Introduction

On 23 November, the European Commission published its long-awaited “risk reduction” legislative proposal to reform key aspects of the Capital Requirements Regulation (“CRR”) and the Capital Requirements Directive IV (“CRDIV”), as well as amendments to the Banking Recovery and Resolution Directive (“BRRD”) and the Single Resolution Mechanism Regulation (“SRMR”). The regulatory capital and liquidity reform proposals which are the subject of this note are contained in a Regulation amending CRR (“CRR2”) and a Directive amending CRDIV (“CRDV”). The proposed rules implement a number of Basel Committee standards including: (i) a binding leverage ratio of 3% Tier 1 capital; (ii) a binding net stable funding ratio; (iii) new market risk rules and trading book requirements; (iv) a new standard for total loss absorbing capital (“TLAC”); (v) amended counterparty credit risk rules including a new standardised approach to calculate the exposure value for derivative transactions and amendments to the rules on cleared derivative exposures; (vi) changes to large exposure rules; (vii) changes to the rules on equity investments in funds; (viii) a modified framework for interest rate risk; and (ix) changes to the Pillar 2 rules. The Commission clarifies that the provisions of CRR2 are “equivalent” to the Basel Committee rules, subject to “targeted adjustments” to reflect “Union specifications and broader policy considerations”.

There are a number of additional changes contained in CRR2 and CRDV which are unrelated to Basel Committee standards and which the European Commission has decided are required as a result of their review of the existing regulatory framework. These changes include: (i) waivers from capital and liquidity requirements subject to satisfaction of certain conditions; (ii) the establishment of intermediate EU parent undertakings and authorisation/direct supervision of financial holding companies; (iii) the preferential treatment for infrastructure lending; (iv) the extension of the risk weight reduction for exposures to small and medium sized firms; and (v) amended remuneration rules.

The amendments contained in CRR2 and CRDV represent a substantial overhaul of the current regulatory framework and will have a significant impact on all firms to whom the new rules apply, not just in terms of

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compliance costs, but also regulatory capital and liquidity costs which are likely to increase as a result.

Set out below is a summary of each of the key new or amending proposals in CRR2 and CRDV, highlighting any significant differences in drafting or approach between the EU rules and the Basel Committee rules they are implementing. This note does not cover the TLAC and Pillar 2 proposals contained in the amendments to BRRD and CRDV nor the remuneration proposals in CRR2 and CRDV. For further detail on the TLAC and Pillar 2 proposals please click [here](#) for the Linklaters Client Alert on “CRD and BRRD Reform Proposals” and click [here](#) for the Linklaters Client Alert on the “Proposed Amendments to remuneration provisions of CRDIV and CRD”.

**Scope**

The current CRR and CRDIV prudential framework applies to investment firms and deposit taking banks (“institutions”), unlike the Basel framework which only applies to deposit taking banks. The definition of an “investment firm” is very wide and captures most financial firms, including asset management, stockbroking and other types of firms. The European Banking Authority published a report in December 2015 in which it found that the CRR rules were not “fit for purpose” for the majority of investment firms, and is currently consulting on a more proportionate and appropriate regime for investment firms, other than systemic ones, with the aim of publishing a legislative proposal for a new prudential regime for non-systemic investment firms by the end of 2017. A new Article 501 excludes investment firms that are not systemic firms from the amendments contained in CRR2 and provides that these firms will remain subject to the current CRR framework. Therefore, only deposit taking banks and systemically important investment firms will be required to comply with the prudential requirements in CRR2, including the NSFR and leverage ratio, on an individual basis. However, if a non-systemic investment firm is part of a regulatory consolidation group which contains a bank or systemic investment firm, the CRR2 rules will nonetheless apply to the non-systemic firm on a consolidated basis.

As regards the scope of CRDV, there is no limitation in scope as there is in CRR2, and therefore the CRDV amendments will apply to all investment firms and banks currently subject to CRDIV.

In addition, as discussed in further detail in Section 2.2 below, financial holding companies and mixed financial holding companies are being brought directly within the scope of the prudential framework.

