CAPCO

CRD V & CRR II:

SETTING UP FOR SUCCESS

The EU's Capital Requirements Directive V and Capital Requirements Regulation II should be seen as more than just a compliance program. The acts implicitly call for stricter alignment across entities and business units within firms, and a strategic approach to implementing the new acts will accordingly reap the most benefits.

The 2008 financial crisis highlighted banks failure to hold enough capital to protect themselves against large losses. Not only did banks collapse but the contagion spread to other firms and countries due to the global interconnectedness of the industry. This prompted work to ensure we do not see a repeat of the financial crisis. Capital Requirements Directive V (CRD V) and Capital Requirements Regulation II (CRR II) form part of a wider banking package and are the latest acts to be rolled out with the objective of enhancing the stability of the financial system by increasing the quality and quantity of regulatory capital and liquidity. The acts refine and continue to implement the Basel III framework, in addition to introducing the first elements of the much-anticipated Basel IV framework. The national transposition for most provisions in CRD V is 28 December 2020. Whereas the majority of CRR II provisions will come into force on 28 June 2021.

THE IMPACT AND OPPORTUNITIES FOR FIRMS

CRD V and CRR II pose significant infrastructure changes and requires firms to be able to store, calculate and report much larger data volumes than ever before. Failure to act will result in firms experiencing higher capital charges. And in the event of not being compliant firms may face huge penalties from the regulator that will result in financial and reputational damage. However, for firms choosing to take a strategic approach, the opportunities include lower capital charges and process optimization that will result in increased efficiency, reduced costs and stronger assurance in data that is being reported externally. In a climate where compliance costs are increasing, and revenues are diminishing as a result of increased regulation (e.g. Volcker Rule) this should be a firm's top priority. Further, firms choosing to strategically invest in CRD V and CRR II will leave themselves well placed to tackle the upcoming Basel IV framework that is expected to result in firms having to run even more calculations and put up an increased amount of regulatory capital. A 2017 study by the European Banking Authority (EBA) they found that banks could see their minimum risk-based tier 1 capital increase by 14.5 percent[1].

THE DETAIL… WHO IS AFFECTED AND HOW?

The impact of CRD V and CRR II cannot easily be contained as investment firms and credit institutions across the EU are set to be impacted. Further, there are ramifications for numerous Business Units (BUs) across a firm. This includes but is not limited to market risk, credit risk, treasury risk, finance, front office, legal, compliance and operations. Appendix 1 shows a summary of the key requirements[2]. Whilst the requirements are broken up in the appendix it is important to understand the interdependencies between the requirements. For example, the Standardised Approach for measuring Counterparty Credit Risk (SA-CCR) is used to calculate the large exposure requirement. SA-CCR is also used to calculate the exposure value of derivatives that feeds the leverage ratio requirement. Finally, the (Exposure at Default) EAD from SA-CCR can be used by firms

1. European Banking Authority, Ad Hoc Cumulative Impact Assessment of the Basel Reform Package, 2017
2. Official Journal of European Union, CRD V and CRR II Final Text, 2019

taking the Basic Approach for CVA (BA-CVA). These points are important because failing to understand the interdependencies between requirements can result in the same information being produced in different silos when instead it can just be shared.

The extent of the impact CRD V and CRR II will have on a firm can be attributed to several variables. They include the size of the firm, how the firm previously implemented CRD IV and CRR, and the maturity of other in-flight programs. Under CRD V and CRR II, if a firm does not meet a specific threshold it does not have to comply with certain requirements or can use a more simplified model. An example is the Simplified SA-CCR for firms with an on-and off-balance sheet derivative business being equal to or less than 10 percent of the institution's total assets and €300 million. Regarding other requirements, such as the leverage ratio in CRR there was no requirement for firms to maintain a leverage ratio to any specific level. However, many firms would have maintained it to more than 3 percent meaning their work on the CRR II 3 percent requirement will be minimal. Finally, the CRD V and CRR II program team will be required to liaise with other in-flight programs, such as Fundamental Review of the Trading Book (FRTB). This is because some requirements build on what has already been done in other in-flight programs. Therefore, the extent to which these other programs are successful will have a big impact on CRD V and CRR II.

FINDING SOLUTIONS AND THE BENEFITS OF A STRATEGIC APPROACH

In the previous section we demonstrated that CRD V and CRR II will affect a lot of BUs, has data interdependencies between requirements and will require engagement with other in-flight programs across a firm. In response to this Capco believe it is imperative that firms take a strategic approach when assessing CRD V and CRR II so that cross functional solutions can be identified and implemented. This is not a one solution fits all type problem and will instead require firms to take a step back and assess the architecture across BUs and question whether it is optimal. Below are some questions firms should ask themselves when assessing this.

