EU BANKING REFORM PACKAGE

Ready for implementation

Mariken van Loopik and Maurits ter Haar | April 2019
On 16 April 2019, the European Parliament adopted a set of legislative measures referred to as the “banking reform” or “CRR II” package. The texts have been agreed with the Council, which will also formally adopt the package soon. This will conclude a negotiation process that started in November 2016, when the European Commission first published the legislative proposals.

The banking reform package is aimed at completing the regulatory reforms that were initiated after the financial crisis and consists of an extensive set of amendments to existing EU banking regulation. The banking reform package stems from international standards as finalised by the Basel Committee and the Financial Stability Board (FSB), and from a comprehensive review of existing EU banking regulation by the European Banking Authority (EBA) and the European Commission. In this publication, we highlight the most important changes to the capital requirements framework and the resolution framework applicable to banks in the EU.

We expect the banking reform package to enter into force in the summer of 2019. Most provisions will apply 18 months to two years later, but a number of provisions will apply sooner. The capital requirements will have a significant impact on banks, including on their risk modelling, funding structure and reporting systems. In some instances, the requirements may also entail the raising of additional own funds or the reduction of exposures. The package, however, also introduces a larger degree of proportionality to the rules for smaller banks. The resolution provisions will also have a significant impact on banks, especially on their funding structure. In some cases, they may also require the raising of additional own funds or eligible liabilities. However, banks have already had several years to prepare for most of these changes.

A number of international standards for the finalisation of the Basel III reforms (informally known as Basel IV) were only finalised by the Basel Committee in December 2017 and January 2019. This is why these are largely excluded from the package. Work to implement these additional Basel III reforms in the EU regulatory framework is ongoing.
AMENDMENTS TO THE CAPITAL REQUIREMENTS FRAMEWORK

NEW PILLAR 1 CAPITAL REQUIREMENTS AND LIQUIDITY STANDARDS
- Binding minimum leverage ratio of 3%
- Leverage ratio buffer requirement for G-SIBs set at 50% of RWA G-SIB buffer
- Binding minimum net stable funding ratio of 100%

CHANGES TO PILLAR 2 CAPITAL AND THE MAXIMUM DISTRIBUTABLE AMOUNT
- Clarification and tightening of the criteria for applying the Pillar 2 buffer
- Introduction of a Pillar 2 leverage ratio buffer
- Introduction of Pillar 2 capital guidance and Pillar 2 leverage ratio guidance
- Clarification that the Pillar 2 capital buffer must be included in calculating the MDA
- Flexibility retained in order of distribution AT1 instruments

REVISED RISK-WEIGHTING AND LARGE EXPOSURES STANDARDS
- Implementation of the Basel Committee’s revised market risk framework (the fundamental review of the trading book (FRTB)) in a staggered approach starting with a reporting requirement
- Implementation of the Basel Committee’s revised standards for interest rate risk in the banking book (IRRBB)
- Implementation of the Basel Committee’s standardised approach for counterparty credit risk (SA-CCR)
- Implementation of the Basel Committee’s standard on the treatment of exposures to central counterparties (CCPs)
- Implementation of the Basel Committee’s standard on the treatment of equity investments in funds
- Implementation of the Basel Committee’s revised large exposures regime

MORE PROPORTIONALITY
- Changes to the frequency and substance of reporting and disclosure for small and non-complex banks
- Changes to the remuneration rules, including several exemptions for small banks and staff with low variable remuneration
- Exemptions from the scope of CRD IV for Dutch credit unions
- Investment firms: the new regime to be applicable only to certain large investment firms

FINANCIAL HOLDING COMPANIES
- Requirement to establish an intermediate holding in the EU for non-EU banking groups with two or more banks in the EU that are non-EU G-SIBs or have total assets in the EU of EUR 40 billion or more
- Approval requirement for and direct supervision of financial holding companies, unless they qualify for an exemption

OTHER RELEVANT CHANGES TO CAPITAL REQUIREMENTS FRAMEWORK
- Extension of the transitional period for the exemption to deduct equity holding in insurance undertakings from a bank’s CET1
- Five year phase-in for implementation of IFRS 9
- Expansion of SME supporting factor and introduction of preferential treatment of infrastructure exposures
- Increased attention on environmental, social and governance (ESG) risks, including a disclosure requirement on ESG-related risks for large banks with listed securities
AMENDMENTS TO THE RESOLUTION FRAMEWORK

REVISIONS TO THE MREL FRAMEWORK
- Distinction between G-SIBs, top tier banks and other banks
- Introduction of Pillar 1 MREL for G-SIBs and top tier banks
- Changes to the method of calculating Pillar 2 MREL
- Changes to the eligibility requirements
- MREL subordination requirement
- Deduction of MREL holdings
- More detailed requirements for internal MREL
- Clarification of the stacking order and consequences of a breach of MREL
- Protection of retail investors in MREL instruments
- Introduction of reporting and disclosure requirements

OTHER CHANGES TO THE BANK RESOLUTION FRAMEWORK
- Introduction of a new optional “senior non-preferred” category of debt for MREL purposes
- Relaxing of the contractual recognition of bail-in requirement
- Introduction of formal legal basis for contractual recognition of resolution stay requirement
- Introduction of a pre-resolution moratorium tool for payment and delivery obligations
CAPITAL REQUIREMENTS
WHAT CAN OUR CLIENTS EXPECT?
CAPITAL REQUIREMENTS FRAMEWORK

NEW PILLAR 1 CAPITAL AND LIQUIDITY STANDARDS

PILLAR 1 LEVERAGE RATIO
The banking reform package introduces a binding (Pillar 1) leverage ratio (LR) of 3% of Tier 1 capital, which banks must meet in parallel with their risk-weighted assets (RWA). The design and calibration of the leverage ratio follow the standards published by the Basel Committee in January 2016. However, since a 3% leverage ratio would constrain certain business models and lines of business, several amendments have been made to the leverage ratio exposure measure set by the Basel Committee. Items for which the leverage ratio exposure measure may be reduced include: public lending by public development banks, passing-through promotional loans to other banks, officially guaranteed export credits, and initial margin received from clients for derivatives cleared through central counterparties. Due to their distinct business model, central counterparties (CCPs) will be exempted from the leverage ratio.