**The Legislative Process**

The publication of these proposals kicks-off an EU legislative process known as the “Ordinary Legislative Procedure”. This entails the European Parliament and the Council of the EU each considering their position on the proposals before entering into informal “trilogue” negotiations facilitated by the European Commission. Once agreement is reached and endorsed by the European Parliament plenary and the Council of the EU, the legislation is published in the Official Journal of the EU.
Timing

The average length of the Ordinary Legislative Procedure is around 18 months – about 85% of the proposals going through the Ordinary Legislative Procedure are published in Official Journal of the EU within this period. However, in the past, more complex legislative proposals (including the original versions of CRR and CRDV) have taken around 24 months. Therefore, it is likely that the earliest date that CRR2 and CRDV will be published in the Official Journal is late 2018/early 2019. The timing provisions in CRR2 and CRDV differ. The current proposal is for CRDV to come into force twenty days after its publication in the Official Journal, with Member States required to adopt national laws to implement the provisions of the CRDV one year after the Directive enters into force (two years in the case of the interest rate risk provisions). CRR2, which is directly applicable in all Member States and will not require implementing legislation, will come into force in all Member States, two years after the date of publication. The two year period is in square brackets, and it is likely that the timing will be a key topic of negotiation.

There is likely to be a mismatch in timing in relation to a number of the Basel Committee reform proposals, which have implementation dates prior to 2019. For example, the Basel Pillar 1 leverage rules have an implementation date of 1 January 2018 while the counterparty credit risk rules have an implementation date of 1 January 2017. This may raise issues for non-European banking groups, whose consolidated regulatory capital and liquidity returns will be calculated based on different rules to their European subsidiaries.

1 CRR2 rules implementing Basel Committee standards

1.1 Net Stable Funding Ratio

Summary

The Net Stable Funding Ratio (“NSFR”) aims to ensure that institutions do not have too great a mismatch between the tenor of their funding and their assets, thereby minimising the funding risk of these assets. Currently institutions are subject to reporting obligations in respect of stable funding, but banks and systemic investment firms will be subject to a binding NSFR requirement under CRR2. The NSFR is measured over one year, requiring banks to maintain a stable funding profile in relation to the composition of their assets and off-balance sheet activities. The NSFR is designed so that banks rely on their own stable funding rather than relying on funding from other financial institutions that are vulnerable to funding in times of stress. The NSFR applies on an individual and consolidated basis, unless regulators waive the individual requirement under Article 8 or 10 CRR2 and is calculated as follows:

Available Stable Funding (“ASF”) = 100%

Required stable Funding (“RSF”)
In other words, institutions are required to have weighted stable funding (“ASF”) greater than or equal to their weighted stable funding requirements (“RSF”). If the institution’s NSFR falls or can reasonably be expected to fall below 100%, it must immediately notify the competent authorities and submit a liquidity restoration plan. Competent authorities will be required to assess the reason for non-compliance before taking any supervisory measures.

> **Available Stable Funding and Required Stable Funding**

Regulatory capital and liabilities are assigned ASF “factors”, depending on the maturity of the liability and the nature of the counterparty. A factor of 100% means that the full amount of the liability counts as ASF, whereas a factor of 50% means that only half the value of the funding can be used as ASF and a factor of 0% means that none of the funding can be used as ASF. The NSFR is calibrated so that longer term liabilities are assumed to be more stable than short-term liabilities and that deposits provided by retail customers and SME customers are more stable than wholesale funding of the same maturity.

The ASF factors mostly follow the Basel NSFR rules. Liabilities with a maturity exceeding one-year receive a factor of 100%, as do Tier 1 or Tier 2 instruments that count as regulatory capital. This means that the full value of any funding over one year, whoever the counterparty is, counts as ASF. An ASF of 50% is applied to liabilities with a contractual maturity of six months or more but less than a year (including those provided by financial customers), operational deposits and liabilities with a residual maturity of less than one year provided by non-financial corporates. Importantly, a 0% ASF is applied to other liabilities not in one of the specified categories. This would include funding from financial customers of less than six months maturity.

RSF is calculated by multiplying the accounting value of various categories of assets and off-balance sheet assets by the RSF factors. RSF factors range from 0% to 100%. Assets with a 0% RSF include unencumbered assets in the form of highest quality liquid assets, known as “Level 1 HQLA”, such as European sovereign bonds, while those with a 100% RSF factor include loans to financial customers of over a year and derivative assets less derivative liabilities. Assets with a higher RSF percentage are therefore more expensive in terms of liquidity costs.

