

How do EU Financial Regulations Come About? Status of the CRD IV/CRR Review



Scope
Ratings

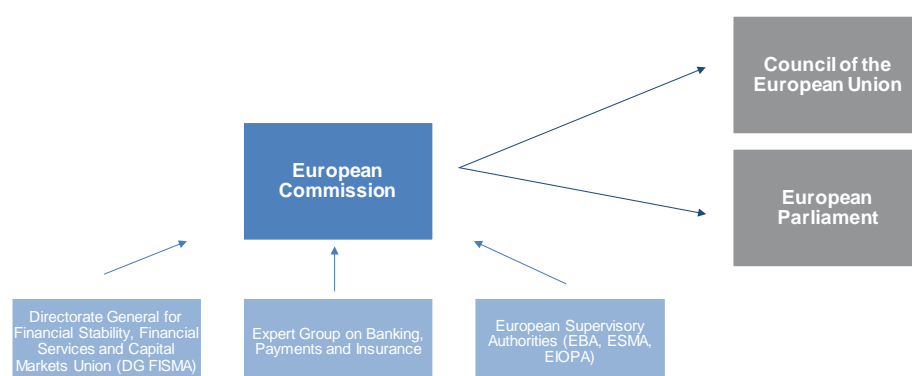
In recent years, investors in banks have been closely following the regulatory landscape. And rightly so: since the financial crisis began in 2008, the European Commission has proposed a host of reforms to strengthen the financial sector. There is ongoing discussion at the Basel level, but implementation in Europe is through the CRD IV/CRR. By the end of this year, the European Commission is expected to finish its review of the CRD IV/CRR and put forward proposals for amendments.

In recent speeches in reference to Basel, Vice-President Dombrovskis, responsible for Financial Stability, Financial Services and Capital Markets Union, said “we could not support an approach which would weigh unduly on financing of the broader economy...we want to avoid changes which would lead to a significant increase in overall capital requirements.”¹ With this in mind, we examine the legislative process within Europe to understand which changes may be made to CRD IV/CRR.

We acknowledge the challenges of having three institutions involved in the legislative process, each with its own committees and working groups. This is further complicated by the involvement of 28 Member States with varying perspectives. While the Brexit situation is developing, the expected departure of the UK, one of the strongest supporters of markets, will likely have an impact on the EU decision-making process. The three European supervisory authorities also play a significant role. With the multitude of players involved and the number of potential statements and opinions being put forward, it becomes quite difficult to follow the legislative process. In our view, there should be greater transparency, coordination and communication.

Further, we point out that the Council of the European Union and the European Parliament are under no formal time constraints to adopt legislation. The process can therefore be quite lengthy. We note positively, however, the widespread support for clarifying and finalizing the regulatory environment for European banks so that they can play their role in supporting the economy.

Figure 1: Overview of European legislative process



Source: Scope Ratings

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¹ Keynote speeches given at the Peterson Institute and Securities Industry and Financial Markets Association, 6 October 2016. Vice-President Dombrovskis was assigned responsibility for Financial Stability, Financial Services and Capital Markets Union when UK Commissioner Hill stepped down after the Brexit vote.

Key players in the EU legislative process

The three primary institutions involved in the EU legislative process are the European Commission (Commission), the Council of the European Union (Council) and the European Parliament (Parliament).

The Commission makes legislative proposals

The Commission represents the interests of the EU as a whole and is comprised of one commissioner from each Member State. Each commissioner is given responsibility for specific policy areas by the president. The president is elected by Parliament following a proposal from the Council. The current Commission's term of office runs until 31 October 2019.

As the Commission has the right of legislative initiative, legislative decisions taken by the Council and Parliament are based on proposals made by the Commission. Before making a formal proposal, the Commission consults experts as well as white and green papers. The directorate of the Commission responsible for policy in the area of banking and finance is the Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA). It is based in Brussels, with approximately 380 members of staff and is currently headed by Vice-President Dombrovskis.

The Council and Parliament consider proposals and adopt legislation

Commission proposals are reviewed simultaneously by the Council and Parliament. This review is known as a 'reading' and there may be up to three readings before the Council and Parliament agree on or reject a legislative proposal. The majority of European laws are adopted under the ordinary legislative procedure, with the Parliament and Council jointly adopting a regulation or directive following a proposal from the Commission. Alternatively, under the special legislative procedure, a regulation or directive can be adopted by the Council after consultation with, or consent from, Parliament.

