ALLEN & OVERY

Beyond capital and liquidity: structural implications of the EU's prudential regulatory reforms

We look at the architecture of the new European regulatory framework and some of the key areas relevant to the corporate structure of UK and other European financial institutions.

JULY 2019

In regulatory terms, UK and other European financial institutions have found it hard to see far past the management of Brexit. But that is set to change. New challenges lie only a short way over the horizon. We stand at the cusp of some highly material prudential regulatory reform in the form of the EU risk reduction package – comprising changes to the Capital Requirements Directive (CRD5), Capital Requirements Regulation (CRR2), Bank Recovery and Resolution Directive (BRRD2) and Single Resolution Mechanism Regulation (SRMR2) – which was finalised and published in the Official Journal on 7 June, and investment firms prudential package – comprising an Investment Firms Directive (IFD) and Investment Firms Regulation (IFR) – which are currently being finalised.

Together, these reforms affect all European (including UK) banks and investment firms and require significant implementation over a period of multiple years. There will be material changes to the capital and funding needs of firms as well as to their governance, risk management, systems and controls, reporting, recovery and resolution planning and in some cases corporate structures.

NEW FRAMEWORK FOR NON-SYSTEMIC INVESTMENT FIRMS

First up, some (largely) good news. Historically, the EU has struggled with the regulation of investment firms. In this context, 'investment firms' is a portmanteau term that includes brokers, dealers, portfolio managers, investment advisers and assorted other actors in securities and derivatives markets. The EU's default approach has been to apply the same standards to banks and investment firms with limited exceptions for certain types of investment firms that have a low prudential risk profile. Subjecting investment firms to Basel standards is inefficient, and is occasionally cited as one of the possible reasons for the comparative weakness of the EU investment bank sector.

The IFD and IFR, which are expected to come into effect at the beginning of 2021, will ameliorate this situation somewhat by recasting the prudential framework for all non-systemically important investment firms. In general, this will result in the simplification and reduction of prudential requirements for such firms, although there will be some losers – proprietary dealers and commodity derivatives dealers in particular – which will become subject to meaningful harmonised capital requirements for the first time, increasing their required minimum capital substantially.

EXTENDING THE ECB'S OVERSIGHT OVER SYSTEMIC INVESTMENT FIRMS

For the systemic (so-called 'class 1') investment firms – in broad terms, those whose EU proprietary-risk-taking firms have consolidated assets exceeding EUR15 billion, or potentially less, subject to regulatory discretion – little changes on the face of things. They continue to be regulated in the same way as banks and will have to implement the changes in CRR2 and CRD5. But behind this lies some sleight of hand by the EU authorities. The IFR brings the largest class 1 firms – broadly those whose proprietary-risk-taking firms worldwide have consolidated assets exceeding EUR30bn – into the supervisory regime for banks.

For Euro-area firms, this means migration into the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM). Eurozone class 1 investment firms will therefore face a change in their supervisor and resolution authority, which is likely to feed through to changes in the supervisory relationships, potential differences in the exercise of options and discretions, and questions around the carry-over of existing waivers – in addition to the challenge of implementing CRD5 and CRR2. Such firms also will be required to submit applications for authorisation to their local bank regulator (probably in Q3 2020), which is likely to prove a time-consuming disclosure exercise.

REGULATION OF FINANCIAL HOLDING COMPANIES

Unlike the U.S., the EU has not historically regulated bank holding companies. Subject to limited exceptions, CRD5 introduces a requirement for the approval of a financial holding company which – in broad terms – is the 'top' holding company in a Member State or in the EU of a group or subgroup which includes a credit institution or class 1 investment firm, or a holding company which attracts sub-consolidated supervision in the EU. Applications will need to be made with respect to existing financial holding companies by 28 June 2021. It is not yet clear how onerous the approval process will be.