The Basel Committee published further calibrations to the leverage ratio framework in December 2017. The Basel Committee’s new standards include a leverage ratio buffer for global systematically important banks (G-SIBs) to be met with Tier 1 capital and set at 50% of the applicable risk-weighted G-SIB buffer. The package implements this leverage ratio buffer requirement. The European Banking Authority (EBA) will further analyse whether it would be appropriate to apply a leverage ratio buffer requirement to other systemically important banks (O-SIBs) as well, an idea strongly supported by the Dutch government.

In addition to the regular reporting requirements, the package requires large banks to report specific components of the leverage ratio to their competent authorities, based on averages over the reporting period and the data used to calculate those averages. This is meant to prevent observed “window dressing” behaviour, where banks temporarily reduce transaction volumes around reference dates resulting in elevated leverage ratios.

Current capital requirements

- Combined buffer requirement: 2.5% or more of RWA
- Pillar 2 buffer: No quantitative maximum
- Pillar 1 capital requirement: 8% of RWA

New capital requirements

- Pillar 2 guidance: No quantitative maximum
- Combined buffer requirement: 2.5% or more of RWA
- Pillar 2 buffer: No quantitative maximum but stricter criteria
- Pillar 1 capital requirement: 8% of RWA
- G-SIB LR buffer: 50% of RWA G-SIB buffer
- Pillar 2 LR buffer: No quantitative maximum
- Pillar 1 LR requirement: 3% of total exposure measure
PILLAR 1 NET STABLE FUNDING RATIO

The banking reform package also introduces a binding net stable funding ratio (NSFR) to combat inappropriate funding structures observed during the crisis. The NSFR is aimed at harmonising how many stable, long-term sources of funding a bank requires to weather periods of market and funding stress over a one-year period. The NSFR is expressed as a percentage, and set at a minimum level of 100%, which indicates that a bank must hold sufficient stable funding to fully cover its funding needs during a one-year period under both normal and stressed conditions.

The package closely follows the final NSFR standard as published by the Basel Committee in October 2014. However, in line with the EBA’s report, certain adjustments have been made to prevent the standard impeding the proper functioning of EU capital markets and the financing of the European real economy. These adjustments entail the application of an adjusted haircut for elements such as trade finance activities, centralised regulated savings, residential guaranteed loans, credit unions, high quality liquid assets (HQLA), pass-through models in general, and covered bonds issuance in particular.

Small and non-complex banks (see below) may use a simplified version of the NSFR after obtaining the competent authority’s prior approval. However, competent authorities can require small and non-complex banks to apply the fully-fledged NSFR instead of the simplified version if they believe that the simplified methodology is not adequate to capture the funding risks of that bank.

CHANGES TO PILLAR 2 CAPITAL AND THE MAXIMUM DISTRIBUTABLE AMOUNT

CHANGES TO THE CRITERIA FOR THE PILLAR 2 BUFFER

In addition to the regular CRD IV and CRR capital and buffer requirements that a bank must meet, a bank-specific additional capital requirement, the Pillar 2 buffer, can be imposed to cover risks not sufficiently covered by the Pillar 1 capital requirements. The Pillar 2 buffer is imposed and annually reviewed by the supervisory authority on the basis of the supervisory review and evaluation process (SREP). The banking reform package introduces stricter criteria for the imposition of a Pillar 2 buffer. In particular, the Commission proposed that its use should be strictly limited to addressing micro-prudential considerations and not to address concerns of systemic risk, which should be left to the various macro-prudential tools. In the final package, it is clarified that the Pillar 2 must address risks incurred by individual banks due to their activities, but may include those reflecting the impact of certain economic and market developments on the risk profile of an individual bank.

New compared to the Commission’s proposal is that a Pillar 2 leverage ratio buffer can be imposed to cover the risk of excessive leverage not sufficiently covered by the Pillar 1 leverage ratio.

PILLAR 2 CAPITAL GUIDANCE

The banking reform package also introduces a distinction between the Pillar 2 buffer and the Pillar 2 capital guidance, formalising what is already current practice for many supervisors, including the ECB, and included in the 2018 EBA SREP guidelines. While the Pillar 2 buffer continues to be treated as a mandatory part of capital requirements, the Pillar 2 guidance acts as a softer “expectation”, which means that it is not legally binding in itself. A breach of Pillar 2 guidance will, therefore, in itself not trigger the Maximum Distributable Amount (MDA) immediately. The supervisor can, however, convert the guidance into an actual Pillar 2 buffer if a bank repeatedly fails to comply with it.

While the Commission’s proposal had only included Pillar 2 guidance for the risk-weighted capital requirement, the final package also introduces the possibility to impose Pillar 2 guidance for the leverage ratio. Such guidance can be imposed to cover the risk of excessive leverage not sufficiently covered by the Pillar 1 leverage ratio and Pillar 2 leverage ratio buffer.

MAXIMUM DISTRIBUTABLE AMOUNT

If the capital requirements are not complied with, the MDA is triggered and dividend distributions, variable remuneration, discretionary pension benefits or coupon payments on AT1 instruments are restricted. In line with an earlier opinion from the EBA, the package clarifies that, in calculating the MDA, banks must take their Pillar 2 buffer into account.

The banking reform package also introduces MDA restrictions in the case of non-compliance with the leverage ratio (L-MDA).
ADDITIONAL TIER 1 INSTRUMENTS AND ORDER OF DISTRIBUTIONS
In response to a period of turmoil on the market for Additional Tier 1 (AT1) instruments, the hybrid instruments also known as contingent convertible bonds (CoCos), the Commission proposed to make AT1 instruments more attractive for investors. The Commission’s proposal was to give distributions on AT1 instruments preferential status over distributions in connection with CET1 instruments or obligations to pay variable remuneration, if such actions are restricted under the MDA-regime as a result of a bank’s failure to meet its capital buffers. However, this change was removed by the Council, which wanted banks to retain flexibility in their distribution policy.

