What's New? The Banking Package[1]

(Part II)

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5 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 7.6.2013, p. 1–337).
6 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 7.6.2013, p. 338–436).
7 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12/06/2014, p. 190–348).
8 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010 (OJ L 225, 30.7.2014, p. 1–90).
9 Kravecová, D., Országhová, L., Šesták, Ľ.: What's New? The Banking Package (Part I), BIATEC, Issue 27, No. 4/2019, Národná banka Slovenska, August 2019.
10 Cf. European Commission: EU Banking Reform: Strong banks to support growth and restore confidence, 23 November 2016.
11 European Commission's public consultation on the review of the EU macroprudential framework, European Commission, Brussels, July 2016.
12 See the speech by the Commission Vice-President, Mr Dombrovskis, 19 May 2017.
13 Cf. Council agreement on measures to reduce risk, European Council press release, 25 May 2018 and the Report by the ECON Committee of the European Parliament, 28 June 2018.
14 See the ESRB's response to the European Commission's public consultation on the review of the EU macroprudential framework, ESRB, Frankfurt am Main, 24 October 2016 and the ESRB's Opinion to the European Commission on structural macroprudential buffers, ESRB, Frankfurt am Main, December 2017.

Proposed by the European Commission in November 2016, the package of banking reforms (The Banking Package) covers both prudential regulation and resolution. It comprises extensive amendments to Capital Requirements Regulation and Directive (CRR[5]/CRD IV[6]) as well as to the Bank Recovery and Resolution Directive (BRRD[7]) and the Single Resolution Mechanism Regulation (SRMR[8]). The first part of this paper published in August 2019[9], described the main changes to the microprudential policy framework. This second part discusses changes to the macroprudential policy and resolution frameworks.

Changes regarding macroprudential policy

The Commission proposed in November 2016 only a single change regarding macroprudential supervision – to remove the macroprudential use of Pillar 2.[10] After a public consultation[11] on the review of the EU macro-prudential framework, the Commission concluded that only targeted improvements to the existing macroprudential framework were needed; however, the Commission did not envisage any further legislative proposals at this stage.[12] The European Parliament and Council were only willing to accept to confine Pillar 2 to microprudential purposes if this would be balanced by greater flexibility for the remaining macroprudential tools.[13] The Banking Package aims at increasing flexibility of the instruments, while avoiding overlaps between instruments addressing similar risks, in line with the ESRB proposal.[14]

Removal of the macroprudential use of Pillar 2

CRD V removes references to the assessment of systemic risk and strenghtenes the institution-specific nature of Pillar 2. This change aims to enhance the separation of microprudential and macroprudential tools and the respective roles of microprudential and macroprudential authorities. It should serve as a safeguard against double-counting of risk and further streamline the activation procedures for macroprudential tools. The main advantage of Pillar 2 was its great flexibility in terms of addressable risks and potential measures which allowed authorities to fine-tune the instrument to a specific risk. On the other hand, Pillar 2 decisions are often not public, which could reduce the risk-signalling aspect of macroprudential measures and might be operationally burdensome to be implemented across multiple banking groups with cross-border presence in a coherent way. In short, the new regime would provide a more transparent macroprudential framework albeit with less flexibility in fine-tuning macroprudential tools to specific exposures.

Increased range for buffers for other systemically important institutions (O-SIIs)

Under the existing framework, the O-SII buffer rates are severly limited in the CRD at a 2% maximum and even stricter limit applies for subsidiaries of other EU institutions which are designated as O-SIIs or global systemically important institutions (G-SIIs). For the subsidiary, the O-SII buffer rate must not be higher than 1% or the O-SII or G-SII buffer rate applied for the parent institution, whichever is higher. Several authorities have seen these limits as too restrictive and had applied the systemic risk buffer and/or Pillar 2 measures to set higher buffers for O-SIIs within their jurisdiction.[15]

Under CRD V, these limits are substantially increased. The overall limit is raised to 3% with the possibility for national authorities to set O-SII buffer rates exceeding 3% with the approval of the Commission taking into account the opinions of the ESRB and the EBA. The cap for subsidiaries is also raised and corresponds to the lower of (i) The higher of the O-SII and G-SII buffer rate applicable at the parent institution level plus 1%; and (ii) 3% or a higher O-SII buffer rate that had been authorised for the parent institution.

