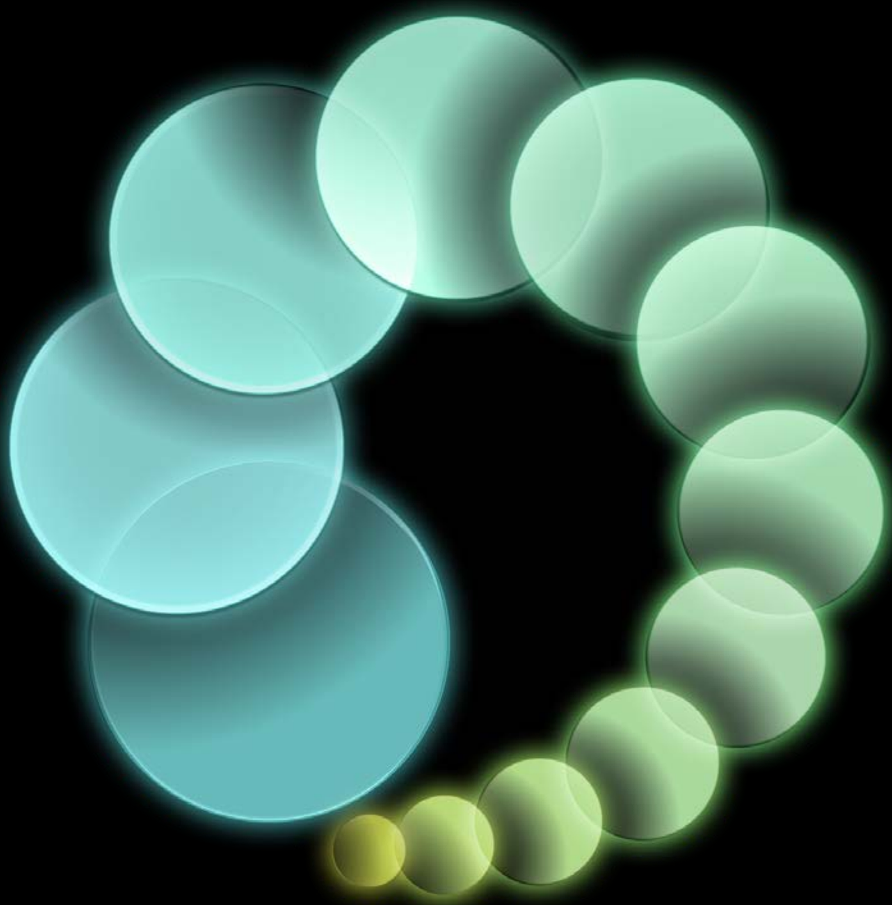

Regulatory developments in August / September

Key regulatory developments during the August/September 2017

EU bank capital negotiations

Update on CRD5/CRR2 latest progress, October 2017

Original texts of the European Commission's CRD5/CRR2 proposals

Negotiations in Brussels have kicked-off again on the European Commission's 'CRD5/CRR2' bank capital and liquidity package (including amendments to the BRRD).

The proposed legislation implements important components of Basel III and the FSB agenda – including Total Loss-Absorbing Capacity (**TLAC**), the Net Stable Funding Ratio (**NSFR**) and the Fundamental Review of the Trading Book (**FRTB**) – into EU law, but excludes the package of Basel reforms that is still being finalised by the Basel Committee on Banking Supervision (BCBS) (i.e. SA credit risk, IRB constraints, operational risk, and standardised output floors) often referred to as 'Basel IV'.

This note updates on the key points of debate that we understand have emerged in the EU's CRD5/CRR2 negotiations in the last three months, and our views on the next steps as it progresses towards becoming law. It is presented on a best efforts basis, recognising that further changes may yet emerge in the negotiations to finalise the package.

The following points reflect our latest understanding:

- The EU negotiations are **progressing more slowly than anticipated,** and the fast-tracking of some elements of the package (e.g.IFRS9 phase-in) have slowed down talks on its other components
- More detailed **negotiations on the NSFR and FRTB are due to kick-off this Autumn**, for the first time, as the Estonian Presidency of the European Council seeks to make progress on a broader range of components
- **US regulatory developments**, including the US Treasury's recommendation to pause implementation of the NSFR and FRTB are being frequently cited by EU negotiators as justification for potentially extending the delay of certain standards (particularly FRTB application).
- It is unlikely that the Council will conclude its internal negotiations on CRD5/CRR2 before the end of the year, this now looks **more likely to happen in H1 2018**
- The European Parliament's Economic and Monetary Affairs Committee (ECON) is also delayed in its parallel negotiations on CRD5/CRR2
- These developments, taken together, will push back the date when the Council and Parliament can begin negotiations with each other on a final CRD5/CRR2 text (talks which are expected to take roughly one additional year to complete)
- As a result, we are updating our projection for the finalisation of CRD5/CRR2 from Q1 2019 to **Q2/Q3 2019**
- This will have a knock-on effect for the implementation of CRD5/CRR2 components that are due to apply only 2 years after the law is finalised (e.g. NSFR, FRTB, etc.)