INCORPORATION OF REVISED RISK-WEIGHTING AND LARGE EXPOSURES STANDARDS

REVISED RISK-WEIGHTINGS FOLLOWING ADOPTION OF BASEL STANDARDS
The banking reform package implements a number of revised standards on risk-weighting as finalised by the Basel Committee since the adoption of Capital Requirements Directive IV (CRD IV) and Capital Requirements Regulation (CRR) in 2013. The revised standards include:

- the revised market risk framework, also known as the “fundamental review of the trading book” (FRTB), published by the Basel Committee in January 2016. This standard contains revised rules on using internal models to calculate own funds for market risk, as well as a new standardised approach. The 2016 standard was included in the Commission’s proposals. However, following the resolution of a number of irregularities and some recalibration work, the Basel Committee published a further revised version of the rules in January 2019. Therefore, the package will now merely
include a reporting requirement for the calculation derived from the revised standardised approach. The Commission will next submit a legislative proposal on how the FRTB framework should be implemented in EU law to set own funds requirements for market risk;

- the revised standards for interest rate risk in the banking book (IRRBB), finalised by the Basel Committee in April 2016. These standards introduce a common standardised approach that banks can, or may be required to, use to capture these risks;

- the standardised approach for counterparty credit risk (SA-CCR), finalised by the Basel Committee in March 2014 as a new standardised method of computing the exposure value of derivatives exposures, replacing the two existing standardised methods;

- the final standard on the treatment of exposures to central counterparties (CCPs), finalised by the Basel Committee in April 2014; and


REVISED LARGE EXPOSURES FRAMEWORK
The banking reform package revises the large exposures framework, following the Basel Committee’s final standard for the supervisory framework for measuring and controlling large exposures, published in April 2014, and in line with the EBA’s report on the review of the large exposures regime of October 2016. Changes include:

- improvement of the quality of capital that must be taken into account to calculate the large exposures limit (Tier 1 capital instead of eligible capital);

- introduction of a lower limit for G-SIBs’ exposures to other G-SIBs (15% instead of 25%);

- an obligation to use the standardised approach for counterparty credit risk (SA-CCR) for determining exposures to OTC derivative transactions, even for banks that have been authorised to use internal models;

- a mandate for the EBA to carry out further work on reviewing existing exemptions from the large exposure limits.

MORE PROPORTIONATE RULES FOR SMALLER AND NON-COMPLEX BANKS

DISCLOSURES AND REPORTING
The banking reform package includes a more proportionate disclosure regime that takes into account the relative size and complexity of banks. Banks are classified into three categories: large banks, small and non-complex banks and other banks.

Large banks are:

- G-SIBs;
- O-SIBs;
- the three largest banks in each member state by total value of assets; and
- banks with assets equal to or exceeding EUR 30 billion (on a consolidated basis).

Small and non-complex banks are banks that are not large banks and also meet certain conditions. These include a threshold for the total value of the bank’s assets on an individual basis or, where applicable, on a consolidated basis. They also include the condition that the bank is subject to no or simplified obligations in relation to recovery and resolution planning in accordance with Bank Recovery and Resolution Directive (BRRD), and that the bank has a small trading book business.

Other banks are banks that do not qualify as large or small and non-complex. The package further distinguishes between listed and non-listed banks.

A sliding scale of disclosure requirements apply to each category, differentiating in disclosure substance and frequency. In terms of reporting, the EBA is mandated to further assess the financial impact of reporting requirements on banks, and to issue recommendations on how reporting for small and non-complex banks can be simplified by amending existing reporting templates.
REMUNERATION
The banking reform package also introduces more proportionality to the remuneration rules. The amendments aim to address shortcomings in the application of the proportionality principle under the current remuneration rules. This had raised interpretation issues for banks and competent authorities as the wording of CRD IV does not in fact permit exemptions or waivers in relation to the remuneration principles, which was found to be the practice in many member states.

The package introduces exemptions from two remuneration rules for small banks and staff receiving low variable remuneration. This concerns the deferral requirement for variable remuneration, and the requirement to pay out a substantial portion of variable remuneration in the form of instruments. A small bank for these purposes is a bank that is not a large bank (as defined above) and that has assets that do not exceed EUR 5 billion over the preceding four-year period. The competent authority may, under certain conditions, lower or increase this threshold. A staff member is deemed to receive a low variable remuneration if his or her annual variable remuneration does not exceed EUR 50,000 and does not represent more than one-third of his or her total annual remuneration. Furthermore, like non-listed banks, listed banks will be allowed to use share-linked instruments instead of shares.

In addition to these amendments, which were proposed by the Commission, the Council and European Parliament have included further changes to the remuneration rules. First of all, the package will include further detail on which categories of staff qualify as material risk-takers, and should therefore be subject to the remuneration rules. These changes largely reflect the criteria currently laid down in the regulatory technical standards on identified staff. In addition, remuneration policies and practices must be gender neutral, defined as a remuneration policy based on equal pay for women and men for equal work of equal value. The EBA will issue guidelines on what constitutes a gender-neutral remuneration policy.

Furthermore, changes have been made to the application of the remuneration rules in a group context. Current CRD IV remuneration rules, as detailed by the EBA’s 2016 guidelines on sound remuneration policies, require that subsidiaries or at least their material risk-takers, also comply with the remuneration rules, even where such subsidiaries are subject to other sectoral legislation. The banking reform package provides that if a subsidiary is subject to other sectoral legislation, the sector-specific provisions will apply rather than the CRD IV requirements. Accordingly, asset management and investment firm subsidiaries within banking groups will no longer be subject to the CRD IV remuneration rules. However, in order to prevent circumvention of the rules, the remuneration rules will still apply to individuals in those subsidiaries that have a direct material impact on the risk profile of the group as a whole. Also, member states remain free to apply the remuneration rules to a broader scope of subsidiaries and staff.

Finally, changes are made to the deferral period for the deferred component of variable remuneration, which is increased from a three-year to a four-year minimum. For members of the management body and senior management of banks that are significant in terms of their size, internal organisation and the nature, scope and complexity of their activities, the deferral period should not be shorter than five years.