1. Are related data inputs (e.g. time series) for CRD V and CRR II retained in centralised sources?

2. Have data inputs for CRD V and CRR II gone through a data cleansing initiative?

3. Do the systems that store data inputs for CRD V and CRR II have strategic controls in place to detect inaccurate and incomplete data?

4. Are we duplicating CRD V and CRR II model calculations in different areas of the firm?

5. Are the systems storing CRD V and CRR II calculation outputs capable of aggregating the data to different levels?

Capco's view is that CRD V and CRR II are implicitly calling for such an approach as demonstrated by what we have outlined above (interdependencies between requirements) and new requirements such as the Intermediate Parent Undertaking (IPU), which seeks to enhance the governance and structure of subsidiaries sharing the same parent organization. Therefore, by considering the above questions, firms can start to work towards the following.

1. Cleansed data inputs stored in centralised systems that are accessible to different BUs to run calculations. These systems should have strong controls that are capable of detecting 'bad data'.

2. Single calculation engines that are not duplicated across different areas of the firm.

3. Systems capable of storing calculation outputs and aggregating the data to a variety of different levels. Again, this data should be accessible to any BUs who need access.

At Capco we have already carried out the rule interpretation and impact assessment for CRD IV / CRR and CRD V / CRR II, which covers over 650+ articles and spans multiple BUs. This leaves us well placed to help clients accelerate the scope and impact assessment phases to identify the exact delta between CRD IV / CRR and CRD V / CRR II. Further, our previous credentials in supporting firms with CRD compliance programs demonstrate we have the expert knowledge required to deliver a CRD program.

CONCLUSION

Other EU regulations such as FRTB have required closer alignment between BUs within organizations, and now CRD V and CRR II are calling for similarly tight alignment between subsidiaries sharing the same parent company. The EU wants firms to be better integrated. Anyone taking the view that CRD V and CRR II compliance is simply a matter of building upon pre-existing requirements from CRD IV and CRR is misguided. That 'path of least resistance' approach will not necessarily deliver a closer alignment of entities and BUs, and in fact could lead to higher levels of risk and increased operational costs further down the line. In this article we have demonstrated the importance of taking a strategic approach for CRD V and CRR II and believe it will not only ensure successful compliance, but also put firms in a strong position when it comes to navigating subsequent legislative change, such as Basel IV.

APPENDIX 1: SUMMARY OF KEY REQUIREMENTS

Capital Requirements Regulation II

1. **FRTB –** in January 2019 BCBS released final revisions to FRTB that sets out a revised standardised approach and internal model approach and provides a stricter boundary between the trading book and banking book amongst many other things. However, the CRR II final text only contained the reporting requirements for the revised Standardised Approach and revised Internal Models Approach. These reporting requirements go live in 1 and 3 years respectfully from the adoption of the Commission delegated act expected by 31 December 2019.

   CRR II allows firms with trading book size of under €50 million and less than 5 percent of their total assets to apply the credit risk framework for banking book positions for their trading books. Finally, CRR 2 allows firms with medium-sized trading books (less than €300 million and less than 10 percent of their total assets), to use the simplified standardised approach as in CRD IV.

2. **Total Loss Absorbing Capacity (TLAC) –** TLAC requires Global Systemically Important Banks (G-SIB's) to have enough highly loss absorbing liabilities to ensure smooth and fast absorption of losses and recapitalisation. CRR II requires firms identified as resolution entities and that are G-SIB's to satisfy the following requirements for own funds and eligible liabilities:

   (a) a risk-based ratio of 18 percent, representing the own funds and eligible liabilities of the institution expressed as a percentage of the total risk exposure amount

   (b) a non-risk-based ratio of 6,75 percent, representing the own funds and eligible liabilities of the institution expressed as a percentage of the total exposure measure

3. **Leverage Ratio –** CRR II introduces a binding leverage ratio for firm's subject to CRR. This is 3 percent of Tier 1 capital in line with the Basel agreed level. For G-SIBs there will be an additional buffer requirement, which will be set at 50 percent of the capital add on currently applied.

4. **Standardised Approach for Counterparty Credit Risk –** SA-CCR will replace the Mark to Market Method and remove the Standardised Method. The SA-CCR will provide a more risk sensitive measure of counterparty exposure and will include the benefits of netting, hedging, and collateral. The regulation also introduces a simplified approach for firms with the size of the on-and off-balance sheet derivative business less than 10 percent of their total assets and €300 million. Original Exposure Method has been retained and should only be used by firms with a very small derivatives exposure.