> **Changes from the Basel NSFR rules**

The European Commission has made a number of changes to the Basel NSFR rules. The five key changes relate to the definition of interdependent assets and liabilities, the treatment of trade finance transactions, derivative transactions and short term transactions with financial institutions and sovereign bonds.
(i) Interdependent assets and liabilities

Under the Basel NSFR rules, national supervisors are given discretion to determine whether certain assets and liabilities are, on the basis of contractual arrangements, interdependent, so that the proposed payment flows from the asset cannot be used for anything other than repaying the liability and the liability cannot be used to fund other assets. If various criteria are met, assets and liabilities categorised as interdependent are assigned RSF and ASF factors of 0%. The Commission has modified the Basel NSFR rules, so that instead of having the same maturity, the liability and asset must have “substantially matched” maturities, with a maximum 20 day maturity lag. In addition, it has categorised certain covered bonds, promotional loans and derivative client clearing activities where the institution does not guarantee the CCP’s performance as interdependent.

(ii) Trade finance transactions

Under the Basel NSFR rules, national supervisors can specify the RSF factors for trade finance-related obligations such as guarantees and letters of credit. If the European Commission gave national regulators such discretion, arguably there could be a wide range of different RSF factors applied, from 0% to 100%, which could adversely impact the trade finance market. Therefore, the Commission has clarified that on-balance sheet trade finance related products with a residual maturity of less than six months and off-balance sheet products between 6 months and one year are subject to a 10% RSF factor, while on balance sheet trade finance products with a residual maturity of between six months and one year are subject to a 50% RSF. Trade finance off-balance sheet and on-balance sheet products with a residual maturity of one year or more are subject to a factor of 15% and 85% respectively.

(iii) Derivative transactions

The third change relates to the treatment of derivative transactions. The Basel rules apply an RSF of 20% to gross derivative liabilities (calculated before deducting variation margin posted). The Commission considered that this treatment over-estimates additional funding risks related to the potential increase of derivative liabilities over a one year horizon and could lead to lower availability or increased costs for end-users of derivatives, such as corporates or pension funds. Therefore, un-margined derivative liabilities are given a reduced 10% RSF factor. For margined derivative liabilities an option is introduced for institutions using the SA-CCR (as described below) either to apply the 20% RSF or to use an alternative treatment based on the Potential Future Exposure (“PFE”). In addition, under the Basel and EU NSFR rules, if net derivatives assets are greater than net derivative liabilities, the difference is subject to a 100% RSF. When calculating the value of derivative assets, the Basel NSFR rules do not permit collateral received to offset the value, unless it is received in cash variation margin. The Commission has extended the type of
collateral to include variation margin received in the form of Level 1 HQLA.

(iv) Short term transactions

The fourth change relates to the treatment of short-term transactions with financial institutions. Under the Basel NSFR rules, there is asymmetric treatment between short term funding provided by financial customers, such as repos, where such funding does not count as ASF, and short term lending, such as reverse repos, where stable funding is required, with either a 10% or 15% RSF factor applied, depending upon the type of collateralisation. While the aim of this treatment is to discourage excessive reliance on short term funding between institutions, the Commission has argued that it is too conservative and may adversely affect the liquidity of securities used as collateral in repo transactions as well as undermining market-making in securities and affecting the liquidity of interbank funding markets. The Commission has accordingly therefore reduced the RSF percentages to 5% and 10% respectively.

(v) Sovereign bonds

The fifth change relates to the treatment of sovereign bonds. Under the Basel NSFR rules, Level 1 HQLA, such as European sovereign bonds, are subject to a 5% RSF factor. The Commission believes that this treatment could incentivise institutions to deposit cash at central banks rather than act as primary dealers and provide liquidity in sovereign bond markets. Therefore, the RSF factor applicable to Level 1 HQLA is reduced from 5% to 0%.

