# CRD V/CRR II: Overhauling risk and compliance management

**By Joost Roelin and Xavier Dubois**

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As the EU continues to fine-tune its financial regulatory framework, the banking sector must now grapple with a revised Capital Requirements Directive (CRD V): the proposed implementation of key Basel III standards into European law. CRD V is part of a broader package of legislative amendments currently under revision by the EU Parliament and EU Council – including the Capital Requirements Regulation II (CRR II), EU Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism (SRM).

There's a wide range of regulatory initiatives – from this package and Basel III – that banks need to understand, plan for and implement on many levels. Most firms recognize that these reforms are more than just the latest iteration of Basel III – and that their impact will be vast. Many of these institutions will need to keep pace with multiple local and global regulatory rules, which requires a substantial amount of effort across the organizational structure.

In a recent Wolters Kluwer poll of more than 100 webinar delegates from financial institutions across the EMEA region, only 18% viewed CRD V as an opportunity to improve risk and compliance management, and 12% perceived this as an opportunity to fix the Basel "chain". This highlights that the remaining majority of firms may still need to assess whether their overall risk and compliance management systems are aligned with the scope and complexity of the proposed changes.

While it's certainly important to evaluate each legislative element on its own merit with the relevant expertise, it's also advisable to guard against taking a fragmented, siloed approach when managing this new package of reforms. Without an enterprise view that takes the interrelationships among individual components (and related risks) into account, or a coordinated approach across functions – banks may experience several disadvantages. These include redundant processes, disconnected data management strategies and a higher cost of ownership associated with their governance, finance, risk and compliance solutions.

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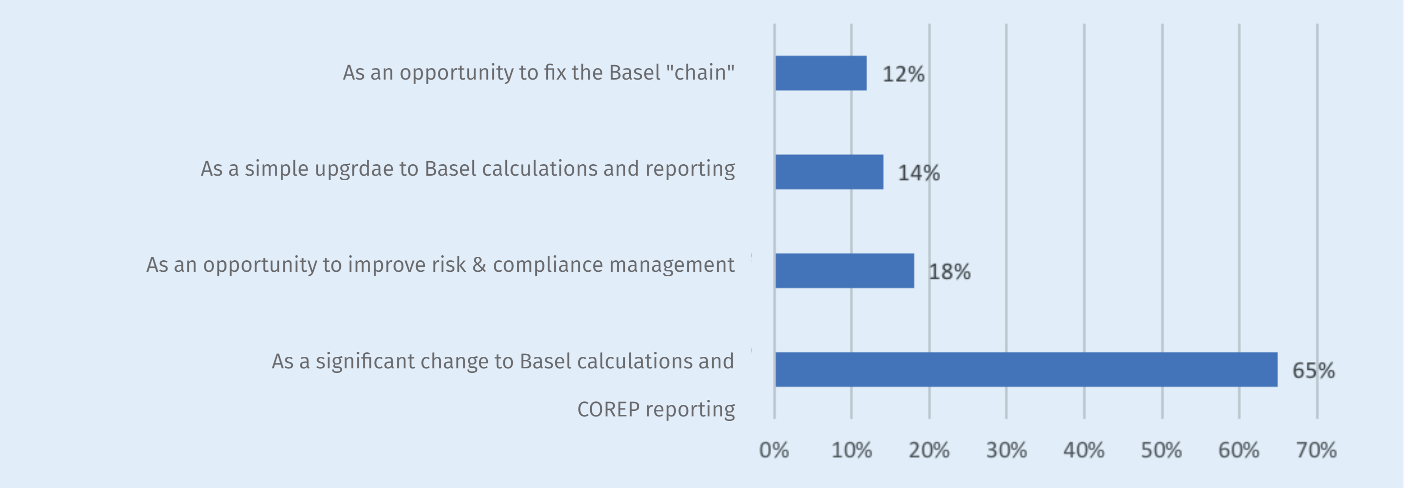
**Webinar Poll Results: How do you currently perceive CRD V from an implementation perspective?**



## What's changing?

Among other developments, the proposed framework introduces[1]:

