The EU has adopted a major reform of its prudential framework for banks.

The revised rules on capital and liquidity (CRR2 and CRDV) and resolution (BRRD2 and SRMR2) were published in the Official Journal on 7 June following a legislative process which began at the end of 2016. Most changes will start to apply from mid-2021. Some will apply sooner. Although the changes ostensibly apply to CRR investment firms as well as banks, many EU investment firms will soon be removed from the scope of the CRR with the introduction of the new Investment Firms Regulation and Directive.

Click here for a more detailed discussion of CRR2/CRD V and here for an analysis of the resolution related parts of the package.

What are CRR2 and CRDV?
CRR2 and CRDV amend the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRDIV), which provide the legal architecture for the prudential regulation of banks in the EU. Many of the changes made by CRR2 and CRDV continue the EU’s implementation of internationally agreed Basel standards. However, the EU’s implementation deviates from Basel standards in a few areas and some components of CRR2/CRDV are unrelated to international standards but instead aim to drive forward the EU Banking and Capital Markets Unions.

Binding leverage ratio
The new rules impose a binding leverage ratio requiring institutions to maintain Tier 1 capital of at least 3% of their non-risk-weighted assets. An additional leverage ratio buffer will apply to global systemically important institutions (G-SIIs). Unlike the Basel standard, CRR2 allows initial margin to reduce the exposure measure when applying the leverage ratio to derivatives.

Net stable funding ratio (NSFR)
CRR2 imposes a net stable funding requirement. Unlike the liquidity coverage ratio (which focuses on the quality and liquidity of institutions’ assets) the NSFR focuses on the liabilities side of the balance sheet and is designed to ensure that exposures are broadly matched with stable funding sources. The NSFR has been calibrated with a view to avoiding disruption to EU covered bond, derivatives and repo markets with discrete divergences from the international standard.

Market risk
CRR2’s new approach to market risk reflects the Basel Committee’s Fundamental Review of the Trading Book (FRTB). Initially the new framework will only apply as a reporting requirement. Since work on FRTB is continuing at the level of the Basel Committee, the new framework will only be implemented as a binding capital requirement in the EU at a later date, subsequent to a separate legislative proposal from the Commission.

Intermediate parent undertakings for third country groups
A controversial element of the Commission’s original legislative proposal for CRDV was a requirement for certain large third country groups to establish an intermediate parent undertaking (IPU) in the EU by the end of 2023. In the final text the IPU regime has been softened slightly, with an asset threshold of €40bn, no automaticity for G-SIBs and scope for the requirement to be satisfied through the use of two IPUs where necessary to satisfy the structural separation rules of a third country. Nonetheless, for affected third country groups, the IPU requirement will present a significant restructuring challenge.

Counterparty credit risk
CRR2 constitutes the EU’s implementation of the new Basel standardised approach to counterparty credit risk (SA-CCR). The new approach is more risk sensitive, providing better recognition of hedging, netting, diversification and collateral.

Changes to Pillar 2
CRR2 and CRDV overhaul the approach to institution-specific (Pillar 2) capital add-ons. Notably, Pillar 2 requirements will only be used to address micro-prudential risks, not macro-prudential ones. The relationship between mandatory Pillar 2 add-ons and supervisory expectations to hold more capital (so-called Pillar 2 Guidance) is clarified.
TLAC for G-SIBs
BRRD2 (and in the Banking Union, SRMR2) are the key parts of the package relating to resolution. However, CRR2 contains important provisions implementing the international standard on total loss absorbing capacity (TLAC) for EU G-SIBs. CRR2 achieves this by aligning the EU’s regime on minimum requirements for own funds and eligible liabilities (MREL) – as it applies to G-SIBs – with the international standard. These and other resolution changes (including the relationship between MREL and regulatory capital) are explained in greater detail in our separate client alert.

Holding companies and perimeter
CRR2 brings holding companies within the supervisory perimeter and submits them to a requirement to obtain “approval” from a group’s consolidating supervisor. CRR2 also ensures that holding companies (not just operating companies) will have to comply with core capital, large exposure, liquidity and reporting obligations to the extent applicable to them.

Infrastructure investment and exposure to SMEs
The new rules aim to encourage lending to SMEs by increasing the threshold below which SME exposures can benefit from reduced capital requirements. Capital requirements are also lowered by 25% for investments in infrastructure that satisfy key criteria relating to risk profile and the predictability of cash flows.

Non-performing loans (NPLs)
Hot on the heels of a separate 2019 Regulation amending CRR in relation to minimum loss coverage for non-performing exposures, CRR2 also includes provisions designed to facilitate the management of NPLs by EU banks. Specifically, CRR2 adjusts credit risk provisions of the CRR to mitigate the capital impact of ‘massive disposals’ of non-performing loans.

Environmental, social and governance (ESG)
CRR2 and CRDV contain some measures that focus on sustainable finance. In particular the European Banking Authority is tasked with preparing two reports: one on how to incorporate ESG risks into the supervisory process and another on the treatment of assets associated with environmental and social objectives. The new framework also establishes a requirement for large institutions to publicly disclose their ESG related risks.

What else is in the pipeline?
The EU has also recently adopted final texts for the Investment Firms Regulation and Directive (IFR and IFD). These are expected to be published in the Official Journal and enter into force later this year. They will effect further changes to the CRR framework so as to remove most investment firms from the scope of the CRR regime. Under the IFR/IFD most EU investment firms will be regulated for prudential purposes under the IFR. However, the very largest investment firms will be required to be re-authorised as banks and remain within the scope of the CRR regime. Some smaller investment firms may also be required to continue applying the CRR regime (rather than IFR) albeit without being reclassified as banks.