These changes should allow all national authorities to use the dedicated instrument – the O-SII buffer – to address the risks posed by O-SIIs. At the same time, the caps and the authorisation procedure will ensure a level-playing field for EU banks and ensure greater homogeneity of capital requirements within banking groups and their subsidiaries. In addition, the EBA is required to report to the Commission by 31 December 2020 on the appropriate methodology for the design and calibration of O-SII buffer rate to further harmonise the application of O-SII buffers within the EU.[16]

Increased flexibility of the systemic risk buffer (SyRB)

Under the CRD IV, the SyRB is a flexible instrument that can prevent and mitigate long term non-cyclical systemic or macroprudential risks not covered by the CRR or by other macroprudential instrument. CRD V further increases this flexibility by allowing its application to sectoral exposures. In addition to the current possible SyRB application to all exposures, domestic exposures, exposures located in third countries and exposures located in other Member States, the SyRB can be applied also to residential real estate exposures, commercial real estate exposures, exposures to non-financial corporations excluding real estate, exposures to households excluding real estate and subsets of these four exposure classes. The EBA should issue guidelines specifying the appropriate subsets of exposures by 30 June 2020 after consulting the ESRB.

This will allow the SyRB to target specific systemic risks stemming from sectoral developments, which are one of the major sources of systemic risks stemming from the real economy.[17] Although it is theoretically possible to target sectoral risks already within the "old" SyRB framework, the revised framework substantially improves risk-sensitiveness of the SyRB calibration, transparency and reciprocity. To target sectoral risks by the "old" SyRB the designated authority needed to calibrate the SyRB rate on the total risk exposure amount. Consequently, it required to calibrate the SyRB rate individually for each institution taking into account the share of the targeted exposures in the portfolios of institutions and regularly update the calibration. This poses communication challenges for designated authorities and reduces transparency of the SyRB. Within the new framework, the designated authority needs only to communicate the systemic risk the SyRB addressed, the SyRB rate and the subset of exposures to which the SyRB applies.

The transparency of the SyRB is further strengthened by allowing multiple SyRB application targeting distinct systemic risks. The overall SyRB requirement is simply a sum of all individual SyRB requirements. When Member States reciprocate the SyRB activated in another Member State, they should assess whether the systemic risk is already addressed by their own SyRB. If the risks are distinct, the reciprocated SyRB is cumulative with the domestically set SyRB. If the buffers address the same risk, only the higher SyRB rate applies.

CRD V also removes the requirement that the SyRB applies to 'long-term non-cyclical risks'. In practice it is often difficult to separate structural and cyclical components of the systemic risk. Such requirement could induce authorities not to act, if they could not sufficiently prove the structural characteristic of systemic risk. In order to avoid the double-counting of risks, the CRD V specifies that the SyRB should not cover risks addressed by the CCyB – i.e. the risks stemming from the excessive credit growth in the whole economy. Nevertheless, the SyRB could replace a sectoral CCyB, which has not yet been agreed by the Basel Committee on Banking Supervision (BCBS).[18]

However, the procedural requirements for SyRB activation had only been simplified to some extent. On one hand the 'pecking order'[19] had been removed and the activating authority needs only justify why the SyRB is considered likely to be effective and proportionate to mitigate the systemic risk and whether there are any overlaps with the O-SII or G-SII buffer. In addition, only a notification is required when the SyRB decision results in a decrease or no change from the previously set SyRB rate. On the other hand, the cumbersome process with multiple thresholds and different procedures remain and is in some cases even less clear than its CRD IV version:

- The thresholds apply to the cumulative SyRB rate applicable to any of the subsets of exposures and any single credit institution the SyRB is imposed on.
- If the cumulative SyRB rate is below 3%, the activating authority only needs to notify the ESRB one month before publication of the decision. The reciprocated SyRB set by another Member State is not counted only towards this threshold.
- If the cumulative SyRB rate is between 3% and 5% the activating authority should request Commission's Opinion and comply with the Opinion or give reasons for not doing so. However, if the SyRB applies to a subsidiary of an EU institution from another Member State, the activating authority should request a recommendation from the Commission and the ESRB. If the authorities of the subsidiary and parent disagree on the SyRB rate applicabel to the institution and in the case of a negative recommendation from the Commission and the ESRB, the matter could be submitted for mediation[20] to the EBA.
- If the cumulative buffer rates is above 5% the authorisation by the Commission is required after the ESRB provides its opinion on the SyRB. The EBA may also provide its opinion to the Commission.