EXEMPTED ENTITIES AND PROCEDURE FOR FURTHER EXEMPTIONS
The banking reform package adds Dutch credit unions to the list of entities exempted from the scope of the EU banking rules. In doing so, the Commission delivers on a commitment made to the Netherlands regarding the introduction in the Netherlands of a specific regulatory regime for credit unions (Wet toezicht kredietunies). The Commission proposed to fine-tune the procedure and criteria for granting further
exemptions from the scope of CRD IV and CRR for public development banks and credit unions by introducing a delegated power for the Commission. However, the Council preferred to keep changes in this area subject to the ordinary legislative procedure.

TREATMENT OF INVESTMENT FIRMS
To ensure more proportionality in the rules applicable to investment firms, the package includes in its scope only the largest and most interconnected investment firms, those that have business models and risk profiles similar to that of significant banks. In the Commission’s proposals, a distinction was made between systemic and non-systemic investment firms on the basis of their qualification as G-SIB or O-SIB. In the final package, the threshold has become more elaborate and is based on the nature and volume of investment firms’ activities:

- Investment firms that deal on their own account or underwrite financial instruments, that are not a commodity and emission allowance dealer, fund manager or insurer, and that, put briefly, have consolidated assets exceeding EUR 30 billion, will remain subject to CRD IV and CRR. These investment firms will qualify as “credit institutions”, which means that they will need to seek authorisation under CRD IV and will be supervised by the ECB in the Single Supervisory Mechanism (SSM);

- Investment firms that deal on their own account or underwrite financial instruments, that are not a commodity and emission allowance dealer, fund manager or insurer, and that, put briefly, have consolidated assets exceeding EUR 15 billion, or EUR 5 billion in cases where the competent authority considers this justified in light of the investment firm’s activities, will remain subject to CRD IV and CRR. These firms will remain “investment firms” and subject to authorisation under MiFID II.

- Any other investment firms will be excluded from CRD IV and CRR and will become subject to new rules consisting of the Investment Firm Regulation and the Investment Firm Directive, adopted by the European Parliament on 16 April 2019.

FINANCIAL HOLDING COMPANIES

REQUIREMENT FOR INTERMEDIATE EU PARENT UNDERTAKINGS
The banking reform package introduces a new requirement for groups of two or more banks established in the EU that have the same ultimate parent undertaking in a third country, to establish an intermediate EU parent undertaking. This should facilitate the implementation of the Financial Stability Board’s minimum total loss-absorbing capacity (TLAC) in the EU and, more broadly, simplify and strengthen the resolution process of third-country groups with significant activities in the EU.

Contrary to the Commission’s proposal, the final package includes a number of exemptions from this requirement. Competent authorities may allow the group to establish two intermediate EU parent undertakings if the establishment of a single intermediate EU parent undertaking would either be incompatible with a mandatory requirement for separation of activities imposed by the rules or supervisory authorities of the third country where the third country’s ultimate parent undertaking has its head office, or render resolvability less efficient. The threshold of the requirement has also been increased. It will also apply only to third-country groups that are identified as non-EU G-SIBs or that have total assets in the EU of at least EUR 40 billion, while this was EUR 30 billion in the Commission’s proposal. Finally, in addition to a bank authorised in the EU or a holding company subject to the requirements of CRR and CRD IV, the intermediate EU parent undertaking can, under certain circumstances, now also be an investment firm authorised under MiFID II.

AUTHORISATION REQUIREMENT FOR FINANCIAL HOLDINGS
The package also brings financial holding companies and mixed financial holding companies directly within the scope of the EU prudential framework by introducing an approval requirement along with direct supervisory powers. Additionally, the package makes these holdings responsible for ensuring compliance with requirements on a consolidated level. Financial holding companies are undertakings engaging in non-banking financial activities, whose subsidiaries are exclusively or mainly banks, investment firms or financial institutions. Contrary to the Commission’s proposals, the final package includes an exemption from the approval
requirement if a number of conditions are met, including that the holding company’s activities are limited to acquiring holdings, that it has not been designated as resolution entity in accordance with the BRRD and that it does not engage in management, operational or financial decisions affecting the group.

OTHER RELEVANT CHANGES TO CAPITAL REQUIREMENTS FRAMEWORK

WAIVERS FROM INDIVIDUAL CAPITAL AND LIQUIDITY REQUIREMENTS REMOVED

Currently, the CRR generally only allows the waiving of prudential requirements at an individual level for subsidiaries within the same member state that are overseen on a consolidated basis by the same supervisory authority. Since the adoption of CRD IV and the CRR, group supervision has been substantially reinforced as a result of the attribution of supervisory competences to the ECB within the SSM. For this reason, the Commission considered it appropriate to also propose allowing cross-border banking groups to benefit from such waivers, subject to certain safeguards. However, the Council removed these provisions as it believed that the waivers would be detrimental to financial stability and premature as long as the consequences of bank failures still need to be borne in part at the national level.

PHASED-IN IMPLEMENTATION OF IFRS 9

International Financial Reporting Standard (IFRS) 9 was issued as an important new accounting standard in July 2014 and governs the accounting for most assets and liabilities on banks’ balance sheets. It includes a change from an incurred credit loss approach (actual losses) to an expected credit loss approach (expected losses), which can have a significant impact on banks’ capital ratios. As part of the banking reform package, the Commission proposed a five-year phase-in period for IFRS 9 in CRR to prevent the unwarranted sudden impact on capital ratios. Because this phase-in had to enter into force by January 2018, it was “fast tracked” and adopted as a separate regulation in December 2017.

“SME SUPPORTING FACTOR” AND PREFERENTIAL TREATMENT OF INFRASTRUCTURE EXPOSURES

The CRR currently contains a supporting factor for small and medium-sized enterprises (SMEs), which lowers the capital requirements for credit risk on exposures to SMEs of up to EUR 1.5 million by 23.81%. The banking reform package expands this “SME supporting factor”. The current reduction of 23.81% is extended to exposures of up to EUR 2.5 million and a new SME supporting factor of 15% is introduced for the part of SME exposures exceeding EUR 2.5 million. The package also introduces preferential treatment (a capital reduction of 25%) for specialised lending exposures for infrastructure projects. The aim is to encourage private investments in infrastructure projects as outlined in the Capital Markets Union and the Juncker Plan.

