Banking Union which established that bank's risk reduction was needed before moving forward. The spirit of the Capital Market Union is also present as the Commission wants to ensure that strong banks continue to play a key role in supporting growth and financing the economy. The scope of this revision is double:

1. **Prudential framework**: the Capital Requirements Regulation (CRR) and the Capital Requirement Directive (CRD IV) are amended to introduce international standards and technical improvements.

Main changes in CRR include:

- Introduction of a mandatory requirement of **leverage ratio** of 3% of Tier 1 aimed at preventing excessive leverage and at acting as a backstop to internal model based capital requirements. No buffer for GSIBs has been included.
- Implementation of the **Net Stable Funding Ratio** (NSFR), with the objective of promoting a sustainable stable funding structure, with some adjustment from Basel so as to adjust to European specifities
- Clarification of the **minimum requirement for own funds and eligible liabilities** (MREL), which is specified for global systemically important banks (G-SIBs) and will be determined on a case-by-case basis for the rest of entities.
- A new standardised approach for measuring **counterparty credit risk** exposure, in substitution of the Current Exposure Method and the Standard method and aimed at increasing risk-sensitivity in non-internal models.
- Implementation of the **Fundamental Review of the Trading Book (FRTB)**, including modifications to both the standard and internal approaches and a new definition of trading desk.

- New rules for exposures to **central counterparties (CCPs)** and the treatment of default funds in both qualifying and non-qualifying CCPs.
- New framework for **equity investment in funds**, with revised conditions for the use of the different methods allowed.
- Implementation of the new **Large Exposure Framework**, which includes: i) a new capital base (Tier 1 instead of eligible capital), ii) a hardened requirement for exposures of a G-SIB to another G-SIB (limit set at 15% of Tier 1) and iii) a final provision requiring that sovereign exposures incurred from november 2016 are subject to this framework (with a phase in period of three years).
- New **disclosure requirements**, to enhance consistency with the new Pillar 1 and ensure a proportionate application of these requirements.

Main changes in CRD IV include:

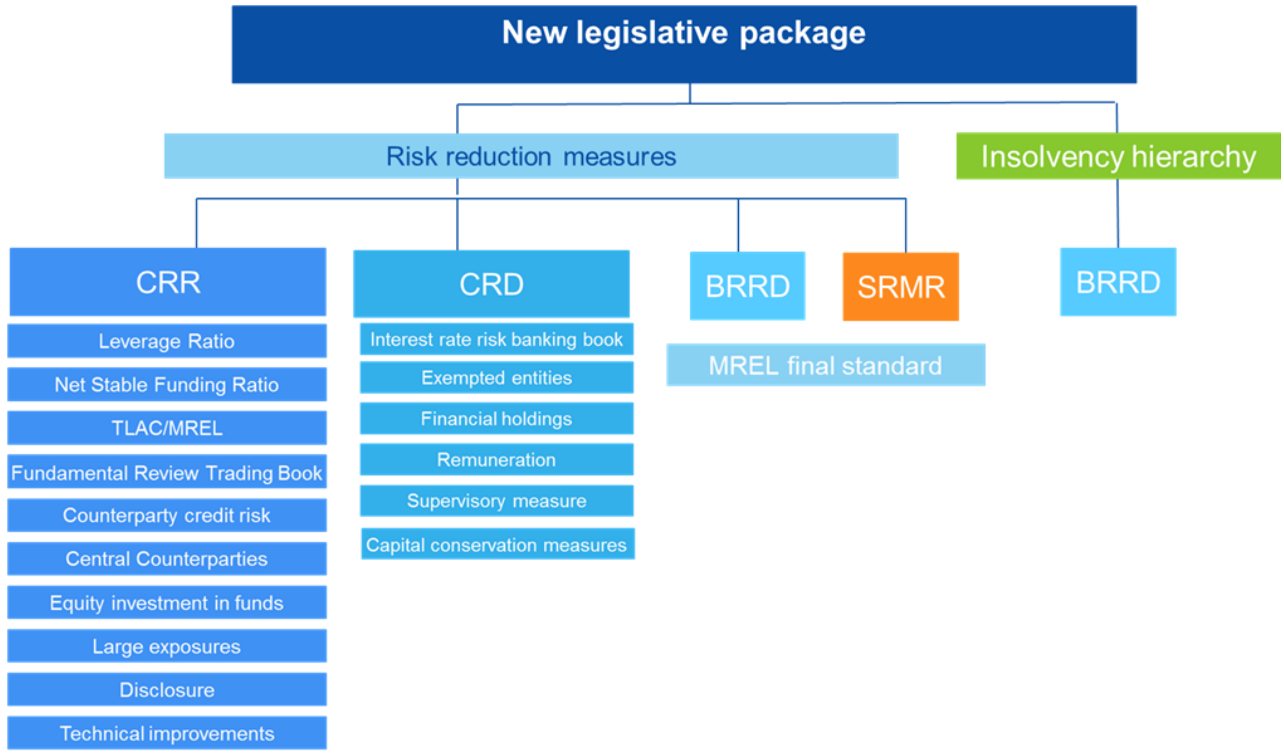
- Implementation of a new framework for measuring the **interest rate risk in the baking book**, which remains as a Pillar 2 risk.
- Update of the criteria and powers of the Commission to **exempt entities** from the compliance of the CRR and the CRD IV.
- Inclusion of **financial and mixed financial holdings** under the scope of CRD IV, including of the need for authorisation and supervisory powers over these companies. Moreover, a provision is introduced so that third country banking groups, which are G-SIBs or have total assets above EUR 30 billion and two or more subsidiaries operating in the EU, have to establish an intermediate parent undertaking in the EU.
- **Remuneration** rules have been adapted to ensure their proportional application. Small and non-complex institutions will not be subject to deferral rules and pay-out requirement in their variable remuneration.
- **Pillar 2 framework** is clarified, differentiating between Pillar 2 requirement and guidance. Also light is shed regarding the stacking order for the activation of **capital conservation measure**.