Although these procedures are the same as under CRD IV, their application to the cumulative rate applicable to any subset of exposures will have substantial impact on triggering these procedures. To date, no authority have set the SyRB above 3%.[21] However, to generate sufficient buffer requirements, it is likely that higher SyRB rates would be applied to sectoral exposures, which would trigger the approval procedures at the EU level. In Member States where subsidiaries of EU banks are located, it is also likely the specific procedure requiring an ESRB recommendation will be triggered. Moreover, the introduction of the combined threshold of 5% for the SyRB rate cumualted with the O-SII or G-SII buffer applicable to any subset of exposures is likely to trigger additional approval procedures. While it is understood that the EU approval procedures aim to preserve the single market by reviewing higher buffer requirements by EU institutions, the legislators failed to simplify the procedure, for example by introducing only a single threshold and only a single type of procedure.

Finally, it is not clear how reciprocated SyRB apply towards the calculation of these thresholds. Article 133(10) of the CRD V states that reciprocated SyRBs should not count towards the initial 3% threshold; however this is not the case for par-

15 For a detailed analysis see the Special feature C of the ESRB's Review of macroprudential policy in the EU in 2017.

16 At present, only the identification of O-SIIs is harmonised through the EBA guideline EBA/GL/2014/10 on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of O-SIIs.

17 See Section 3.3 of Chapter 4 of the ESRB Handbook on operationalising macroprudential policy in the Banking Sector. Such risks include, for example, foreign exchange risks of unhedged borrowers, risks in the residential real estate risks, concentration of exposures to a particular economic sector, persistently high levels of indebtedness of the private non-financial sector.

18 See BCBS Working Paper 36: "Towards a sectoral application of the countercyclical capital buffer", 3 April 2019, available online.

19 The 'pecking order' denotes the CRD IV requirement to justify why other instruments had not been used instead of the SyRB.

20 Article 19 of Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority).

21 See Section 2.6 of the ESRB's Review of macroprudential policy in the EU in 2018, April 2019 and the overview of national capital-based measures published by the ESRB online.

22 Under CRD IV, the SyRB was cumulative with the O-SII or G-SII buffer when it applied to domestic exposures, but the higher of the buffers applied when the SyRB was targeting all exposures.
23 Article 133(11) of the CRD IV.
24 See BCBS: Basel III: Finalising post--crisis reforms, December 2017.
25 According to Article 511(1)a) of the CRR 2, the Commission shall by 31 December 2020 submit a report to the European Parliament and to the Council on this issue.
26 See Section 3.1 of the ESRB Handbook on operationalising macroprudential policy in the Banking Sector for the G-SII score methodology.
27 Measures concerning the leverage ratio would be under Article 458(2)(d)(i) and measures concerning the NSFR under Article 458(2)(d)(v) of the CRR.
28 For discussion on the benefits and drawbacks of their macroprudential use, see the ESRB Handook, in particular Chapter 5 of the ESRB Handbook on operationalising macroprudential policy in the banking sector and the Addendum regarding macroprudential use of leverage ratios.

agraphs 11 and 12. This could be an ommission by the legislator, as the economic reasoning why the reciprocated SyRB should not count towards one threshold but not the other thresholds is not clear. Nevertheless, this creates an issue which of the procedures should be activated, if the reciprocated SyRB makes the difference whether the threshold is exceeded or not. For example, if a country wants to reciprocate a 2% SyRB from a different Member State and has already activated its own SyRB of 2% should it apply the notification procedure pursuant to paragraph 10 or request the opinion pursuant to paragraph 11? In addition, it is not clear, if reciprocated SyRBs count towards the 5% threshold applicable to the SyRB rate cumulated with the O-SII or G-SII buffer. Clarification by the Commission is needed in this regard and further simplification of the procedures is waranted during the next review of the macroprudential toolkt.

Delineation of the systemic risk buffer (SyRB) the O-SII buffer and the countercyclical capital buffer

The scope of the SyRB is narrowed, as described above, to remove the overlaps with the O-SII buffer, the G-SII buffer and the countercyclical capital buffer (CCyB). So far, the SyRB could be used also for these purposes, which had blurred transparency of the macroprudential toolkit.