- A new standardized approach for counterparty credit risk (SA-CCR)
- A binding net stable funding ratio (NSFR) to address liquidity mismatches
- A binding 3% leverage ratio, a non-risk sensitive measure to assess banks' ability to meet long-term financial obligations
- Revised risk-weighting and large exposure standards including higher capital requirements for institutions that trade in securities and derivatives (market risk), following Basel Committee proposals on the 'fundamental review of the trading book' (FRTB)
- Revised framework for capturing interest rate risks for banking-book positions (IRRBB)
- Increased proportionality of EU rules regarding disclosure requirements and in other areas
- Facilitating banks' investment in SMEs and infrastructure projects
- Harmonization of MREL and TLAC for G-SIBs, as well as the possibility to impose a Pillar 2 MREL to G-SIBs as introduced in BRRD

Additionally, non-EU groups that have two or more subsidiaries within the EU require an authorized EU parent company, which will be subject to all prudential requirements. This may impact those firms that were planning to restructure due to Brexit.[2]

## Pressure on the balance sheet

Given the new rules governing the determination of capital requirements, banks' balance sheets will feel a significant impact.

In general, the new regulations will generate an increased cost for capital and liquidity. This will impact banks' return on equity; and it might become necessary to implement some balance sheet restructuring. However, the extent to which this will happen is difficult to predict until the CRD V package has been finalized.

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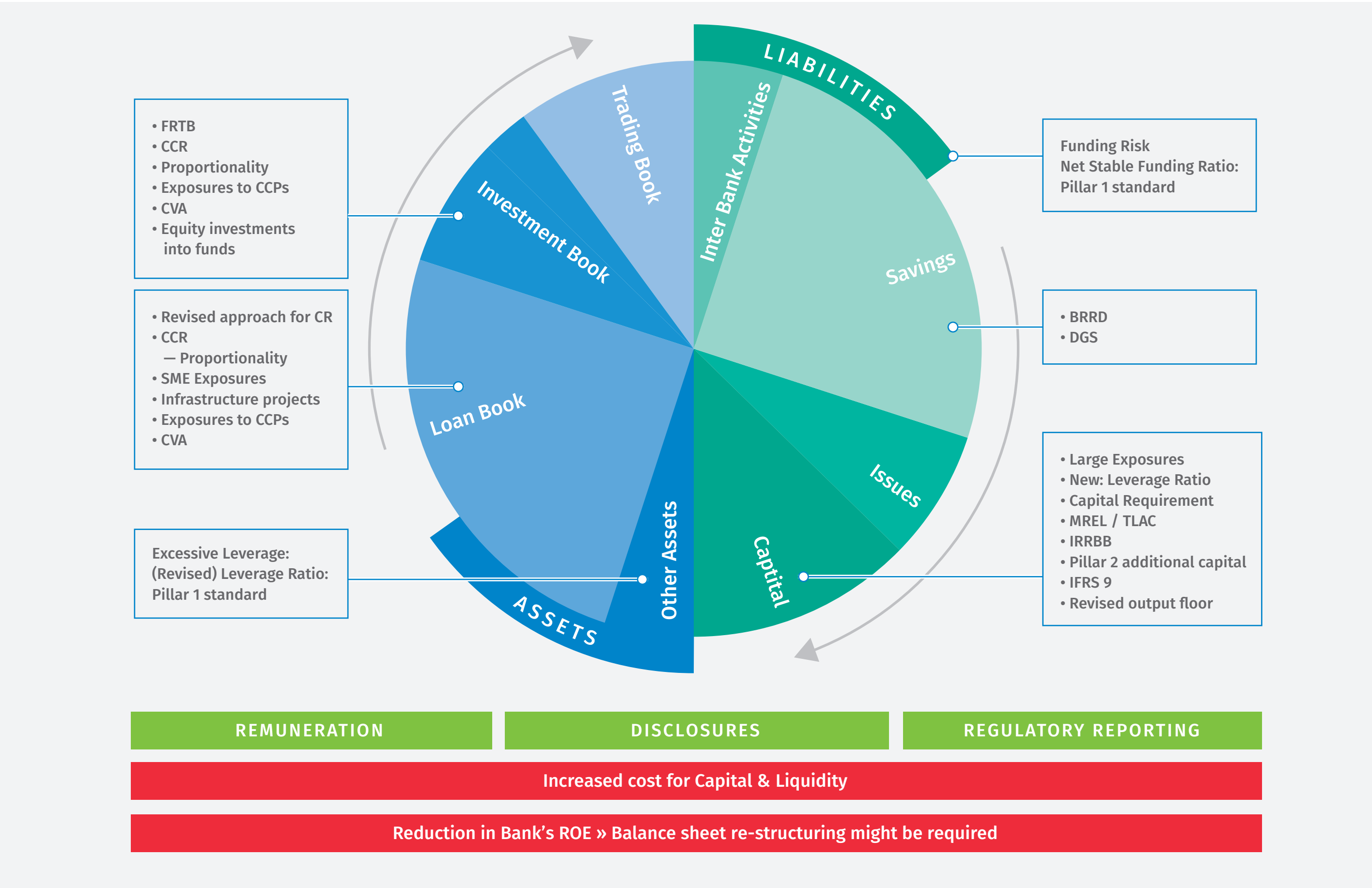
1. http://www.europarl.europa.eu/RegData/etudes/BRIE/2017/599385/EPRS_BRI%282017%29599385_EN.pdf
2. https://www.pwc.co.uk/industries/financial-services/insights/being-better-informed-understanding-crd-v.html

