Introduction

The prudential regulation measures contained in amendments to: (i) the Capital Requirements Regulation (CRR2); (ii) the Capital Requirements Directive IV (CRDV); (iii) the Banking Recovery and Resolution Directive (BRRD2); and (iv) the Single Resolution Mechanism Regulation (SRMR 2) were published in the Official Journal on 7 June 2019, thereby ending a lengthy period of intense negotiation between the Council, the Parliament and the Commission.

The Basel III reforms implemented by CRR2 and CRDV include an overhaul of the market risk regime, new capital rules for derivatives and securities financing transactions, a binding leverage ratio and supplemental leverage requirement for global systemically important banks (G-SIBs), a net stable funding liquidity ratio (NSFR) and rules on total loss absorbing capacity (TLAC) for G-SIBs. CRR2 does not contain the Basel reforms published in December 2017 relating to the credit and operational risk framework and a new limit on the capital benefit of using internal rating based models. These rules, known as Basel IV, will be in a separate legislative proposal due to be published later in 2019.

The EU has deviated in numerous respects from the Basel rules in order to tailor them for European financial markets. One substantial change is to introduce the concept of proportionality and to exempt small non-complex institutions from the more onerous market risk and counterparty credit risk framework and certain disclosure obligations, permitting them to continue using simpler approaches and reduced reporting. There are also numerous changes to the NSFR and leverage rules to ensure that the role of banks in the economy is recognised, and covered bond funding is not disadvantaged.

In addition to the Basel III based prudential reforms, the measures contain a number of further changes including: (i) a new authorisation and supervision regime for financial holding companies; (ii) a new requirement for third country banking groups with significant activity in the EU to establish an EU intermediate parent undertaking (IPU); (iii) amendments to Pillar 2 capital rules; (iv) amendments to large exposure rules; (v) new remuneration requirements; and (vi) proportionality requirements.

These reforms will have a significant impact on banks and may increase capital requirements, especially for institutions with substantial trading books and...
derivative operations. Liquidity requirements will also be more rigorous when the NSFR is introduced as a Pillar 1 requirement, with associated cost implications.

**Implementation timeframe**

CRR2 and CRDV were published in the Official Journal of the EU on 7 June 2019 and will enter into force on 27 June 2019.

However, their implementation timeframe is complex: most provisions in CRR2 will only start to apply on 28 June 2021, whereas the national transposition deadline for most provisions in CRDV will be 28 December 2020.

CRR2 includes different implementation timeframes for certain provisions including both fast-track implementation provisions and transitional provisions (see timeline below for more detail). Also, various Level 2 delegated and implementing acts will be made supplementing the provisions under CRR2 on the NSFR and market risk disclosures.

Within CRR2 there are dedicated transitional provisions for the EU’s implementation of the international standard on TLAC for EU G-SIBs. Lower TLAC ratios will start to apply immediately and will rise to their final levels by 1 January 2022.

CRDV also includes transitioning provisions for certain requirements including the IPU requirement such that in-scope third-country groups must have the IPU in place by 30 December 2023.

**Interaction with Investment Firms Review (IFR)**

Ostensibly, the changes which CRR2 and CRDV make are relevant to all EU banks and investment firms currently within the scope of the CRR. However, the EU’s recently adopted IFR and Investment Firm Directive (IFD) – expected to be published in the Official Journal in autumn 2019 – will significantly alter the basic scope of the CRR regime. Once the changes made by IFR and IFD have taken effect, most EU investment firms will cease to be regulated under the CRR for prudential purposes and will instead be subject to the new regime under IFR.

However, the IFR will require the very largest, most systemically important investment firms in the EU to be re-authorised as credit institutions and these firms (by definition, as credit institutions) will remain within the scope of the CRR regime (as amended by CRR2/CRDV). Under the IFR, some smaller investment firms may still be required to apply the ‘bank’ rules of the CRR framework albeit without being required to be re-licensed as banks.

