



## Prudential Regulation Review

July 2017

July was a busy month, as is often the case ahead of the holiday peak in August. Rules and guidelines on setting up new or expanded operations in the EU were the subject of papers from ESMA, EIOPA and BaFin, while a number of areas around MiFID implementation and finalisation – particularly the need for firms that want MiFID permissions to have their applications submitted – were the subject of papers from the FCA, ESMA and the European Commission. The FSB was particularly busy, giving its views on a range of topics from finalising the post-crisis reforms to shadow banking, TLAC and derivatives reform.

This note is produced for information only on a best effort basis, and does not constitute advice of any kind.

## Capital (including stress testing and macro prudential)

Vitor Constâncio, Vice President of the European Central Bank (ECB), wrote an opinion piece published on the ECB website about the need for a coordinated European strategy on [non-performing loans \(NPLs\)](#). He said NPL resolution could bring substantial benefits for Euro area banks. Separately, the European Systemic Risk Board (ESRB) reported on [the resolution of NPLs in the EU](#) and the Commission sought views on issues relating to [secondary markets for NPLs](#).

The European Banking Authority (EBA) provided an update on the new [prudential regime for investment firms](#), based on a three-tier categorisation system. It recognised that the proposal could be significant for certain firms and therefore proposed a five year transitional period for those firms. The EBA also launched a data collection exercise to [support the new framework](#).

As part of its Regulatory Consistency Assessment Programme, the Basel Committee on Banking Supervision (BCBS) reported that the EU framework for the [Liquidity Coverage Ratio \(LCR\)](#) was largely compliant with the Basel LCR standard. The BCBS identified one material deviation (inclusion of covered bonds in the definition of Higher Quality Liquid Assets) and four potential deviations which may overstate LCR for some EU banks.

The European Systemic Risk Board (ESRB) report on the financial stability implications of IFRS 9 concluded that [IFRS 9 represents a major improvement on IAS 39](#) and is expected to bring substantial financial stability benefits. The report included considerations to help mitigate potentially negative financial stability implications of IFRS 9 by identifying channels through which IFRS 9 may interact with other players. The report was accompanied by the ESRB Occasional Paper ["Assessing the cyclical implications of IFRS 9 – a recursive model"](#) which describes a model for assessing different approaches to accounting for credit impairment losses.

The European Parliament's Economic and Monetary Affairs (ECON) Committee voted to finalise its position on the [transitional implementation of IFRS 9 for regulatory capital](#). Following the European Council's recent decision, ECON agreed to a phased approach allowing banks to add a declining amount of their additional impairments back to Common Equity Tier 1 (CET1) over a five year period.

The EBA updated its [Risk Dashboard](#) for Q1 2017. Compared to the previous quarter, the EU banking sector showed a modest improvement in asset quality, continuing high levels of capital and a strong increase in profitability. The EBA also reported on its [Risk Assessment Questionnaire](#), which showed an optimistic view with regards to the sector's profitability.

The Financial Policy Committee's (FPC's) latest [Financial Stability Report](#) found that the "overall risk from the domestic environment is at a standard level, with most financial stability indicators neither particularly elevated nor subdued." However, it stressed that, "there are pockets of risk that warrant vigilance", citing Brexit as a potential cause of instability. The FPC set out its current and future actions including increasing the UK countercyclical capital buffer rate from 0% to 0.5%, bringing forward the assessment of stressed losses on consumer credit lending, and clarifying its existing insurance measures in the mortgage market.

The PRA consulted on its expectations regarding the relationship between [minimum requirement for own funds and eligible liabilities \(MREL\) and buffer requirements](#), and the consequences of not meeting these. The consultation proposes to update the supervisory statement to clarify that the expectations are not intended to create a different buffer requirement from that which is usable in the going-concern regime.

The FPC and PRA consulted on an increase in the required minimum [leverage ratio](#) from 3% to 3.25%. The proposed increase (equivalent to £13 billion of Tier 1 capital in aggregate for affected banks) offsets an earlier decision by the FPC to exclude central bank claims from the calculation of the total exposure measure.

## Conduct of Business (including MiFID)

ESMA consulted on guidelines for aspects of the [MiFID II suitability requirements](#). The draft guidelines address how firms should deal with information to clients, necessary arrangements for client information collection, arrangements to understand investment products, arrangements to ensure the suitability of an investment, the costs and benefits of switching investments, staff qualifications and record-keeping.

