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The Big Picture: EU's Financial Regulation Offensive

Law360, New York (September 21, 2016, 9:55 AM EDT) --

In the aftermath of the financial crisis, the national and international response by legislators and regulators has been to substantially overhaul and increase financial regulation applicable to banks and other financial institutions. The primary objectives behind these reforms were to restore financial stability and confidence to the international financial markets and to put in place a regulatory framework to minimize the risks of failures of major financial institutions. In addition, in circumstances where an institution does fail, the aim is to minimize systemic consequences for the wider financial market and avoid the need to use public funds to bail out or support failing institutions.

Peter Green

Much of the regulatory response to the financial crisis has been coordinated at an international level through the G-20 group of countries, which has worked closely with global bodies responsible for setting international standards for financial oversight and regulation, including the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS) and the International Organisation of Securities Commissions (IOSCO). The international standards arising from these bodies must be implemented separately by national legislators, giving rise to differences in interpretation and implementation in different jurisdictions. The approach of the European Union to financial regulation has to be viewed in the context of these international standards.

The extent and scope of the new regulation that has come into force as a result of these initiatives should not be underestimated. Almost every facet of financial activity and services has been affected directly or indirectly by the new regulatory framework. New regulations have focused on identifying and ameliorating the buildup of risk in the financial system and have included individual requirements on banks and financial institutions to hold greater capital and to comply with liquidity and leverage ratios. Other measures have sought to improve corporate governance and investor protection in relation to financial products.

We consider below some of the principal areas of international regulatory reform and relevant implementation by the EU:

Bank capital, liquidity and leverage: Work has been coordinated by the BCBS through the introduction of the Basel III framework, which maintains banks' overall minimum capital requirements at 8 percent of risk-weighted assets (RWAs) but has increased the Tier 1 requirement to 6 percent of RWAs. In addition, it has introduced a capital conservation buffer of 2.5 percent of RWAs and a countercyclical buffer (to be imposed at the discretion of national regulators) of up to 2.5 percent of RWAs, each to be comprised of common equity. Basel III also requires banks to comply with (1) a liquidity coverage ratio (LCR) requiring the holding of sufficient high-quality liquid assets to cover total net cash outflows over 30 days, (2) a net stable funding ratio (NSFR) aimed at supporting a one-year period of extended stress and (3) a leverage ratio requiring banks to maintain Tier 1 capital of at least 3 percent of average total consolidated assets. In the EU, these requirements have been implemented under a revamped Capital Requirements Directive and a Capital Requirements Regulation (together referred to as "CRDIV"). Under CRDIV, the new Basel III minimum capital rules are in effect and the capital conservation buffer will be fully implemented by 2019. The leverage ratio is intended to be in effect by 2018 and the LCR and NSFR should be fully phased in by 2019.

Shadow Banking: Concerns about the systemic risks caused by nonbanks carrying out banking-type activity led to the G-20 mandating the FSB to develop oversight and regulation of shadow banking. In response, the FSB has first developed a monitoring framework to track shadow banking activities and identify systemic risks. Second, it has developed five work streams to strengthen the oversight and regulation of shadow banking including the interaction of the regular banking system with shadow banking, securitization and excess leverage, regulation of securities lending and repos and reform of money market funds. In the EU, many of these work streams have already been fully or partly covered by new legislation, including CRDIV. More recently, the Securities Financing Transactions Regulation came into force in January 2016, introducing reporting requirements for securities financing transactions and imposing limitations on the reuse of collateral. A draft EU regulation in relation to money market funds has made slow progress and is still going through the legislative process.