**Proportionality**

As mentioned above, CRR2 includes provisions aiming to ensure the proportionate application of the prudential requirements to institutions based on their size and complexity.
**Classes of institutions**

Institutions are divided into:

> **large institutions** (i.e. G-SIIs, O-SIIs, the three largest institutions in each EU Member State and institutions with assets equal to or higher than EUR 30 billion on a solo or consolidated basis);

> **small and non-complex institutions** (i.e. non-large institutions which meet a number of conditions including that their assets are equal to or lower than EUR 5 billion over the four-year period preceding the current annual reporting period, they are not subject to recovery and resolution planning obligations, they have small trading books and the relevant competent authority deems that they are small and non-complex); and

> **other institutions** (i.e. any institution that does not fall within the other two categories).

**Proportionate application of CRR2 provisions**

First, there is scaling of the Pillar 3 requirements between smaller and less complex banks and larger banks. The EBA has also been mandated to streamline reporting requirements.

Second, CRR2 introduces simplified versions of the market risk rules, the NSFR, counterparty credit risk rules and interest rate risk in the banking book for small and non-complex institutions.

Finally, the rules include simplified obligations on remuneration for smaller and less complex banks.
CRR2 / CRDV published in OJEU

CRR2: some provisions apply immediately e.g. definitions, provisions on massive disposals, certain provisions on own funds requirements for CCP and TLAC (initial ratios)

CRDV: national transposition deadline

CRR2: main application date

CRR2: G-SII leverage ratio buffer applies 1/1/22
    TLAC (full ratios) applies 1/1/22

IPU for third country groups, deadline 30/12/23

Market risk: Commission to adopt delegated act operationalising new reporting calculation by 31/12/19. Institutions begin reporting new calculation no later than one year later (i.e. late Q4 2020)

Commission to publish legislative proposal to implement new Pillar 1 market risk rules by 30/6/20

Retroactive application: The provisions on exemptions from deductions of equity holdings will apply retroactively from 1 January 2019
Liquidity: Net Stable Funding Ratio (NSFR)

The NSFR is a long-term liquidity ratio designed to address liquidity mismatches by requiring institutions to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. The ratio limits overreliance on short-term wholesale funding which was shown to be an unreliable and volatile source of funds in the last financial crisis.

Institutions must maintain an NSFR of at least 100%. The denominator is the amount of Required Stable Funding (RSF). In order to calculate this, different RSF factors are applied to assets and off-balance sheet exposures, depending upon the residual maturity of the asset and the nature of the counterparty. RSF factors reflect the extent to which those assets need to be stably funded, either because continued funding is business-critical (the NSFR is calibrated on the assumption that banks may seek to roll over a significant proportion of maturing loans to preserve customer relationships) or because no funding could be obtained through pledging or disposing of the asset. Short-term assets (maturing in less than a year) require a lower RSF factor because banks could allow some of those assets to mature instead of rolling them over. In addition, unencumbered high-quality assets such as government bonds are given lower RSF factors. RSF factors range between 0% to 100%, and there are 17 different RSF factors in CRR2. For example, a 100% RSF applies to loans to financial customers of over a year, while amounts due from non-financial corporates and SMEs of less than a year are subject to a 50% RSF.

The numerator is the amount of Available Stable Funding (ASF). ASF factors range between 0% and 100% and depend upon the maturity of the liability and the nature of the counterparty. Unsecured borrowings of a year or more are given a 100% ASF, while liabilities with a residual maturity of between 6 months and a year provided by other financial customers are given a 50% ASF. In addition, liabilities of six months or less provided by financial counterparties do not count at all as ASF as they are allocated a 0% ASF factor.

- **Trade finance transactions** – under the Basel standard, national supervisors can specify the RSF factors for trade finance-related contingent funding obligations, such as letters of credit or guarantee facilities and there is no ceiling on the RSF factor that could be chosen. Instead of giving regulators discretion, CRR2 allocates an RSF of between 5 to 10% for trade finance, depending upon the transaction’s maturity.

