The European banking package – revised rules in EU banking regulation

To rectify the shortcomings exposed during the 2007-08 global financial crisis, comprehensive regulatory initiatives relating to financial services were undertaken in multiple stages.

At the global level, the Basel II regime tightened banks' capital requirements and introduced new liquidity standards. As early as 2013, first elements of the Basel III standards were transposed into European law in the shape of the newly enacted Capital Requirements Regulation (CRR) and an amendment to the Capital Requirements Directive (CRD IV). The banking package now implements further material elements of the Basel III framework, which was finalised at the end of 2017, at the European level by way of amendments to the CRR (CRR II) and CRD (CRD V). The Bundesbank welcomes the fact that the standards are being implemented largely in line with international agreements and that any deviations are intended to take account of specificities of the European market.

The EU banking package also amends and augments the new resolution regime introduced in the EU at the start of 2015 by implementing the total loss-absorbing capacity (TLAC) requirement developed by the Financial Stability Board (FSB) for global systemically important institutions only. Furthermore, it adjusts the minimum requirements for own funds and eligible liabilities (MREL) for all European banks. The more stringent new rules increase the bail-inable capital available in case of a bank resolution, thus improving resolvability. This reduces the risk of public funds being used for bank resolutions and thus creates a closer balance between liability and control.

The banking package is a well-balanced compromise and strengthens the stability and resilience of the European banking system. It is to be welcomed that the banking package aims at significantly reducing the administrative burden on small, non-complex institutions, without exempting them from quantitative requirements. Given the growing complexity of banking regulation and the increase in compliance costs, this is an important step towards more proportionate and better suited regulation. Building on this basis, the outstanding implementation of the Basel III reform package from the end of 2017 should continue to pursue this objective.

Introduction

Banking package augments post-crisis agenda in banking sector

The banking package represents another key milestone in the process of eliminating the regulatory gaps and weaknesses identified during the financial crisis. Furthermore – in line with the European Council conclusions adopted in June 2016 – risk reduction measures in the banking sector continue to pave the way for the completion of the banking union.

The new rules implement elements of the changes and additions to the regulatory framework agreed by the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). These include more risk-sensitive capital requirements, particularly with regard to market risk, and the introduction of a binding leverage ratio and a binding net stable funding ratio. In addition, banks will be required to hold a minimum amount of capital that is available to cover losses in the event of recovery or resolution, with the intention of avoiding the need for government support measures. The banking package also puts a much greater focus on proportionality than has so far been the case. These measures will reduce the operational burden on small, non-complex institutions, primarily in terms of the requirements for reporting, disclosure and remuneration. The banking package additionally comprises a series of other measures, including, for example, the requirement that third-country institutions with significant activities in the EU must have an EU intermediate parent undertaking, as well as specific details on the scope of application of Pillar 2 capital requirements and macroprudential instruments.

In order to implement the adjustments detailed above, extensive amendments to the CRR,[1] the CRD,[2] the Bank Recovery and Resolution Directive (BRRD)[3] and the Single Resolution Mechanism Regulation (SRMR)[4] were required.[5]

Material changes to the CRR and CRD

Market risk

Having revised the rules on calculating the capital requirement for market risk, the Basel Committee published the new fundamental review of the trading book (FRTB) framework in January 2016.[6] The FRTB substantially reworked the concept and methodology of both the standardised and the models-based approach as well as adjusted and specified the trading book definition.[7] At the same time that the Basel III reform package was adopted in December 2017, the FRTB implementation date targeted by the Basel Committee was postponed by three years to 1 January 2022.

Publication of the revised FRTB framework

In January 2019, the new Basel market risk framework was endorsed and published in updated and expanded form.[8] It contains technical changes to the FRTB internal models-based approach affecting the eligibility criteria of a model as well as the type and amount of capital backing for illiquid risk factors, technical changes to the FRTB standardised approach including an altered, less conservative calibration as well as the introduction of a simplified standardised approach in the form of the (newly calibrated) Basel II standardised approach for institutions with smaller-scale trading activities.

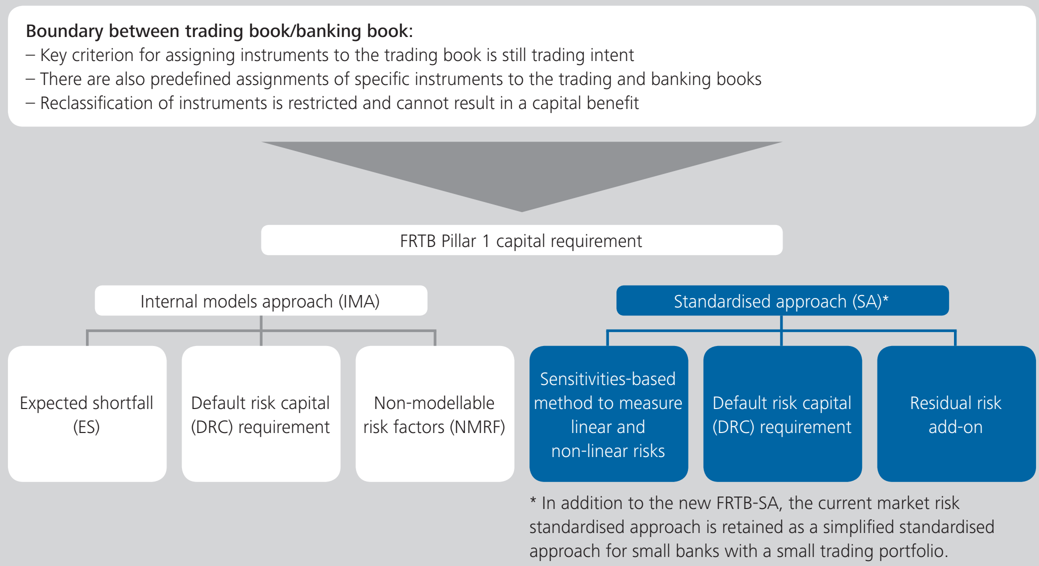
Phase-in

The new FRTB rules will be phased in across the EU. While the basic rules form part of the banking package, a number of amendments to the

1 Regulation (EU) No 575/2013 of 26 June 2013.
2 Directive 2013/36/EU of 26 June 2013.
3 Directive 2014/59/EU of 15 May 2014.
4 Regulation (EU) No 806/2014 of 15 July 2014.
5 See Official Journal of the European Union L150 of 7 June 2019: The amendments to the CRR are to be applied for the first time two years after entry into force, which is on the twentieth day following publication in the Official Journal of the European Union (i.e. 27 June 2019). The new CRD V rules are to be applied 18 months after entry into force.
6 https://www.bis.org/bcbs/publ/d352.pdf
7 For details of the key elements of the FRTB, see Deutsche Bundesbank (2018).
8 https://www.bis.org/bcbs/publ/d457.pdf