1.2 The Leverage Ratio

Summary and timing

European institutions subject to CRR are currently required to report and disclose their leverage ratio requirements in accordance with the leverage rules contained in Article 429 CRR. The leverage ratio is a non-risk based measure which is designed to act as a backstop to the risk-based requirements and to provide a simple and absolute non-risk based limit to the amount of leverage a bank can incur as a multiple of its capital base. The leverage ratio rules in Article 429 CRR were amended in 2014 to implement the changes to the leverage ratio rules made by the Basel Committee in October 2014. There are a number of new amendments to the Basel 2014 rules which are currently being consulted on by the Basel Committee which have been taken into account by the Commission in the new Article 429 of CRR2.

A binding leverage ratio requirement of 3% Tier 1 will be introduced. This means that an institution must not have assets with a value more than 33 1/3 times the value of its capital base. The binding leverage ratio will not come into effect until two years after CRR2 is published in the Official Journal, so likely no earlier than the beginning of 2021. This is at least three years later than the January 2018 implementation date
set by the Basel Committee. Although European institutions may have a few years to wait until they are required to comply with the CRR2 leverage ratio rules, many European countries, including Switzerland and the UK, are currently applying leverage ratio rules to deposit-taking banks and systemic firms. For example, the eight largest banks and building societies in the UK are subject to a 3% leverage ratio requirement.

The leverage ratio is calculated as an institution’s capital measure divided by its total exposure measure. The capital measure is an institution’s Tier 1 capital. The exposure measure includes assets, derivatives, add-ons for counterparty credit risk and off-balance sheet items. Loans and other exposures must be measured based on their accounting value and collateral or guarantees cannot reduce the exposure measure. The area of the leverage ratio which has been subject of much criticism and controversy is the calculation of the exposure value of derivatives.

> Treatment of derivative transactions and Basel Committee differences

Under the current CRR rules, institutions calculate the exposure value of derivatives using the non-risk sensitive Current Exposure Method (“CEM”) which permits limited netting benefits. The Basel Committee is currently consulting on possibly permitting banks to use the new SA-CCR method for leverage ratio purposes. The SA-CCR method is a more risk-sensitive method than the CEM approach, particularly in relation to netting. The Commission has decided not to wait for the outcome of the Basel Committee consultation and has clarified that institutions must calculate the exposure value of derivatives in accordance with the SA-CCR method.

In addition, under the current rules, when calculating the exposure measure of a derivative transaction for the purposes of the Leverage Ratio, an institution cannot take into account initial margin (“IM”) to reduce the “potential future exposure” element of the exposure measure, although it can use variation margin to reduce the “replacement cost” element provided various conditions are fulfilled. The clearing houses and banks that provide clearing services for clients in their role as clearing member argued that the not permitting the clearing member (“CM”) to offset IM posted by the client, where the IM is segregated and on-posted to the CCP, could adversely impact the ability and cost to CMs of providing client clearing services, thereby contradicting the G20 mandate to increase the use of clearing for derivatives. The Basel Committee has stated that it will wait until the end of 2016 to analyse data from its Quantitative Impact Study before making a decision on the treatment of IM. The European Commission has, however decided to permit IM to be taken into account when calculating the exposure value, although this is limited to derivative contracts with clients that are then cleared by a CCP. It appears from
the drafting of the proposed rule that IM in the form of securities, as well as cash, can offset the exposure value.

The only other departure from the Basel Committee leverage ratio rules relates to certain exposures excluded from the exposure measure. The Commission has added a number of exceptions including intra-group exposures which are zero-risk weighted, pass through “promotional loans”, and the guaranteed parts of exposures where the guarantee is provided by an export credit agency.

1.3 New market risk rules

The new market risk rules implement the revisions to the current market risk framework finalised by the Basel Committee in January 2016. This wholesale change of the trading book rules resulted from the Basel Committee’s Fundamental Review of the Trading Book. Notwithstanding the changes to the market-risk framework which were implemented in 2009 (known as Basel 2A) and resultant increase in market risk capital, the Review found that the existing market risk framework did not capture all the different risks institutions are exposed to, bank’s internal models underestimated risks and the trading book/banking book boundary was too subjective. The changes proposed are extensive and contain numerous quantitative calculations which are beyond the scope of this note. The sections below briefly summarise the main changes to the current market risk rules and any European Commission specific modifications to the Basel rules.