- **Pass through models and covered bonds issuance** – the Basel standard lets regulators apply a 0% RSF and ASF to interdependent assets and liabilities where the bank operates as a pass-through between two parties, directly channelling the funding received into specific assets. There are a number of conditions that apply to take advantage of this treatment, but some transactions are deemed to meet these conditions, including assets and liabilities linked to centralised regulated savings
and promotional loans. The Basel standard does not include covered bonds. However, CRR2 allows covered bonds that meet certain conditions to be considered as interdependent and receive a 0% RSF/ASF. This is a significant deviation from the Basel standard and is included to avoid disruption to the EU’s important covered bond market.

> **CCPs and client clearing** – the Basel standard provides no preferential treatment for client clearing activities. However, CRR2 treats these activities as interdependent assets and liabilities and subject to a 0% ASF/RSF, provided that the institution does not guarantee the performance of the CCP to its clients, and as a result does not incur any funding risk.

> **RSF for High Quality Liquid Assets (HQLAs)** – the Basel standard applies a RSF of 0% to coins, banknotes and central bank reserves but a 5% RSF to other unencumbered Level 1 HQLAs (which includes top rated government bonds etc). Banks criticised this conservative treatment, arguing that they were being penalised for holding top liquid assets which they are compelled to hold to meet the LCR. Accordingly, CRR2 reduces the RSF for all level 1 HQLAs to 0%, to ensure consistency with the LCR.

> **Derivative and repos** – CRR2 makes a number of changes to the treatment of derivative and repo transactions under the NSFR, to ensure that end users and European financial markets are not disproportionately impacted by the Basel rules.

The requirement to hold 20% of stable funding against derivative liabilities valued gross of any collateral posted has been reduced to 5% (in accordance with the recent Basel revision), with a review clause to take into account developments at the Basel level.

All HQLA Level 1 assets (such as sovereign bonds) used as variation margin are eligible to reduce the exposure value of derivatives for NSFR purposes, whereas the Basel rules limit eligible assets to cash that meets the leverage ratio strict variation margin conditions.

The RSF for short-term lending transactions with financial customers which are collateralised by Level 1 HQLA has been reduced from 10% to 0% and for non-Level 1 HQLA from 15% to 5%. These revisions, which remove the asymmetry between the NSFR treatment of securities financing transactions, only apply until 28 June 2024, unless the EBA recommends retaining the preferential treatment.
Market risk

Introduction and timing

The global financial crisis exposed flaws in the Basel II market risk framework, with banks’ low capital requirements for market risk being eclipsed by the actual trading book losses they suffered. The Basel Committee introduced a number of “stop-gap” revisions in 2012, to reduce the market risk framework’s procyclicality and increase the overall level of capital. This was known as Basel 2.5. The Committee decided that these changes did not go far enough, and undertook a fundamental review of the trading book (FRTB) in 2012.

The Basel Committee completed the FRTB and published the revised market risk framework in January 2016, and the Commission reflected that framework in its first proposal for CRR2 in late 2016. However, in December 2017 the Basel Committee announced an implementation delay until 2022 and in January 2019 published various revisions. In view of uncertainty over the timing and substance of the revised market risk framework, CRR2 initially applies the new market risk rules as a reporting requirement only. However, once binding, the changes are expected to significantly increase capital requirements for market risk and to involve substantial compliance costs, especially for banks using internal models which will undergo a rigorous model approval process.

By 31 December 2019 the Commission should adopt a delegated act in order to fully operationalise the new reporting requirement, in line with international Basel developments. Institutions must then start reporting the market risk requirements based on the revised standardised approach by no later than one year after the delegated act starts to apply. Institutions that obtain approval to use the revised internal model approach should also report the calculation under the internal model method from 3 years of the delegated act starting to apply.

As regards implementation of the revised rules as a binding Pillar 1 requirement to replace the current market risk rules, the Commission must submit a legislative proposal by 30 June 2020.

The increased complexity and compliance costs posed by the revised rules will present a significant challenge for smaller banks that have a small trading book and lack appropriate infrastructure. Therefore, CRR2 allows institutions with trading book business equal to or less than both EUR 500 million and 10% of the institution’s total assets to treat certain assets as if they were held on the banking book and apply the relevant credit risk requirement accordingly. Firms with medium sized trading books are also exempt from the new reporting requirements.

