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Prudential Regulation Review

June 2017

June saw the publication of some significant EU proposals on the treatment of central counterparties (CCPs) as part of the review of the European Markets Infrastructure Regulation (EMIR). The regulatory implications of IFRS 9 were also in focus, with both the Bank of England and the European Banking Authority (EBA) publishing materials on the incorporation of the new accounting standard into stress testing, and the European Council agreeing to fast-track legislation to introduce a transitional phase-in of the impact of IFRS 9 on capital requirements.

The European Commission published a set of proposals which would create a pan-European Personal Pension Product, or "PEPP". The Single Resolution Board (SRB) undertook its first resolution in the Eurozone with the resolution of Spain's Banco Popular.

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Brexit

- The European Securities and Markets Authority (ESMA) published an opinion addressed to the EU27 national regulators setting out nine general principles aimed at fostering consistency in authorisation, supervision and enforcement related to the relocation of entities, activities and functions from the United Kingdom.

  The opinion covered all legislation referred to in the ESMA Regulation, including the AIFMD, the UCITS Directive, MiFID I and MiFID II. ESMA said it will establish a new Supervisory Coordination Network to allow national authorities to discuss cases of relocating UK market participants and to help promote consistency in decisions taken. ESMA said it intended to develop further guidance in areas such as asset managers, investment firms and secondary markets.

Capital (including stress testing and macro prudential)

- The UK Financial Policy Committee (FPC) published its biannual Financial Stability Report (FSR), outlining changes including an increase to the UK countercyclical capital buffer (CCyB) rate to 0.5%, and a likely increase to 1% in November. The FPC also brought forward the assessment of stressed losses on consumer credit lending, and increased the minimum requirement for the UK leverage ratio from 3% to 3.25% of non-reserve exposures. The FSR also summarised recent work and future plans on cyber resilience.

- The EBA consulted on the draft methodology for the 2018 EU-wide stress test, covering 49 EU banks. For the first time, the methodology will account for the implementation of IFRS 9. The final methodology will be published at the beginning of 2018.

- The EBA sought views on the application of the structural FX provision, which allowed banks to exclude positions of a "non-trading or structural nature" for the calculation of capital requirements, provided the position had deliberately been taken to hedge against the impact of the exchange rate on the capital ratio. The EBA said it would provide guidance on the application of the structural FX provision, given the wide variety of interpretations of the provision among supervisors and banks, and that its Discussion Paper was a first step.

- The ECB published its third biannual macro prudential bulletin, which described the ECB floor methodology for other systematically important institution (O-SII) capital buffers, the quantitative analysis of the European Deposit Insurance Scheme (EDIS) and summarised the macro-prudential measures implemented in euro area countries since October 2016.

- Vítor Constâncio, Vice-President of the ECB, gave a speech on structural and cyclical factors affecting the profitability of the euro area banking sector. He highlighted the large stock of NPLs in some euro countries and remaining cost inefficiencies as reasons for the weak profitability of euro area banks. He said a sustainable target return on equity for euro area banks may be in the 8-10% range, but there remained challenges for meeting that target over the next 3-5 years, even in a cyclical upturn.

- Sabine Lautenschläger, Vice Chair of the ECB's Supervisory Board, spoke about the importance of harmonised rules for a stable European banking market. She said recent proposals from the US Department of the Treasury were "worrying", particularly on the new rules on the trading book, and that it was important for the EU to implement Basel standards. She also spoke on bank business models, noting that "in the long run, only banks that make profits can be stable".

- Valdis Dombrovskis, the Vice-President of the European Commission, wrote to Andrea Enria, Chair of the EBA, with respect to the CRD IV/CRR review. He indicated that the EBA could be allowed a monitoring role in relation to the Net Stable Funding Ratio (NSFR) and leverage ratio, subject to conditions and drafting. He also clarified that the definition of the leverage ratio would not be complemented through a technical standard and should be sufficiently clear to be implemented immediately.

- The European Commission published an Implementing Regulation extending the CRR transitional period for banks' exposure to third-country CCPs in the Official Journal of the EU. The transitional period was extended from 15 June 2017 to 15 December 2017 to enable the European Commission to finalise the EMIR equivalence decisions for a number of outstanding jurisdictions.

