Client Update
Prudential Regulation in an Age of Protectionism

NEW YORK
Gregory J. Lyons
gjlyons@debevoise.com

Chen Xu
cxu@debevoise.com

LONDON
Aatif Ahmad
aahmad@debevoise.com

INTRODUCTION

The regulation of bank capital and liquidity has been in sharp focus ever since the financial crisis of 2008-09. The Basel Committee on Banking Supervision ("BCBS") has led the work internationally to develop a revised set of capital and liquidity standards to update the then existing Basel II accord. These standards, dubbed Basel III, have to a large extent been adopted and enacted in the world's major jurisdictions, including the United States and the European Union.

The development of Basel III did not complete the mandate given to the BCBS by the G20 to overhaul bank capital and liquidity. As a result, the BCBS has continued to work on further refinements to the capital standards, which it believes are within the scope of its original mandate to revise the Basel II accord. These revisions include the new standardized approach for counterparty credit risk ("SA-CCR") and the fundamental review of the trading book ("FRTB").

However, a number of proposed revisions have given rise to the first serious international disagreement over capital regulation. These proposals, dubbed "Basel IV" by those opposed to them, have evoked protests from sections of the banking industry for going beyond the BCBS's remit and potentially giving rise to punitive increases in capital requirements for banks.

This article discusses the Basel IV proposals and why they have given rise to public disagreements between the European Union and the United States, as well as the latest developments in the finalization of these reforms. It also discusses the new legislative proposals in the EU known as "CRDV" which are intended to implement some of the Basel III reforms such as FRTB and SA-CCR.[1]

BASEL IV PROPOSALS, EU PUSHBACK AND BCBS (LACK OF) RESOLUTION

The proposals dubbed Basel IV comprise the following:

- a proposal to reduce variation in credit risk weighted assets,[2] involving the abolition of internal ratings-based ("IRB") approaches for exposures to banks and other financial institutions, exposures to large corporates and equity exposures, applying a floor for the IRB approaches so that the capital requirement produced by the IRB approach must exceed 60% to 90% of the requirement resulting from the standardized approach, input parameter floors for the IRB approaches and harmonization of IRB parameter estimation procedures;
- a revision to the standardized approach for credit risk,[3] to reduce excessive reliance on external ratings and to make the approach more risk sensitive;
- a new standardized approach for operational risk,[4] involving the abolition of internal modeling approaches for operational risk requirement calculation. The Standardized Measurement Approach suggested by the BCBS would be a non-model-based approach that also integrates a bank's operational loss history.

These proposals have evoked strong opposition in the European Union. The European Banking Federation has estimated that the proposals will increase capital requirements for EU banks in aggregate by €860 billion at a time when EU banks are weighed down by a non-performing loan problem and sluggish economic growth. It has been estimated that Basel IV would push up RWA by 29% for certain affected European banks, of which 14% would be due to adjustments

[1] CRDV does not address the Basel IV reforms. If these reforms are ever finalized in a manner acceptable to the EU, then the European Union authorities will in due course publish legislative proposals to implement the reforms in EU law.

[2] BCBS Consultative Document, "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches," March 2016.

[3] BCBS Consultative Document, "Revisions to the Standardized Approach for credit risk," December 2014, and Consultative Document, "Revisions to the Standardized Approach for credit risk", December 2015.

[4] BCBS Consultative Document, "Standardised Measurement Approach for operational risk," March 2016.

to risk calculations and the remaining 15% due to increases in RWA on account of fines and other conduct costs.[5]

EU banks and authorities have argued that the proposals favor U.S. banks, given the following key differences (among others) between the U.S. financial markets and EU markets:

- European banks tend to retain mortgages originated by them, whereas U.S. banks have the option to offload the risk of such mortgages, for example, by selling them to the federal home finance agencies (Freddie Mac and Fannie Mae). Larger U.S. banks already calculate their capital requirements on the higher of the standardized and IRB approaches. In addition, in the European Union SMEs are more reliant upon bank funding compared to the United States, where there is better access to capital markets to provide debt financing.[6] In the European Union, banks provide 70% of the finance required by the economy, with capital markets supplying the remaining 30%, whereas in the United States the proportions are reversed, with banks funding 30% and the capital markets 70%;[7]
- operational risk accounts for 28% of the risk weighted assets for the five largest U.S. investment banks, compared with 12% at European banks. European banks tend to use scenario-based models to calculate operational risk, whereas U.S. banks tend to use the loss distribution approach, with the U.S. bank approach resulting in broadly comparable levels of operational risk capital as the Standardized Measurement Approach proposed by the BCBS. As a result, any increase in operational risk capital requirements resulting from the new approach would have a greater impact on European banks than American banks.