Key revisions

> Stricter boundary between the trading book/banking book – to reduce the risk of arbitrage, certain types of instruments must always be allocated to the trading book or banking book and banks cannot move an instrument between books without supervisory permission, which will only be given in exceptional circumstances.
New internal model approach and approval process – the VaR and stressed VaR metric for internal models has been replaced by the single Expected Shortfall metric, which captures the risk of low probability but high impact events (and is calibrated to a period of significant stress). In addition, banks need to apply for multi-staged approval for their individual trading desks and comply with an assessment process which is known as the profit and loss (P&L) attribution test to determine whether their models reflect the actual risk of their trading desks.

Non-modellable risk factors – if a bank has risk factors which do not meet the modelling eligibility test (minimum of 4 real price observations in a 90-day period or 100 real price observations in the previous 12 months) then the bank must calculate a separate non-modellable risk factor capital requirement based on the loss in a stressed period, with some diversification benefit permitted.

New standardised approach – the standardised approach has been replaced by more risk-sensitive rules which permit more hedging and diversification, but have been criticised as unnecessarily complex. Trading desks which fail the internal model P&L attribution tests must use the standardised rules as a fall-back if they do not rectify the position within a certain period of time.

Incorporating liquidity risks – the current framework assumes that all holdings in the trading book can be liquidated within 10 days with little impact on market prices, but the new rules require all trading book items to be subject to liquidity horizons of between 10 and 120 days meaning that less liquid holdings will incur higher capital requirements.

Leverage ratio

Introduction

The CRR already contains a leverage ratio disclosure and reporting requirement. The leverage ratio is a non-risk-based requirement which is designed to act as a back-stop to the risk-based system and to contain the build-up of excessive leverage. By design, it does not differentiate across asset classes, although there are specific rules for the treatment of derivatives and repos. From mid-2021, CRR2 will impose a binding leverage ratio requiring EU institutions to maintain Tier 1 capital of at least 3% of non-risk weighted assets. CRR2 also requires global systemically important institutions (G-SIIs) to maintain a leverage ratio buffer equal to 50% of the G-SII risk-weighted buffer rate (which ranges from 1 to 3.5%). Where a G-SII does not meet the buffer requirement, it is subject to capital conservation buffer restrictions on the payment of dividends.

It is important to note that regulated banks and building societies in the UK with total deposits equal to or greater than GBP 50 billion are already subject to a 3.25% leverage ratio. Unlike the Basel and CRR2 rules, 75% of the ratio must be made up of CET1 capital and AT1 capital can only be used for the remaining 25% if it converts into CET1 or is written down when the CET1 ratio falls below 7%. In addition, UK banks are already subject to a G-SII buffer of 35% of the
applicable G-SII buffer rate and 35% of the applicable countercyclical buffer rate (which is currently set at 1% in the UK).

**Exposure measure**

The leverage ratio exposure measure is the sum of (i) on balance sheet exposures such as drawn loans, bonds etc; (ii) derivative exposures; (iii) securities financing transactions (SFTs); and (iv) off-balance sheet items. The general rule is that the exposure measure should follow the accounting treatment allocated to the asset or off-balance sheet item in the balance sheet. Netting of loans and deposits is not allowed and collateral, guarantees or credit risk mitigation techniques are not taken into account to reduce the exposure measure, other than in relation to specific rules for derivatives and SFTs.

CRR2 exempts various transactions from the exposure measure, on the basis that the leverage ratio would disproportionately constrain certain business models and lines. These include lending to public sector bodies, if the firm is a public development bank; exposures arising from passing-through promotional loans to other banks granting the loan; and the guaranteed parts of exposures arising from officially supported export credit, where guarantees are provided by export credit agencies (ECAs) or central governments. Supervisors can also temporarily exempt central bank reserves in exceptional macroeconomic circumstances and provided certain criteria are fulfilled.

The conservative treatment of derivative transactions under the Basel rules has largely been followed in CRR2, although there is one substantial divergence in relation to the treatment of initial margin in order to ensure that central clearing continues to be given preferential treatment over bilateral transactions. Specifically, the Basel standard does not permit any form of initial margin to reduce the exposure measure, only allowing variation margin in the form of cash which meets certain conditions. However, CRR2 allows initial margin to reduce the exposure measure, provided that the derivative contract is with a client and is cleared through a qualifying CCP (i.e. EU CCP or third-country CCP recognised by ESMA).