### CRD V: Regulatory Pressure on the Balance Sheet



## How to prepare: now and in the future

Overall, the CRD V package adds multiple layers of complexity to current regulations, introducing a new set of risk factors that banks need to evaluate and manage. Given the amount of work involved, it's never too early to form working groups and assess the potential impacts of each of the elements in the new regime. With these insights, banks can begin to formalize governance and control frameworks, and gain a greater understanding of resource needs.

The proposals take a "single rulebook approach" that covers a lot of areas and issues. On the one hand, it will be essential for firms to drill down and apply the relevant expertise to each regulatory element. On the other hand, there are also multiple dependencies and interactions between the different requirements that need to be strategically managed. As recommended, this calls for an integrated approach, as well as an evaluation of enterprise-wide processes, controls and systems to assess whether they're fit for purpose.

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## Key considerations

**Technology:**
Firms need to assess whether current IT architectures and solutions can support their compliance, risk management and business requirements under CRD V/CRR II. If gaps are identified, it's worthwhile taking time to establish the most strategic course of action for resolving these. This may involve extending existing solutions, building new solutions or going out to market to acquire additional functionality.

**Data management:**
The availability, quality and consistency of data are important, as well as the capacity to calculate and assess risks adequately. Being able to track data lineage is also essential as it does not only support sound data management practices, but also enables banks to demonstrate the data sources and data flows involved in calculations and risk reports.[3]

**Process and system agility:**
As banks prepare for Basel III and its implementations into law, it's advisable to choose technology that is agile and modular. This provide banks with the flexibility to implement industry best practices as the market evolves and their understanding of the full regulatory impact matures.

**Enhanced communication:**
Increasing communication with senior management and the front office will enhance awareness of – and provide support for – the timely and effective implementation of the CRD V package in every line of business.

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3. https://www.isaca.org/Journal/archives/2016/volume-5/Pages/data-lineage-and-compliance.aspx

## The way forward: is Basel III here to stay?

During a recent address, Mr Stefan Ingves, Chairman of the Basel Committee on Banking Supervision, noted that while finalising Basel III was an important milestone, “work remains to (i) implement Basel III nationally in a full, timely and consistent manner; (ii) evaluate its effectiveness in reducing the excessive variability of risk-weighted assets (RWAs); and (iii) continue to monitor and assess emerging risks.”

To play their expected role in the “full, timely and consistent implementation” of this comprehensive new revision package, banks need to guard against taking a fragmented approach to meeting their enterprise-wide CRD V objectives. This could happen if firms focus only on new calculations and regulatory reports, and fail to align internal risk management, controls and – in some instances – business models with the new standards.

Allowing enough time to meet implementation deadlines effectively and consistently is also imperative. Many firms worked against a tight deadline with Basel 2.5. If banks start now, there’s enough time to prepare thoroughly for this new chapter.

The finalized Basel III framework is likely to be one that regulators and banks work with for some time. In this context, it’s worthwhile taking a holistic and long-term view when implementing the proposed standards. Banks that approach CRD V comprehensively can derive significant benefits in comparison with banks that focus on specific areas, such as FRTB or SA-CCR, in isolation.

This represents a unique opportunity for firms to enhance end-to-end risk and compliance management through technology solutions that provide a centralized data architecture, advanced data mining and analytics, and a consolidated view across all risk and business areas. With this approach, banks can remain profitable and competitive in a challenging regulatory environment.

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Contact information:
Wolters Kluwer
25 Canada Square
Canary Wharf
London E14 5LQ
United Kingdom

Please visit www.wolterskluwerfs.com for more information.