Derivatives Regulation: To seek to address concerns as to the lack of transparency of firms' exposures and risk-mitigation measures under financial derivatives, the G-20 mandated reporting of all over-the-counter derivatives transactions to trade repositories, clearing of all standardized OTC derivatives through central counterparties and execution of all standardized OTC derivatives on exchanges or electronic trading platforms, where appropriate. In the EU, provisions implementing most of these requirements are included in the European Market Infrastructure Regulation (EMIR), which also contains additional provisions relating to risk-mitigation measures for noncleared derivatives. EMIR came into force in August 2012 and its reporting requirements were phased in from early 2014. The first mandatory clearing obligation (for certain interest rate derivative transactions) applied from June 2016 and further classes of derivatives, such as credit derivatives, will be subject to this obligation shortly. Mandatory exchange trading of derivatives is dealt with by the Markets in Financial Instruments Regulation (MiFIR) which will now not come into effect until the start of 2018.

Investor Protection and Corporate Governance: Both the BCBS and G-20 have published principles relating to corporate governance. In the EU, the revamped Markets in Financial Instruments Directive (MiFID II) and MiFIR will, from 2018, impose further requirements relating to product governance in relation to financial instruments and organizational and governance requirements for firms engaging in EU financial services or activities. In addition, the Regulation on Key Information Documents (KIDs) for Packaged Retail and Insurance-based Investment Products (PRIIPS) provides requirements for a short-form KID to be produced for packaged or insurance-based products sold to retail investors with effect from the end of 2016.

Bank Structural Reform and Recovery and Resolution: Significant work has been done to seek to ensure that banks and regulators put in place robust and comprehensive recovery and resolution plans. The FSB published its Key Attributes for Effective Resolution Regimes for Financial Institutions in 2011 (updated in October 2014), which form the basis for many of the provisions of the EU Bank Recovery and Resolution Directive (BRRD). The BRRD is now in force and fully implemented within the EU and provides resolution authorities with the power to "bail in" — i.e., impose a write-down or conversion into equity

— of many unsecured liabilities of the institution. Each member state must also set, for all EU banks, a minimum requirement for eligible (loss-absorbing) liabilities (MREL) expressed as a percentage of an institution's own funds and total liabilities. Despite the introduction of a draft regulation in January 2014, which sought to limit proprietary trading activities of larger banks, the EU has not yet agreed on a uniform approach to bank structural reform, although some jurisdictions have introduced their own rules, including the U.K., which has introduced legislation requiring the ring-fencing of retail banking from other activities with effect from 2019.

G-SIB Regulation: The FSB, together with the BCBS, has developed additional capital, stress-testing and other requirements for global systemically important banks (G-SIBs). The FSB maintains a list of G-SIBs, which it updates on an annual basis. There are currently 30 G-SIBs, including 13 within the EU. Rules developed by the BCBS and the FSB subject G-SIBs to a capital surcharge of between 1 percent and 4.5 percent to be set by national regulators. In December 2015, the FSB finalized proposals for minimum levels of total loss-absorbing capital (TLAC) (comprising Tier 1 and Tier 2 regulatory capital and other eligible loss-absorbing instruments) and leverage ratios to be maintained by G-SIBs, which will be phased-in from 2019. TLAC will be imposed on G-SIBs within the EU by relevant national authorities. Under the BRRD, G-SIBs in the EU must also comply with their MREL requirements (there is significant overlap between TLAC and MREL, although the liabilities eligible for TLAC are narrower than those under MREL).

The EU response to financial regulation has therefore been comprehensive and has largely implemented the various requirements mandated by the relevant international bodies referred to above. Consequently, the principal focus on financial regulation in the EU is now moving away from the introduction of new regulation and toward effective implementation of the new rules and consideration of the effect of those rules on financial institutions and the wider economy.

In September 2015, the EU Commission launched a public consultation in the form of a call for evidence relating to the EU regulatory framework for financial services. It stated that in view of the huge amount of financial legislation put in place since the crisis, it sees merit in understanding the combined impact of such legislation and identifying any unintended consequences. In particular, the EU Commission sought views on areas of regulation that firms regard as imposing excessive burdens, costs or complexity out of proportion with the intended policy objectives. Specific questions included:

- Has any legislation produced undue obstacles to the ability of the wider financial sector to finance the economy, in particular in relation to SME financing, long-term innovation and infrastructure projects, and climate finance?

- Whether, and to what extent, the regulatory framework has had any major positive or negative impacts on market liquidity and on investor and consumer protection and confidence.