Market risk (fundamental review of the trading book)

Overview of the BCBS fundamental review of the trading book (FRTB)



Introduction in the EU
– New SA and IMA to be phased in
– Initially as reporting requirement only (SA from 2020; IMA from 2023)
– No date yet for implementation of new trading book definition and capital requirement

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Basel framework made in 2019 still have to be implemented this year by way of a European Commission delegated act.[9]

FRTB application – reporting

The first step in the application of the FRTB by institutions will simply be a reporting requirement. This is to begin one year after the aforementioned delegated act is enacted in the case of the FRTB standardised approach, and three years after for the models-based approach. However, the capital requirement itself will continue to be calculated using the rules currently in force for a certain transitional period. This transitional period for the calculation of capital requirements will end when the FRTB enters into force. The specific design of the capital requirement will be the subject of a legislative proposal to be presented by the European Commission by mid-2020.

First application of FRTB capital requirement

As the FRTB will initially be introduced simply as a reporting requirement, banks will need to use previous procedures in parallel with new FRTB approaches. This will cause added work, on the one hand, but on the other, it will allow banks and supervisors to gain more experience in the use of the new approaches ahead of the introduction of the actual FRTB capital requirement.

Leverage ratio

Introduction of a binding LR minimum requirement of 3%

The banking package also adapts the existing EU provisions on the leverage ratio (LR) to the revised Basel requirements. The leverage ratio is intended to complement the risk-based capital requirements and ensure that banks have a minimum amount of capital that is independent of the riskiness of their exposures. Like the Basel requirements, in the EU the leverage ratio is determined as the ratio of a bank's regulatory tier 1 capital (numerator) and its total ex-

9 The Commission is to enact the delegated act by 31 December 2019. The new definition of the trading book is not included in the scope of this delegated act.

Leverage ratio: additional tasks for the European Banking Authority and the European Commission

Mandates have been put in place for the European Banking Authority (EBA) and the European Commission to revise the EU's framework on the leverage ratio (LR).

In this context, the EBA has been tasked with adjusting the technical standards for reporting and disclosing the LR. A key focus will be on exposures particularly vulnerable to what is known as window dressing, which in this case involves banks changing their business activities as at the reporting and disclosure dates in order to report improved prudential metrics. It has therefore already been decided that large banks will in future have to calculate such exposures more frequently than at the three-month intervals currently stipulated.

In addition, the European Commission has to assess by 31 December 2020 whether the LR buffer requirement should also be introduced for other systemically important institutions.

posure measure essentially comprising all balance sheet and off-balance-sheet items (denominator). The leverage ratio, which currently only has to be reported to the supervisory authorities and disclosed publicly, will become a binding minimum requirement in the EU – a bank will have to have a leverage ratio of at least 3% in future.

Introduction of the option of additional LR requirements at supervisors' discretion

If the supervisory authority considers the leverage ratio minimum requirement insufficient to address the institution-specific risk of excessive leverage, the authority can impose an additional leverage ratio requirement under the new CRD V rules.

Introduction of an LR buffer for G-SIIs: 50% of the risk-based G-SII buffer ratio

In addition to the leverage ratio minimum requirement and, if applicable, the additional leverage ratio requirement, a bank classified as a global systemically important institution (G-SII) will be required to hold an additional leverage ratio buffer in future. This buffer amounts to 50% of the risk-based G-SII capital buffer. The leverage ratio buffer is designed to account for the greater risks to financial stability emanating from G-SIIs. If a G-SII does not have enough tier 1 capital to maintain its leverage ratio buffer, it will be subject to restrictions on distribution and must submit a capital conservation plan to supervisors.

EU-specific deviations from Basel LR standard for economic policy reasons

While the calculation method for the leverage ratio is broadly consistent with the Basel framework, implementation in Europe deviates from the Basel regime by including a large number of specific exemptions for certain types of business and business models. Examples are the non-inclusion of specific export financing transactions and of pass-through promotional loans, as well as reduced requirements for building and loan associations.

All changes to the European leverage ratio framework deriving from CRR II as well as the new minimum requirement are to be applied for the first time two years after CRR II enters into force. Only the additional leverage ratio buffer for G-SIIs will be introduced in line with the Basel implementation date of 1 January 2022.

Net stable funding ratio

Full implementation of the new Basel liquidity standards

The net stable funding ratio (NSFR) establishes as a minimum standard the existing general requirement[10] for an adequate level of stable funding, which was initially implemented in the CRR purely as a reporting obligation. The NSFR rules published by the Basel Committee in October 2014 are thus transposed into EU law.

NSFR regulatory approach

The NSFR complements the liquidity coverage requirement (LCR) applied in the EU since October 2015 to ensure short-term ability to pay, adding the requirement for a stable match between the maturity structures of assets and liabilities over the longer term. Accordingly, the sum of available stable funding (liabilities) must at least match the sum of required stable funding (assets).[11] The NSFR is based on a time horizon of one year,[12] meaning that liabilities with longer residual maturities are classed as "available stable funding" and assets where liquidity is tied up for a longer period as "required stable funding".

Avoidance of excessive maturity mismatches

The NSFR's objective is to avoid excessive maturity mismatches between assets and liabilities and dependence on short-term funding. The intention is to limit the risk of the funding basis eroding in longer stress situations due to excessive outflows.

Deviations from Basel framework

The implementation of the NSFR took on the EU-specific elements of the LCR (e.g. the definition and weighting of liquid assets). Additionally, there are selected deviations from the Basel rules regarding calibration[13] and a number of specific provisions on certain instruments.[14] On the one hand, these deviations take into account European specificities, and on the other, where the relevant rules are transitional or subject to a review clause, they are intended to give institutions sufficient time to adapt to the Basel calibration, which is considered to be very strict. In keeping with this, the European NSFR is calibrated less conservatively on the whole to begin with.

Simplified net stable funding ratio for small, non-complex institutions

In the interest of proportionate regulation, another special feature in the EU is the option of allowing small, non-complex institutions to apply an alternative simplified NSFR in future. The simplified NSFR's main objective is to reduce the work that goes into generating the data needed for the NSFR reports. This is achieved mainly by combining reporting categories and maturity bands. As a result of the recalibration of weighting factors this necessitates in isolated cases, the simplified NSFR is stricter than the general NSFR on balance.

