



Prudential Regulation Review

November 2017

November proved to be a busy month for regulatory and supervisory activity. There was a particular focus on the issue of **non-performing loans (NPLs)** in the European banking sector, with Danièle Nouy highlighting this issue as part of her opening remarks at a public hearing, and Sabine Lautenschläger saying that NPLs are probably the single biggest challenge and a drag on the entire European economy. The European Banking Authority (EBA) published guidelines on the **prudential supervision of significant branches within the EU**, while the European Central Bank

(ECB) published a paper on developing **macroprudential tools for alternative investment funds**.

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Capital (including macro-economic issues and stress testing)

The EBA announced the final **timeline** for the 2018 [EU-wide bank stress test](#). The exercise will be launched in January with three submission dates in early June, mid-July, and late October. Results will be published by 2 November 2018. The [final methodology](#) was published on November 17, and the macroeconomic scenario will be published with the launch of the exercise in January 2018.

The EBA launched a [consultation on draft regulatory technical standards \(RTS\) specifying the different methods of prudential consolidation](#) which can be applied when certain conditions and criteria are met, including full consolidation, proportional consolidation, and the aggregation method. In addition, the draft RTS included indicators that should be assessed by institutions in order to identify which undertakings could lead to 'step-in risk', i.e. the risk that a bank decides to provide financial support to an unconsolidated entity that is facing stress, in the absence of, or in excess of, any contractual obligations to provide such support. The consultation will close on 9 February 2018.

The EBA held a public hearing on its discussion paper on [significant risk transfer in securitisation \(SRT\)](#). The hearing focused on EBA proposals relating to the process of SRT assessment, structural features of SRT transactions, and quantitative SRT tests, as well as the regulatory treatment of NPL securitisation. The EBA proposals aim to harmonise further the regulatory and supervisory treatment of SRT.

The EBA published the results of its [latest annual benchmarking exercise](#) on the consistency of internal models used by banks to calculate their capital requirements, looking at credit and market risks. While the majority of credit risk-weighted asset variations were found to be the result of differences in risk fundamentals (consistent with previous exercises), the EBA said that the exercise confirmed that the definition of default and the treatment of defaulted assets are "key areas of supervisory attention". It subsequently published new Guidelines on these risk parameters.

The EBA published its final Guidelines on the [estimation of risk parameters for non-defaulted exposures, and on the treatment of defaulted exposures under the advanced internal ratings-based \(IRB\) approach](#). These Guidelines seek to restore market participants' trust in internal models by reducing the unjustified variability in their outcomes, ensuring comparability of risk estimates while at the same time preserving risk sensitivity of capital requirements.

The EBA updated its [list of Common Equity Tier 1 \(CET1\) instruments](#) which have been assessed and evaluated as compliant with the Capital Requirements Regulation (CRR). The updated list includes **two new forms of CET1 instruments** issued in two Member States, namely, "non-voting share in the paid-up endowment capital" in Germany and "preferred share" in the Slovak Republic.

The ECB released an occasional paper on [European structured finance counterparty](#)

[networks](#), exploring the network between issuers and service providers for asset-backed securities (ABSS) and covered bonds (CBs). The paper's findings "point to the importance of the Eurosystem's risk management framework for ABSS and CBs and support the orientation of recent regulatory efforts at the European level."

The Financial Stability Board (FSB) published an updated list of [Globally Systemically Important Banks \(G-SIBs\)](#), but announced that it decided not to publish a new list of **Globally Systemically Important Insurers (G-SIIs)**, although it said the policy measures set out in 2016 will still apply to those insurers named on the 2016 list. The updated G-SIB list sees one bank added (Royal Bank of Canada), one removed (BPCE), as well as others moving between categories, affecting their G-SIB capital buffers.

Liquidity

The ECB published a paper discussing [Liquidity Provision as a monetary policy tool](#). The paper aims to provide a quantitative assessment of the impact of non-standard monetary policy in response to the Global Financial Crisis of 2008-09. The paper finds that interbank liquidity shocks led to a large increase in bank lending spreads and to a sizable fall in private investment. It hypothesises that the liquidity injected by the ECB played an important role in cushioning the macroeconomic impact of the money market distortions and lessened a more severe impact on investment.

Conduct of Business

The FSB Regional Consultative Group for Middle East and North Africa discussed the FSB's work related to international post-crisis policy reforms and the reduction of misconduct risk in the financial sector. The meeting further discussed global and regional macroeconomic and financial markets developments and their impact on economies in the region, as well as the [financial stability implications of FinTech, non-performing loans \(NPL\) and the rise of debt levels globally](#).

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

The EBA published its final recommendation on the [coverage of entities in banking group recovery plans](#), defining common criteria for identifying entities that need to be covered in recovery plans and specifying that the coverage of entities in a group recovery plan is proportional to the relevance of the entities.

Danièle Nouy, Chair of the Supervisory Board of the ECB, and Sharon Donnery, Chair of the ECB's High Level Group on non-performing loans (NPLs), made introductory remarks to the public hearing on the [draft addendum to the ECB guidance to banks on NPLs](#). The addendum seeks to clarify supervisory expectations related to the provisioning of loans that become non-performing. Danièle Nouy explained that although these expectations are firm, supervisors will consider the specific circumstances of banks on a case-by-case basis before taking any action under the Pillar 2 framework.

Danièle Nouy also spoke on [progress and developments in European banking](#)

[supervision](#). She addressed the ECB's ongoing work in tackling non-performing loans and focused on banking sector sustainability, particularly given current challenges such as low profitability and increased competition from the fintech sector.