- Have the new rules been appropriately adapted to the diversity of financial institutions in the EU?

There were almost 300 responses to the call for evidence, including from many regulators, governments and central banks. In a feedback paper, the EU Commission highlighted a number of themes that came out of the responses including:

- A significant increase in compliance costs due to the scale and pace of regulatory change and a perceived overlap of different layers of regulation. Concerns were raised as to poorly aligned and tight timelines for implementation and the complexity of the overall framework.

- The need for improvements in financing conditions for SMEs. Many respondents suggested extending capital relief for banks' investments in bonds and equities issued by SMEs.

- Possible adverse consequences of the LCR and its potential negative impact on corporates' cash management.

- Specific pieces of legislation and the cumulative effect of certain rules, have given rise to a detrimental impact on market liquidity, particularly in corporate bond markets.

- Disclosure rules are seen as inconsistent across different pieces of relevant legislation.

The EU Commission has stated that none of these views should be regarded as reflecting the position of the commission. It has not yet given a formal response as to whether, and the extent to which, it intends to address the particular issues and concerns it identified.

Considering the vast amount and scope of financial regulation that has been put in place since the financial crisis, it would be surprising if there had not been some unforeseen consequences. In addition, the balance between the need for effective regulation on the one hand but avoiding unnecessary constraints to banks and other financial institutions performing their functions effectively is never going to be easy to calibrate, and the international bodies overseeing the regulatory reform process have stressed the importance of ensuring an appropriate flow of capital to enable the real economy to grow and function efficiently. There is a tendency among some commentators to refer to any relaxing of regulatory rules or delay to implementation of legislation as an unacceptable watering down of financial regulation or evidence of regulators capitulating to the power of banks, but this reaction is hard to justify, at least without a thorough analysis of the circumstances giving rise to the amendment or delay.

There have been a number of public disagreements in relation to certain elements of financial regulation. For example, Sir John Vickers strongly disagreed with the approach of the Bank of England in setting its systemic risk buffers under the U.K. Banking Reform Act 2013, which deviated from the recommendations of the report of the Independent Commission on Banking that he chaired. Also, Francois Villeroy de Galhau a member of the Governing Council of the European Central Bank (ECB) recently expressed concern that current work being done by the BCBS in looking to further develop the Basel III framework is not consistent with earlier commitments to not significantly increase overall capital requirements for banks.

There is, however, widespread agreement that banks are now significantly better capitalized than in the run-up to the financial crisis and better able to withstand a period of sustained financial stress than was previously the case. While there continue to be very different views on the "right" amount of capital for banks to hold, the international reforms highlighted above were never premised on minimum capital being the only answer. The new regulatory framework has to be looked at as a whole. The focus on identifying and mitigating risks arising from shadow banking, increasing investor protection, requiring banks and regulators to focus on recovery and resolution strategies, improved corporate governance, and an increased focus on liquidity and leverage all have a role to play.

Although the bulk of the primary EU legislation aimed at giving effect to the new regulatory framework is now in place, the EU Commission has indicated a willingness and desire to look at introducing new elements of regulation, including a draft Securitisation Regulation and draft Prospectus Regulation (aimed at overhauling the existing Prospectus Directive) as part of its Capital Markets Union project, seeking to improve the scope and efficiency of the European capital markets. Some EU regulatory initiatives have stalled to some extent, including structural banking reform and the draft Money Market Regulation. In the latter case, work continues and the EU Commission has indicated that it remains committed to finalizing the regulation as part of meeting the FSB's shadow banking objectives. It is also possible that the political fallout from the U.K.'s referendum vote to leave the EU may cause a delay in some initiatives. It is important that the EU authorities focus on finalizing and implementing the outstanding regulatory agenda but it is erroneous to point to a lack of new legislation and initiatives as evidence that the approach to financial regulation is weakening. The ongoing review of the combined effect of the new regulation is necessary to seek to ensure an appropriate balance between the need for financial regulation and the benefit of having efficient and well-operating financial markets.

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