2. Resolution framework: the Bank Recovery and Resolution Directive is also modified to include:

- Clarification of the MREL requirement and also a harmonised ranking of unsecured debt instruments in **insolvency hierarchy**.

Figure 1

Commission's legislative package



Source: BBVA Research

The Commission's proposal is only the first step in the European legislative process. Negotiations will now begin in the Parliament and the Council, both of which need to reach an internal agreement before trilogues can begin and a final text is agreed. The negotiation process is expected to last approximately one year, and after the approval of the final text, the different measures included in this review will have a specific date for their entry into force.

Figure 2

Expected timeline

Source: BBVA Research

BBVA Research assessment

- **The Commission's proposals present a wide and comprehensive review that affects both the prudential and the resolution frameworks**. The implementation of international standards is positive and technical improvements are welcomed. After three years of application of the current prudential framework, we are in a good position to identify issues that are not working as expected.

- **Adjustments made to reflect European specificities are welcome.** Nevertheless, it is also necessary to take into account the specificities of the markets in which European banking groups operate in order not to unduly penalise banking groups with a global footprint.

- **Clarification of the new Pillar 2 framework is very positive.** It is necessary for markets and institutions to provide certainty to the regulatory framework. Nevertheless, the breach of the MREL requirement should not trigger the activation of the MDA, as this requirement responds to a different nature than the prudential requirements.

- **The regulatory overhaul is still running**. After eight years of design and implementation of new prudential and resolution standards, the review process is not yet concluded. With this legislative package just released, the industry and the markets already have an eye on the finalisation of the Basel III framework, which will be discuss in Chile next week, and its future implementation in Europe.

- **This legislative proposal already includes some of the standards that have been discussed under the review of the Basel III framework**, namely: i) the new framework for interest rate risk in the banking book, ii) the revised standardised approach for counterparty credit risk and iii) the fundamental review of the trading book. The rest of the elements of the so-called Basel IV remain under discussion by the group of governors and heads of supervision (GHOS) and will be implemented into the european framework once an international agreement has been reached.

Annex: specifics of the proposal

Amendments to the Capital Requirements Regulation (CRR)

Leverage ratio

The proposal introduces the binding requirement of 3% of Tier 1 for institutions under CRD. This requirement is complementary to the risk-based requirements and will act as a backstop for institutions. The implementation includes targeted adjustments to the exposure method in order not to constrain specific business models (public lending by development banks, pass-through loans, officially guaranteed export credits and initial margin for derivatives cleared by QCCPs). At an international level, discussions are being held on whether it would be appropriate to set a leverage ratio buffer for G-SIBs. This feature will be considered for its inclusion in Europe if it is agreed internationally.