Such a clear delineation of instruments have a clear advantage for the transparency and efficiency of the framework. First, the SyRB will be cumulative with the O-SII buffer or the G-SII buffer as these instruments now address different risks.[22] Second, the legislation no longer requires the activating authority to justify why none of the existing measures in the CRD and CRR, excluding Articles 458 and 459 of the CRR, alone or in combination, will be sufficient to address the identified macroprudential or systemic risk taking into account the relative effectiveness of those measures.[23] It now only requires the activating authority to justify why the SyRB is not duplicating the functioning of the O-SII buffer where the SyRB applies to all exposures. This will simplify the activating procedure for the SyRB.

However, one interaction between the SyRB and the O-SII buffers remains, which could substantially increase the procedural requirements for the SyRB in the future. The new legislation introduces an overall 5% cap on the sum of the SyRB and O-SII buffer or the G-SII buffer applicable applicable to any subset of exposures. If the combined rate would be above 5% for a single institution, the activating authority would need to receive an approval from the Commission after an ESRB and EBA opinion. This might incentivise activating authorities to calibrate buffer rates in a suboptimal way to avoid the more stringent approval requirements. Furthermore, as the overall cap applies to any subset of exposures to which the SyRB applies, it is much more likely that the threshold would be exceeded than if the overall cap would apply to total exposures. The procedural requirments for activating capital buffers could overall increase substantially.

Changes related to the G-SII score methodology and the G-SII leverage ratio buffer

Together with the introduction of the leverage ratio, G-SIIs are required to comply also with the G-SII leverage ratio buffer requirement. This amounts to 50% of ther G-SII buffer (applied to the risk-weighted total risk exposure amount) in line with the December 2017 BCBS agreement.[24] The leverage ratio buffer should ensure that the leverage ratio buffer continues to act as an appropriate backstop to the risk-based capital requirements including a G-SII buffer. The leverage ratio buffers will currently apply to G-SIIs only, but its extension to include O-SIIs will be considered by 31 December 2020.[25] Such leverage ratio buffer requirement could be considered also for other capital buffer requirements.

The EU introduced an additional G-SII score specific for the EU which excludes group's activities across banking union Member States in the cross-jurisdictional activity indicator of the overall G-SII score.[26] The relevant authority may use this additional indicator to allocate a G-SII into a lower bucket through supervisory judgment; however it cannot be used to avoid designating the institution as a G-SII. Consequently, the stricter monitoring of the institution still applies.

The additional methodology is intended to reflect the increased efficiency in bank resolution within the banking union. Competent and resolution authorities cooperate together as part of a common resolution mechanism. The spillover effects from cross-border resolution are expected to be lower and resolution less complex. This means that the cross-jurisdictional activity within the banking union would no longer be a good proxy for the systemic importance of EU-based G-SIIs.

National flexibility measures now include leverage ratio and the NSFR (Article 458 CRR)

The Banking Package introduced a binding leverage ratio and the net stable funding ratio (NSFR) to EU legislation applicable from 28 June 2021. Both instruments fall within the scope of measures addressing macroprudential or systemic risk identified at the level of a Member State.[27] The leverage ratio and the NSFR could be an useful tool to mitigate excessive credit growth and leverage or liquidity and maturity transformation.[28]

Furthermore, the procedural elements for activating national flexibility measures have been simplified. The notification of the measures should be submitted only to the ESRB, which forwards the notification to all other relevant authorities. The activiating authority does not need to consider whether Pillar 2 would be suitable and effective to address the systemic risk in line with the redefined aim of Pillar 2. The activating authority can also extend the measure for two years instead of one year and review the situation every two years.

Finally, it was clarified that other Member States, when reciprocating the measure, may apply it to domestically authorised institutions which have branches or have exposures located in the Member State authorised to apply the measure.[29]

Responsibilities of authorities regarding real estate measures (Article 124 and 164 of the CRR)

CRR allows competent authorities to set a higher preferential risk weights in the standardised approach for exposures secured by mortgages on immovable property and to apply stricter criteria for the eligibility of such preferential risk weights[30]. The legislation also allows competent authorities to set higher minimum values of exposure weighted average LGD for the IRB approach for retail exposures secured by residential or commercial immovable property. However, the application for the IRB approach remains limited to retail exposures and does not include corporate exposures unlike provisions with respect to the standardised apprach, which applies to all exposures secured by immovable property.