Key issues being negotiated now

Fundamental Review of the Trading Book (FRTB)

After being largely ignored before the summer, FRTB negotiations are now expected to pick up in earnest. Transitional arrangements will be a key feature of the early talks, and we understand that the European Council feels a large majority of EU Member States and the ECB now favour a 3 rather than 2 year implementation period in order to give supervisors more time to assess internal model applications. If adopted, **this would mean the FRTB would likely not come into force in the EU until 2022** (based on an expected 2019 agreement). The subsequent 3-year 0.65 multiplicative factor on own funds requirements for market risk will also be discussed, but some Member States will likely seek amendments to ensure full compliance at the end of the 3-year period (i.e. remove the Commission's ability to extend this partial waiver) and design a floor to ensure that the overall own funds requirements of banks do not drop from existing levels as a result of applying the discount to the new approach. We understand that, when considering the delays to the FRTB framework that this approach would create, EU negotiators have noted the June recommendation of the US Treasury to delay the application of the FRTB in the United States.

Net Stable Funding Ratio (NSFR)

Similarly to the FRTB, negotiations on the NSFR are expected to pick up in the coming months. Initial discussions will be held on the Commission's proposed 3-year reduction in Required Stable Funding (RSF) for securities financing transactions (a deviation from the BCBS rules) where some opposition has been registered from Member States who are keen to keep to the Basel standard. Importantly, however, we now understand that for the proposed 3 year reduction in RSF for gross derivatives liabilities, the Council Presidency has proposed to park those negotiations entirely until the Basel Committee finalises its ongoing review of the treatment of margining in the NSFR. Meanwhile, the Council Presidency has split a number of 'technical' NSFR issues away from the more political ones mentioned above, and intends to make progress on these negotiations via a 'written procedure' process of collecting written comments and proposals from national subject-matter experts.

Pillar 2 capital buffers

Talks on the Pillar 2 capital framework are further along than other components of CRD5/CRR2, but will still require more work. It now appears highly likely that the European Council will require supervisors to make a clear division between firm-specific 'hard' Pillar 2 capital requirements and 'soft' Pillar 2 supervisory guidance (bringing EU-wide practices much closer to the UK's practice of dividing Pillar 2 buffers between 'Pillar 2A' and the 'PRA buffer'). A number of Member States have a range of smaller concerns over the re-design of the Pillar 2 framework, concerning potential overlaps and the relationship between the two buffers, but we understand that technical work to address these concerns is making good enough progress in negotiations. Member States, however, are far less satisfied with Pillar 2 modifications in other areas, particularly one proposing to restrict competent authorities from setting Pillar 2 buffers based on macroprudential concerns. We understand that the latest proposed compromise by the Council Presidency has been rebuffed, with most of the Council preferring to keep the status quo here.

Minimum Requirements for Own-funds and Eligible Liabilities (MREL, or bail-inable debt)

In CRD5/CRR2 the Commission proposed to re-cast loss-absorbing capacity as a combination of a Pillar 1 TLAC requirement for G-SIBs accompanied by a Pillar 2 MREL regime for all banks (as a top-up for G-SIBs and a full loss-absorbency measure for non G-SIBs). The Council's talks on this proposal are now focusing on how best to re-design the MREL framework as an explicit 'Pillar 2' mechanism (*n.b. MREL, under the BRRD, has always been set at the discretion of resolution authorities*). In particular, we understand that the Council is pushing to retain the current discretion of resolution authorities to set MREL despite the Commission having proposed a cap (of double a bank's own-funds requirements). This has led to an extended debate in the Council on how to best balance having a comparable MREL framework with setting loss-absorbency levels that reflect the individual resolution objectives of each bank set by their resolution authorities, including maintaining market confidence in resolution.

Intermediate Parent Undertaking (IPU)

The Council held a brief discussion on the IPU proposal in September where the Commission defended its scheme to require large third country banks to structure their EU operations under an EU-based intermediate parent entity. We understand that most Member States (with some exceptions) remain supportive in principle of the IPU but have repeatedly expressed a desire to see a more thorough impact assessment, which the Commission's recent work does not appear to have satisfied. Overall, and perhaps because of the view that more study is needed, there does not appear to be any rush by the Council to prioritise negotiations on this file relative to other components of CRD5.