Sabine Lautenschläger, Member of the Executive Board of the ECB, spoke on [risks to the European banking sector](#), covering NPLs, Brexit and internal models. She outlined the ECB's assessment of banks' strategy to reduce NPLs. In relation to Brexit, she noted that provision for the continuity of contracts to existing customers must be factored into firms' contingency plans. As part of the targeted review of internal models (TRIM), the ECB will begin to assess internal models that cover low-default portfolios from mid-2018 to 2019.

The FSB issued a consultation on two proposals for the implementation of particular aspects of its "[Key Attributes of Effective Resolution Regimes](#)" for global systemically important banks (G-SIBs) in order to end "too-big-to-fail". The consultation document proposes a set of principles to assist authorities as they make G-SIB bail-in resolution strategies operational, while looking to minimise the impact of resolution on financial stability, ensure the continuity of critical functions, and avoid exposing taxpayers to loss. Regarding the development of a plan for funding in resolution, the consultation proposes a set of key funding strategy elements, building on existing guidance on liquidity risk management and resolution planning.

Regulatory perimeter

The EBA published final [guidelines on the prudential supervision of significant branches within the EU](#). The guidelines provide a framework for the identification of 'significant-plus' branches which will face heightened supervision, including having a branch risk assessment carried out as part of the SREP of the institution or group to which they belong. The guidelines will apply from 1 January 2018.

The ECB published a paper on developing [macroprudential policy for alternative investment funds](#). The paper devises a framework for assessing financial stability risks from leverage in investment funds, and explores the potential effectiveness and efficiency of different designs for macroprudential leverage limits.

Rethinking the domestic and international architecture for regulation

The EBA published its third annual [report on the convergence of supervisory practices across the EU](#). The report found a good degree of progress has been made by competent authorities in the implementation of the SREP guidelines. However, it noted that challenges remain in converging capital adequacy assessments and determining institution-specific additional own funds requirements (P2R). Further progress on convergence will be supported by adjustments to the SREP framework and revisions to the Pillar 2 framework in the CRR/CRD.

The European Commission consulted on a [fitness check on supervisory reporting](#). The report sought to gather evidence on the cost

of compliance with existing EU-level supervisory reporting requirements, and more specifically to collect quantitative evidence on any investments required and to gather examples of inconsistent, redundant or duplicative requirements.

Sabine Lautenschlager, Member of the Executive Board of the ECB, spoke about what is next on the banking supervision agenda highlighting that [non-performing loans “NPLs”](#) are probably the single biggest challenge and a drag on the entire economy. Since 2015, significant banks in the euro area have brought down their non-performing loans by almost €200 billion; from €989 billion to €795 billion but the ECB considers that NPLs are still too high in parts of the banking sector.

Daniele Nouy, Chair of the Supervisory Board of the ECB, spoke on the **banking union**. Her speech highlighted the [benefits of supervision and resolution under the banking union](#), whilst noting that a third pillar, the European Deposit Insurance Scheme, still needs to be finalised. She also commented on the importance of further integrating the European banking market to address issues including “overbanking” in the market.

Information security and data privacy

The EBA published its [final Guidelines on the treatment of connected clients](#) as defined in the CRR. The guidelines clarify requirements for firms to identify interconnections among their clients, in particular when relationships of control or economic dependency lead a group of clients to be regarded as a single risk. They also consider developments in shadow banking and large exposures in the EU and internationally, and replace 2009’s “Guidelines on the implementation of the revised large exposures regime”.

The FSB published a report on the [financial stability implications of the growing use of artificial intelligence \(AI\) and machine learning in financial services](#). The report presents the potential risks and opportunities of these technologies for financial markets and institutions, customers and investors, and the overall financial system. Key areas of concern for the FSB include the lack of auditability and interpretability of AI and machine learning, their potential network effects and scalability, and the risks they present in terms of conduct and cybersecurity.

Central Bank of Ireland

Gerry Cross, Director of Policy and Risk of the Central Bank of Ireland spoke at the Certified Bank Director Annual Seminar, providing [insights into some aspects of the regulatory and supervisory horizon as seen from the Central Bank](#).

Central Bank of Ireland Governor, Philip R. Lane, spoke on the [review of mortgage measures 2017](#). The primary focus of the annual review was to evaluate whether the calibration of the measures matches the Central Bank of Ireland’s assessment of the risk in the mortgage and property markets. [The outcome of the annual review of the residential mortgage measures](#) has also been published by the Central Bank of Ireland.

Gerry Cross, Director of Policy and Risk of the Central Bank of Ireland spoke at the Banking & Payments Federation Ireland (BPMFI) Conference on the [evolving supervisory architecture](#). The Central Bank of Ireland announced the outcome of the [annual review of Other Systemically Important Institutions](#) in Ireland. The O-SII buffer aims to increase the resilience of institutions that are systemically important by requiring them to hold additional capital.

Other items

Negotiations in Brussels are making important progress 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, TLAC, the NSFR and the FRTB into EU law, but excludes most of the package of Basel reforms that was agreed on 7 December by the Basel Committee on Banking Supervision (BCBS) (i.e. SA credit risk, IRB constraints, operational risk, and standardised output floors) sometimes referred to as ‘Basel IV’.

After more than a year of stalled negotiations, the Basel Committee on Banking Supervision (BCBS) announced an agreement on the remaining elements of the [Basel III post-crisis bank capital framework](#). Striking a deal on this package of reforms (often called ‘Basel IV’) is a significant milestone in the post-crisis regulatory journey and a huge achievement for the BCBS.

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