The application of these powers is based on loss experience and taking into account forward-looking markets developments and financial stability considerations. Consequently, under the new rules, Member States will be able to entrust these powers either to the competent authority or to the designated authority. Member State should also adopt the necessary provisions to ensure proper coordination and exchange of in-

29 Article 458(5) of the CRR.

30 The preferential risk weigh is 35% for exposures secured by mortgages on residential property referred and 50% for exposures secured on commercial immovable property.

Figure 2 Activation process for macroprudential instruments

<table>
<tr><th colspan="2" rowspan="2">Instrument</th><th colspan="4">Threshold</th></tr>
<tr><th>0%</th><th>2.5%</th><th>3%</th><th>5%</th></tr>
<tr><td colspan="2">Countercyclical capital buffer</td><td>Notification</td><td colspan="3">Notification – automatic reciprocity does not apply</td></tr>
<tr><td colspan="2">G-SII buffer</td><td colspan="4">Notification</td></tr>
<tr><td rowspan="2">O-SII buffer</td><td>for a group or standalone institution</td><td colspan="2">Notification</td><td colspan="2">• ESRB (and possibly EBA) opinion to the Commission
• Commission act authorising the measure</td></tr>
<tr><td>for subsidiary of an G-SII or O-SII</td><td colspan="2">Notification – up to 3% (or the rate authorised by the Commission at the consolidated level) or the buffer applicable at the consolidated level + 1%, whichever is lower</td><td colspan="2">Not possible to set the O-SII buffer higher than the buffer applicable at the consolidated level +1% or above 3% or above the rate authorised by the Commission at consolidated level</td></tr>
<tr><td colspan="2">O-SII buffer + SyRB</td><td colspan="3">No procedure</td><td>• ESRB (and possibly EBA) opinion to the Commission
• Commission act authorising the measure</td></tr>
<tr><td colspan="2">Systemic risk buffer – rate is maintained or decreased</td><td colspan="4">Notification</td></tr>
<tr><td rowspan="2">Systemic risk buffer – rate is increased or a new SyRB is activated</td><td>for a group or standalone institution</td><td colspan="2" rowspan="2">Notification – reciprocated SyRB from other Member States are not counted towards the threshold</td><td>• Commission opinion to the Member State concerned
• Member State should comply with a negative opinion or explain reasons for not doing so</td><td rowspan="2">• ESRB (and possibly EBA) opinion to the Commission
• Commission act authorising the measure</td></tr>
<tr><td>for subsidiary of an EU institution</td><td>• ESRB and Commisison recommendation to the Member State concerned
• in case both opinions are negative and the authorities of the parent and subsidiary disagree on the SyRB rate, the matter may be referred to the EBA for mediation (Article 19 of Regulation 1093/2010)</td></tr>
<tr><td colspan="2">Risk weights for real estate exposures in the standardised approach</td><td colspan="4">ESRB and EBA Opinion to the Member State concerned</td></tr>
<tr><td colspan="2">LGD floors for real estate exposures in the IRB approach</td><td colspan="4">ESRB and EBA Opinion to the Member State concerned</td></tr>
<tr><td colspan="2">National flexibility measures (Article 458 CRR)</td><td colspan="4">• ESRB and EBA opinion to the Commission, Council and Member State concerned
• the Commission may propose to the Council an implementing act rejecting the measure
• the Council may reject or not the draft measure</td></tr>
</table>

Source: Authors.

formation between the competent authority and the designated authority for the proper application of these Articles.

The scope of these Articles is also made more flexibile – they can be applied to one or more property segments located in one or more parts of a Member State's territory. The extension of the granularity to take into account also different parts of territory is important as real estate developments often vary in different parts of Member States, for example in large cities.

The coordination requirements for these powers are also streghtened. Up to now, competent authorities were required to consult the EBA on the application of these powers. According to the new rules, the EBA and the ESRB should issue an opinion on the measures within one month following the notification by the relevant authority. More guidance on the application of these powers will be provided by EBA regulatory technical standards or an ESRB recommendation.