Net Stable Funding Ratio

The implementation follows the Basel standard but includes targeted provisions that partially deal with the main concerns expressed by the industry.

- It recognizes a 0% required stable funding (RSF) factor for eligible high quality liquid assets (HQLA) Level 1, contrary to the 5% RSF established by the BCBS. This better aligns the NSFR with the LCR by recognizing the same liquidity category for assets under both ratios and thus limits any negative impact the NSFR might have on sovereign bond markets.
- It temporarily reduces the RSF factor for assets resulting from transactions with financial clients which have a residential maturity of less than six months, therefore reducing the asymmetrical treatment of repos and reverse repos, which was one of the main concerns raised by the industry.
- Finally, it temporarily applies a 10% RSF factor (instead of 20%) to unmargined gross derivatives liabilities. For margined gross derivatives liabilities it allows either a 20% RSF factor or the use of a potential future exposure (PFE) methodology as calculated under the standardized approach for counterparty credit risk (SA-CCR). The Commission has up to three years from the introduction of the NSFR for the implementation of a delegated act in order not to revert to the more stringent BCBS standard.

Fundamental Review of the Trading Book

The new market risk framework includes significant changes. Among others, it clarifies the criteria to assign positions to the trading and banking book in order to avoid regulatory arbitrage. A new concept of trading desk is defined and the authorisation for the use of internal models has been established at trading desk level. This new framework also includes modifications to the calculation of capital requirements both in the standardised approach (which is substituted by a new one, including a simplified SA) and in the internal models approach, in line with the final Basel standards. In order to achieve a proportional application of these standards the scope of entities that can apply simplified requirements is widened (trading book < EUR 50 million or 5% of total assets).

Counterparty credit risk, central counterparties and equity investment in funds

- The proposal also implements the new standardised approach for measuring **counterparty credit risk** exposure. This new standardised approach is introduced in substitution of the current non-internal models (Current Exposure Method and Standard Method). The main objective of this new framework is increasing risk-sensitivity for those entities not applying internal models.

- New rules are introduced for **exposures to central counterparties** (CCPs). Some of the novelties include the recognition of exposures due to cash transactions and the treatment of default funds both for qualifying and non-qualifying CCPs.
- Finally, a new framework for the treatment of **equity investments in funds** has also been introduced, aimed at better achieving a more risk-sensitive treatment of such exposures.

Large Exposures Regime

Following the Basel standard, the proposal modifies the capital base that is taken into account to calculate the large exposures limit. Currently, this limit is established as 25% of eligible capital (which is defined as Tier 1 plus Tier 2 equal or less than ⅓ of Tier 1) and now, the limit is established in terms of Tier 1. Moreover, a lower limit of 15% of Tier 1 is introduced for exposures between G-SIBs, with the aim of limiting potential contagion between these entities.

Disclosure requirements

The proposed amendments for disclosure requirement include:

- Enhanced proportionality of requirements: the new provisions consider the size and complexity of the institutions to determine the precise burden of disclosure. Three categories are defined according to their significance (significant, small and other institutions) and requirements differ both in substance (items to disclose) and frequency (annual, semi-annual or quarterly) depending on the classification of the institution.
- Enhanced consistency with new Pillar I requirements: the provisions include disclosures on new requirements such as own funds and eligible liabilities, expositions to counterparty risk, liquidity requirements (LCR and NSFR) or leverage.

Other technical improvements to the CRR

- **Minority interests**. Capital issued in third countries by Intermediate Financial Holding Companies can now be recognised at a consolidated level when these holding companies are subject to an equivalent prudential regulation in the country of issuance.
- **Regarding the new provisioning standards**, the proposal also includes a phase-in period to allow banks adapt to the new IFRS 9 and its effect on capital. This way, the Commission proposes to phase-in the effect of this standard in capital in a period of five years since the entry into force of the amendments.
- The **SMEs supporting factor** is not only maintained, but widened in its scope, to capture exposures of over EUR 1.500.000, although the capital reduction is lower for this tranche.