EQUITY HOLDINGS IN INSURANCE UNDERTAKINGS

The CRR requires banks in principle to deduct equity holdings in insurance undertakings from its CET1 capital. However, if a number of criteria are met, including that the bank and the insurance undertaking are supervised as part of a conglomerate, a risk-weighting can be applied instead of a deduction. The CRR also contains a transitional provision providing an exemption from this deduction requirement on the basis of less strict criteria until 31 December 2017 (the so-called Danish Compromise). The package now extends this transitional period to 31 December 2024.

ENVIRONMENTAL, SOCIAL & GOVERNANCE-RELATED RISKS

A number of provisions have been included in the banking reform package relating to environmental, social and governance (ESG) aspects. Large banks that have issued securities admitted to trading on a regulated market will have to disclose information on ESG-related risks, including physical and transition risks. Within six years after the entry into force of the package, the EBA is to report on whether a dedicated prudential treatment of exposures related to assets or activities associated substantially with environmental and/or social objectives would be justified. In addition, the EBA will assess the potential inclusion of ESG risks in the supervisory review and evaluation process (SREP) and may, if appropriate, adopt guidelines to this effect.
LOSS ABSORBING CAPACITY
WHAT CAN OUR CLIENTS EXPECT?
RESOLUTION FRAMEWORK

BACKGROUND OF EU BANK RESOLUTION FRAMEWORK AND MREL REQUIREMENT

Over the past few years, a comprehensive EU bank recovery and resolution framework has been set up for the orderly resolution of failing banks. This should ensure that a bank’s critical functions are continued, financial stability is preserved and the burden of a bank’s losses is shifted from the taxpayer to bank shareholders and creditors. The EU bank recovery and resolution framework is principally based on three pieces of legislation: the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Intergovernmental Agreement on the Single Resolution Fund (IGA).

As part of the bank recovery and resolution framework, resolution authorities will have the power to subject shareholders and creditors to a “bail-in” in order to absorb a bank’s losses and recapitalise the bank. In order to ensure that a bank has sufficient liabilities that can be subjected to a bail-in, banks must continuously meet a minimum requirement of own funds and eligible liabilities (MREL). The required level of MREL for each bank is set by the relevant resolution authority.

The changes to the EU bank recovery and resolution framework largely concern the incorporation in the MREL framework of the international Total Loss-absorbing Capacity (TLAC), developed by the Financial Stability Board (FSB) for all G-SIBs. In addition, the banking reform package includes various other changes, both to the MREL requirements and to other aspects of the resolution framework, resulting from the experience with these rules over the past years.
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<th>PARAMETERS</th>
<th>MREL CURRENTLY</th>
<th>NEW MREL FOR G-SIBS</th>
<th>NEW MREL FOR TOP TIER BANKS</th>
<th>NEW MREL FOR OTHER BANKS</th>
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<tbody>
<tr>
<td>SCOPE</td>
<td>All banks in the EU</td>
<td>All G-SIBs in the EU</td>
<td>Non-G-SIB resolution group with assets exceeding EUR 100 billion or when designated by resolution authority</td>
<td>All non G-SIBs and non top tier banks in the EU</td>
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<tr>
<td>DENOMINATOR OF THE RATIO</td>
<td>Own funds and total liabilities</td>
<td>- Risk-weighted assets exposure measure</td>
<td>- Risk-weighted assets exposure measure</td>
<td>- Risk-weighted assets exposure measure</td>
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<tr>
<td>CALIBRATION</td>
<td>Individual bank-specific requirement (Pillar 2)</td>
<td>Common minimum requirement (Pillar 1) + individual bank-specific requirement (Pillar 2)</td>
<td>Common minimum requirement (Pillar 1) + individual bank-specific requirement (Pillar 2)</td>
<td>Individual bank-specific requirement (Pillar 2)</td>
</tr>
<tr>
<td>SUBORDINATION</td>
<td>Resolution authority may require on a case-by-case basis</td>
<td>Required but exceptions apply. A new non-preferred senior debt class, eligible for MREL, is created</td>
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</tr>
<tr>
<td>INTERNAL MREL</td>
<td>No detailed rules, but resolution authorities can set requirements on a case-by-case basis</td>
<td>Material subsidiaries of non-EU G-SIBs must comply with an internal MREL requirement of 90% of the G-SIBs Pillar 1 MREL requirement</td>
<td>Internal MREL requirement set out in more detail and with strict exemptions</td>
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<tr>
<td>THIRD-COUNTRY CONTRACTUAL BAIL-IN RECOGNITION</td>
<td>Broadly scoped requirement for contractual recognition clause</td>
<td>A waiver may be granted if inclusion is impracticable for banks, and does not impede resolvability</td>
<td>A waiver may be granted if inclusion is impracticable for banks, and does not impede resolvability</td>
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<tr>
<td>TREATMENT OF HOLDINGS</td>
<td>No deduction requirement</td>
<td>Deduction required for own eligible liabilities instruments and holdings of eligible liabilities of other G-SIBs</td>
<td>No deduction requirement</td>
<td>No deduction requirement</td>
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<tr>
<td>CONSEQUENCES OF BREACH</td>
<td>Not defined</td>
<td>Specific powers for supervisory and resolution authorities. M-MDA regime with potential nine month grace period</td>
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<tr>
<td>DISCLOSURE TO BANK CREDITORS</td>
<td>No requirements</td>
<td>Disclosure at least semi-annually and quarterly for key metrics</td>
<td>Disclosure at least annually</td>
<td>Disclosure at least annually</td>
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CHANGES TO THE MREL REQUIREMENTS

DISTINCTION BETWEEN G-SIBS, "TOP TIER" BANKS AND OTHER BANKS
The MREL requirements of the banking reform package will introduce a distinction between three types of banks:

- G-SIBs
- "top tier" banks
- other banks

The category of “top tier” banks is new and has resulted from the negotiations in the Council about the calibration of MREL and the MREL subordination requirement. Top tier banks are resolution entities that are not G-SIBs but are part of a resolution group whose total assets exceed EUR 100 billion. In addition, resolution authorities can assign other banks as top tier banks if they determine that such a bank is reasonably likely to pose a systemic risk in the event of its failure.