ESMA provided [interim transparency calculations for MiFID II](#) and issued [FAQs](#) for such calculations. The transitional transparency calculations are used for the assessment of liquidity and the calculation of large-in-scale (LIS) and size-specific to the instrument (SSTI) thresholds for pre-trade and post-trade transparency purposes.

The EU Commission adopted the [regulatory technical standards \(RTS\)](#) for the information to be included by proposed acquirers when notifying National Competent Authorities (NCAs) of a proposed acquisition of a qualifying holding in an investment firm. The Commission also published draft [implementing technical standards \(ITS\)](#) on standard forms, templates and procedures for the consultation process between NCAs on such a notification in accordance with MiFID I and MiFID II.

ESMA published policy on [reporting of circuit breakers' parameters by National Competent Authorities](#) (NCAs). The document formalised a common standard and procedure for NCAs to report to ESMA parameters to halt or constrain trading.

## Crisis management (including special resolution, systemically important firms, and business continuity)

Elke König, Chair of the Single Resolution Board (SRB), presented the 2016 [Single Resolution Board \(SRB\) Annual Report](#) to the ECON committee. The report highlighted progress made in the Single Resolution Fund (SRF) and in establishing Loan Facility Agreements (LFAs) with all Member States. Future work will focus on the operationalisation of resolution plans, cross-border resolution exercises, developing binding MREL targets at consolidated level for all major banking groups and addressing the quality of MREL within a group.

EIOPA published an opinion calling for a [minimum harmonised recovery and resolution framework for \(re\)insurers](#) within the scope of Solvency II. EIOPA's framework closely follows the international standards on recovery and resolution established by the Financial Stability Board, and, if implemented, will introduce new requirements and resolution powers that go well beyond the Solvency II framework. EIOPA's proposals will require legislation from the European Commission, Parliament and Council in order to be implemented for European insurers.

The Financial Stability Board (FSB) assessed [resolution reforms](#) ten years on from the financial crisis. The report detailed the adoption of the CCP resolution and resolution planning in 2017, and progress on the implementation of the total-loss absorbing capacity standard (TLAC) for globally systemically important banks (G-SIBs), resolution planning for globally systemically important insurers, and the implementation of the Key Attributes of Effective Resolution Regimes for Financial Institutions in FSB jurisdictions.

The FSB issued [guiding principles on the internal TLAC of G-SIBs](#). The principles cover the process for identifying material sub-groups; the role of home and host authorities; and the factors to be considered when determining the size of internal TLAC requirement; practical considerations relating to the issuance and composition of internal TLAC; and features of the trigger mechanism for internal TLAC. The FSB also issued a response [summarising the feedback it received on its consultation](#).

## Regulatory perimeter

Valdis Dombrovskis, Vice-President of the European Commission, spoke on the [pan-European covered bonds](#) framework stating that an EU initiative should serve to stimulate covered bond markets as a stable and cheap source of funding for banks, and to ensure the framework is robust enough to justify the preferential prudential treatment granted to it. He emphasized the potential in developing covered bond markets in EU countries that do not have them yet, and attracting investors from third countries. The Commission is also assessing the case for developing European Secured Notes.

ESMA issued a final report on draft technical standards for the [publication of derivatives data](#) by trade repositories under EMIR. The requirements covered by the report include the calculation of market activity and outstanding volumes for on-venue and off-venue traded derivatives, the avoidance of double counting across trade repositories, and the details of aggregations for commodity derivatives using benchmarks.

The FSB published its [annual review of OTC derivatives market reform](#). It reported that while significant progress has been made in central clearing frameworks, capital charges and margin requirements (for non-centrally cleared derivatives), platform trading frameworks are still relatively undeveloped in most jurisdictions.

## Rethinking the domestic and international architecture for regulation

The Financial Stability Board **reported to the G20 on progress in financial regulatory reforms**. In a [letter](#) to the G20 leaders, Chair of the FSB, Mark Carney, wrote that "G20 reforms have now addressed the fault lines that caused the financial crisis". He noted that while there are still some areas where more work is needed, particularly to finalise Basel III, the focus of the FSB will shift to post-implementation evaluation of the effectiveness of reforms, rather than development of new policy initiatives.