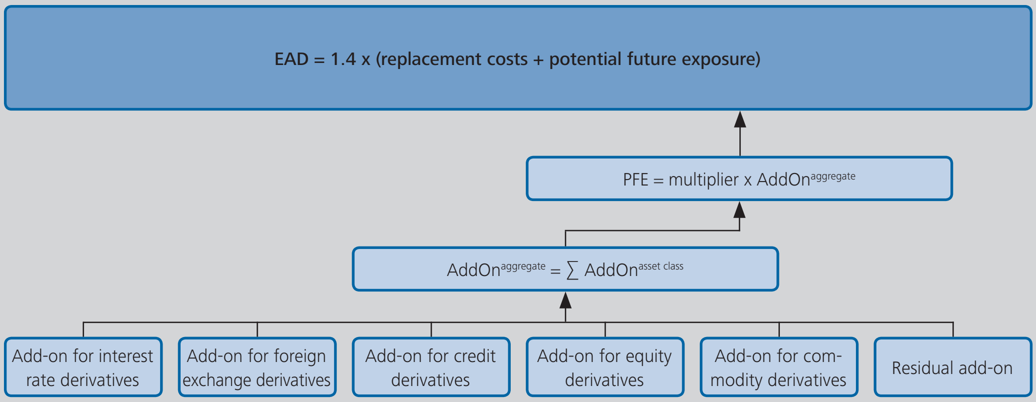
Standardised approach for counterparty credit risk

New standardised approach for counterparty credit risk, SA-CCR, replaces existing standardised approaches

Counterparty credit risk (CCR) is the risk that the counterparty to a transaction (especially in derivatives) could default before the final settlement of the transaction's cash flows. There are currently three standardised approaches to measuring the default risk of derivatives transactions for counterparty credit risk: the original exposure method, the mark-to-market method and the standardised method. Whereas the original exposure method may only be used by institutions with a small trading book, nearly all German trading book institutions apply the

10 See Article 413 CRR.
11 Liabilities and assets are weighted according to their long-term availability or liquidity characteristics, taking into account the medium-term funding needs from off-balance-sheet exposures.
12 A distinction is made between the maturity bands "less than six months" and "at least six months and less than one year", particularly on the assets side.
13 In particular, the stable funding requirements for Level 1 assets and for short-term (i.e. with residual maturities of less than six months) exposures to financial customers are lowered.
14 In particular, the classification of assets and liabilities in connection with specific products and services (e.g. pass-through of promotional loans or certain own issues of covered bonds) as interdependent, which are effectively excluded from the NSFR by receiving a flat weighting of 0% (or zero weighting).

Standardised approach for counterparty credit risk (SA-CCR)



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mark-to-market method; the standardised method is not used.

SA-CCR takes into account margining and netting

CRR II introduces a new standardised approach for counterparty credit risk (SA-CCR) to measure exposure at default, which will replace the three existing standardised approaches. The Basel Committee developed the SA-CCR to increase the sensitivity of risk measurement and to eliminate known deficiencies in the current standardised approaches. In particular, margin agreements (margining) are taken into account for the first time and offset agreements (netting) are given much more adequate attention. Moreover, the new approach is applicable to a large number of derivatives transactions and is simple to implement.

Like the mark-to-market method, the SA-CCR uses two components to measure exposure at default (see the chart above). The first component is the current replacement cost (RC), which corresponds to the current positive market value of the exposures to a counterparty. The second component is the potential future exposure (PFE), which reflects the risk of the contract increasing in value between the default of a counterparty and entry into a new contract with another counterparty. A lump-sum add-on of 40% to cover potentially underestimated risks is applied to the sum of the two components.

Proportionality

Here, too, the rules are designed with proportionality in mind. Institutions with a small or very small trading book are permitted to use simplified variants of the SA-CCR for their calculations, relieving them of the operational burden.

Changes to the large exposures regime

The implementation of the Basel framework for large exposures results in the following main changes. In future, only tier 1 capital can be applied as the capital base. This reduces the scope to grant large exposures. The previous provision, whereby a certain percentage of tier 2 capital could also be recognised when setting large exposure limits (eligible capital), no longer applies. Consequently, a large exposure will be defined as an exposure to a client or a group of connected clients that amounts to 10% or more of tier 1 capital (threshold definition for large exposures). The limit on large exposures[15] will remain at 25% in future, however, also in

15 The limit which an institution must not exceed with an exposure to a client or a group of connected clients.

relation to the institution's tier 1 capital. The limit on large exposures of G-SIIs to other G-SIIs will be lowered to 15%. In addition, institutions that have applied a credit risk mitigation technique when calculating capital requirements for credit risk must, in future, also apply it when calculating an exposure under the large exposure regime.

Further changes

Exception for promotional banks

All German legally independent promotional banks are exempted from the scope of the CRD V

One element of the banking package is that certain banks are specifically exempted from the scope of application of the CRD V. This includes all German legally independent promotional banks,[16] including the three development banks that are directly supervised by the ECB. To date, the only German promotional bank to be exempted from the scope of application of the CRD was Kreditanstalt für Wiederaufbau (KfW).

Shift of supervisory responsibility to BaFin and Bundesbank

When the CRD V enters into force (20 days after publication in the Official Journal of the European Union, i.e. on 27 June 2019), the exemption for promotional banks from the scope of application of the CRD V will become legally enforceable. As a consequence, these banks will then no longer be CRR credit institutions[17] and will no longer fall under the scope of application of the SSM Regulation either. Therefore, these German legally independent promotional banks named in the CRD V will in future be supervised by the Federal Financial Supervisory Authority (BaFin) and the Bundesbank on a purely national basis. This also applies to the three German promotional banks currently still under the direct supervision of the ECB. According to Section 1a(1) of the German Banking Act *(Kreditwesengesetz),* the exempted promotional banks[18] will nonetheless continue to be governed by the CRR rules.

However, once they are no longer classified as CRR institutions, they will no longer be subject to the scope of application of the SRM Regulation, the Recovery and Resolution Act *(Sanierungs- und Abwicklungsgesetz)* and the Restructuring Fund Act *(Restrukturierungsfondsgesetz).*

Duty to draw up recovery and resolution plans and to contribute to the SRF ends

The duty to draw up recovery and resolution plans as well as to contribute to the Single Resolution Fund (SRF) thus ends. In addition, these institutions leave the scope of application of the Deposit Guarantee Act *(Einlagensicherungsgesetz),* as the latter specifies that only CRR credit institutions are subject to the protection requirement. When the CRD V is implemented, legislators will have to decide whether adjustments to German law, in as far as it relates to promotional lending business, should be made for the German promotional banks that are now exempted.