Streamlining EU coordination procedures

The ESRB is expected to play a key role in the coordination of macroprudential measures as well as the transmission of information on planned macroprudential measures in Member States.[31] First, the ESRB becomes a central hub for notifications regarding macroprudential measures. Member States will only be required to submit their notifications of macroprudential measures to the ESRB, which will then be responsible for transmitting the notification, where applicable, to the Commission, the EBA, competent and designated authorities of other Member States concerned and supervisory authorities of third countries. However, this procedure does not apply to all macroprudential tools – relevant authorities should send their notifications regarding the application of real estate measures, to the ESRB and the EBA. Second, the ESRB should become an information hub for national macroprudential measures by publishing on its website the list of G-SIIs and O-SIIs, CCyB rates and real estate measures.

Third, while designated authorities are still required to assess the CCyB rate quarterly, they should only send a formal notification to the ESRB when the buffer rate is effectively changed. With regard to the SyRB, only a notification is required when the SyRB rate is maintained or reduced and no formal approval process is initiated. The mandatory review period for the application of national flexibility measures is extended from one year to two years as is the case for the SyRB. The 'pecking order' is removed completely for the SyRB and Pillar 2 is removed from the 'pecking order' for national flexibility measures.

However, the approval procedures for the application of the SyRB, the O-SII buffer and national flexibility measures remain complex and there is further scope for their simplification (see Figure 2). While it is important that EU institutions review national measures above certain threshold to safeguard the single market, the number of thresholds and different approval procedures just adds complexity. In particular, the special procedure for subsidiaries of EU institutions in the specific case when the SyRB is set between 3% and 5% seems redundant. Next, the ESRB and the EBA have six weeks to provide their opinion for the SyRB and O-SII buffer, but only one month for the application of measure inthe CRR.

Changes to the EU bank resolution framework

Resolvability is together with resilience one of the overarching goals of the existing bank regulation. While micro- and macro-supervisions are primarily tasked with ensuring that credit institutions are sufficiently resilient (thus preventing financial crises from occurring), the resolution framework is primarily tasked with managing the financial crises that may still occur.

A comprehensive EU bank recovery and resolution framework has been in place since 2015. The proposed changes in the Banking Package largely concern the incorporation of the outstanding elements finalised at international level (by the Financial Stability Board – FSB) as well as some improvements to the existing framework, following experience with the application of the rules over the past years.

BRRDII introduces a distinction between three different types of banks, namely global systemically important banks (G-SIIs), top tier banks (TTB) and all other banks (see also Figure 3). Top tier banks is a new category of credit institutions, which represent resolution entities other than G-SIIs with total assets of above EUR 100 billion. Additional banks, so called "fished banks"[32] could be also subject to the same treatment as TTBs, upon decision of the resolution authority, if such a bank is reasonably likely to pose a systemic risk in case of failure. In line with proportionality principle, these different categories of credit institutions are subject to different requirements and timelines.

The majority of resolution-specific changes in the Banking Package are related to the Minimum Requirement for own funds and Eligible Liabilities (MREL), a requirement imposed on all banks in the EU with the objective of ensuring effective and credible resolution in case of a banking crisis. The MREL requirement has been originally set as a bank-specific requirement, with no minimum level. The Banking Package introduces a minimum Pillar 1 MREL requirement for G-SIIs and TTBs (see Box 2). With this minimum requirement, the EU framework incorporates the international standards on Total Loss Absorbing Capacity (TLAC) for G-SIIs, developed by the FSB. Pillar 2 MREL requirement continues to be bank-specific. It can be imposed to G-SIIs and TTBs on top of Pillar 1 MREL requirement while it represents the full MREL requirement for all other banks.

The legislation requires banks to comply with MREL at all times by holding easily 'bail-inable' instruments, so as to ensure that losses are absorbed

31 Cf. Recital 25 of CRD V.

32 Donnay, M., De Temmerman, T. and Pranckevicius, A.: The EU Banking Package, Presentation for Florence School of Banking and Finance, 26 June 2019, http://fbf.eui.eu/wp-content/uploads/2019/06/Online.seminar_FBF_Banking.Package_DG.FISMA_.pdf