For SFTs, the exposure measure is equal to the sum of gross SFT assets and a counterparty credit risk measure. Netting of the securities received with cash payable under an SFT such as a repo is not permitted - only netting of cash receivables and cash payable under transactions with the same counterparty (e.g. repo and reverse repo) is permitted. This blunt measurement of SFTs does not accurately reflect their commercial realities and may have an adverse impact on repo markets.

**Standardised approach to counterparty credit risk for derivatives and SFTs (SA-CCR)**

Currently, banks can use one of four methods, namely the standardised approach (SA), current exposure measure (CEM), original exposure measure or internal model method (IMM) to calculate the exposure value of their derivative transactions for risk weighting purposes. The non-internal methods
have all been criticised as being insufficiently risk sensitive and not adequately reflecting the effects of margining, netting, and over-collateralisation.

In March 2014, the Basel Committee finalised a new non-internal models method, known as standardised approach to counterparty credit risk (SA CCR), which replaces all the other non-internal model methods. The Basel SA-CCR standard was intended to apply from 2018, although some jurisdictions, including the EU, have been slow in adopting the SA-CRR. The new rules contain more recognition of hedging, netting, diversification and collateral and are more risk sensitive.

CRR2 does not depart materially from the Basel standard, except for allowing smaller institutions to use simpler approaches.

Large Exposures (LE)

The framework in CRR aims to limit concentration risk by prohibiting a bank from having total exposures to a client or group of connected clients that is equal to or over 25% of its capital base. In addition, any individual exposure equal to or over 10% of a bank’s capital base must be reported. The two key components of the LE rules are the measurement of exposures (including which exposures are exempt and the use of the credit risk mitigation framework) and how the exposure limit is calculated (namely what capital base is used). The changes to the LE rules are mainly based on the Basel Committee “supervisory framework for measuring and controlling large exposures” of April 2014.

One of the key changes is that the 25% exposure limit is calculated on a narrower capital base, namely Tier 1 capital. Under current rules, the capital base was “eligible capital” which included Tier 2 capital. This will result in more stringent limits. In addition, the exposure limit is reduced to 15% for exposures between G-SIBs, in order to mitigate systemic risk.

As regards the measurement of exposures, one of the key differences with the current rules is that when calculating the exposure value of derivative and other instruments subject to counterparty credit risk, the use of the internal models approach is not allowed (even if the firm uses that approach for CCR purposes). Instead, a firm must use the new SA-CCR approach to calculate the exposure value for such instruments. This change may have a substantial impact on IMA firms with large derivative books. In addition, under the current rules, when calculating the impact of financial collateral, banks can use the relevant collateral method they use for risk weighting purposes, including where they use their own estimate for volatility adjustments. This discretion is removed and banks must use the Financial Collateral Comprehensive Method (FCCM) which is less risk sensitive than the internal methods.

Another change of note is that where an exposure is guaranteed by a third party or secured by collateral issued by a third party, the bank must always treat the exposure as to the guarantor and not the borrower, unlike the current rules where this type of substitution is an option.
PILLAR 2

Pillar 2, capital guidance and maximum distributable amount

Under the current Pillar 2 rules, a regulator can impose additional capital requirements to deal with idiosyncratic risks (such as pension risk or group risk) that are not covered by the Pillar 1 requirement and which emerge from an institution’s supervisory review and evaluation process (SREP). Pillar 2 capital requirements can be significant and are relevant for investors because an inability to meet them may lead to restrictions on distributions.

In a bid to overcome inconsistent application of Pillar 2 in different Member States, CRR2 clarifies conditions for imposing Pillar 2 capital requirements. Notably, Pillar 2 can no longer cover macroprudential risks; only micro-prudential risks. Pillar 2 also cannot be used to address risks that are subject to grandfathering or transitional provisions.