Amendments to the Capital Requirements Directive (CRD)

Interest Rate Risk in the Banking Book

The **interest rate risk in the banking book** (IRRBB) is included as part of the Supervisory Review Process (Pillar 2) and in line with the BCBS standard published in April 2016. The proposal introduces a new framework for measuring interest risk arising from banking book positions. Three of the main elements included in this review are: an update of the standard outlier test, the inclusion of credit spread risk in the banking book (CSRBB), and some additional disclosure requirements. Finally, the EBA is mandated to define 6 supervisory shock scenarios and to further elaborate the details of the new standard methodology.

Financial and mixed financial holdings

Financial and mixed financial holdings are included in the scope of the CRD IV. The proposal includes the need for authorisation and introduces direct supervisory powers over these holding companies in Europe. The proposal also includes a provision requiring the constitution of an intermediate EU parent undertaking when a third-country group, which is a G-SIB or has total assets >EUR 30bn, has two or more institutions operating the EU. This provision is included to facilitate the implementation of internal loss-absorbing capacity for non-EU global systemically important institutions (G-SIIs) in EU law and also to simplify and strengthen resolution processes of third country groups.

Remuneration

The Commission has found that the current remuneration framework is not workable for small and non-complex institutions. For this reason, it has been revised to exempt these entities from complying with some of the established rules, namely: i) the obligation to defer at least a 40% of variable remuneration and ii) the obligation to pay-out at least 50% of variable remuneration in shares.

Pillar 2

The proposal also reviews the current Pillar 2, one of the main elements of the Basel framework, which aims at covering risks that are not adequately covered in Pillar 1. The different interpretation of the current provisions among Member States, has revealed a need to clarify this framework.

Supervisory powers conferred to competent authorities are clarified, especially in relation to the capacity to impose additional capital requirements. This capacity is now included in the new **Pillar 2 requirement** and can only be applied under certain and specified situations. When this power is issued and an entity is required to hold additional own funds, these must be at least in ¾ Tier 1, and among this Tier1 another ¾ shall be CET1.

Apart from the Pillar 2 requirement, the proposal also introduces the **Pillar 2 guidance**. This second leg of the Pillar 2 framework allows competent authorities to inform an entity that it is expected to hold additional own funds, above of those of the Pillar 1, Pillar 2 requirement and capital buffers as a result of the review of the internal capital adequacy assessment process.

The interaction between all the different requirements (Pillar 1, Pillar 2, MREL and combined buffers) is clarified for the application of the capital conservation measures. The additional own funds communicated under Pillar 2 guidance would not activate the MDA when breached.

Amendments to the resolution framework

TLAC implementation and MREL review.

The Commission's proposal brings MREL closer to TLAC. Finally there is enough clarity for banks to start complying with the new loss-absorption requirements. The Commission's proposal introduces TLAC in the EU by adapting the MREL of EU G-SIIs so its features coincide with those of the Financial Stability Board's Term Sheet (with very few exceptions) in terms of calibration, eligibility, mandatory debt subordination, timing to comply, etc. Key points of the proposal are:

- EU G-SIIs now have to comply with a common minimum MREL level of 16% of RWAs or 6% of the leverage ratio exposure (LRE) in 2019 and 18% of RWAs or 6,75% of the LRE in 2022. The resolution authority may decide to complement that minimum MREL requirement with a specific add-on.

- The requirement for banks other than EU G-SIIs will continue to be set on a case-by-case basis although its features have been amended and clarified.
- Furthermore, the proposal also introduces a clear and harmonized creditor hierarchy in Europe. The Commission has opted to mirror the French approach by forcing Member States to create a “non-preferred” senior debt class that banks can use in order to issue TLAC/MREL compliant debt.
- Also, the proposal introduces the concepts of resolution entities and groups (also as per the TLAC term sheet) which clarifies the scope of application of MREL and is consistent with both multiple and single point of entry resolution strategies.
- Finally, the Commission seems to have taken EBA’s recommendations into account besides the one related to reducing the scope of affected liabilities in art. 55 of the BRRD. EBA’s final report on MREL is not yet published but is expected to come out very soon.

DISCLAIMER