Changes relating to credit risk

New rules for determining capital requirements for equity investments in funds

With the CRR II, various rules on determining the minimum capital requirements for credit risk will be changed. For instance, the 2013 recommendations of the Basel Committee on capital requirements for equity investments in funds will be transposed into EU law. Accordingly, institutions will, in future, have to determine capital requirements either by looking through to the exposures contained in the fund assets or, where this is not possible, based on the fund's investment mandate. Where an institution lacks the information to do either, a risk weight of 1,250% must be applied. An important novelty is that a fund's potential leverage must be recognised as increasing risk when determining capital requirements.

16 See also Article 2(5) number 5 CRD V.
17 See Article 1 CRR; according to Article 4(1) number 1 CRR, a CRR credit institution is defined as an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account.
18 With the exception of the KfW, to which Section 1a(1) of the Banking Act does not apply.

Expansion of SME supporting factor and new supporting factor for infrastructure finance exposures

In addition, the scope of application of the existing supporting factor for exposures to small and medium-sized enterprises (SMEs) will be expanded[19] and a new supporting factor will be introduced for exposures to entities that operate or finance physical structures or facilities, systems and networks that provide or support essential public services.[20] Overall, this results in a reduction in prudential capital requirements for the exposures in question. Both supporting factors are consequently intended to set incentives for expanded lending to these areas of the economy. From a banking supervisory perspective, neither the supporting factor for SMEs nor that for infrastructure finance exposures is unproblematic, as the general reduction in capital requirements that their use entails does not necessarily also signify that the exposures are less likely to default.

Further details relate, for instance, to the rules for determining capital requirements for minimum payment commitments of institutions for guarantee fund products, which are now explicitly specified in the CRR. This is necessary in order to limit to an appropriate level capital requirements for guarantee commitments on equity investments in funds used for old-age provision (Riester pension plans). Another novelty relates to the rules for the internal ratings-based approach: institutions will, in future, be able to disregard in their risk parameter estimates some of the losses incurred in a massive disposal of defaulted exposures.

Regulatory own funds

Eligibility of common equity tier 1 instruments in the presence of a profit and loss transfer agreement

Several changes to the rules defining regulatory own funds in the CRR were made. For instance, the eligibility criteria of common equity tier 1 (CET1) instruments were adjusted: going forward, the requirements for CET1 instruments will be considered to be met notwithstanding an obligation to transfer under a profit and loss transfer agreement, provided certain criteria are satisfied. For example, the parent undertaking in question must own 90% or more of the voting rights and capital of the subsidiary; in addition, the parent undertaking and the subsidiary must be located in the same Member State. Moreover, the profit and loss transfer agreement must have been concluded for taxation purposes and institutions must have discretion to strengthen their CET1 capital by allocating profits to reserves before making a payment to the parent undertaking.

Adjustment to the definition of available distributable items

The definition of "available distributable items" is adjusted such that all reserves formed under national legislation (in Germany, pursuant to the German Commercial Code *(Handelsgesetzbuch)* and relevant company law)[21] are de facto available to the institution for distribution to additional tier 1 (AT1) capital.[22] This was previously not the case.

Exemption from deductions for certain software assets

Finally, a new exemption is included in terms of the assets that need to be deducted from own funds. In future, prudently valued software assets, which in the past have had to be deducted from CET1 capital like all intangible assets, will be exempt from deduction. Precisely what software will be included and what concrete conditions will have to be met is yet to be defined by the European Banking Authority (EBA) in a technical standard.

Pillar 2

The CRD V clarifies a number of points relating to the supervisory review and evaluation process (SREP) as well as the supervisory measures

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19 The current SME supporting factor of 0.7619 can, in future, be applied up to a total amount owed by the borrower of €2.5 million (currently €1.5 million), with a reduced factor of 0.85 applying to any exposure over and above this amount.
20 For infrastructure finance exposures that meet the catalogue of criteria outlined in the new Article 501a CRR, institutions may apply a supporting factor of 0.75.
21 For instance, the statutory reserves formed pursuant to Section 150 of the Stock Corporation Act *(Aktiengesetz)*.
22 That means banks can use reserves that are not available for distribution pursuant to Section 268(8) of the Commercial Code or the statutory reserves to be formed pursuant to Section 150 of the Stock Corporation Act for distributions to AT1 capital.

Separation of supervisory measures and macroprudential capital buffers

based on it. There is now a clear separation of bank-specific supervisory measures and the macroprudential capital buffers. In future, it will no longer be permissible for the capital add-ons resulting from the SREP to include components to cover systemic risks; the latter are to be addressed using macroprudential measures only. In addition, guidelines are put in place for determining bank-specific capital add-ons (Pillar 2 requirement, or P2R) in order to further harmonise EU administrative practice.

Capital add-ons governed by minimum requirements under Pillar 1

Going forward, the minimum requirements for credit quality under Pillar 1 are to apply to capital add-ons. That means that at least 56.25% of the requirement must generally be met with CET1 capital and at least 75% with tier 1 capital. The supervisory authority must give reasons if it demands a more conservative capital composition.

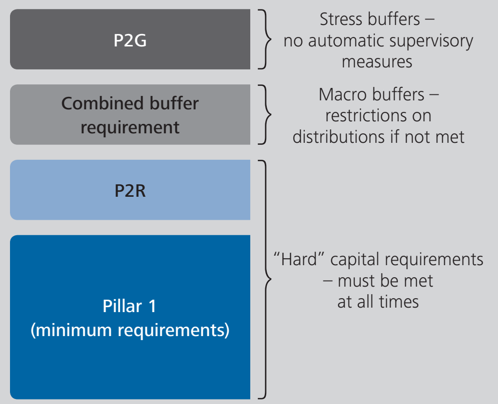
Bank-specific recommendation as a supervisory instrument

Supervisors will also be given the opportunity to issue bank-specific recommendations to hold additional capital (Pillar 2 guidance, or P2G). This higher level of own funds should allow institutions to cover losses incurred during stress periods without breaching prudential minimum capital requirements, consisting of Pillar 1 capital requirements and the capital add-ons (P2R). The results of supervisory stress tests are to be used to determine this recommendation.

Stacking order of various capital requirements

In addition, the stacking order of the various capital requirements is also described. According to this, the own funds that institutions are required to hold must be used as follows to cover any losses as a result of risk materialising. Initially, the additional own funds held based on a supervisory recommendation (P2G) are to be used, then capital buffers such as the capital conservation buffer and the macroprudential capital buffers. Further losses are to be covered by additional capital requirements (P2R) and, finally, by the minimum capital requirements under Pillar 1.

