European Commission - Fact Sheet

Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) and resolution (BRRD/SRM)

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1. CONTEXT

Why did the Commission propose this package of banking reforms in 2016?

The banking reform package proposed by the Commission in November 2016 represents an important step towards the completion of the European post-crisis regulatory reforms. These risk-reduction measures will allow further progress in completing the Banking Union and the Capital Markets Union, as called for by the Euro Summit, most recently in December 2018. The package is also a response to the June 2016 ECOFIN Council conclusions, which invited the Commission to put forward proposals to further reduce risks in the financial sector no later than by the end of 2016.

These reforms also comply with the standards agreed with international partners at the G20 and to capitalise on the lessons learnt from the financial crisis. In particular, the banking package, as agreed today by the European Parliament, implements some outstanding elements that are essential to make the financial system more resilient and stable, which have been finalised by global standard setters (i.e. the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB).

How will this package reduce risks in the banking sector?

The agreed rules will reduce risks in the banking sector by further reinforcing banks' ability to withstand potential shocks. They will update the framework of harmonised rules established in the wake of the financial crisis, the so-called 'Single Rulebook'.

The 'Single Rulebook' ensures that:

o banks have enough capital to cover unexpected losses and are prepared to withstand economic shocks (through the *Capital Requirements* Directive and Regulation)

o bank failures are resolved with the use of funds provided by banks, with minimum impact on taxpayers (through the Bank Recovery and Resolution Directive)

o depositors' savings are protected at a uniform level of €100,000 across the EU Member States when a bank fails (through the Deposit Guarantee Scheme Directive), and

o bankers have fewer incentives to take excessive risks.

For the banks in the euro area and those that would like to join the Banking Union, the regulations on the Single Supervisory Mechanism and the Single Resolution Mechanism have further harmonised the way in which banks are supervised and resolved. All these elements have led to reinforcing the EU institutional and regulatory framework for banks, resulting in a substantial reduction of risks in the banking sector.

The rules adopted today will fine-tune some prudential and bank resolution aspects in order to make the banking sector even more resilient to shocks, while making it more growth-friendly and proportionate to banks' complexity, size and business profile. This means that the rules will be better adapted to the size, risk and systemic importance of the banks.

Furthermore, in order to facilitate an orderly resolution of banks in difficulty the adopted rules further adapt the requirements governing how banking groups deal with operations between the various entities.

How will this package affect the global competitiveness of EU banks?

The measures contained in the package will ensure that EU banks will maintain strong capital and liquidity positions that will enable them to compete with their international peers.

Which additional risk-reduction measures are being introduced beyond the banking package?

Since the Commission adopted the banking package in 2016, it has proposed additional risk-reducing measures for the banking sector in the EU.

One such measure is the ambitious and comprehensive package on non-performing loans (NPLs) proposed by the Commission in March 2018. The package's aim is to preserve the banking sector's ability to lend and finance the economy by facilitating the reduction of the remaining stocks of NPLs and by preventing the build-up of NPLs in the future. The European Parliament and the Council already reached an agreement in December 2018 on prudential requirements for banks to cover the risks associated with loans issued in the future that may become non-performing. The Commission continues to call on the co-legislators to show determination on the outstanding proposals on the development of secondary markets for NPLs and on facilitating debt recovery.

In addition, in September 2018 the Commission adopted a Communication and a proposal on anti-money laundering (AML) which complements the 2017 proposal to review of the functioning of the European Supervisory Authorities (ESAs). The main goal is to reinforce EBA's competences in ensuring compliance with AML and terrorist financing rules. As highlighted in the Commission Communication, prudential and AML supervision are complementary and need to go hand in hand. The European Parliament and the Council reached an agreement on this package of measures during the inter-institutional negotiations on 21 March 2019.

Does the banking package contain any of the standards adopted by the Basel Committee in December 2017?

The 2016 banking package includes the elements of the Basel III framework already agreed at international level at the time of the Commission's proposal. The more recent changes to that framework, most notably those on credit and operational risk agreed by the Basel Committee in December 2017, are not included in this banking package. The only exceptions are the revised rules on the leverage ratio and the new rules on the leverage ratio buffer.

The Commission will assess the possible implementation of the most recent changes into EU law under the new legislature, following a thorough consultation and an impact assessment to evaluate its consequences for EU banks and the EU economy. This Memo provides further detail on all the aforementioned points.