CHANGES TO THE MREL DENOMINATOR
MREL is currently expressed as a percentage of a bank’s total liabilities and own funds (TLOF). For all types of banks, the banking reform package aligns the MREL denominator with the TLAC standard in that it consists of a dual requirement: a risk-based ratio (a percentage of the total risk-weighted assets) and on a non-risk-based ratio (a percentage of the exposure measure of the leverage ratio).

INTRODUCTION OF PILLAR 1 MREL
The MREL requirement is currently set on a purely bank-specific (Pillar 2) basis. No minimum (Pillar 1) requirement applies. The TLAC standards, by contrast, consist of a combination of a Pillar 1 minimum and a bank-specific Pillar 2 add-on. The banking reform package introduces a minimum Pillar 1 MREL requirement for both G-SIBs and top tier banks.

For G-SIBs, the Pillar 1 MREL requirement is calibrated at the same level as the TLAC standard:

- a risk-based ratio of 18% of RWAs; and
- a non-risk-based ratio of 6.75% of the exposure measure of the leverage ratio.

For top tier banks, the minimum Pillar 1 MREL requirement will be:

- a risk-based ratio of 13.5% of RWAs; and
- a non-risk-based ratio of 5% (as a percentage of the exposure measure of the leverage ratio).

CHANGES TO THE CALIBRATION OF PILLAR 2 MREL
Resolution authorities can impose a bank-specific (Pillar 2) MREL requirement. For G-SIBs and top tier banks, such bank-specific Pillar 2 MREL is additional to their Pillar 1 minimum MREL requirement. For other banks, it constitutes their full MREL requirement. The methodology for determining a bank’s Pillar 2 MREL requirement is currently laid down in the Commission’s MREL RTS. The banking reform package changes the methodology for determining a bank’s Pillar 2 MREL as currently laid down in the Commission’s MREL RTS and incorporates it into the text of the BRRD. The default amount of MREL that can be imposed will decrease from the sum of twice the amount of Pillar 1 and Pillar 2 capital requirement and twice the combined buffer requirement, to twice the amount of the Pillar and Pillar 2 capital plus, only once, the combined buffer requirement. However, as capital counting towards the combined buffer requirement can no longer also count towards MREL, the capital buffers are stacked on top of the MREL requirement as a result. There are some tweaks to the discretion of resolution authorities in deviating from this default requirement.
New capital requirements

- Capital guidance: No quantitative maximum
- Combined buffer requirement: 2.5 or more of RWA
- Pillar 2 buffer: No quantitative maximum but stricter criteria
- Pillar 1 capital requirement: 8% of RWA

Current MREL requirement

- Default: Capital requirement + Pillar 2 buffer + Combined buffer requirement

New MREL requirement

G-SIBs and top tier banks

- Combined buffer requirement: 2.5 or more of RWA
- MREL Pillar 2 buffer: Bank specific and based on methodology for other banks
- TLAC/MREL minimum requirement
- G-SIBs: 18% of RWA / 6.75% LREM
- Top tier banks: 13% of RWA / 5% LREM

Other banks

- Combined buffer requirement: 2.5 or more of RWA
- Default: Capital requirement + Pillar 2 buffer + Combined buffer requirement
- MREL loss absorption amount
- Default: Capital requirement + Pillar 2 buffer
ELIGIBLE LIABILITIES
As part of the incorporation of the TLAC requirements, the banking reform package introduces stricter requirements for the eligibility of MREL liabilities of G-SIBs. For example, liabilities may no longer include any incentive for their principal amount to be called, and any early call requires permission from the resolution authority. As a general rule, eligible liabilities will also need to be subordinated (see below). While liabilities arising from derivatives do not qualify as MREL already, liabilities arising from debt instruments with embedded derivatives will also no longer qualify. As a result, eligible liabilities will come to resemble Tier 2 instruments more closely, but with a shorter duration.

For top tier banks and other banks, the conditions for eligibility of liabilities to count towards MREL will be aligned with those for G-SIBs, with two exceptions. First, subordination is not required, although it can be imposed by the resolution authority on a case-by-case basis (see below). Second, debt instruments with derivative futures, such as structured notes, can be included if the given amount of the liability arising from the instrument is fixed, known in advance and not affected by the derivative feature, and not subject to any netting agreement instruments.

SUBORDINATION REQUIREMENTS
In case of resolution, a bank’s creditors are protected by the No Creditor Worse Off (NCWO) principle, which enables creditors to claim compensation from a resolution fund if it becomes apparent that they were put in a worse position under resolution than under insolvency. This principle could, in particular, be breached where liabilities eligible for bail-in rank equally with liabilities that are not eligible for bail-in under the BRRD. The risk of breaching the NCWO principle can be reduced if liabilities which are most credibly contributable to loss absorbency, are subordinated. The current MREL framework does not require that MREL instruments be subordinated, although resolution authorities are able to require this on a case-by-case basis.

Therefore, an important new requirement is that the Pillar 1 MREL requirement of G-SIBs and top tier banks must be subordinated, either contractually or structurally, or on the basis of the law governing the liabilities. Under certain conditions, part of MREL in the amount of 3.5% of RWAs may be unsubordinated. However, the subordinated part of MREL must be equal to at least 8% of a bank’s total liabilities, including own funds (TLOF). The resolution authority may permit a lower level of subordination, in which case a minimum threshold applies, reflecting the exception of 3.5% of RWAs but rebased on a bank’s TLOF. For top tier banks, a ceiling of 27% of RWAs applies under certain circumstances.

Under certain circumstances, and subject to a ceiling of the higher of 8% of a bank’s TLOF or twice its total capital requirement plus combined buffer requirement, the resolution authority can also resolve that a G-SIB or top tier bank’s Pillar 2 MREL must be subordinated. Banks other than G-SIBs and top tier banks will not be subject to a minimum subordination requirement, but the resolution authority can decide their subordination requirement case by case, based on the need to prevent breach of the NCWO principle. The same ceilings apply as those for G-SIBs and top tier banks.