> Trading book boundary

Although the definition of the trading book is still based on “trading intent”, a bank is required to allocate to its trading book any position which falls within a list of mandatory trading book instruments including financial assets measured at fair value and listed equities and cannot include a position in the “excluded” list which includes real estate holdings. In addition, there is a strict limit on the movement of instruments between the banking and trading book with capital disincentives on switching. The aim of these changes is to reduce the scope for regulatory arbitrage and to ensure that only genuinely liquid and tradeable positions are included in the trading book.

> Revised Internal Models approach

(i) Expected Shortfall Measure

The new internal model approach (“IMA”) rules require banks to use an Expected Shortfall (“ES”) metric rather than a Value at Risk (“VaR”) and Stressed VaR metric. A VaR based metric effectively measures the loss level on a portfolio resulting from market movements that will not be exceeded with a certain confidence level during a certain period of time so not taking account of the size of the loss that could occur outside the confidence level. The ES measure, in contrast, considers both the size and likelihood of losses above a certain confidence level, and thereby captures “tail” risk. In addition, the ES
measure is calibrated to a period of stress and does not permit the extensive diversification benefits under the VaR model.

(ii) Model Approval process

The new model approval process requires institutions to seek model approval for each regulatory trading desk, which is defined as a group of dealers set up to jointly manage a portfolio of trades operating under the same risk management strategy. This is different to the current approach under which the institution applies for and is given a single approval for its whole trading operation.

Each trading desk will be assessed against certain qualitative criteria. If it does not meet any of those criteria, it must apply the new standardised approach instead. This desk-level approval provides regulators with the ability to revoke models for specific trading desks, without forcing the institution to forego its whole model approach. The new model approval process will require substantial compliance and organisational costs and may require institutions to restructure their trading operations in order to fall within the new individual trading desk approval process.

(iii) Reporting on new standardised approach

Each trading desk which is given model approval, must also report to the competent authorities the capital requirements for market risk that would be calculated based on the new standardised approach. This monthly reporting requirement will be burdensome for institutions, requiring them to effectively calculate capital requirements in accordance with two different sets of rules.

(iv) Securitisations and covered bonds

Capital requirements for securitisations in the trading book must be calculated in accordance with the new standardised approach. Institutions which have significant securitisation exposures in their trading book which currently use the VaR model to calculate capital requirements for such exposures may find this results in a substantial regulatory capital increase.

> New standardised approach

The standardised approach has been substantially overhauled to meet a number of objectives. First, in order to make it more risk-sensitive than the current approach, a number of changes have been made, including greater reliance on “risk sensitivities” to certain risk factors, including equity, commodity and credit-spread risk. Secondly, it has
been calibrated more closely to the IMA, to facilitate comparable reporting of market risk requirements under both approaches. Thirdly, so that banks’ trading desks which lose their IMA and fall back on the standardised approach do not suffer a “cliff effect”.

> **Proportionality and Simplified approaches**

In accordance with their proportionality objective, the Commission has included a new simplified approach which is not contained in the new Basel market risk rules. The simplified standardised approach rules are the same as the standardised approach rules in the current CRR market risk framework. Institutions can use this approach until the new standardised approach comes into force. After that, only institutions which fulfil certain eligibility criteria, namely that the size of its business subject to market risk is less than the higher of 10% of its total assets or EUR 300 million, can use the simplified standardised approach.

There is also a derogation available for small trading book businesses, which do not have market risk assets which are over the higher of 5% of its total assets or EUR 50 million. In such a case, an institution can apply the credit risk framework to these trading book positions effectively treating them as non-trading book positions. Therefore, small and medium trading book businesses can avoid the large compliance and capital costs of the new market risk framework.

> **Changes from the Basel rules**

In addition to the inclusion of the simplified approach, the Commission has made a few significant changes to the Basel market risk rules. First, exposures to all EU sovereigns are included in the lowest risk weighting bucket under the standardised approach, without taking into account their credit rating. Similar beneficial treatment is provided for under the IMA. This change corresponds to the non-rating dependent treatment of EU sovereigns in the non-trading book. Secondly, the risk weight applicable to covered bonds issued by EU institutions are lower than the Basel Committee risk weights under both the standardised approach and IMA. This is to ensure that the capital requirements of covered bonds do not adversely affect the funding cost of mortgage loans in the EU.