2. INTER-INSTITUTIONAL NEGOTIATION PROCESS ON THE BANKING REFORM PACKAGE

What has been decided today by the European Parliament? What are the key elements of the agreement?

The European Parliament endorsed today the provisional agreement reached with Member States during the political trilogues at the beginning of December. The legislative texts still need to be formally adopted by the Council of Ministers.

The agreement includes the following key measures of the package:

- a leverage ratio requirement for all institutions as well as a leverage ratio buffer for all global systemically important institutions;
- a net stable funding requirement;
- a new market risk framework for reporting purposes;
- a requirement for third-country institutions having significant activities in the EU to have an EU intermediate parent undertaking;
- revised rules on capital requirements for counterparty credit risk and for exposures to central counterparties;
- a revised Pillar 2 framework;
- an updated macro-prudential toolkit;
- the exclusion of certain banks from the scope of application of the CRR and the CRD;
- a number of measures aimed at reducing the administrative burden related to reporting and disclosure requirements for small non-complex banks, as well as simplified market risk and liquidity rules for those banks;
- a new discount on capital requirements for investments in infrastructure and a more generous discount on capital requirements for exposures to SMEs;
- targeted amendments to the credit risk framework to facilitate the disposal of non-performing loans and to reflect EU specificities;
- targeted amendments related to the incorporation of environmental, social and governance aspects into prudential rules;
- enhanced prudential rules in relation to anti-money laundering;

- a new total loss absorbing capacity (TLAC) requirement for global systemically important institutions;
- enhanced Minimum Requirement for own funds and Eligible Liabilities (MREL) subordination rules for global systemically important institutions (G-SIIs) and other large banks referred to as top-tier banks;
- a new moratorium power for the resolution authority;
- restrictions to distributions in case of MREL breaches;
- Home-host related measures.

3. CAPITAL and LIQUIDITY REQUIREMENTS

3.1 Leverage Ratio (LR)

What impact does the banking package have on the leverage ratio?

The financial crisis highlighted that institutions were highly leveraged, i.e. they took on more and more exposures (loans, derivatives, guarantees etc.), while raising relatively limited amounts of additional capital.

The banking package introduces a binding leverage ratio requirement (i.e. a capital requirement independent from the riskiness of the exposures, as a backstop to risk-weighted capital requirements) for all institutions subject to the CRR. The leverage ratio requirement complements the current requirements in the CRD and the CRR to calculate the leverage ratio, to report it to supervisors and, since January 2015, to disclose it publicly.

The leverage ratio requirement is set at 3% of Tier 1 capital and institutions must meet in addition to/in parallel with their risk-based capital requirements. The 3% calibration is in line with the internationally-agreed level.

Does the banking package contain an additional leverage ratio buffer for G-SIIs?

Yes. Rules requiring global, systemically important institutions to hold an additional leverage ratio buffer on top of the leverage ratio applicable to all banks were added in the package during the negotiations between the European Parliament and the Council. The Commission's proposal did not contain such rules because international discussions were still ongoing at the time.

3.2 Net Stable Funding Ratio (NSFR): What is the compromise on the NSFR?

Before the financial crisis, banks relied too much on short-term funding raised in wholesale markets to finance their long-term activities, meaning that long-term assets growth was not accompanied by a similar increase in stable funding sources. When short-term funding became unavailable, institutions were either forced to request emergency liquidity assistance from central banks or engage in 'fire sales' of assets with the ultimate consequence of driving a number of them into insolvency.

The net stable funding ratio (NSFR) requires banks to ensure that exposures are matched with stable funding sources, thereby preventing liquidity crises. The NSFR standard agreed by the Basel Committee is implemented with some adjustments recommended by the EBA's NSFR report in order to ensure that the NSFR does not hinder the financing of the European economy. They relate mainly to specific treatments such as pass-through models in general and covered bonds issuance in particular, whose funding risk can be considered as low when assets and liabilities have the same maturity. The proposed specific treatments broadly reflect the preferential treatment granted to these activities in the EU Liquidity Coverage Ratio **(**LCR). As the NSFR complements the LCR, these two ratios need to be consistent in their definition and calibration.

Other adjustments to the Basel standard relate to the treatment of short-term transactions with financial institutions in order not to hinder the good functioning of EU capital markets. These adjustments are only transitional for a period of four years, after which the calibration of the Basel standard would apply unless the Commission submit a legislative proposal to amend the treatment of these short-term transactions.