On November 23, 2016, the European Parliament adopted a motion calling upon the BCBS to ensure that the revision of the standardized approach and the restrictions on the IRB approach do not cause disproportionate effects for the real economy. Whilst noting the differences between U.S. banks and EU banks, the motion called upon the BCBS to assess "carefully and comprehensively the qualitative and quantitative impact of the new reforms, taking into consideration their impact on different jurisdictions and different banking models before the

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[5] Keefe Bruyette and Woods research report.

[6] As part of its Capital Markets Union, the European Union is currently engaged in a reform of EU capital markets to reduce the reliance of EU borrowers on bank funding.

[7] European Banking Federation, 2014.

adoption of the standard by the Committee …" and to preserve the "risk sensitivity of the prudential regulation …". These views have been echoed by the EU's financial services commissioner, Valdes Dombrovskis, who disagreed with the proposal to 'iron out' the average risk weightings used around the world and asked for the BCBS to revisit its proposals. Many European government bodies have also objected to much of the Basel IV proposals. Andreas Dombret, a member of the board of Germany's Bundesbank, said that Germany would not accept the Basel IV proposals "at any price". His concerns focused in particular on the use of internal models for credit risk and the output floor.

The United States has been one of the few advocates at the international level for the Basel IV reforms, cautioning global regulators against watering down standards. Officials such as the FDIC's Thomas Hoenig and the Federal Reserve Board's Daniel Tarullo have repeatedly pushed for tougher capital requirements along the lines proposed by the BCBS in Basel IV. Hoenig recently said that the "mere fact that risk-based approaches must always be constrained and negotiated by regulators—through the complex processes of flooring inputs and outputs, for example—only underscores the necessity of a simple, robust, and uncompromised leverage ratio." Given the differing business models and capital levels, as well as the better performance of the U.S. economy, U.S. banks would stand to benefit from any tightening of capital standards requiring their EU competitors to raise additional capital or sell off assets.

In the face of this disharmony, the BCBS met at the 19th International Conference of Banking Supervisors in Chile on November 28 to 29, 2016. The goal of the meeting was to settle the differences over the Basel IV proposals and arrive at a compromise on the above-mentioned issues. Although the Chairman of the BCBS, Mr. Stefan Ingves indicated that an outline agreement had been reached over the disputed proposals and that the BCBS is "well on track to finalize by the end of [2016] its reforms related to reducing excessive variability in risk-weighted assets," no final agreement appears to have been reached. The industry in Europe has, in the meantime, continued to express its opposition to the reforms.

EU CRDV PROPOSALS

On November 23, 2016, the EU Commission published proposals (known as "CRDV") to amend the existing EU legislation on capital requirements (known as "CRDIV"), namely the Capital Requirements Regulation[8] and the Capital

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[8] Regulation 575/2013/EU.

Requirements Directive.[9] CRDIV was adopted by the European Union to implement most of the provisions of Basel III. CRDIV required the Commission to review the operation of the regulation and directive forming part of that legislative package, with a view to proposing an amending package before the end of 2016. The CRDV package would address any flaws in CRDIV, as well as potentially implement any new standards finalized by the BCBS in the meantime (subject to any revisions to the BCBS framework the European Union believed appropriate and succeeded in getting adopted by the BCBS).

More specifically, the CRDV proposals published by the Commission address various reforms and standards, including Total Loss Absorbency Capacity ("TLAC"), FRTB, SA-CCR, the Net Stable Funding Ratio ("NSFR"), the Leverage Ratio, and a new requirement for third country groups to set up an intermediate holding company ("IHC"). As noted below, in many cases CRDV makes adjustments to the framework adopted by the BCBS.