Regulated financial holding companies will become subject to all of the requirements of the prudential framework in relation to their consolidated position. Regulated financial holding companies and their management will also be subject to the oversight and supervisory and disciplinary powers of the competent authority. The application of the full suite of CRDV and CRR requirements for regulated financial holding

© Allen & Overy LLP 2019

companies is likely to require substantial change to their board composition and governance, in particular. Affected groups will need to identify the relevant holding companies and build a plan to enhance their capabilities to meet the full prudential framework.

THE INTERMEDIATE PARENT UNDERTAKING REQUIREMENT

Another area in which the ECB has sought greater supervisory oversight is the regulation of non-EU institutions. The existing SSM framework confers supervisory powers on the ECB in respect of EU banks and their consolidated EU sub-groups. It does not extend to EU branches of third-country banks and does not require third-country groups to house their EU regulated holdings under a single holding company. As a result, the ECB considers it suffers from an inability to have a single consolidated view of the risks that third-country groups pose.

The ECB fought for supervisory powers in both areas, but won only in the latter: to widen ECB oversight. CRD5 includes a requirement for an intermediate parent undertaking (IPU) for a large third-country group (one whose EU-*situs* assets exceed EUR40bn) which has more than one credit institution and/or class 1 investment firm in its group, which must be in place from January 2024. All EU credit institutions and investment firms, including class 2 and class 3 investment firms, must be owned by the IPU.

Exceptionally, two IPUs may be permitted in certain circumstances. This concession was largely driven by the constraints placed on U.S. banks.

Post-Brexit, the IPU requirement will be applied separately by the UK in respect of UK sub-groups of non-UK groups, and by the EU27 in respect of non-EU27 groups. International banks that meet the criteria in both the UK and EU27 therefore potentially face dual IPU requirements.

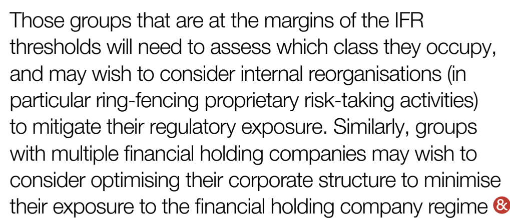
BRANCH REGULATION: EU BRANCHES OF NON-EU BANKS

EU branches of third-country banks are generally not subject to EU prudential standards. CRD5 does not change this position, but introduces minimum harmonised reporting requirements for branches and requires EU regulators to cooperate where there is both an EU branch and one or more subsidiaries within the EU to ensure that there is comprehensive supervision of the relevant group.

Longer term, it seems likely that branch regulation will be revisited both in Europe and the UK, albeit for different reasons. In the EU27, the lack of ECB oversight and concerns around the utilisation of branch structures to avoid aspects of EU regulation are primary concerns, whereas in the UK questions remain about whether the PRA will more meaningfully enforce its branch risk appetite given the systemic implications of having a population of very large international branches in London.

Banking and investment services providers will need to work through the corporate structural and governance implications of the new regime, prepare regulatory applications as necessary in the short term, and commence the restructuring process where they are to be subject to the IPU requirement.

Those groups that are at the margins of the IFR thresholds will need to assess which class they occupy, and may wish to consider internal reorganisations (in particular ring-fencing proprietary risk-taking activities) to mitigate their regulatory exposure. Similarly, groups with multiple financial holding companies may wish to consider optimising their corporate structure to minimise their exposure to the financial holding company regime



BOB PENN
Partner, London
Tel +44 20 3088 2582
bob.penn@allenovery.com

ALEXANDER BEHRENS
Partner, Frankfurt
Tel +49 69 2648 5730
alexander.behrens@allenovery.com

BRICE HENRY
Partner, Paris
Tel +33 1 40 06 53 66
brice.henry@allenovery.com

Allen & Overy means Allen & Overy LLP and/or its affiliated undertakings. The term **partner** is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings. This document is for general guidance only and does not constitute definitive advice.

© Allen & Overy LLP 2019 | CS1905_CDD-55385_ADD-83820_article_pru-reform