- The Basel Committee on Banking Supervision (BCBS) reported on the range of practices in implementing the countercyclical capital buffer (CCyB). CCyB policy frameworks differ markedly with respect to governance structures, the number of indicators used to identify periods of excess credit and systemic risk, the degree of reliance on formal versus judgemental approaches in making CCyB decisions, and their communication and reciprocity practices.

- The BCBS consulted on an alternative version of the Standardised Approach (SA) to market risk capital requirements. This approach would be a simplification of the current sensitivities-based method, by removing capital requirements for certain types of risks, simplifying the basis risk calculation, and reducing risk factor granularity. The BCBS also sought feedback on whether retaining a recalibrated version of the Basel II SA to market risk would better serve the purpose of a simplified method for calculating market risk capital requirements.

Liquidity

- The BCBS updated for a second time a set of frequently asked questions (FAQs) on the Liquidity Coverage Ratio (LCR). The additions covered a wide range of aspects of the LCR, including in relation to Level 2B eligible debt securities, the periodic monetisation of Higher Quality Liquid Assets, the treatment of secured funding and lending, and central bank facilities.

Governance and risk management (including remuneration)

- The EBA launched the Credit Valuation Adjustment (CVA) risk monitoring exercise using end-2016 data, and said that it would put on hold the work on its draft Guidelines on the treatment of CVA risk under the Supervisory Review and Evaluation Process (SREP) until revised international standards on CVA risk were made public.

- The ECB published its second stocktake of national supervisory practices and legal frameworks related to non-performing loans (NPLs). The update covered all euro area countries, including the remaining 11 SSM countries that were not part of the first stocktake. Progress had been made from a supervisory perspective, although some banks cannot resolve NPLs efficiently due to legal backlogs in some countries relating to insolvency and debt restructurings.

- Sabine Lautenschläger spoke about four priorities for supervisors of banks: the global nature of the issue of banking regulation and the importance of focusing on the application of the rules of banking regulation; banks applying for a licence in the EU to respond to Brexit; developing ways of dealing with the issue of non-performing loans; and the complex nature of risk management models used by banks.

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

- The SRB resolved Banco Popular following the ECB's decision that the bank was "failing or likely to fail", and all shares of were transferred to Santander Group. This means that Banco Popular will operate under normal business conditions as a solvent and liquid member of the Santander Group with immediate effect. Separately, the SRB announced that it would not take resolution action over two Italian banks, which were placed into national insolvency proceedings following the ECB's determination that they were "failing or likely to fail".

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Rethinking the domestic and international architecture for regulation

- The European Commission published feedback from its consultation paper regarding the future operations of the ESAs, focusing on the ESAs' tasks and powers, governance, supervisory architecture and funding. The majority of respondents supported increasing the ESAs' responsibilities in monitoring and implementing equivalence decisions, and opposed the ESAs being fully funded by the industry.

Disclosure, valuation and accounting

- The European Council agreed to fast-track transitional provisions to phase-in the regulatory capital impact of the new impairment methodology under IFRS 9 as part of the CRDIV/CRR review. The Council also agreed to fast-track a Directive which would create a new class of "non-preferred" senior debt eligible to meet the subordination requirement for TLAC. Negotiations with the European Parliament and Commission will take place in the coming months.

Central Bank of Ireland

- Central Bank Commission approves restructuring of financial regulation functions.

- A research paper by James Carroll and Fergal McCann examines how banks in Ireland treat collateral provided by SMEs against loans.

Other

- The EBA published its 2016 annual report, which included areas of focus in the coming years. Among other things, the EBA will focus on liquidity and leverage ratios, credit risk and credit risk modelling, recovery planning and early intervention, improving the framework for the protection of consumers, and the monitoring of financial innovation. The EBA expected that legislative reforms from the European Commission would affect its planned work, particularly the implementation of TLAC and the FRTB.

- The ECB consulted on the methodology and criteria for calculating the annual supervisory fee, which is levied on institutions according to their status as either significant or less significant. The consultation covered the determination of the variable fee component and the criteria that will be used to support the analysis, including the administrative impact on firms and limiting the volatility of the annual fee.

- The European Systemic Risk Board (ESRB) published its risk dashboard, which indicated that market-based measures of systemic stress in the EU remain low. EU economic recovery continued in Q1 2017, unemployment remained high in many EU countries but continues its downward trend, and bank profitability remained weak but improved in Q1 2017.

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