5. **Net Stable Funding Ratio (NSFR) –** CRR II largely adopts the NSFR that was set out by Basel but includes some EU-specific adjustments. A threshold of 100 percent is applied. Finally, small sized firms are granted permission to use a simplified version of the NSFR.

Capital Requirements Regulation II continued

6. **Regulatory Reporting and Disclosures –** firms will be required to report its leverage ratio, risk and non-risk ratios, large exposures and liquidity information. Small firm reporting obligations have been relaxed and they are now obligated to report on an annual basis. Further, there are new disclosure requirements for TLAC, SA-CCR, FRTB and own funds. Size of firms will drive these disclosures.

7. **Small and Medium Enterprises (SMEs) Supporting Factor –** the current capital reduction of 23,81 percent for an exposure to an SME, if it does not exceed €2,5 million. In relation to an SME exposure exceeding €2,5 million, 15 percent capital reduction is enforced.

8. **Large Exposures –** the regulation contains stricter requirements on the treatment of large exposures. We see the introduction of SA-CCR and Simplified Standardised Approach for firms Even those authorised to use internal models. For exposure between G-SIB's a new limit of 15 percent has been introduced. There are several new reporting requirements.

9. **Treatment of Infrastructure Exposures –** The regulation contains preferential treatment (credit risk calculation multiplied by a factor of 0.75) in the calculation of credit risk for firms making specific types of loans i.e. infrastructure projects. There is a specific criterion that loans need to meet to qualify for this. Firms eligible for this will need to report to competent authorities every 6 months on the total amount of exposure.

10. **Interest Rate in the Banking Book (IRRBB) –** the regulation sets out new disclosure requirements for IRRBB.

11. **Exposure to Central Counterparties (CCPs) –** For exposures to a Qualified CCP (QCCP) we see a simplified calculation for prefunded contributions to the default fund. And for Non-Qualified CCP's (NQCCP's) we see the factor of 1.2 no longer being applied in RWA calculations for prefunded and unfunded contributions.

12. **Waivers from Capital and Liquidity Requirements –** If a firm meets several requirements set out in articles 7 & 8 and has its parent and subsidiaries established in different countries within the Banking Union then the subsidiaries will receive a waiver for the application of capital and liquidity requirements.

13. **Equity Investments in Funds –** the new changes align to the BCBS 266 standards from 2013.

Capital Requirements Directive V

1. **Pillar 2 Capital Requirements & Guidance –** the directive has been more explicit as to what constitutes a pillar 2 capital charge. CRD V requires firms to meet their pillar 2 capital requirements with at least 75 percent tier 1 capital, of which 75 percent of that must be CET1. Further, competent authorities are to provide firms with a full explanation of the pillar 2 capital add on's in writing.

2. **Modified Framework for IRRBB –** Competent Authorities must ensure firms are using a Standardised or Simplified Standardised Approach to managing its interest rate risk on the banking book. Further, the text provides clear scenarios for when competent authorities can exercise supervisory powers and includes increased disclosure.

3. **Establishment of an EU Intermediate Parent Undertaking (IPU) –** CRD V requires large non-EU banking groups with over €40 billion assets (including third country branch assets) which have with two or more subsidiaries in the EU to restructure their EU entities under an intermediate EU parent undertaking (IPU). The article provides guidance on calculating the total value of assets.

4. **Remuneration –** CRD V exempts the application of payment in instruments, retention, and deferral to:

    1) Non-large institutions, in which the firm's average asset value on an individual basis is equal to or less than €5 billion over the four-year period immediately preceding the current financial year.

    2) Staff members whose annual variable remuneration does not exceed €50,000 and does not represent more than one third of the staff member's total annual remuneration.

CONTACTS

George Phillips
Senior Consultant
george.phillips@capco.com

James Arnett
Partner – Capital Markets
james.arnett@capco.com

ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

To learn more, visit our web site at **www.capco.com**, or follow us on Twitter, Facebook, YouTube, LinkedIn and Instagram.

WORLDWIDE OFFICES

APAC
Bangalore
Bangkok
Hong Kong
Kuala Lumpur
Pune
Singapore

EUROPE
Bratislava
Brussels
Dusseldorf
Edinburgh
Frankfurt
Geneva
London
Paris
Vienna
Warsaw
Zurich

NORTH AMERICA
Charlotte
Chicago
Dallas
Houston
New York
Orlando
Toronto
Tysons Corner
Washington, DC

SOUTH AMERICA
São Paulo

WWW.CAPCO.COM

© 2019 The Capital Markets Company (UK) Limited. All rights reserved.

CAPCO
THE FUTURE. NOW.