TLAC

The TLAC standard was agreed internationally by the Financial Stability Board in November 2015 and adopted at the G20 summit. The standard requires global systemically important banks to have a sufficient amount of loss absorbing or bail-inable liabilities to enable the recapitalization of the institution in the event of its failure. The Commission proposes to implement the TLAC standard in the European Union by making amendments to the existing minimum requirement for own funds and eligible liabilities ("MREL") in the bank recovery and resolution directive ("BRRD"). [10] The TLAC MREL requirement will apply to global systemically important institutions ("GSIIs") or entities that are part of a GSII and will comprise a risk-based ratio of 18% and a non-risk based ratio of 6.75%.

FRTB

FRTB addressed certain flaws in the existing Basel provisions on market risk, including insufficient capture of the entire range of risks in the trading book and lack of a clear boundary between the trading book and banking book facilitating regulatory arbitrage. CRDV proposes a phase-in period for the implementation of FRTB. It should be noted that the European Banking Authority has recently

[9] Directive 2013/36/EU.

[10] Directive 2014/59/EU.

recommended the introduction of proportionality in the application of the market risk framework to small institutions.[11]

NSFR

CRDV makes a number of departures from the NSFR standard as adopted by the BCBS. Assets eligible as level 1 high quality liquid assets ("HQLA"), such as sovereign bonds, are subject to a 0% required stable funding ("RSF") factor, unlike the 5% assigned by the BCBS NSFR standard.

CRDV treats derivatives slightly differently from the BCBS standard. Although both CRDV and Basel require a 100% RSF factor for the amount of derivative assets exceeding derivative liabilities, CRDV allows the derivative asset amount to be offset by variation margin received in the form of cash and level 1 HQLA.[12] Basel III (and the proposed U.S. implementation of NSFR) permits only cash variation margin to offset the derivative asset amount.

For unmargined derivatives contracts, a 10% RSF factor applies under CRDV to the gross derivative liabilities and for margined derivatives there is an option to apply either a 20% RSF factor to gross derivatives liabilities or to use the potential future exposure as calculated under the SA-CCR. By contrast, Basel III requires 20% of derivative liabilities (without deducting any variation margin posted) to be subject to a 100% RSF factor.

CRDV modifies the RSF factors applicable to repos to 5% and 10%, depending on the asset repo'd (compared to 10% and 15% in Basel III). In addition, it introduces additional categories of RSF factor (7%, 12%, 20%, 25%, 30%, 35%, 40%, and 55%).

In addition, the exemption in Basel III for interdependent assets and liabilities (whereby they are assigned 0% factors) has been expanded in CRDV, with many categories of transaction regarded as constituting interdependent assets and liabilities. This is unlike the position in the United States, where the prudential regulators have, in their proposed rule to implement the NSFR, taken the view that there are no interdependent assets and liabilities within the entire range of transactions carried out by banks subject to their supervision.

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[11] EBA Discussion Paper, "Designing a new prudential regime for investment firms," November 4, 2016: https://www.eba.europa.eu/documents/10180/1647446/Discussion+Paper+on+a+new+prudential+regime+for+Investment+Firms+(EBA-DP-2016-02).pdf

[12] Excluding extremely high quality covered bonds.

One of the examples of interdependent assets and liabilities in CRDV is "derivative client clearing activities" (provided the institution does not guarantee the performance of the CCP to its clients). It is not clear whether this exemption would cover synthetic prime brokerage where the institution provides synthetic exposure to an underlying asset to its clients, for example by entering into a total return swap or contract for differences with its clients, and then hedges its market risk exposure by purchasing the underlying. In this situation, requiring the institution to hold stable funding in relation to the hedge asset would be punitive. Given the institution's ability to unwind the derivative and the hedge asset simultaneously and as long as the derivative is appropriately margined, there should be no requirement for the institution to hold stable funding for the hedge asset.

The Commission's proposals on NSFR have been broadly welcomed by the industry. In particular, the ability to offset non-cash collateral in the form of level 1 HQLA is perceived as easing the liquidity requirements that would otherwise apply if only cash collateral could be deducted.