Fast-tracking

The Spring 2017 decision to fast-track two elements of the CRD5/CRR2 package – the IFRS9 phase-in regime and the MREL/TLAC creditor hierarchy – will require further negotiations this Autumn in order to finalise them before they can enter into law. Of these, we understand that the IFRS9 phase-in will proceed quickly and likely be agreed by October or November (in order to be 'on the books' before IFRS9 implementation in January 2018). The progression of the MREL/TLAC creditor hierarchy points, however, is less clear and will likely move more slowly due to lack of a pressing deadline and potentially larger misgivings among some of the key negotiators.

UK / EU FCA / EC Second consultation paper on the Insurance Distribution Directive (IDD) implementation and Draft Delegated Act

The FCA published its second **consultation paper** on implementing the IDD, covering changes to the FCA's rules to implement the IDD requirements for life insurance business, including information provision requirements, and additional requirements related to the distribution of insurance-based investment products. Furthermore, proposed changes to FCA rules are set out to implement IDD requirements that apply to life and non-investment insurance business, including product oversight and governance, and professional and organisational requirements provisions. The FCA will publish feedback on responses and issue a Policy Statement in December 2017.

Separately, the European Commission launched a consultation on a **draft delegated regulation** on the IDD. The draft delegated regulation covers product oversight and governance requirements, including: conflicts of interest and inducements, disclosure and record keeping, assessment of suitability, automated advice, and assessment of appropriateness.

EU ESAs Joint Technical Advice on the packaged retail and insurance-based investment products with environmental or social objectives

The ESAs **submitted** Technical Advice to the European Commission, concluding that it would not, in general, be proportionate to establish detailed standalone obligations for PRIIPs with environmental or societal objectives (EOS PRIIPs). The ESAs observed that existing sectoral measures (e.g. requirements under AIFMD, MiFID II, IDD) already offer, or are in the process of putting in place, a sufficiently stringent and flexible basis for the sound regulation of EOS PRIIPs. Further specification was provided, however, around disclosure of specific investment policy (technical advice 2).

EU ESRB Annual Report

The ESRB **published** its annual report which summarises the main ESRB activities and achievements over the last year. The ESRB paid particular attention to two overriding areas of risk: risks arising from the continued low interest rate environment and risks concerning vulnerabilities related to residential real estate. 2016 also saw the ESRB expand its capacity to monitor the non-banking sector i.e. Shadow Banking monitoring, as well as a substantial increase in the number of macro prudential matters covered.

Int'l IOSCO Thematic Review of Client Asset Protection Recommendations

IOSCO **published** its findings of a review into the progress of jurisdictions' attempts to implement client asset protection legislation and regulation. IOSCO found that the majority of jurisdictions have adopted an appropriate client asset regime, but implementation progress is varied across jurisdictions. In the EU and North America, most jurisdictions reported having final adoption measures across all IOSCO Principles, but implementation was less advanced in Latin American countries.

Int’l Guiding Principles on the Internal Total Loss-Absorbing Capacity of G-SIBs (‘Internal TLAC’)

The FSB proposed a set of guiding principles to assist home and host authorities of crisis management groups (CMGs) for G-SIBs in the implementation of internal TLAC mechanisms. Overall, respondents welcomed the clarification on issues relating to the implementation of internal TLAC, but a number of respondents expressed the view that the document contained some shortcomings, e.g. with regard to the role of home and host authorities, surplus TLAC and internal TLAC issuance and deductions. The paper sets out minor changes and clarifications, where appropriate, to address these concerns.

EU EBA

Twelfth report of the CRD IV – CRR / Basel III monitoring exercise on the European banking system

The EBA published its twelfth report on CRD IV/CRR/Basel III monitoring exercise of the European banking system, showing a further improvement of European banks' capital positions, with a total average Common Equity Tier 1 (CET1) ratio of 13.4%. Leverage ratios have also improved. Around 87.5% of participating banks were also found to meet the minimum NSFR requirement (as defined by the BCBS) of 100%.

The Basel Committee also published the results of its latest Basel III monitoring exercise, finding all banks in the sample meet Basel III minimum and CET1 capital requirements, and all G-SIBs meet their fully phased-in liquidity requirements. The Basel III minimum capital requirements are expected to be fully phased-in by 1 January 2019.

Int’l BIS

Mark Carney to chair two key BIS central bank groups

The BIS announced Mark Carney is to chair the Global Economy Meeting (GEM) and the Economic Consultative Committee (ECC). The GEM’s main role is to assess developments, risks and opportunities in the world economy and the global financial system, and provide guidance to three Basel-based central bank committees - the Committee on the Global Financial System, the Committee on Payments and Market Infrastructures and the Markets Committee. The ECC supports the work of the GEM, preparing proposals for the GEM’s consideration.