Alongside the letter from Mark Carney, the FSB published its third annual report on the [implementation and effects of the G20 financial regulatory reforms](#) and the framework for [post-implementation evaluation of the effects of G20 financial regulatory reforms](#).

The FSB published its assessment of [shadow banking](#) activities, risks and the adequacy of post-crisis policy tools to address financial stability concerns. The assessment highlights that the aspects of shadow banking activities generally considered to have contributed to the financial crisis have declined significantly and are generally no longer considered to pose financial stability risks.

The FSB published guidance on [continuity of access to financial market infrastructures](#) (FMI) for a firm in resolution. The guidance details considerations for providers of critical FMI services in relation to the interactions between resolution of their service users and their own risk management frameworks, as well as the measures which firms should take to ensure their continued access to critical FMI services when in resolution.

The FSB published its fifth progress report on implementing its principles for [sound compensation practices](#), taking stock of progress across the banking, insurance and securities sectors. In banking in particular, the FSB noted that supervisors and firms are increasingly using back-testing or validation practices to facilitate the effective implementation of compensation systems.

The FSB published a progress report on [reducing misconduct risks in the financial sector](#), with governance, robustness of market structures, and conduct standards in markets at the top of the agenda. The FSB will continue to develop "responsibility mapping" and related tools for increasing individual accountability and tackling misconduct risks arising from the governance frameworks of significant financial institutions.

ESMA published a letter to the Commission in favour of the Commission's proposals for the recognition and supervision of [third-country Central Counterparties](#) (CCPs). ESMA also suggested similar changes for third-country credit rating agencies, trade repositories, benchmarks and possibly trading venues and data providers.

## Disclosure, valuation and accounting

ESMA published a peer review report identifying areas where national competent authorities (NCAs) can improve their [enforcement and supervision of financial information](#) (IFRS). The report identified that further improvements are needed in relation to: how issuers are selected to examine their financial information; the depth of inquiries into financial statements going beyond correcting disclosure; and the financial and human resources allocated by NCAs to the enforcement of financial information. The report also makes recommendations, including the call for NCAs to use a common approach for selection, to support these improvements.

The EBA consulted on Guidelines specifying a [uniform format for institutions' disclosure requirements of IFRS 9](#) and analogous expected credit losses (ECLs) transitional arrangements. The guidelines aim at ensuring market discipline and consistency of information disclosed by institutions during the transition to the full implementation of the new accounting standard.

The EBA published its final draft regulatory technical standards specifying the information that should be provided to competent authorities when applying for [authorisation as a credit institution](#). It also contained the final template to be used by applicants for submitting such information.

The ECB consulted on a draft regulation imposing [statistical reporting requirements for pension funds](#) located in the euro zone. The consultation is aimed at closing the gaps in the data available for this sector and the lack of comparability.

The BCBS issued its sixth report on the implementation of the [Basel III regulatory standards](#). It found that further progress had been made on the enforcement of its standards. Nevertheless, some elements, such as capital requirements for exposures to central counterparties and equity investments in funds, had been delayed in many jurisdictions.

## Other

The EBA published a [revised Decision](#) adding five additional External Credit Assessment Institutions (ECAIs) to the list of recognized ECAIs for unsolicited credit assessments, and removing one. Following the ESMA decision, the Joint Committee of the ESAs launched a public consultation to [amend the implementing Regulations on the mapping of credit assessments of External Credit Assessment Institutions \(ECAIs\)](#) accordingly.

Separately, ESMA published its [future work plan](#) in this area, which involved the production of mappings and treatment of unsolicited credit assessments for newly registered ECAIs and the monitoring of existing mappings.

The Council adopted the Commission's mid-term review of the [Capital Markets Union](#) (CMU) action plan. The Council supports the new measures announced as part of the mid-term review and backed the Commission's agenda to finalise the CMU building blocks by 2019. The Council also invited the Commission to submit a progress report at least every six months.

The EBA consulted on its draft report regarding the implementation of its guidelines on methods for calculating contributions to [deposit guarantee schemes](#) (DGSs). It said the guidelines broadly achieved the aim of introducing differentiators between firms based on risk, but that some elements may need to be revisited in the future. According to the EBA, there was no need to provide additional transparency or amend reporting requirements.

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