



CRD5/CRR2 EU bank capital negotiations

There have been important developments in the last two months on the European Commission's "CRD5/CRR2" banking package (including amendments to the BRRD), which was proposed in late November 2016.

The proposed legislation implements **outstanding components of Basel III, TLAC, the NSFR and the FRTB** into EU law, but excludes the package of Basel reforms that is still being finalised by the BCBS (i.e. SA credit risk, IRB constraints, operational risk, and standardised output floors) often referred to as "Basel IV".

The EU negotiations are progressing despite continued delays in the finalisation of the Basel framework at the international level. While there is some speculation of a potential "Basel IV" deal our view is that continuing uncertainty over the US approach to international financial negotiations and the still outstanding nomination of anyone to fill the US Federal

Reserve's Vice Chair Supervision role means that a BCBS agreement is unlikely before September.

This note updates on the key points of debate that we understand have emerged in the EU's CRD5/CRR2 negotiations in the last two months, and our views on the next steps as it progresses towards becoming law.

The following points reflect our latest understanding :

- **In the European Council:** negotiations are now progressed enough to see the direction the Council is taking a number of key files. The Presidency of

the Council has begun to propose specific compromises that it believes a majority of EU Member States will support.

- **In the European Parliament:** negotiations have begun but have not yet made much substantial progress. The Parliament's Economic and Monetary Affairs Committee (ECON) held a public hearing on CRD5/CRR2 and the BRRD on 25 April at which a number of regulators and supervisors (including the EBA, SSM and SRB) expressed their views on the package.

- **Fast-tracking:** negotiators are calling to "fast-track" a number of elements of



the CRD5/CRR2 package in order to have these rules ready sooner than the two years that the whole package is expected to take to be finalised. Among the various candidates, and on top of the proposed IFRS9 phase-in regime, and a transitional extension of the derogation from large exposure requirements for sovereign debt issued in the currency of another EU Member State, the fast-tracking of CRR and BRRD provisions on the eligibility of TLAC/MREL-compliant instruments is also being seriously considered.

We maintain our expectation that this package will take two years to negotiate at the EU level,

and as a result, our projected timeline to implementation and full application is as follows :

Political negotiations (Two years)	Ending in Q1 2019 at the earliest
Implementation period after finalisation (Two or more years)	Ending in Q1 2021 at the earliest (excluding TLAC and IFRS9 provisions)
Phase-in period for FRTB and NSFR (Three years)	Ending in 2024 or later

What are the most recent developments in negotiations?

- **Market Risk (FRTB):** discussions appear to have become significantly more detailed in the last two months and Member States are now trying to determine appropriate implementation and transition periods.
 - Two year implementation period: several Member States seem to be concerned that the two-year implementation period before the new approach begins to apply may be too short for supervisors to validate internal models. As a result, the Council is now seriously considering extending this to three years (i.e. application from Q1 2022 by our estimates).
 - **Three year transitional period and scalar:** the majority of Member States now appear to back the transitional scalar of 65% proposed by the Commission but are pushing to modify it to put it on an ascending path towards 100% compliance by the end of the transitional period.
 - **Pillar 2 changes:** following broad objections from Member States to parts of the Commission's Pillar

2 proposal, we are hearing that they are moving to amend the text to allow national competent authorities (NCAs) to set Pillar 2 requirements based on a broader range of criteria and leave supervisors with the option to demand that Pillar 2 requirements be fully met with CET1. The Commission's proposed distinction between Pillar 2 requirements and guidance, and its clarification of the location of the MDA trigger between these, however, look likely to receive support.

• **Intermediate Parent Undertaking (IPU):**

in its first substantial discussions of the IPU requirement, most Member States are believed to have agreed that the proposal required more study and a detailed assessment of its impact, an exercise which will likely be conducted by the Commission. According to press reports, the ECB and SRB produced a joint opinion supporting the IPU proposal, but voiced concern over the potential for arbitrage by banks using foreign branches in the EU to undertake activities outside of the EU-based IPU structure. As a result, both are said to have called for the inclusion of large foreign branches under the IPU structure. We are shortly expecting the ECB to publish an opinion on the CRD5/CRR2 proposal, which may shed more light on its position here.

• **TLAC/MREL eligibility of instruments:** negotiations on loss-absorbency are primarily focused on whether parts of the Commission's CRR2 proposal on eligible liabilities (Articles 72a, 72b, and 72c) should be fast tracked to provide more certainty to banks already issuing loss-absorbing debt. The Council is also considering amending these articles to include a relatively short period of grandfathering for some instruments that do not meet the TLAC/MREL eligibility criteria. Support for fast-tracking these provisions is growing among EU Member States and the Commission, but support for it in the European Parliament still appears lukewarm.

• **TLAC scope:** we understand that one Member State is strongly opposed to limiting the application of TLAC-requirements to G-SIBs and is pushing to have TLAC extended as a Pillar 1 requirement to EU D-SIB banks as well. The European Parliament has also noted concern

about a "cliff effect" of loss-absorbency requirements between G-SIBs and D-SIBs. Several important Member States and the Commission, however, remain opposed to this. Interestingly, in testimony to the European Parliament, the SRB supported the extension of TLAC's scope to D-SIBs, while the SSM found the G-SIB-only scope to be "appropriate".

- **IFRS9 phase-in:** following the proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 on May 31st it is now clear that the IFRS9 phase-in provisions included in CRR2 (providing CET1 relief over a period of 5 years) will be split into a standalone proposal so that it can be fast-tracked.. For more analysis, see our recently published blog on the implications of fast-tracking these provisions.
- **Home-host balance:** a group of predominantly host jurisdiction Member States appear to be opposing the CRR2 Articles 7 and 8 proposals to allow home supervisors to waive capital and liquidity requirements for subsidiaries located in other EU Member States without the explicit agreement of the relevant host supervisor.
- **NSFR:** as noted in our March update, Member States remain deeply divided here over the proposed deviations from the Basel framework, namely the temporary reductions in Required Stable Funding (RSF) for assets arising from short-term interbank financing and some derivatives contracts, and a permanent reduction in RSF for sovereign bonds. We understand that Member States have re-iterated these concerns in their detailed written comments on the proposal, but that little negotiating time has been dedicated to this so far and no clear compromise has yet emerged.

Supervisory reactions to the proposal:

as part of the European Parliament ECON Committee's public hearing on CRD5/CRR2 and the BRRD on 25 April, supervisors from the EBA, SSM and SRB all gave their opinions on the Commission's proposals (statements linked). Apart from the views on the scope of TLAC mentioned above, the SSM and EBA also discussed the proposed deviations from BCBS standards in areas such as the FRTB and NSFR. On this, the EBA urged negotiators to grant it a mandate to monitor these deviations across the Single Market to ensure their consistent and conservative application. The SSM urged negotiators to consider "further analysis" of whether these deviations are needed to reflect European specificities. The SSM also opposed greater restrictions on the ability of supervisors to set Pillar 2 requirements, opposed the reduction of the frequency of regulatory reporting for smaller banks (favouring instead less granular reporting), and called for negotiators to give it a greater role in assessing and harmonising the application of options and national discretions in the CRD/CRR.

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