Pending work of the Commission

Financial reforms to be completed

According to its website, the Commission has since the start of the financial crisis in 2008 proposed more than 40 legislative and non-legislative measures to reform and strengthen the financial sector. The large majority of these measures are considered complete, with the exception of two: shadow banking, including money-market funds and the structural reform of banks.

In September 2013, the Commission adopted a communication on shadow banking and proposed new rules for money-market funds. The communication provided a 'roadmap for tackling the risks' associated with shadow banking. The work remains ongoing with various measures moving through the legislative process.

In January 2014, the Commission proposed new rules to prevent the largest and most complex EU banks from engaging in proprietary trading.² This proposal remains outstanding with the Council and Parliament.

Review of the CRD IV/CRR planned for 2016

As noted above, the DG FISMA within the Commission is responsible for initiating and implementing policy in the area of banking and finance. Its work over the 2016-2020 strategic plan period is guided by three general objectives: (1) boosting employment, growth and investment; (2) developing a deeper and fairer internal market with a

² In November 2011, an expert group was established to assess the need for structural reform of the EU banking sector; chaired by Erkki Liikanen, Governor of the Bank of Finland. The group delivered its report in October 2012, recommending mandatory separation of certain high-risk trading activities for banks whose trading activities exceeded certain thresholds.

strengthened industrial base; and (3) developing a deeper and fairer economic and monetary union.

While DG FISMA's flagship initiative is the Capital Markets Union, we highlight key outstanding issues concerning banks:

- Amending CRR to incorporate modifications to the Basel framework. The CRR also mandates various reviews that may lead to targeted changes to the CRR (Figure 2).
- Structural reform to deal specifically with risks stemming from trading activities.
- Implementation of Total Loss Absorbing Capacity (TLAC) and review of the Minimum Requirement for Own Funds and Eligible Liabilities (MREL).
- Potential initiatives at EU level to overcome obstacles to a fully integrated retail financial services market across the EU.
- Review of the EU macro-prudential framework to better address systemic risks to financial stability.

Figure 2: Selected issues to be addressed under CRD IV/CRR

Timing	CRR / CRD	Issue
By 31 Dec 2016	CRR Art.150	The Commission will, if appropriate, submit a legislative proposal on how to ensure that institutions use stable sources of funding , taking into account reports from the EBA and the diversity of the banking sector in the Union.
By 31 Dec 2016	CRR Art.511	The Commission will report on the impact and effectiveness of the leverage ratio .
By 31 Dec 2016	CRD Art.132	Provisions relating to G-SIIs . After consulting ESRB and EBA, the Commission will submit a report on whether the provisions should be amended, and submit a legislative proposal where appropriate.
By 1 Jan 2017	CRR Art.500	The Commission will submit a report on whether it is appropriate to extend the application of the Basel I floor beyond 31 December 2017 to ensure that there is a backstop to internal models, taking into account international developments and internationally agreed standards. That report will be accompanied by a legislative proposal if appropriate.
By 2 Jan 2017	CRR Art.501	The Commission will report on the impact of the own funds requirements in this regulation on lending to SMEs and natural persons and will submit that report, together with a legislative proposal if appropriate.
After 2017	CRR Art.506	In regards to credit risk and the definition of default – how replacing 90 days by 180 days past due has an impact on risk-weighted exposure amounts and the continued application of this definition after 31 December 2019. Based on a report from the EBA, the Commission may submit a legislative proposal to amend the regulation.

Source: CRD IV/CRR

Expert Group on Banking, Payments and Insurance also involved in CRD IV/CRR review

The Expert Group on Banking, Payments and Insurance, a consultative entity, comprised of experts appointed by the Member States, provides advice to the Commission in the preparation of draft delegated acts in the areas of banking, payments and insurance. Delegated acts are acts supplementing or amending certain non-essential elements of a basic act.

From the published minutes of their June and July 2016 meetings (for further details, [click here](#)), we note that the expert group is working on several issues related to the CRD IV/CRR review. While we find the minutes useful, we note that the level of detail is relatively limited and there are often no clearly stated conclusions stemming from the discussions. Highlights from the minutes are detailed below:

- **Leverage ratio**. Member States supported a 3% Tier 1 leverage ratio combined with a surcharge for G-SIIs and possibly for O-SIIs.
- **Net stable funding ratio (NSFR)**. The vast majority of Member States supported the conclusions of the EBA's report on NSFR, i.e. alignment with the Basel NSFR

standard with some technical adjustments for EU specificities. There were also discussions on the treatment of derivative transactions, short-term transactions with financial counterparties and interlinked assets and liabilities.