Pillar 2: stacking order of the various capital requirements



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Expanded requirements for interest rate risk

In terms of interest rate risk in the banking book, another step towards implementing the Basel Committee’s 2016 rules was made following the EBA Guidelines published in 2018. The EBA will receive mandates to develop technical standards involving, amongst other things, developing a standardised method to calculate interest rate risk based on the economic value of equity. This method can be used by institutions or mandated by supervisory authorities if the internal procedures are not satisfactory. However, the Bundesbank believes that the use of institutions’ established internal systems should remain the norm.

The current indicator for elevated interest rate risk (decline in economic value of more than 20% of own funds) is being tightened. Going forward, both a decline in the economic value of equity of more than 15% in one of six supervisory interest rate shock scenarios and a sharp drop in net interest income in one of two of these scenarios will be considered indicators of elevated interest rate risk.

New requirement to set up intermediate parent undertakings

New requirement for third-country banking groups to set up an IPU

A new requirement is introduced for third-country banking groups that have at least two subsidiaries established in the EU and whose assets within the EU exceed a threshold of €40 billion: they must set up an intermediate parent undertaking (IPU) in the EU for the EU subsidiaries. This requirement means that all activities of subsidiaries established in the EU must be supervised on a consolidated basis under this EU parent. The objective here is to make it easier to supervise third-country banking groups in the EU and to resolve their EU activities. In special cases, supervisors may allow structures with two intermediate EU parent undertakings.[23]

Project of an integrated reporting system

Adjustments to reporting system being considered

Reporting requirements for credit institutions derive from the respective prudential or statistical data collection purposes and are, to date, issued by the respective regulators independently of one another. This has meant that data for different reporting purposes were, in some cases, collected twice, as there were instances of parallel reporting methods and contents developing over time. Against this backdrop, the European System of Central Banks (ESCB) and the EBA are currently working on initiatives for an integrated European reporting system, in which existing reporting formats are to be replaced by granular reports that can be used to fulfil various reporting purposes.

EBA mandate in expanded context

In a first step, the EBA is to draw up a feasibility study for an integrated reporting system that encompasses both prudential and statistical reporting requirements as well as the reporting requirements of the resolution authorities.

Review of the macroprudential rules

Clearer separation between microprudential and macroprudential powers

Macroprudential instruments will, in future, be separated more clearly from microprudential powers. In addition, overlaps between the macroprudential buffers are to be eliminated. There are now no overlaps between the areas in which the systemic risk buffer can be used and those where the capital buffers for systemically important institutions (O-SII/G-SII buffers)[24] are deployed. These capital buffers will therefore have to be used additively, going forward. As of a cumulative buffer rate of 5%, approval by the European Commission is necessary. Moreover, the scope of application of the systemic risk buffer was expanded and rendered more flexible, meaning that it can address all systemic risks that are not already covered by the capital buffers for systemically important institutions, the countercyclical capital buffer or CRR measures.[25] It is now explicitly intended that it should, in future, also be used for sectoral exposures and subsets of these exposure categories, thus allowing sectoral risks to be addressed in a more targeted manner. The option of using several systemic risk buffers for different exposures at the same time increases the tool's flexibility.

Changes to systemic risk buffer

Cap on O-SII buffer lifted

The cap on the O-SII buffer rate of 2% has been lifted. As of a buffer rate of 3%, however, approval by the European Commission is necessary. National authorities have more leeway when determining the O-SII buffers than with the G-SII buffer. This tool is therefore currently used in very different ways within Europe. The EBA will consequently receive a mandate to as-

23 For instance, if ringfencing rules in the third country include a mandatory requirement for separation of activities and are therefore incompatible with the consolidation of all EU business activities under a single intermediate EU parent.
24 Capital buffers for other systemically important institutions (O-SIIs) and for global systemically important institutions (G-SIIs).
25 However, national measures to tighten CRR requirements (Article 458 CRR) remain secondary to the systemic risk buffer.

Investment firms

Alongside the banking package, a new European-level supervisory regime for investment firms (IFs) within the meaning of MiFID II[1] is also being drawn up. This new package seeks to create a simpler and more suitable set of rules for these institutions (securities trading banks and financial services institutions within the meaning of the German Banking Act),[2] and its main objective is to take the specific business models of this very heterogeneous group of institutions into account. Once the new supervisory regime has been introduced, these IFs are to be divided into three groups, with specific supervisory requirements applying to each group. For instance, IFs whose business activities give them a risk profile similar to that of credit institutions will, in future, be categorised as CRR[3] credit institutions and supervised on the basis of CRR II if their business reaches a certain volume. This category will include IFs that engage in own-account trading and in underwriting. As from a business volume threshold of €30 billion, IFs are to be supervised by the ECB under the SSM.[4] In this way, adequate consideration is to be given to the systemic importance of these institutions, which quite commonly are parts of large international financial corporations (class 1). All the other IFs will be supervised outside the sphere of application of the SSM Regulation by the respective national supervisory bodies, based on a specific, newly developed supervisory regime where the calculation of an institution’s capital requirements is geared to its business model (class 2). Additional exemptions are envisaged in the case of IFs with only a limited business volume or business model (class 3). This new supervisory regime for class 2 and class 3 IFs consists of several elements, the most important one being the calculation of proportionate capital requirements on the basis of each IF’s business model and business volume. For example, capital requirements will be calculated according to the volume of customer assets under management, the volume of processed customer orders and the volume of trading in financial instruments. In addition, the new supervisory regime also stipulates minimum requirements with regard to the liquidity of institutions and rules covering the areas of governance and compensation for staff members. The first-time application of the new regime is expected in 2021.[5]

1 Markets in Financial Instruments Directive.
2 Gesetz über das Kreditwesen.
3 Capital Requirements Regulation.
4 European Single Supervisory Mechanism.
5 It is expected that the legislative package (directive and regulation) will be published in the Official Journal of the European Union in autumn 2019.

sess, by the end of 2020, what form a potential harmonisation might take.

In terms of the method used to identify G-SIIs, the EU will in future deviate from the international standard. It will introduce an alternative way to calculate the G-SII buffer, in which transactions within the euro area are treated as domestic transactions and thus not considered. This deviation from the international standard is at odds with its objective of securing a global level playing field and is therefore to be viewed critically.

Proportionality

Ever since the European Commission unveiled its draft CRR II in November 2016, the Bundesbank has been comprehensively looking into ways of minimising the regulatory burdens on small credit institutions without impairing their solvency and soundness. A look at the structure of Germany's banking sector serves to drive home the relevance of this question. There are nearly 1,500 smaller institutions in Germany, making up around 40% of all such institutions in the euro area.