### 1.4 Standardised Approach to Counterparty credit risk

> **Summary**

Under the current CRR rules, institutions can calculate the exposure value of their OTC and exchange traded derivative transactions in accordance with the internal model method (“IMM”) or one of three non-internal model approaches: the current exposure method (“CEM”); the Original Exposure Method (“OEM”) or the Standardised Approach. The method used to calculate the exposure value of derivative transactions is important as it is used in a number of areas of CRR, including the calculation of the credit risk capital requirement for a derivative transaction, the Counterparty Valuation Risk Adjustment
(“CVA”) capital charge, the large exposure calculation and in connection with the leverage ratio. The current non-internal model methods have been criticised for not being sufficiently risk sensitive, for having insufficient netting benefits and for failing to differentiate meaningfully between margined and un-margined transactions. The Basel Committee therefore formulated a new non-internal model method, called the SA-CCR method, in order to address these shortcomings. The SA-CCR replaces both the existing Standardised Approach and CEM and therefore must be used by institutions which currently use one of those approaches when calculating the exposure value of derivative transactions, unless those institutions instead apply for regulatory permission to use the IMM approach. Key features of the SA-CCR method include (i) calibration to a period of financial stress; (ii) more accurate recognition of the benefits of initial margin and variation margin; and (iii) greater recognition of netting benefits.

Changes to Basel SA-CCR rules

A number of banks currently use the CEM to report their regulatory exposures and will therefore be impacted by the mandatory move to the SA-CCR, as will IMM banks who must use the SA-CRR for leverage ratio and large exposure purposes. Although the SA-CCR method is designed to be more risk sensitive, it appears that it will lead to a substantial increase in exposure levels for certain transactions, such as single transactions or portfolios which are unmargined or not diversified.

The CRR amendments to the counterparty credit risk rules to implement SA-CCR follow the Basel rules very closely. However, there are a couple of specific amendments which ensure that banks with small derivatives businesses are not required to incur the substantial compliance costs associated with putting new systems in place to meet SA-CCR. First, the Commission has formulated a “Simplified Standardised Approach” which can only be used by an institution whose on and off-balance sheet derivative business is equal to or less than the higher of 10% of its total assets or EUR 150 million. Secondly, the Commission has retained a modified version of the Original Exposure Method and an institution may determine only its interest rate, foreign exchange and gold derivative positions in accordance with the modified OEM, provided its derivatives business is equal to or less than 5% of its total assets or EUR 20 million.

1.5 Exposures to Central Counterparties

The current CRR contains specific rules on the calculation of the own funds requirements for exposures to central counterparties (“CCP”), which are based on the Basel Committee’s interim standard on “Capital requirements for bank exposures to central counterparties”. The interim standard was updated by the Committee and a final standard was published in 2014 after CRR came into effect. Articles 300-310 CRR have been amended to incorporate this final standard. There are no substantive divergences
between the Basel CCP rules and the final standard in CRR2. These rules include adopting a single approach for calculating capital requirements for an institution’s exposure that arises from its contributions to the default fund of a qualifying CCP, using the SA-CCR rather than the CEM approach to measure the hypothetical capital requirement of a CCP, and specifying the treatment of multi-level client structures whereby an institution clears its trading through intermediaries linked to a CCP.

1.6 Large Exposures

The current large exposures framework provides that an institution cannot have an exposure to a client or a group of connected clients the value of which is over 25% of the “eligible capital” of the institution. The Commission considers that the “eligible capital” definition in the current framework is too wide as it includes Tier 2 capital, and the 25% limit which applies to all types of counterparties does not take into account the higher risks that globally systemically important institutions (“G-SIs”) have to counterparties, in particular to other G-SIs. The amendments to the large exposures rules are aimed at dealing with these perceived deficiencies in the framework as well as implementing the Basel Committee April 2014 standards on large exposures.

There are three main changes to the large exposure rules. First, the limit on an exposure to another counterparty is now based on Tier 1 capital, not “eligible capital”, which included Tier 2 capital. The narrower capital base will mean that an exposure which under the current rules is close to the 25% limit, may under the narrower capital base, breach the limit.

The second change is to reduce the limit from 25% to 15% where the institution is a G-SI and the relevant exposure is to another G-SI. This means that G-SIs will need to carefully monitor their exposures to other G-SIs to ensure the tighter 15% limit is not triggered.

