From Basel to Brussels: Revising CRR, CRD4 and the BRRD to reflect latest international standards

The European Commission has published a substantial set of proposed revisions to the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD4), together with some related revisions to the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR).

In summary

The proposed revisions implement recent Basel Committee standards and other updates, including:

- The revised market risk framework;
- Total loss absorbing capacity and related bail-in issues;
- Revised large exposures standards;
- Revised approaches to counterparty credit risk, exposures to central counterparties, and exposures to collective investment undertakings;
- Interest rate risk in the banking book;
- Making the leverage ratio and the net stable funding ratio (NSFR) binding minimum requirements;
- Pillar 3 disclosure requirements and regulatory reporting; and
- Phasing-in the regulatory implications of IFRS 9's new impairment model.

The proposed revisions will need to be discussed by the European Parliament and Council, with the intention that most of them will be implemented from 2020. For the revisions to the CRR, the text states that CRR2 will enter into force twenty days following its publication in the Official Journal of the European Union. The amendments relating to IFRS 9 would then apply as soon as CRR2 comes into force, while the TLAC revisions would apply from 1 January 2019. All of the other revisions would apply from two years after date of entry into force.

So if CRR2 entered into force at the end of 2017 – which may be an ambitious target – this would allow the IFRS 9 phasing-in to begin from January 2018, and the TLAC provisions to be applied in line with the January 2019 timing set out by the Financial Stability Board, while all the other CRR2 revisions would apply from January 2020.

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As with the original CRR and CRD4 legislation, the European Banking Authority (EBA) will be mandated to produce a large amount of regulatory technical standards and guidelines to supplement the legislative text.

The proposed revisions reflect four driving forces:

Copy out – the revisions mostly copy out the international standards agreed by the Basel Committee.

EU specific amendments – in places the proposed revisions introduce an EU specific overlay and some fine-tuning in response to industry feedback to the Commission's 'call for evidence'. These mostly reflect long-standing EU policy objectives (the preferential treatment of covered bonds and SME financing) and the Capital Markets Union initiative (the preferential treatment of qualifying infrastructure lending, simple securitisations and transactions that enhance market liquidity), together with some other adjustments to reduce the exposure measure used to calculate the leverage ratio. In addition the revisions cover a 'corresponding deduction' approach to banks' holdings of other banks' loss absorbing capacity, and waivers from the capital and liquidity requirements on the EU subsidiaries of EU parent banks.

An adjustment period – most of the proposed revisions will not apply until 2020, depending on when CRR2 enters into force. And some additional phasing-in is proposed for the market risk and IFRS 9 requirements.

Proportionality – the proposed revisions introduce greater proportionality for credit institutions, with smaller institutions facing lower regulatory reporting and public disclosure requirements, and non-systemically important investment firms being exempted from the proposed revisions.

However, **two critically important areas are not addressed by the proposed revisions**.

First, because the Basel Committee has still not finalised some of its revised standards, the Commission's proposals **do not cover any of the prospective Basel Committee revisions to credit risk, operational risk and the capital floor**. Even if the Basel Committee finalises its standards in these areas early next year it is not clear how or when the Commission would introduce further revisions to the CRR to implement these standards. Further ahead there may also be amendments to the treatment of sovereign risk exposures.

Second, notwithstanding the reduced (65 percent) capital requirement for market risk in the first three years of application, the copy-out of (almost all of) the revised market risk framework means that the Commission is **not currently proposing any EU-specific push back against the eventual impact of this framework on banks' capital requirements**, notwithstanding strong EU political support for the much-quoted Basel Committee mantra that revisions to the risk weighting of banks' exposures should not generate significant increases in banks' capital requirements.

Implications for banks

There are no major surprises for banks here on the substance of the proposed revisions, which will implement international standards agreed over the last two to three years.

Larger credit institutions – especially global systemically important banks – will eventually face significantly higher capital, liquidity, reporting, and internal system and control requirements as a result

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of these proposed revisions, with the largest impacts likely to be from the market risk and TLAC requirements.

There is some comfort for banks with significant trading books. The date of implementation seems likely to be 2020 at the earliest, and there will then be a three-year period during which only 65 percent of the full market risk capital charge will be applied. Thereafter, 'Basel 4' is expected to increase significantly the capital requirements on many European banks, as a result of both the new market risk framework and the prospective revised Basel Committee standards on credit risk (standardised and internal ratings-based approaches), operational risk and the capital floor.

The EU-specific adjustments to some of the relevant Basel Committee standards – in particular the leverage ratio - will generally have a downward, albeit modest, impact on banks' capital requirements compared with the Basel Committee standards themselves.

Meanwhile, the moves towards greater proportionality could reduce significantly some of the reporting, disclosure and additional capital requirement burdens on smaller credit institutions.

There is a potential awkwardness with the timing of the IFRS 9 provisions. If the CRR2 does not enter into force before the end of 2017 then another way will need to be found to activate the phasing-in of the impact of IFRS 9 on banks' regulatory capital positions from the IFRS 9 start date of 2018.

Further insights

For more details please consult the extended version.

Key links

- Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD4)
- Bank Recovery and Resolution Directive (BRRD)
- Single Resolution Mechanism Regulation (SRMR).

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