TREATMENT OF MREL HOLDINGS
To prevent contagion within the financial system, the capital requirements ensure that a bank must deduct its holdings in another bank’s capital from its own capital. The banking reform package introduces a similar requirement for MREL holdings of G-SIBs. G-SIBs must deduct holdings of their own eligible liabilities instruments, and holdings of eligible liabilities of other G-SIBs (that is, liabilities issued by other G-SIBs). The package also sets out a proportionate deduction for holdings of liabilities that rank equally with excluded liabilities. Deductions are made from eligible liabilities, and from own funds, on the basis of a corresponding-deduction approach. The EBA is mandated to study the possible extension of this regime to O-SIBs.

MREL GUIDANCE REMOVED
The Commission had proposed to introduce the option for resolution authorities to impose bank-specific MREL guidance supplementary to the Pillar 1 and Pillar 2 requirements, subject to certain conditions. The purpose of this MREL guidance was to cover potential losses - in addition to those foreseen under the regular MREL requirements - and to ensure sufficient market confidence in case of resolution. However, the concept of MREL guidance has been removed by the Council, which considered that it added unnecessary complexity and uncertainty regarding the binding nature of the MREL requirements. The “market confidence buffer”, which would have been composed of MREL guidance, has been reverted to a “hard” MREL requirement as part of the recapitalisation amount, as is the case under the current Commission MREL RTS.
To improve the resolvability of banking groups, resolution authorities should be able to upstream the losses of subsidiaries to the resolution entities, the entity to which resolution tools are applied (and to which external MREL applies), without placing that subsidiary into resolution itself. To this end, the banking reform package states that resolution authorities impose MREL requirements as an “internal MREL” requirement on all banks that are subsidiaries of resolution entities. This requirement can only be waived by a resolution authority under strict circumstances, including that the subsidiary and its parent undertaking are established in the same member state and are part of the same resolution group. A resolution authority can also decide to impose internal MREL requirements on subsidiaries that are financial institutions or financial holdings.

**INTERNAL MREL**

To improve the resolvability of banking groups, resolution authorities should be able to upstream the losses of subsidiaries to the resolution entities, the entity to which resolution tools are applied (and to which external MREL applies), without placing that subsidiary into resolution itself. To this end, the banking reform package states that resolution authorities impose MREL requirements as an “internal MREL” requirement on all banks that are subsidiaries of resolution entities. This requirement can only be waived by a resolution authority under strict circumstances, including that the subsidiary and its parent undertaking are established in the same member state and are part of the same resolution group. A resolution authority can also decide to impose internal MREL requirements on subsidiaries that are financial institutions or financial holdings.

Internal MREL instruments must fulfil the same eligibility conditions as external MREL instruments. In addition, they must be issued to and bought (directly or indirectly) by the resolution entity, or another existing shareholder, must rank below all other liabilities, and must contain a trigger clause allowing conversion and write-down without the subsidiary itself entering into resolution. Subject to strict conditions, the internal MREL requirement may either be met by a guarantee from the resolution entity granted to its subsidiary or may be fully waived.

In line with the TLAC requirement, all material subsidiaries of non-EU G-SIBs, to the extent that they are not themselves entities to which resolution tools are expected to be applied, must comply with a specific internal MREL requirement. This requirement is set at a level equal to 90% of the G-SIBs’ (external) Pillar 1 MREL requirement, which is at the higher end of the range prescribed by the TLAC standards. While the Commission’s proposal appeared to suggest that the internal MREL of material subsidiaries had to be held directly by the subsidiary’s ultimate third country parent undertaking, the final text clarifies that it may be issued through other entities, provided that they are established in the same third country or in the EU.

**STACKING ORDER AND CONSEQUENCES OF AN MREL BREACH**

The banking reform package provides that the combined capital buffer will be stacked above the MREL requirement. This means that if a breach of MREL occurs because a bank does not have a sufficient amount of eligible liabilities, the resultant shortfall is automatically filled up with Common Equity Tier 1 (CET1) capital used to comply with the combined buffer requirement. This may, in turn, result in a breach of the combined buffer requirement, which would normally automatically trigger the maximum distributable amount (MDA) regime. As a result, dividend distributions, variable remuneration payments to employees, and coupon payments on AT1 instruments may be restricted. Because this could be too severe a consequence for a breach of MREL, the banking reform package provides that where a breach of the combined buffer requirement results from a shortage of MREL rather than from a shortage of capital, it is up to the resolution authority whether or not to apply the MREL-related MDA regime (M-MDA). The resolution authority can decide to apply a “grace period” of up to nine months before applying the M-MDA. After this nine-month grace period, the resolution authority will need to exercise its power to restrict distributions, except where certain conditions are met, including that the failure is due to a serious disturbance to the functioning of financial markets.
The BRRD’s current text does not prescribe any specific course of action in the case of a breach of MREL. Under the banking reform package, the resolution authority or competent authority will be required to take action to move the bank to restore its MREL. Besides by imposing the abovementioned M-MDA regime, this can take the form of applying the power to address or remove impediments to resolvability, or of regular supervisory or early intervention measures.

RETAIL INVESTORS
Over the past years, a significant part of a bank’s MREL in some member states has been found to be held by retail investors; this can constitute a significant impediment to effective application of the bail-in tool. On the instigation of the European Parliament, the banking reform package therefore now includes a number of conduct requirements that should prevent such mis-selling of MREL instruments to retail investors. The new requirements are twofold. First of all, the seller of MREL liabilities must perform a suitability test in accordance with the rules currently applicable to investment firms providing investment advice or portfolio management under the Markets in financial instruments directive II (MiFID II). Member states may extend this requirement to all instruments qualifying as own funds or as bail-inable liabilities. Secondly, where the retail clients portfolio does not exceed EUR 500,000 the seller must ensure that the retail client does not invest an aggregate amount of more than 10% of its portfolio in such instruments, and that the required initial investment amount is at least EUR 10,000. As an alternative to these requirements, member states may instead set a minimum denomination amount of at least EUR 50,000.