Article 4 CRR amended to include new definition of a "small and non-complex institution"

It is therefore a welcome development that the principle of proportionality has been taken into account at the EU level in the banking package. Article 4 CRR has been amended to include the category of "small and non-complex institutions", to which the following criteria apply:

– the institution is not large;[26]

– the value of its total assets is, on average, equal to or less than €5 billion over a four-year period;[27]

– the institution is not subject to any obligations, or is subject to simplified obligations, in relation to recovery and resolution planning;

– the institution has only a small trading book and low derivatives business;

– more than 75% of both the institution's consolidated total assets and liabilities relate to activities conducted within the EEA;

– the institution does not use internal models.[28]

Moreover, supervisors and the institution both have an opt-out clause, i.e. the option to decide that the institution shall not be classified as a "small, non-complex institution".

Taking greater account of proportionality in prudential reporting

The principle of proportionality[29] is deepened in supervisory reporting, in particular. In this context, the EBA has been tasked with conducting a cost-benefit analysis of the current European supervisory reporting system, particularly as it relates to small and non-complex institutions. The EBA has a deadline of 12 months after CRR II enters into force to present a report and recommendations on how reporting requirements can be simplified, at least for small, non-complex institutions. The desired objective is to reduce reporting costs by, on average, at least 10%, but ideally by 20%. Within these parameters, and ensuring that supervision remains effective, it is being analysed, in particular, whether certain reporting requirements can be waived below certain thresholds and whether the frequency of reports can be reduced for small and non-complex institutions. Competent authorities will also be empowered to waive the requirement for supervisory reports provided the rele-

26 Article 4 CRR has also been amended to include a definition of a "large institution". An institution is deemed "large" if it is systemically important, if it is one of the three largest institutions in its Member State, or if the total value of its assets is equal to or greater than €30 billion.
27 A Member State is permitted to reduce this threshold.
28 This does not apply to subsidiaries using internal models developed at the group level and if the group is subject to the disclosure requirements for large institutions.
29 The scope and frequency of reporting hinge crucially on the complexity of the approaches used to measure own funds requirements and on certain thresholds being exceeded. An inherent proportionality therefore already exists.

vant data points are already available elsewhere. In addition, the exchange of data between the various authorities should be enabled to the greatest possible extent.

Proportionality especially pronounced as regards disclosure

Disclosure is an additional focal point of proportionality. Since the purpose of disclosure requirements is to strengthen market discipline, they are relevant to large, capital market-oriented institutions, in particular.

Requirements graduated according to size and capital market orientation

The disclosure requirements will therefore in future be graduated according to banks' size and capital market orientation;[30] the relief will cover both the frequency and scope of disclosures. Whereas large, capital market-oriented institutions will have to meet all disclosure requirements, all other banks will have reduced requirements. For small, non-complex and non-capital market-oriented institutions, the requirements will be reduced to the annual disclosure of a very few regulatory "key metrics", such as information on the applicable accounting standard, capital ratios, risk-weighted assets (RWAs) and capital buffers.

New legislation in the area of bank resolution

Implementing the FSB's TLAC standard and aligning the requirements of TLAC and MREL

One key element of the revision of EU bank resolution legislation is the implementation of globally agreed rules and the need to align existing rules as a consequence. In 2015, the FSB published its TLAC standard, which is now being transposed into European law. The TLAC standard is applicable only to G-SIIs and requires them to hold a sufficient amount of liabilities that can be written down or converted into liable capital in the event of a resolution. The purpose is to enable a systemically important bank to be resolved without resorting to public funds (bail-out). As the TLAC standard was being published, European legislators had, as part of the BRRD, already introduced a similar requirement – the minimum requirement for own funds and eligible liabilities (MREL).[31] The purpose of this requirement is likewise to force banks to maintain a minimum volume of bail-inable liabilities. MREL, however, was designed for all European banks irrespective of their size or systemic importance. The requirement also has to be set specifically for each institution by the resolution authority, without a default statutory minimum requirement. European resolution legislation has now been amended to align these two requirements.

Implementation of a minimum MREL requirement and introduction of a new category: "top-tier" banks

Implementation of TLAC for G-SIIs

Consistent with the TLAC standard, a minimum MREL requirement for G-SIIs will be introduced and calibrated at the same level as intended in the TLAC standard. The calibration parameters are thus based on two variables: a risk-based ratio based on risk-weighted assets (RWAs), and the non-risk-based ratio based on the leverage ratio exposure (LRE), which represents a hard floor. It will be introduced once the banking package enters into force: the requirements will be gradually increased in two stages (see the table on p. 44).

New category: "top-tier" banks

Moreover, European legislators have also decided to enlarge the group of banks for which a statutory minimum requirement is applicable beyond G-SIIs. The BRRD II (and SRM Regulation II) accordingly created a new category known as "top-tier" banks. These comprise non-G-SIIs with total assets in excess of €100 billion. Institutions not meeting this criterion can still, under certain conditions, be classified by the resolution authority as a top-tier bank

30 Capital market orientation, i.e. whether or not the institution has issued debt in the regulated market of a Member State, is an additional criterion for disclosure.
31 See Deutsche Bundesbank (2016).

Overview of MREL

	G-SIIs	"Top-tier" banks (> €100 billion total assets and "fishing" option	Other banks subject to resolution[1]
From entry into force of banking package	16% of RWAs 6% of LRE Higher institution-specific requirement as appropriate[2]	Institution-specific requirement[2]	Institution-specific requirement[2]
From 2022	18% of RWAs 6.75% of LRE Higher institution-specific requirement as appropriate[2]	13.5% of RWAs 5% of LRE Higher institution-specific requirement as appropriate[2]	Institution-specific requirement[2]
From 2024	See above, additionally 8% of TLOF[3]	See above, additionally 8% of TLOF[3] (but not more than 27% of RWAs)	Institution-specific requirement[2] additionally 8% of TLOF[3] at discretion of resolution authority
Subordination requirement[4]	In principle, yes[5]		Case-by-case decision (assessment based on "no creditor worse off" principle)

1 For banks subject to insolvency proceedings, the resolution authority will set MREL at the level of the loss absorption amount (= minimum capital requirements). **2** Starting formula for calculating the institution-specific requirement: 2 * P1 + 2 * P2 + CBR + market confidence charge or 2 * LRE. **3** Total liabilities and own funds. **4** The subordination requirement is capped by law; the resolution authority can only demand fulfilment of the institution-specific MREL requirement using subordinated instruments up to a maximum of 8% of TLOF or a statutory formula ("prudential formula": 2P1 + 2P2R + CBR). **5** Exceptions are possible under Article 72b (3) to (5) CRR.
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(fishing option)[32] if they are considered by the resolution authority[33] as being likely to pose a systemic risk in the event of failure.