- **Proportionality.** A majority of Member States opposed exempting small banks from CRR. All Member States agree on the need to reduce the administrative burden from prudential rules, in particular with regard to reporting and disclosure requirements.
- **Pillar II.** The majority of Member States supported intentions to clarify rules related to Pillar II. Some Member States expressed strong reservations or objections regarding the need to treat AT1 investors preferentially.
- **Prudential treatment of infrastructure exposures.**
- **New trading book rules.** Proposals for proportionality within the revised market risk framework as well as calibration to ensure that they do not undermine the objectives of the Capital Markets Union.
- **IFRS 9.** Interaction between IFRS 9 and CRD IV/CRR capital requirements.

The Council and Parliament decide whether to adopt Commission proposals

Role of Council

The Council represents the governments of Member States. In its work, the Council is supported by the Committee of Permanent Representatives of the Governments of the Member States to the European Union (COREPER) and more than 150 specialised working parties and committees.

Commission proposals are considered by a working group of national representatives who aim to agree on the text. There is no formal time limit for the working group to complete its work. When an agreement has been reached, COREPER aims to resolve any remaining differences. The Council must formally agree to the proposal but the Council's final position cannot be adopted until Parliament has delivered its own first reading opinion.

Role of Parliament

The European Parliament represents EU citizens, who are responsible for electing its members. Each Member State is represented by a number of members roughly proportional to its population.

When Commission proposals are received, they are assigned to a lead committee within Parliament. In the area of financial services, this is likely to be the Committee on Economic and Monetary Affairs (ECON). A member of the lead committee (the rapporteur) is appointed to write a first draft opinion on the proposal. This opinion, which can be amended and includes proposed amendments, is discussed with other relevant committees within Parliament. There is no time limit for providing an opinion. After being submitted to a vote by the lead committee, it is placed on the agenda of the plenary session of Parliament. During the plenary debate, the Commission's position is presented and explained. Legislative resolution requires a simple majority.

Four-level procedure for financial services industry legislation

Since 2002, financial services legislation in the EU has followed a four-level legislative procedure referred to as the Lamfalussy approach:³

- **Level 1.** Legislation proposed by the Commission is adopted under ordinary legislative procedure. This legislation may be a directive or a regulation.
 - Regulations are directly applicable and binding on Member States. They do not need to be transposed into national law.
 - Directives are binding for member states in terms of results that have to be achieved, but there is discretion in how they are incorporated into national law.
 - Examples: CRD IV, BRRD
- **Level 2.** Individual articles in the Level 1 legislative act specify where the Commission has been delegated to adopt Level 2 measures. These measures may be delegated acts, implementing acts or technical standards.
 - The Commission presents delegated acts to the Council and Parliament. If there are no objections within a specified period of time, the delegated act goes into force.
 - Implementing acts are reviewed by committees comprised of representatives of the finance ministers of Member States and chaired by the Commission. Through the examination or the analysis procedure, the Commission decides whether or not to accept the measures.
 - When Level 2 measures have been adopted by the Commission, each Member State then implements the Level 1 text and Level 2 measures in its domestic legal system.
 - Technical standards are prepared by the relevant European supervisory authorities (ESAs) – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA), or the European Securities and Markets Authority (ESMA). The Commission decides whether or not to endorse them.
 - Examples: delegated act on liquidity coverage ratio and leverage ratio; technical standards on risk weights for mortgage lending and thresholds for past-due items in the definition of default.
- **Level 3.** Guidance to facilitate convergence of regulatory practice. The ESAs advise the Commission in preparing Level 2 measures and may also adopt 'comply or explain' guidelines.
- **Level 4.** Supervision and enforcement.

Upcoming agenda items for Parliament

As of September 2016, legislative procedures regarding financial services currently in progress include structural banking reform (related to trading activities) and revision of the capital framework on capital charges for exposures to securitisations, within the objective of reviving the EU securitization market. Both issues have reached the first reading stage within Parliament. However, the legislative proposal regarding structural reform remains under debate with the Council while the legislative proposal regarding securitisation is set to appear on the plenary agenda in December 2016.

³ In July 2000, a committee chaired by Baron Lamfalussy was brought together by the Council to develop proposals for making the regulatory process for EU securities legislation more flexible, effective and transparent. This approach was eventually extended in 2002 to all financial services legislation.



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