CRR2 requires regulators to provide a full explanation of the Pillar 2 charges. At least three quarters of the Pillar 2 requirement must be met with Tier 1 capital and at least 75% of this Tier 1 capital must be made up of CET1 capital. However, there is a new discretion for regulators to require an institution to meet its Pillar 2 requirement with a higher proportion of Tier 1 capital or CET1 capital. This requirement has been criticised on the basis that Pillar 2 risks should logically be met with the same quality of capital as required to meet Pillar 1 risks and should follow the minimum ratio requirements for CET1, Tier 1 and total capital.

CRR2 distinguishes between Pillar 2 requirements and capital “guidance”. The concept of capital guidance, which was introduced by the EBA in the 2016 stress test results, has been formally incorporated into the Pillar 2 framework, describing capital guidance as being “internal capital” that must be held above both Pillar 1 and Pillar 2 requirements to avoid cyclical economic fluctuations leading to a breach of those requirements and to ensure that stress test losses can be absorbed without breaching requirements. An institution that does not meet the capital guidance will not be in breach of capital levels and therefore no restriction on distributions will be imposed. However, restrictions on distributions in the form of the Maximum Distributable Amount (MDA) are still imposed in case of failure to meet various combined buffer requirements. CRR2 includes provisions clarifying the stacking order, namely the relationship between Pillar 1 and Pillar 2 requirements, the own funds and eligible liabilities requirement, the minimum requirements for own funds and eligible liabilities (MREL) and the combined buffer requirement. For more information between regulatory capital, the combined buffer requirement and MREL, see our separate client alert.
PILLAR 3

Pillar 3 disclosures

CRR2 implements the revised Basel Pillar 3 requirements published in 2015. As part of the proportionality framework introduced in CRR2, the frequency and content of required disclosures depends on the classification of each institution as a large institution, small and non-complex institution or other institution (see definitions above).

The new rules include carve-outs for non-material, proprietary or confidential information (e.g. impacts on competition). Broadly, information is deemed material if its disclosure would affect market decisions.

The original Commission proposal for CRR2 included a requirement for IRB banks to disclose their hypothetical RWAs under the standardised approach which became the subject of lobbying by banks and trade associations. Also, the original proposals included a requirement for market risk to be disclosed at trading desk level which would have revealed information about banks’ trading strategies. The final text instead requires disclosure of market risk at a sub-portfolio basis.

Despite the final rules being less stringent than the original proposals, they still expand the scope of disclosure requirements (especially for large institutions) by requiring granular disclosure of credit risk (non-performing loans, geographical breakdown, concentration of exposures by industry or counterparty types, residual maturity breakdown of loans and debt securities) and credit risk mitigation techniques, disclosure of MREL (although parallel disclosure obligations are imposed under the BRRD2), disclosure of non-deductible holdings in insurers and re-insurers and disclosure of environmental, social and governance (ESG) risks of large institutions.

Finally, CRR2 requires institutions to disclose the amount of the additional own funds requirements based on the SREP and its composition in terms of Common Equity Tier 1, additional Tier 1 and Tier 2 instruments. In effect, this means that institutions will have to disclose their Pillar 2 buffers for the benefit of external investors, although the final text includes a recital clarifying that the Pillar 2 guidance shall not be disclosed.
Changes to consolidation rules

The intermediate parent undertaking (IPU) requirement

Background

When the Commission published its proposal for CRDV in November 2016, there was concern at the last-minute inclusion of an intermediate parent undertaking requirement for third country banking groups. This was seen by the market as a “tit for tat” response to US requirements for large foreign banks to set up an intermediate holding company (IHC) in the US, although EU lawmakers have stated that their aim was to achieve the creation of an EU sub-consolidation group within third country groups with significant activity in the EU (and therefore make them subject to EU supervision).

The requirements

Under CRDV, third country groups with:

> two or more institutions in the EU; and

> more than EUR 40 billion assets in the EU¹,

must have an IPU established in the EU.

The EUR 40 billion asset threshold takes into account the assets of institutions as well as branches of institutions and of all MIFID/MIFIR- authorised investment firms in the EU. The original proposals envisaged a EUR 30 billion asset threshold which was increased after political pressure primarily from the UK.