Leverage Ratio

CRDV follows the Basel III requirement of a 3% leverage ratio based on tier 1 capital. Adjustments have been proposed to reduce the exposure measure for public lending by public development banks, pass-through promotional loans and officially guaranteed export credits. In addition, initial margin received for derivatives cleared with a qualifying CCP is also omitted from the exposure measure. No leverage ratio buffer has been proposed for global systemically important banks. The Commission intends to await international agreement on such a ratio before it is implemented in EU law.

IHC Requirement

The most controversial aspect of the CRDV proposals is a provision which will impose a requirement on all third country banking groups operating with two or more institutions in the European Union and which either have assets in the European Union of more than €30 billion or are part of a GSII, to establish an EU-based and separately capitalized IHC. A similar requirement has been introduced in the United States since July 2016. Many market participants see the EU proposal as a retaliatory measure against the United State's introduction of its own holding company requirement and its advocacy of the Basel IV reforms. This may be only the beginning of retaliatory measures, as Federal Reserve Governor Tarullo noted in remarks on December 2, 2016 that, among the "relatively near-term steps" that the Federal Reserve should pursue is "another look at the capital and liquidity positions of large U.S. branches of some foreign banks," given the difficulty of determining their capital strength when they use internal models.[13]

An IHC requirement is likely to have a significant impact on the ability of third country groups to leverage capital and liquidity resources from their non-EU entities for the purposes of business in the European Union. Many groups may decide to exit their EU business if the capital and liquidity inefficiencies associated with setting up an IHC outweigh any profits derived from their EU business. In addition, the IHC requirement is likely to complicate post-Brexit structuring plans, especially if the requirement, combined with the absence of any passport for UK-based financial services firms in any future Brexit arrangement, makes it unattractive to locate any significant EU-facing businesses in the United Kingdom.

DIVERGENCE AND PROTECTIONISM: IMPLICATIONS FOR THE INDUSTRY

CRDV, as well as the ongoing disagreements over Basel IV, signal a new era of divergence in prudential requirements in the world's leading economies. If CRDV is adopted in the form proposed and if the Basel IV reforms are adopted by the BCBS as proposed, it would spell an end to the post-financial crisis commitment amongst global regulators to harmonizing financial regulation, especially in the area of prudential regulation. Such a trend to easing requirements on domestic firms or imposing tougher requirements on foreign firms could also point towards increasing protectionism and the erection of barriers to cross-border trade in financial services.

The Trump transition team has already indicated that it may abandon many of the reforms enacted by the previous administration as part of the Dodd-Frank Act. The EU financial services commissioner recently said, in reaction to this possibility, that the EU expects its "international partners to stick to globally-agreed standards." Any attempt by the United States to renege on international commitments such as the G20 commitment to require clearing of OTC derivatives (as contained in the Dodd-Frank Act) may well trigger retaliatory measures from the European Union, such as the requirement to set up an IHC or a prohibition on EU entities trading OTC derivatives with or through US persons. Similarly, any attempt by the United States to push through Basel IV in or near its currently proposed form may well result in the European Union

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[13] Remarks by Daniel K. Tarullo, Member Board of Governors of the Federal Reserve System at Federal Reserve Bank of Cleveland and Office of Financial Research 2016 Financial Stability Conference Washington, D.C., on December 2, 2016: https://www.federalreserve.gov/newsevents/speech/tarullo20161202a.pdf

rejecting any new standards adopted by the BCBS, calling into question the credibility of the BCBS as a global standard-setter. It is unlikely that the European Union would allow its banks to be placed at a competitive disadvantage in relation to their U.S. competitors.

This increasing breakdown in globally consistent frameworks also places additional burdens on global financial services firms to simultaneously track and evaluate regulatory requirements across the globe. To arrive at an optimal structure and approach for their global financial services businesses, firms will need to understand the implications of the CRDV reforms in the light of any compromise that may be reached at the BCBS level on Basel IV, any action that is taken by the Trump administration in the area of financial regulation, and the developments in the United Kingdom in relation to Brexit.

Debevoise's Financial Services practice has regulatory, transactional and enforcement expertise in the European Union, United States and Asia. We would be pleased to discuss these critical issues with you further.

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Please do not hesitate to contact us with any questions.