The third change is to provide that the exposure value of derivative transactions for large exposure purposes is calculated under the SA-CCR method, rather than under the CEM or IMM method. This will be particularly burdensome for banks which use the IMM method as it is likely that the exposure value of their derivative transactions under the SA-CCR method will possibly be higher than under the IMM method.

1.7 Equity investments in Collective Investment Undertakings

The Commission has made changes to the credit risk rules regarding the treatment of equity investments in collective investment undertakings (“CIUs”), to implement the Basel Committee Standard published in 2013. The aim of these revisions is to ensure that the capital requirement reflects both the risk of the fund’s underlying investments and its leverage, and is aimed at providing transparency with respect to the underlying exposures of the CIU. The revised framework is based on the general principle that institutions should apply a look-through approach to identify the underlying assets when investing in CIUs, although sometimes this is not feasible.
A CIU is defined as either an Undertaking for Collective Investment in Transferable Securities (“UCITS”) or an Alternative Investment Fund (“AIF”). Institutions may determine the risk weight for a CIU in accordance with one of two methods, the look-through method or mandate approach method, provided various eligibility criteria (relating to the type of CIU and assets it invests in) are met. If these criteria are not met, or the institution cannot apply one of these approaches, then it must apply the fall-back approach, which is a 1250% risk weighting. This penal risk weighting may compel banks to try to improve the transparency regarding the CIU’s underlying investments.

1.8 Modified framework for interest rate risk

Under the current CRR rules, interest rate risk in the banking book (“IRRBB”) is captured under the Pillar 2 framework. IRRBB is the risk to an institution’s earnings and capital from adverse movements in interest rates that affect banking book positions. This treatment is in accordance with the Basel Committee’s 2004, “Principles for the Management and Supervision of Interest Rate risks” (“Principles”), which was updated in early 2016 to reflect changes in market and supervisory practices and on the basis that interest rates may normalise from the historic lows. The CRDV amendments implement the updated Principles. The key changes include more detailed guidance on an institution’s IRRBB management process, tougher disclosure requirements and a new standardised framework which would require institutions to calculate a separate capital requirement for IRRBB only when required to do so by a competent authority.

2 Significant amendments not based on Basel Committee standards

2.1 Waivers from capital and liquidity requirements

Under Articles 7 and 8 of CRR, competent authorities can waive the application of solo capital requirements for subsidiaries of an institution or a parent institution within a single Member State and liquidity requirements for members of a liquidity sub-group in the same Member States, provided various conditions are fulfilled. These criteria include safeguards to ensure that capital and liquidity are distributed adequately among the parent and its subsidiaries and not subject to any impediments to transfer. The Commission has stated that with the Single Supervisory Mechanism (“SSM”) taking effect, group supervision has been substantially reinforced especially where group entities are situated in Member States that are part of the SSM. Therefore, the Commission has replaced Article 7 with a new provision, which permits the competent authority to waive the application of solo capital requirements to a subsidiary established in a different Member State than its parent institution provided that the subsidiary is included in consolidated supervision and the institution grants a guarantee to its subsidiary. The guarantee must fulfil various criteria, which include that it is for an amount at least equivalent to the own funds of the subsidiary, is fully collateralised for at least 50% of the amount and there are no legal, regulatory or operational barriers to the transfer of collateral from the institution to the subsidiary. As regards liquidity requirements, the Commission has replaced Article 8 and permits the
creation of a single liquidity sub-group where members of the sub-group are established in different Member States. Similar conditions to those in Article 7, described above apply.

Although the wording of this waiver will be welcome news for banks, in particular those banks who find that capital is trapped in overseas subsidiaries due to the application of solo capital requirements, the conditions which need to be satisfied, including the collateralised guarantee, may mean that the waiver is not taken up to the extent it otherwise would be.

2.2 Financial holding companies and Authorisation requirements

> Intermediate financial holding companies

The Commission has introduced a new requirement in Article 21(b) of CRDV for the establishment of an intermediate holding company where two or more institutions established in the EU have the same ultimate parent undertaking in a third (i.e. non-EU) country. The requirement only applies to a third country group that is identified as a non EU-GSII or that has entities in the EU with total assets of at least EUR 30 billion.