8% of TLOF as additional backstop

A European specificity is the additional introduction of a minimum requirement of 8% of total liabilities and own funds (TLOF) applicable to G-SIIs and top-tier banks as from 2024. This is not contained in the TLAC requirements. The rationale to this is that, according to the rules of the European resolution framework, use of resources from the Single Resolution Fund (SRF) is generally permissible only if shareholders and creditors have contributed an amount equivalent to at least 8% of the institution's TLOF. This additional requirement ensures that large, systemically important banks (are able to) fulfil the requirements for accessing the SRF, thereby improving the ability of banks to be resolved and consequently the functional viability and thus the credibility of the resolution regime. The highest of the three requirements described above (RWA, LRE and TLOF) ultimately exerts binding force on the institution.

Institution-specific MREL for non-G-SIIs and non-top-tier banks

As a general rule, the resolution authority determines an institution-specific MREL for all European banks. This means that the resolution authority also has the option of imposing on G-SIIs and top-tier banks institution-specific requirements that exceed the existing statutory minimum requirements. For all non-G-SIIs and non-top-tier banks, there will be (as before) no statutory minimum MREL requirement.

32 As regards the top-tier banks for which the fishing option has been exercised, the provisions in BRRD II and the SRM Regulation II differ in that, under BRRD II, the resolution authority, after consultation with the supervisory authority, can determine whether the minimum requirements for top-tier banks can be applied to an institution with total assets of less than €100 billion, whereas under the SRM Regulation II it is the Single Resolution Board (SRB), upon a request from the national resolution authority, which classifies a bank as a top-tier bank.
33 After consulting with the supervisory authority.

Creditor protection

Rules protecting retail investors

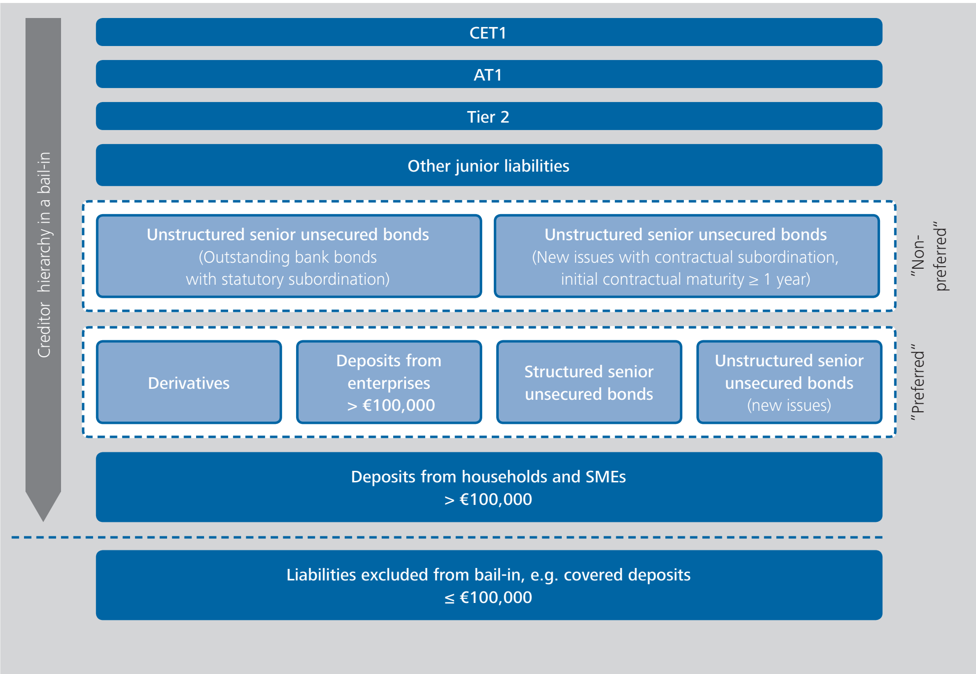
Over the past years, crisis situations in the European Union have shown that including retail investors in loss absorption can be an impediment to the application of the bail-in tool. Thus, the BRRD II[1] provides for certain protection requirements with respect to retail investors who wish to invest in MREL[2]-eligible instruments. For example, Member States can, inter alia, decide to set a minimum denomination amount of €50,000 for the sale of subordinated liabilities.

New creditor hierarchy in bail-in procedure

The partial amendments to the creditor hierarchy were also part of the banking package, but had already been published in the Official Journal of the European Union at the end of 2017 in a directive amending the BRRD.[3] As a number of Member States had adopted different national approaches to creating the new class of non-preferred senior debt, which is subordinated to other debt (ordinary senior debt), EU legislators deemed it necessary to amend the European legislation.[4] They followed the French approach in establishing the concept of contractual subordination for the new class of debt. According to this, non-preferred senior debt must meet the following conditions:

1 Bank Recovery and Resolution Directive.
2 Minimum requirement for own funds and eligible liabilities.
3 See Official Journal of the European Union L 345/96 (2017).
4 See Deutsche Bundesbank (2016).

New creditor hierarchy in a bail-in procedure



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– The initial contractual maturity of the debt instruments is of at least one year;

– The debt instruments do not contain embedded derivatives and are not derivatives themselves;

– The contractual documentation explicitly refers to the lower ranking.

With effect from 21 July 2018, Section 46f (5) to (7) of the German Banking Act[5] was amended accordingly to implement this amending directive. In line with the amending directive, grandfathering arrangements are in place for outstanding German bank bonds with statutory subordination under the previous rules[6] (see the chart on p. 45).

Excursus: Common backstop

A common backstop for the Single Resolution Fund (SRF) was already decided upon in December 2013 by the ministers of the Eurogroup and ECOFIN. The common backstop aims to increase the effectiveness of the SRF, amongst other things by facilitating borrowing for the SRF and thus ensuring its viability.

In December 2018, the Eurogroup agreed that the European Stability Mechanism (ESM) should provide the common backstop for the SRF. This agreement entails conditions for a possible early introduction of the common backstop, with risk reduction in the banking sector (including with regard to NPLs) playing a key role here. Early introduction of the backstop can be considered provided that sufficient progress has been made in risk reduction, which is to be assessed in 2020.[7]

The ESM provides the common backstop in the form of a revolving credit line to the SRF. It is also intended to replace the ESM direct recapitalisation instrument. The size of the common backstop is to be capped at the size of the SRF (at least 1% of covered deposits; currently estimated at roughly €65 billion). A political agreement was also reached clarifying the principle of fiscal neutrality over the medium term. The repayment of public funds is to be made via extraordinary ex post contributions from the banking sector within three years, with a potential extension of up to two years.