EU EBA

The EBA published guidance to further harmonise EU banks’ internal governance

The EBA published guidance to further harmonise EU banks’ internal governance. The Guidelines put more emphasis on the duties and responsibilities of the management body in its supervisory function in risk oversight, and they aim at improving the status of the risk management function, enhancing the information flow between the risk management function and the management body and ensuring effective monitoring of risk governance by supervisors. The EBA Guidelines will apply as of 30 June 2018.

EU EBA

The EBA issued its final recommendation to the Commission on the new prudential regime for investment firms

The EBA issued its final recommendation to the Commission on the new prudential regime for MiFID investment firms. The Opinion touches on a wide range of issues, including the firm categorisation system, consolidated supervision, capital definition and composition, capital requirements and the methodology for calculation, liquidity requirements, concentration risk, Pillar 2, reporting, requirements for commodity derivatives investment firms and remuneration and governance.

EU ECB

Vitor Constancio, vice-chairman of the ECB spoke about stress-test tools for the non-banking sector

Mr Vitor Constancio, Vice President of the ECB, spoke at the ESRB annual conference on the financial soundness of non-bank financial institutions, and the development of necessary tools to mitigate potential risk. His comments focussed on systemic concerns are arising from the increased size of the investment fund sector, and the amplified funding stresses that stem from the procyclical nature of existing margin and haircut-setting practices for collateralised securities and derivative transactions.

EU ESMA

ESMA published its final draft regulatory technical standard implementing the trading obligation for derivatives

ESMA published its final draft regulatory technical standard implementing the trading obligation for derivatives. The report presents ESMA's approach for determining which derivatives should be subject to the trading obligation, and declares the classes of interest rate and credit derivatives that should be subject to the trading obligation. While the proposed application date of the RTS is 3 January 2018, ESMA has said it “would not be opposed to a short delay of application of the trading obligation at the start of 2018 which should not exceed three months”.

EU EBA

ESMA and the EBA provided guidance to assess the suitability of management body members and key function holders

The EBA and the European Securities and ESMA published their joint Guidelines to assess the suitability of members of management bodies and key function holders in line with CRD IV and MiFID II. The Guidelines highlight the importance for institutions to consider whether candidates have the knowledge, qualification and skills necessary to safeguard proper and prudent management of the institution.

EU EC

The European Commission adopted a package for the proposals to amend the mandates, governance and funding of the 3 ESAs and functioning of the ESRB

The European Commission published a Communication on reinforcing integrated supervision and adopted a package of proposals to amend the regulations establishing the European Supervisory Authorities (ESAs) and the European Systemic Risk Board (ESRB). The legislative proposals will make substantial changes to the powers, governance and funding of the ESAs, including a greater role in the monitoring of third-country equivalence decisions and of firms that intend to make an extensive use of outsourcing, delegation and risk transfer (back-to-back business or fronting). As proposed, ESMA will also be given direct supervisory powers of data reporting service providers, critical benchmarks and third-country benchmark administrators. The Communication highlights the Commission's intention to propose to subject certain large investment firms established in Member States participating in the Banking Union to supervision by the ECB in its supervisory capacity, the Single Supervisory Mechanism (SSM).

EU EBA

The EBA launched a consultation on significant risk transfer in securitisation

The EBA launched a consultation on its discussion paper on significant risk transfer in securitisation. Based on its monitoring activity, the EBA found that further regulatory specifications may be needed with regards to the process of significant risk transfer assessment, its quantitative assessment by competent authorities as well as the supervisory approach to core structural features of the securitisation transaction, such as amortisation structure, excess spread, cost of credit protection, and call options.

EU ECB

Sabine Lautenschläger spoke on 'Regulation, supervision and market discipline – striking a balance'

Sabine Lautenschläger, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, spoke on 'Regulation, supervision and market discipline – striking a balance'. She stressed the importance completing Basel III, and of not having too detailed Rulebooks so as to allow supervisors flexibility and avoid supervised entities using loopholes to escape the system.

EU ESAs

The ESAs published guidelines to prevent the abuse of funds transfers for terrorist financing and money laundering purposes

The European Supervisory Authorities (ESAs) published guidelines to prevent the abuse of funds transfers for terrorist financing and money laundering purposes. The guidelines explain in practical terms what payment service providers should do to detect missing or incomplete information on the payer or the payee and what they should do when managing a transfer of funds that lacks the required information or receive transfers of funds from a payment service provider that repeatedly fails to provide the required information.

List of regulatory publications and events expected this quarter

This quarter

Bank prudential framework				Due Date
Overdue	EU	ECB	Official Opinion on CRD V/CRR II	TBC
	EU	EBA	Consultation on revisions to the SREP framework	Dec
Insurance prudential framework				
	EU	EIOPA	Final advice to the EC on certain aspects of the Solvency Capital Requirement	Oct
Overdue	Int'l	IAIS	Consultation on the first International Capital Standards for insurers	Mid-2017

Deloitte.