Figure 3 Comparison between BRRD and BRRD II

Dimension	BRRD I	BRRD II		
Scope	All banks	G-SIIs	Top Tier Banks	Other banks
Calibration	bank-specific	Pillar 1 (common minimum) + Pillar 2 (bank-specific)		Pillar 2 (bank-specific)
Subordination	Case-by-case	Required		Case-by-case
Internal MREL	No detailed rules, Case-by-case	90% of G-SII Pillar 1 requirement for material subsidiaries	Detailed rules with strict exemptions	
Treatment of holdings	No requirement	Deduction for instruments of other G-SIIs	No requirement	
Disclosure	No requirement	At least semi-annually and quarterly for key metrics	At least annually	
Denominator	Own funds and total liabilities	TRE amount or Leverage ratio exposure measure		
Breaches	Not defined	Specific powers, M-MDA regime with potential 9-month grace period		
Third-country bail-in recognition	Contractual recognition clause	Possibility of a waiver if not impeding resolvability		

Source: Authors

and banks are recapitalised once they get into a financial difficulty and are subsequently placed in a resolution. The application of no creditor worse of principle (NCWO), however, could be breached in a situation where liabilities eligible for bail-in rank equally with liabilities that are not eligible for bail-in. This risk could be reduced if liabilities which are contributable to loss absorbency, are subordinated. In order to achieve a credible bail-in tool, the Banking Package tightens the rules on the subordination of MREL instruments. The subordination, either contractual or structural, is imposed for Pillar 1 MREL requirements for both G-SIIs and TTBs,[33] while the subordination of Pillar 2 MREL requirement remains at the discretion of the resolution authority, based on the NCWO principle.

To improve the resolvability of banking groups, resolution authorities should be able to upstream the losses of subsidiaries to the resolution entities, without placing that subsidiary into resolution itself. For this purpose, an internal MREL requirement is foreseen for all banks that are subsidiaries of EU-based resolution entities (non-resolution entities) at 100% of formula applied to calculate Pillar 2 MREL requirement (see Box 2). For material subsidiaries of 3rd country G-SIIs, a 90% internal MREL requirement is foreseen.

The combined buffer requirement (CBR) stacks on top of MREL expressed as RWA. This means that such set-up could easily result in a breach of the CBR before the breach of MREL. In a risk-weighted framework, a CBR breach automatically triggers the maximum distributable amount (MDA) regime. If a breach of CBR is present in the MREL framework only, the resolution authority has some flexibility: for the first nine months, restrictions might be applied only under certain conditions; after nine months, the presumption is that restrictions must be applied, but can be waived subject to market conditions and the broader financial stability considerations. Furthermore, resolution and supervisory authorities have been provided with a vast toolkit to address MREL breaches, and they are required to take at least one of the measures, e.g. in the form of applying the power to address or remove impediments to resolvability, or of regular supervisory or early intervention measures.

33 *Under certain conditions, 3.5% of RWA may be unsubordinated, if the subordinated part of MREL equals at least 8% of banks TLOF (total liabilities including own funds).*

34 *The reference level for market confidence buffer is based on combined buffer requirement (CBR) less countercyclical buffer. In contrary to the existing legislation, the Banking Package uses the market confidence buffer only once in the formula for Pillar 2 MREL calibration.*

Box 2

MREL calibration

Pillar 1 MREL calibration

G-SIIs: 16% RWA (18%) and 6% leverage ratio (6.75%) from 2019 (2022)
TTBs: 13.5% RWA and 5% leverage ratio from 2022

Pillar 2 MREL calibration

G-SIIs & TTBs: formula below, but Pillar 1 MREL requirement as a floor
Other banks: Loss absorption amount + Recapitalisation amount
(prudential Pillar 1 + Pillar 2R) + (post-resolution prudential Pillar 1 + Pillar 2R + market confidence buffer1)[34]

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. The banking package supplements this power by an additional moratorium power in the pre-resolution phase. The resolution authority could trigger it after the bank has been declared "failing or likely to fail" and when this is necessary to assess whether resolution action is in the public interest or to choose the appropriate resolution actions.[35] The scope of this new power is broader than the existing moratorium power, since it also covers covered deposits. The moratorium powers are however not cumulative and could also be imposed for a maximum duration of two days, in line with the ISDA agreements.[36]

In addition, the banking reform package includes various other changes, e.g. it introduces disclosure requirements, MREL holdings deductions for G-SIIs,[37] stricter criteria on eligible liabilities for G-SIIs, or requirements to prevent misselling of MREL instruments to retail creditors. Furthermore, it relaxes conditions on contractual recognition of bail-in powers and of resolution stay powers (see also Figure 3).