CRDV allows third country groups to have two separate EU IPUs (allowing for two separate consolidation groups) where (i) the competent authority determines that the laws of the jurisdiction of the ultimate parent on separation of activities would be breached; or (ii) the relevant resolution authority makes an assessment that resolution would be more efficient if the group had two IPUs. The first derogation was driven mostly by US separation rules (requiring the broker-dealer chain to be kept under a separate holding company from the bank chain).

The IPU can be either a credit institution or a financial holding company (in the latter case, that financial holding company would have to be approved under the new regime discussed below). In investment firm-only groups (or where the group was allowed to have two IPUs as a result of mandatory separation rules) the IPU can be an investment firm.

Similar to the US IHC, the EU IPU would need to meet the EU prudential standards on a consolidated basis, including capital and liquidity rules, as well as governance, disclosure and remuneration rules.

¹ On 27 June 2019.
Transitional arrangements

The IPU requirement is subject to a 3-year transitional arrangement. Therefore, affected third country groups are required to establish an EU IPU by 30 December 2023.

Impact

Assuming that Brexit proceeds, the UK will become a third country. As a result, a UK parent bank or holding company of a UK or other third country group cannot be the EU IPU. Given that a number of UK groups will meet the EUR 40 billion asset threshold, the IPU rule may lead to substantial restructuring costs as well as ongoing prudential costs from the application of consolidated requirements to the IPU (although the EU IPU rules do not require the establishment of a new entity unlike the US rules and therefore, in principle, third country groups can use an existing bank in the EU as their IPU).

The approval regime for financial holding companies

Under current rules, a bank or investment firm must include in its consolidation group its EU parent financial holding company, and all financial subsidiaries of that parent company. If the financial holding company is incorporated in a third country, then it is not captured by the consolidation rules (as consolidation only goes up to the top EU entity in the group). In the current regime, where the EU parent of the group is a financial holding company or mixed financial holding company, it is the subsidiary bank or investment firm that is responsible for the consolidated return and ensuring compliance with consolidated prudential requirements. Today, a national regulator has no direct authority or supervisory capacity under CRR over the holding company except for limited governance requirements. This is changing under CRR2.

The requirements

CRDV requires parent financial holding companies and mixed financial holding companies (and those financial holding companies and mixed financial holding companies required to comply with the prudential requirements at the sub-consolidation level) in the EU to seek “approval” from the consolidating supervisor. This approval requirement has been watered down from the original “authorisation” and supervision wording in the November 2016 Commission proposal for CRDV which was heavily criticised as too onerous. However, even after the amendments, the approval regime for financial holding companies read together with the intermediate parent undertaking requirement are likely to force some banks to reconsider the structure of their group.

In order to gain approval, a holding company must provide an open-ended list of information to the relevant regulator. Approval should only be given, provided that various conditions are fulfilled, including that the structural organisation of the group does not obstruct or prevent the “effective supervision” of the parent or subsidiary institutions. A decision to grant approval (or not) must be taken within six months of receipt of the application.

Holding company approval is not required in certain circumstances such as where the financial holding company (i) is a pure holding company; (ii) is not a
resolution entity; and (iii) does not take management, operational or financial decisions regarding the group. Where the consolidating supervisor discovers that the approval conditions have not been met or cease to be met, it can take steps such as suspending the exercise of the voting rights attached to the shares of the subsidiary, prohibiting distributions or interest payments to shareholders and requiring the financial holding company to divest its holdings in institutions or financial sector entities.

**Impact**

The scope of CRR2 has been amended so that financial holding companies will have to comply with the own funds requirements, LE requirements, liquidity requirements, reporting and Pillar 3 requirements, to the extent applicable to them (i.e. at the consolidated and sub-consolidated level), whereas currently the scope of application of CRR only includes institutions (i.e. operating companies). Also, CRR2 and CRDV expressly state that for any obligations imposed at the consolidated level or sub-consolidated level, the term “institutions” should be read so as to include authorised financial holding companies.