3.3 Market Risk – trading book

What is the compromise on the revised market risk capital requirements?

During the financial crisis, the level of capital required against trading book positions proved insufficient to absorb losses when they materialised. That is why the Basel Committee carried out a fundamental review of the trading book (FRTB) framework.

The FRTB standard of the Basel Committee as a whole was completed in January 2016. However, certain elements of the new market risk framework were subsequently revised by the Basel Committee in January 2019. In December 2017, the Basel Committee also announced a delay of the

implementation deadline of the FRTB standard to 1 January 2022.

In light of these developments, which came after the Commission made its proposal, the co-legislators agreed that it would not be appropriate to implement the FRTB rules as initially proposed by the Commission in the banking package because it would oblige institutions to meet requirements subject to change in the short term.

Instead, the co-legislators have adopted a reporting requirement. Reporting will start once the elements reviewed at international level are introduced via a number of level 2 measures (delegated act for the standardised approach and RTS developed by EBA for the internal model approach).

The EBA has been mandated to report to the Commission on the appropriateness of the final FRTB standards for capital requirement purposes and, in light of this report, the Commission will be invited to submit a legislative proposal by June 2020 to turn the reporting requirement based on the FRTB approaches into a capital requirement.

3.4 Own funds – Treatment of software

What is the agreement on the deduction of software assets from own funds?

As a general rule, banks are required to deduct the value of software assets identified as intangible from their capital. This increases their capital needs. The co-legislators have agreed to exclude certain software assets from the scope of assets that need to be deducted from own funds. In order to ensure a level-playing field at international level and to foster the investments in software in the context of an even more digital environment, the European Banking Authority will be mandated to draft technical standards to define those software assets that do not need to be deducted.

This specification is important as software is a broad concept that covers many different types of assets not all of which preserve their value in a winding-down situation. The technical standards should ensure prudential soundness, taking into account the digital evolution, difference in accounting rules at international level as well as the diversity of the EU financial sector including FinTechs.

3.5 Pillar 2

What are the main changes regarding "Pillar 2" capital add-ons?

Pillar 2 capital requirements are bank specific requirements which supervisors can impose in addition to generally applicable minimum requirements (“Pillar 1”) to cover the specific risks a bank is exposed to. Today's agreement confirms the thrust of the Commission's proposal to clarify the conditions for the application of Pillar 2 capital add-ons and the distinction between mandatory Pillar 2 requirements and supervisory expectations to hold additional capital, also known as Pillar 2 Guidance. The agreement also ensures that competent authorities have the necessary flexibility in the application of Pillar 2 requirements.

What is the difference between "Pillar 2" capital add-ons and macro-prudential tools?

The Commission's proposal provided that Pillar 2 capital add-ons should be confined to a purely micro-prudential perspective, to avoid overlaps with the existing macro-prudential tools which aim to address systemic risk. Today's agreement confirms this separation and provides additional flexibility for the application of the existing macro-prudential tools in order to ensure that authorities have sufficient means to address systemic risk.

3.6 Macro-prudential toolbox

What are the main changes regarding the macro-prudential toolkit?

Targeted improvements have been introduced in the macro-prudential toolkit by the co-legislators to enhance its flexibility and comprehensiveness. It was agreed to:

(i) increase the authorities' flexibility in the use of the Systemic Risk Buffer and the Other Systemically Important Institutions buffer;

(ii) clarify their scope of application of the Systemic Risk Buffer;

(iii) clarify the roles and responsibilities of authorities in tackling financial stability risks linked to exposures secured by mortgages on immovable property;

(iv) reduce the administrative burden linked to the activation and reciprocation of macro-prudential instruments;

(v) introduce a leverage ratio buffer for G-SIIs;

(vi) introduce the option to reflect progress with respect to the Banking Union in the calculation of G-SII score.

3.7 Exempted Entities

What changes are being introduced with regard to entities exempted from CRD/CRR?

Currently the CRD contains a list of entities that have historically been exempted from its scope. Those are public development banks and credit unions in certain Member States. To ensure a level playing field, it should be possible for other similar entities to operate only under national regulatory safeguards, proportional to the risks incurred. In addition to exemptions proposed by the Commission, the co-legislators have exempted a few additional entities, some of which are newly established. In one case, several additional entities were added to the list to ensure the level playing field with an already exempted entity in that particular Member State.