In principle, the creation of a common backstop for the SRF is to be welcomed. However, any early introduction should be contingent on a sufficient level of risk reduction being achieved. This should be carefully assessed in order to prevent the mutualisation of legacy risks.

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5 *Gesetz über das Kreditwesen.*
6 Section 46f (5) to (7) of the Banking Act in the version valid until 20 July 2018 continues to apply to debt instruments issued prior to 21 July 2018.
7 The assessment is to examine (at a minimum) the build-up of MREL in relation to the 2024 targets and the trend in the reduction of non-performing loans (NPLs) (aim: 5% gross NPLs or 2.5% net NPLs and adequate provisioning) for all SRB banks.

With regard to institutions subject to regular insolvency proceedings (owing to the absence of public interest in resolution), the resolution authority can set MREL at the level of the loss absorption amount, i.e. the prudential minimum capital requirement.[34]

Amendments to the existing rules for setting MREL

The revision of the BRRD will also entail more specific rules for setting MREL. MREL consists of a loss absorption amount and a recapitalisation amount, both of which are calibrated on the basis of RWAs and LRE. Thus, both a risk-based ratio and a non-risk-based ratio variable are taken into account for the calibration of MREL. Such calibration rules were previously located in the delegated regulation on MREL.[35] They will now be amended and prospectively transferred to the BRRD.

*RWA calibration: 2 * P1 + 2 * P2R + CCBR + market confidence charge*

For the calibration of MREL based on RWAs, both the loss absorption amount and the recapitalisation amount components are based on own funds requirements (i.e. Pillar 1 and Pillar 2 capital requirements). Above and beyond this amount, the resolution authority can impose an additional buffer (market confidence buffer)[36] to absorb potential additional losses or restore market confidence.

*LRE calibration: 2 * LRE*

For calibrating MREL on the basis of the LRE, the loss absorption amount and the recapitalisation amount will each be subject to a requirement of 3% of LRE, or a total of 6% of LRE. The LRE-based MREL does not include a market confidence buffer.

Benchmark: 8% bail-in for access to SRF

When setting an institution-specific MREL, the resolution authority can take into account not only the two above-mentioned metrics but also the 8% TLOF requirement,[37] thereby ensuring a level of MREL that might allow access to the SRF which could potentially be necessary in a resolution case.

Subordination[38]

Cap on subordination to meet institution-specific MREL

One significant element of the TLAC requirements is what is known as the subordination criterion. Alongside an institution's own funds, only those liabilities which are junior to certain other liabilities (e.g. deposits, derivatives) are eligible. Exceptions are permitted only under certain conditions.[39] Given that the TLAC standard applies only to G-SIIs, the negotiations surrounding the banking package raised the question as to whether – and if so, to what extent – a binding subordination criterion should be introduced for all banks.

On balance, a distinction will be made in future between the above categories. G-SIIs and top-tier banks will be generally required to use subordinated instruments to meet the future MREL. For all other banks the resolution authority will decide the amount up to which the institution-specific MREL will have to be met using subordinated capital (i.e. own funds and subordinated, MREL-eligible liabilities).[40] That

34 This also applies to institutions covered by an institutional protection scheme.
35 Commission Delegated Regulation (EU) 2016/1450 of 23 May 2016.
36 The market confidence buffer is defined as the amount of the combined buffer requirement less the countercyclical capital buffer. In the EU, the combined buffer requirement can consist of the following buffers: capital conservation buffer, countercyclical capital buffer, buffer for global or other systemically important institutions and systemic risk buffer.
37 Use of the SRF is fundamentally conditional on the initial bail-in of 8% of TLOF for loss absorption and recapitalisation purposes.
38 See Deutsche Bundesbank (2016).
39 Thus, pursuant to Article 72b(3) CRR II read in conjunction with Article 494(2) CRR II, G-SIIs would be permitted to include liabilities which meet all criteria other than that of subordination up to 2.5% (or, as from 2022, 3.5% of RWAs) as MREL instruments. In addition, the "de minimis" exception provided for in the TLAC standard has been implemented in Article 72b(4) CRR II; here, the subordination criterion is not mandatory provided liabilities excluded as "eligible liabilities" within the meaning of Article 72a(2) CRR II which are pari passu or junior to "eligible liabilities" make up less than 5% of the institution's total own funds and eligible liabilities (TLOF). This means that, if the amount of excluded eligible liabilities that rank pari passu with eligible instruments is limited, an exemption to the subordination requirement can be made.
40 This discretionary scope will depend to a material degree on the risk of a breach of the "no creditor worse off" principle (i.e. a creditor must not be worse off under a resolution procedure than in insolvency proceedings).

will also be the case for the institution-specific requirements for G-SIIs and top-tier banks in excess of the mandatory minimum requirements. However, the resolution authorities' discretionary scope will be capped.

Outlook

Preliminary work on CRR III and CRD VI already under way

The entry into force of the EU banking package represents by no means the end of the process of revising European banking regulation. In fact, the European Commission has already launched work on CRR III and CRD VI. The elements of the Basel III reform package[41] adopted in December 2017 by the Basel Committee on Banking Supervision are to be transposed into European legislation. These include the new approaches to calculating RWAs and thus capital requirements for credit risk (credit risk standardised approach and internal ratings-based approaches), the abolition of the use of the models-based approach to calculate operational risk and the remaining new standardised approach, the floor for capital requirements (output floor) of 72.5% for institutions which use internal models to calculate their risk, and the revised procedure for calculating credit valuation adjustments (CVAs) in derivatives business.

EBA impact analysis

In order to prepare a relevant legislative proposal, in May 2018 the European Commission tasked the EBA with assessing the impact of the Basel reform package on the European banking industry and real economy and exploring potential regulatory options for transposing Basel III into EU law. On the basis of the EBA report, the European Commission will prepare a legislative proposal to amend the CRR. This proposal will probably be submitted in the first half of 2020.

Completing the banking union

Mitigating existing risks on the balance sheets of European banks and completing the banking union remain elements of the effort in Europe to deal with the effects of the financial crisis. However, the banking package is just one of the components of appropriate risk mitigation being called for. Harmonisation of insolvency legislation and regulation of sovereign risk exposures, which had been left out of the finalisation of Basel III, are still unresolved. In addition, it is important to deliver genuine progress in reducing NPL ratios and building up bail-in buffers.

41 See https://www.bis.org/bcbs/publ/d424.htm

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