REPORTING AND DISCLOSURE REQUIREMENTS
The banking reform package introduces new reporting and disclosure requirements for MREL, which are absent from the current rules. Banks will have to report to their supervisory authority and resolution authority on their amounts of own funds and eligibly liabilities at least every six months, and in more detail at least once a year. MREL reporting...
requirements for G-SIBs will be further detailed in regulatory technical standards, including in relation to their frequency. In terms of disclosure, G-SIBs will be required to publish information on the composition of their own funds and MREL liabilities, including their main characteristics, the ranking of eligible liabilities in the creditor hierarchy, and whether contractual recognition has been included on a semi-annual basis. G-SIBs will also have to disclose their MREL ratios as part of their quarterly “key metrics” disclosures. Banks other than G-SIBs will need to disclose the levels of available MREL items and the composition of these items, including maturity profile and ranking in normal insolvency proceedings, and their MREL requirement on, at a minimum, an annual basis. These reporting and public disclosure requirements will not apply to entities whose resolution plan provides that the entity is to be wound up under normal insolvency proceedings.

TRANSITIONAL ARRANGEMENTS
The new MREL requirements are subject to an extensive set of transitional provisions. For G-SIBs, the Pillar 1 MREL requirement will, until 31 December 2021, consist of a risk-based ratio of 16% of RWAs and of a non-risk-based ratio of 6% of the exposure measure of the leverage ratio. Other than this, the transitional periods are to be set by the resolution authority on a case by case basis and must include a planned target for each 12-month period. The deadline for full compliance should be no later than 1 January 2024, although a longer period may be set under strict circumstances. The deadline for the Pillar 1 MREL requirement of top tier banks should be no later than 1 January 2022. The package also includes a grandfathering provision for MREL liabilities issued prior to the package’s entry into force.

OTHER CHANGES TO THE BANK RESOLUTION FRAMEWORK

REVIEW OF CREDITORS’ HIERARCHY
As discussed above, under the new MREL rules many banks will have to comply with their MREL requirement at least partially by subordinated instruments. In order to facilitate this, the Commission proposed a change to the insolvency hierarchy by introducing a new statutory category of “senior non-preferred” debt. This category ranks just below the most senior debt and other senior liabilities for the purposes of resolution, but still ranks as part of the senior unsecured debt category and not as subordinated debt. The rules do not affect the stock of bank debt issued before the date of application of the rules and only applies to debt when designated as such by the issuing bank.

As a number of member states had already adopted various national measures to enable banks in their jurisdiction to comply with the MREL subordination requirement, potentially resulting in an unlevel playing field, the EU legislator deemed it necessary to put this new category of debt in place as soon as possible. The proposal was therefore “fast-tracked” and the resulting directive entered into force in December 2017.

In order to prevent a breach of the NCWO principle in the case of resolution, the package also clarifies that own funds instruments must rank in insolvency below any other subordinated claim that does not qualify as a capital instrument. This provision entails that those member states in which Tier 2 instruments rank equally to other subordinated debt, or in which deeper subordination is based on contractual clauses, must amend their bankruptcy laws.
CONTRACTUAL RECOGNITION OF BAIL-IN REQUIREMENT
Banks must ensure that the resolution tools, such as bail-in, can be effectively exercised. The effective exercise of the bail-in tool can be impeded where a contract is governed by the law of a third (non-EU) country. In such case the bail-in of a liability arising from the contract may not be recognised in this third country. Article 55 BRRD therefore requires banks to include a clause in contracts governed by third-country law stating that counterparties recognise that their claims may be converted or written down. However, this requirement has in practice often proved to be difficult to implement. Therefore, the banking reform package allows resolution authorities to grant a waiver for this obligation for liabilities not counting towards MREL if it is legally or otherwise impracticable for a bank to include the recognition clause. The EBA is mandated to further determine the conditions under which the waiver could be granted.

CONTRACTUAL RECOGNITION OF RESOLUTION STAY POWERS
Like the application of the bail-in tool, the suspension by a resolution authority of a bank’s payment or delivery obligations, or of a counterparty’s termination or security enforcement rights, may also not be recognised for contracts under third-country law. In practice, many resolution authorities have therefore required banks to include a contractual term in relevant financial contracts recognising the exercise of such powers. The banking reform package provides a formal legal basis for this requirement. Resolution authorities may also require parent undertakings to ensure that their third-country subsidiaries comply with this requirement.

EXTENSION OF THE MORATORIUM TOOL
The BRRD currently provides the possibility for a resolution authority to suspend a bank’s payment obligations for a maximum of two days when a bank is in resolution, so as to have the time to put the resolution tools into effect. The banking reform package supplements this resolution moratorium by allowing resolution authorities to also impose the suspension in the pre-resolution phase. Resolution authorities can apply it when this is necessary to assess whether resolution action is in the public interest or when choosing the appropriate resolution actions. The extension of the moratorium tool is more limited than initially proposed by the Commission, as it cannot be exercised by supervisory authorities when assessing whether a bank meets the conditions for early intervention or whether a bank is failing or likely to fail.
As indicated above, the texts will now soon be formally adopted by the Council, following which they will be published in their final form. The timing of the banking reform package’s entry into force and applicability is as follows:

A number of international standards for the finalisation of the Basel III reforms (informally known as Basel IV) were only finalised by the Basel Committee in December 2017 and January 2019. Therefore, these have largely not been included in the package yet. Work on the implementation of these additional Basel III reforms into the EU regulatory framework remains ongoing.
The texts of the legislative instruments forming part of the banking reform package that were adopted by the European Parliament, can be found here:

- a directive amending the Capital Requirements Directive (CRD IV)
- a regulation amending the Capital Requirements Regulation (CRR)
- a directive amending the Bank Recovery and Resolution Directive (BRRD) in relation to loss-absorbing and recapitalisation capacity
- a regulation amending the Single Resolution Mechanism Regulation (SRMR)

In addition, the two other elements of the package, which were “fast-tracked” and have already entered into force can be found here:

- a regulation amending the CRR as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds and for the large exposures treatment of certain public sector exposures denominated in the domestic currency of any member state
- a directive amending BRRD as regards the ranking of unsecured debt instruments in insolvency hierarchy, and the Act implementing this directive in the Netherlands

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