The intermediate financial holding company will need to be authorised as a financial holding company or as an institution. The stated rationale for this new requirement is to facilitate the implementation of the TLAC standard for non EU G-SIIIs and to simplify and strengthen the resolution process of third country groups with significant activities in the EU. The requirement to insert an EU intermediate holding company within certain third country groups will automatically trigger EU consolidated supervision at the level of the EU holding company downwards. This means that certain third country groups, which have historically been able to escape or mitigate the scope of EU consolidated supervision, may in the future need to comply with the full rigours of EU prudential regulation at the level of the EU sub-group.

> Authorisation and supervision of financial holding companies

Under the current CRR, prudential requirements apply on solo basis to each regulated institution in the EEA, as well as on a consolidated basis to the regulated institution and its consolidation group, which includes those subsidiaries which are financial firms. If the institution is controlled by a financial holding company (“FHC”), then it is the institution which must comply with the consolidated requirements on the basis of the consolidated position of the parent financial holding company or mixed financial holding company (“MFHC”). Therefore, although a parent financial holding company is included in consolidated supervision, it is effectively only indirectly subject to prudential requirements in CRR. The competent authorities do not have the power under the current drafting of CRR directly to enforce compliance and supervise FHCs and MFHCs.

The Commission has taken the decision that financial holding companies, which can often play a very important role in a banking group, must be brought directly within the scope of the prudential
framework. This does not mean that FHC's and MFHC's are subject to prudential requirements on an individual basis, but rather it is now the holding company itself which is directly responsible for compliance with the consolidated capital and liquidity requirements. It is unclear whether all financial holding companies within a group must be authorised, or just the top “parent” financial holding company in the EU. It would seem very burdensome to include every financial holding company, but the current drafting does not rule this out.

In addition, a new authorisation requirement is imposed on FHCs and MHFCs under Article 21(a) CRDV. The competent authority must be satisfied that, among other things, the FHC or MHFC is capable of ensuring compliance with the consolidated requirements and it does not impinge on the effective supervision of the subsidiary or parent institutions. The regulator may only withdraw authorisation in limited circumstances, which include that it no longer meets the consolidated prudential requirements or can no longer be relied on to fulfil its obligations towards its creditors.

The Commission has also amended the definition of a “financial holding company” to clarify the extent to which the subsidiaries of a holding company must engage in financial activities for the holding company to fall within the “financial holding company” net. A financial holding company is defined in Article 412 as a “financial institution, the subsidiaries of which are exclusively or mainly institutions or financial institutions, and which is not a mixed financial holding company”. This part of the definition remains the same. The Commission has however clarified that the “mainly” criteria is met where at least one of the subsidiaries is a bank or investment firm and where more than 50% of the equity, consolidated assets, reviews, personnel or another indicator deemed relevant by the competent authority of the financial institution are associated with subsidiaries that are institutions or financial institutions. This is useful guidance for a number of groups which contain banks but whose main business is not financial, such as supermarket groups.

2.3 SME’s and reduction in risk-weighting

One of the key priorities of the European Commission when considering amendments to the CRR was to ensure that the new rules did not adversely impact bank financing of small and medium enterprises (“SME’s”). The Commission has decided to retain the 23.81% reduction in the risk weighted exposure amount for an exposure to an SME, provided the exposure does not exceed Euro 1.5 million. In addition, the new rules provide a 15% risk-weighting reduction for exposures that exceed Euro 1.5 million. The widening of the SME supporting factor is good news for SME’s as loans to them will be subject to lower RWA than is currently the case.
2.4 Preferential Treatment of infrastructure assets

Banks which use either the IRB approach or Standardised Approach to credit risk can make use of the proposed preferential treatment of specialised lending exposures which are to an entity which was created specifically to “finance or operate physical structures or facilities, systems and networks that provide or support essential public services”, provided a number of key criteria contained in Article 501a are met. These criteria include requirements relating to the contractual protection provided to the lenders, the predictability of cashflows and seniority of the exposure. The capital requirement for credit risk for the relevant exposure which meets these criteria is multiplied by a factor of 0.75%, so reducing the required capital by a quarter. The aim of this provision is to ensure that bank financing of large infrastructure projects is not constrained by regulatory capital costs which may increase as a result of Basel Committee proposal to disallow IRB banks from using their internal models to calculate capital requirements for such exposures.