In practice, this means that the financial holding company itself would be responsible for meeting the capital, liquidity and LE requirements and for compliance with reporting requirements at the consolidated level. However, financial holding companies will still not be subject to prudential requirements and formal supervision on a solo basis.

In terms of governance, the current regime already extends some of the governance obligations (e.g. the requirement that the board members are skilled) to the management of FHCs and various Level 3 measures (such as EBA Guidelines) already apply the same level of scrutiny to the management of institutions and financial holding companies.

**Scope of consolidation**

Under the current rules, only subsidiaries which carry out financial activities are included in regulatory consolidation. However, CRR2 gives regulators discretion to require full or proportional consolidation of entities engaged in non-financial activities where there is “a substantial risk that the institution decides to provide financial support to the undertaking in stressed conditions, in the absence or, or in excess of any contractual obligations to provide support”. This is a relatively wide and subjective discretion and may mean that the entities included a banks consolidation groups increase as a result.
Remuneration, total loss absorbing capacity and environmental, social and governance risks

Remuneration rules

Scope of application

Under CRDV, small institutions and staff with low levels of variable remuneration are not subject to the rules on deferral and pay-out in instruments.

Generally, CRDV remuneration provisions do not apply on a consolidated basis to subsidiaries that are not institutions. However, to prevent possible arbitrage, an exception is made for staff in subsidiaries who are material risk takers at the level of the banking group.

The changes in CRDV are only relevant to banks (including the largest investment firms who will become banks due to IFR) and to those investment firms (Class 1 minus) who are required by IFR to apply the CRR bank rules without actually becoming banks. For other investment firms, their remuneration rules will be established under the IFD.

Bonus cap and deferral

CRDV extends the bonus cap to all EU firms regardless of size. Hitherto, most UK firms have avoided the cap due to UK authorities’ flexible application of the proportionality principle. However, the practical impact of extending the cap may be relatively small for affected UK firms as many employees would be under the cap anyway.

Deferral and non-cash rules will apply to material risk takers with variable pay above EUR 50,000 or one third of total remuneration. The application threshold for these rules is EUR 5 billion in assets (with scope to increase to EUR 15 billion – which is close to the current UK threshold of GBP 15 billion).

Gender neutrality

CRR2 requires institutions to implement gender neutral remuneration policies and mandates the EBA to issue guidelines on gender neutral remuneration policies for institutions.

Total loss absorbing capacity (TLAC)

The most important changes to the EU’s MREL are contained in BRRD2. However, CRR2 was chosen to implement the international standard on TLAC for G-SIBs. It achieves this by imposing a fixed minimum (i.e. a Pillar 1) MREL requirement on EU G-SIBs, calculated by reference to the asset-based ratios set out in the international TLAC standard and including a subordination requirement. TLAC was intended to apply from the start of 2019 so the provisions of CRR2 implementing the standard will apply immediately upon entry into force of CRR2. The full TLAC ratios will apply from the beginning of 2022.
CRR2 is also home to key provisions which establish the eligibility criteria for MREL more generally (not just TLAC compatible MREL for G-SIBs). Accordingly, complete comprehension of the EU’s revised MREL regime (for G-SIBs and for smaller entities) requires sight of both CRR2 and BRRD2. For a more detailed explanation of the EU’s approach to the implementation of the TLAC standard, as well as the introduction of fixed minimum levels of MREL and subordination requirements for various non-G-SIBs, please refer to our separate client alert on resolution related components of the risk reduction package.

**Environmental, social and governance (ESG) risks**

CRR2 includes provisions relating to sustainable finance. First, it includes disclosure requirements on ESG risks for large institutions. Also, it mandates the EBA to produce a report in 2025 (which may lead to legislation) on the prudential treatment of assets associated with environmental or social objectives and a second report on how to incorporate such risks in the supervisory process. CRR2 allows for capital relief for loans to certain infrastructure entities provided that various conditions are met including conditions on sustainable finance.

Similar provisions are included in the investment firm review proposals, and the PRA is taking measures at the domestic level (such as the inclusion of management of ESG risks in the senior managers regime). We will be publishing a paper dedicated on ESG considerations in due course.
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