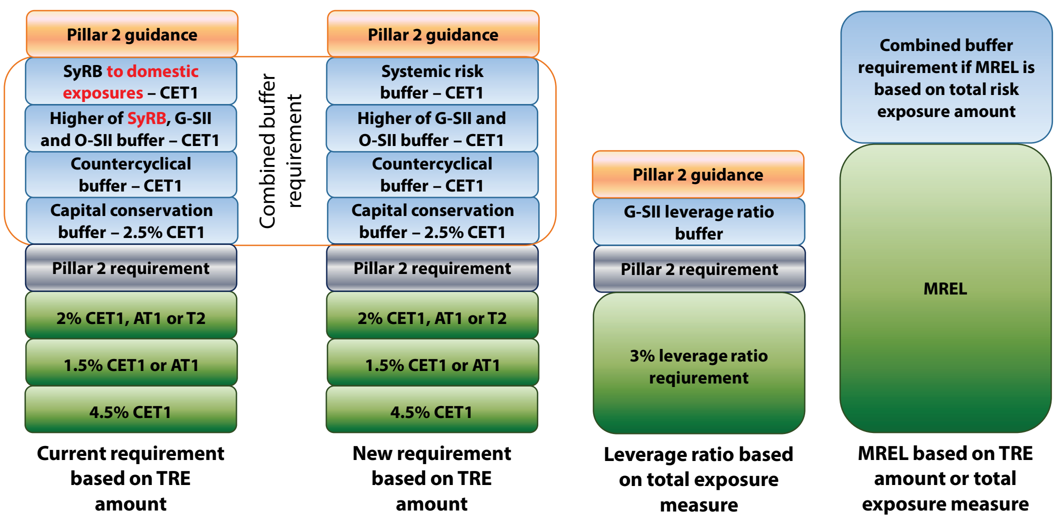
Conclusions

The Banking Package represents an extensive set of amendments to the prudential and resolution frameworks, following the finalisation of international standards and experience gained in the EU with the application of the existing legislative acts. It comprises extensive amendments to CRR/CRD IV as well as to BRRD and SRMR. The amended regulatory framework addresses several outstanding challenges to financial stability, while it ensures that banks can continue to support the real economy. It strengthens the resilience and resolvability of banks, makes the financial system more stable as well as reduces the administrative burden for smaller and less complex banks. The framework, however, will be introduced only gradually over coming years, given the extensive set of transitional provisions.

Moreover, the work on the implementation of Basel III reforms into the EU regulatory framework remains ongoing. A number of revised international standards were only finalised in December 2017 and January 2019, after the Commission's proposal on the Banking Package from 2016. Only selected elements of the revised Basel III framework have been incorporated into the Banking Package, namely the revised rules on the leverage ratio and the new rules on the leverage ratio buffer. Other elements, including those regarding the credit and operational risk, are yet to be incorporated into EU legislation, after providing an impact study evaluating its consequences for EU banks and the EU economy.

One of the objectives of the Banking Package was to introduce a separation between microprudential and macroprudential rules. At the same time, the amended text introduced a binding minimum leverage ratio and binding minimum MREL requirements for selected banks (in the form of Pillar 1 MREL), which are both characterised with an overlap, in terms of the use of capital, with the risk-based capital requirements and macroprudential capital buffers (see Figure 4). The existence of parallel requirements represents a profound change in the regulatory framework. It follows that the interaction between minimum requirements, which have to be fulfilled at all times, and risk-weighted capital buffers expected to be released in times of stress, needs to be monitored going forward, in particular the materiality of the overlap in different phases of the financial cycle and for different types of institutions.

Figure 4 Interaction between leverage ratio, MREL, and risk-based capital requirements



Source: Authors' compilation.
Notes: The CET1 capital used to meet combined buffer requirement must not be used to meet MREL, if based on total risk exposure amount (TRE).

35 The European Commission originally proposed also a supervisory moratorium, which was planned to be applied by supervisory authorities when assessing whether a bank meets the conditions for early intervention or whether it is failing or likely to fail. Only a single moratorium power to resolution authorities was retained.

36 ISDA refers to International Swaps and Derivatives Association.

37 To prevent contagion within the financial system, all G-SIIs are required to deduct their holdings of their own eligible liabilities instruments and holdings of liabilities instruments of other G-SIIs.