Additionally, the co-legislators agreed that the list of exempted entities should only be only by the co-legislators and not through Delegated Acts as proposed by the Commission.

Lastly, the co-legislators have added an anti-circumvention clause expressly prohibiting Member States to exempt from the CRD through national law credit institutions which are not on the list.

3.8 Credit risk

Why does the adopted text include provisions on credit risk?

Credit risk is the risk of loss due to a borrower's failure to make payments on his or her debt or on other contractual obligations. The European Parliament has proposed some targeted amendments to the existing credit risk framework. The co-legislators agreed to such amendments in two areas: (i) provisions that would help banks with high-levels of non-performing loans to sell them with a limited impact on their capital requirements (so-called massive disposals) and (ii) a more favourable treatment for pensions and salary-backed loans.

What are 'massive disposals'?

The term 'massive disposals' refers to situations where banks sell large parts of a portfolio of non-performing loans. These measures are usually part of a multiple-year programme and have the objective to reduce a bank's non-performing exposure on its balance sheet.

What does the agreed package envisage for massive disposals?

A number of banks use internal models to quantify their own Loss-given default (LGD) estimates. These estimates are one parameter for the calculation of regulatory capital requirements and must be based on observed losses. In short, the higher these observed losses are, the higher will be a bank's LGD estimates and subsequently it will face higher capital requirements.

There have been concerns that massive disposals would not reflect the true long-term economic value of the underlying loans and hence the observed losses could lead to an unjustified increase in banks' loss estimates.

The new rules will allow banks to adjust their loss estimates for a limited period and under strict conditions. This should make it easier for banks to clean up their balance sheets from bad assets and hence improving their lending capacity.

These rules were not included in the Commission proposal.

What does the agreed package envisage for pension and salary-backed loans?

The compromise envisages lower capital requirements for these specific loans to natural persons. These loans typically have comparably low default risk. The compromise sets out a number of safeguards to ensure that this remains the case.

These rules were not included in the Commission proposal.

3.9 Proportionality

What do the agreed rules introduce in terms of proportionality?

First, the text renders requirements for banks to publically disclose certain information more proportionate for smaller and less complex banks. A mandate is also given to the European Banking Authority with the aim to streamline reporting requirements. Moreover, a feasibility study to integrate different types of regulatory reporting by banks will be undertaken.

Second, where new prudential standards are introduced, simple and conservative alternatives are proposed for smaller, less complex banks, notably for market risk, the net stable funding ratio, counterparty credit risk and interest rate risk in the banking book.

Finally, the agreed rules introduce simplified obligations on remuneration and on the net stable funding ratio for smaller and less complex banks.

3.10 Financing of SMEs

How will the banking package affect the financing of SMEs and infrastructure investment?

As regards lending to SMEs, the banking package raises the threshold below which exposures to SMEs can benefit from the existing 25% reduction in capital requirements for lending to SMEs. Compared to the existing rules, it also reduces capital requirements by 15% for exposures above that threshold.

Similarly to the prudential requirements on insurance, the banking package lowers capital requirements by 25% for investments in infrastructure provided they comply with a set of criteria able to reduce their risk profile and enhance predictability of cash flows.

3.11 Sustainable finance

Does the banking package contain any measures related to sustainable finance?

The banking package mandates the European Banking Authority to prepare two reports: one on how to incorporate environmental, social and governance (ESG) risks into the supervisory process and one on the prudential treatment of assets associated with environmental or social objectives. In addition, it requires large institutions to publicly disclose information on ESG-related risks they are exposed to.

3.12 Intermediate parent undertaking

Today's agreement endorses the Commission's proposal to require third-country groups operating in the EU to set up an intermediate parent undertaking (IPU) in the EU, which would allow for a more holistic supervision of the EU activities and would facilitate resolution within the EU.

Co-legislators agreed to limit the application of such new requirement to groups with significant EU activities of at least EUR 40 billions, regardless of whether they are global systemically important banks or not. With a view to respond to structural separation requirements in certain third countries, the agreement also envisages a derogation permitting the establishment of two intermediate parent undertakings where such separation is warranted or resolution would be more effective. To avoid disruptive effects existing third country groups operating in the EU will benefit from a transitional period.

Are branches also covered by the intermediate parent undertaking?

EU branches of third-country credit institutions and investment firms are relevant for determining whether the activities of third-country groups in the EU are significant, i.e. whether the EU assets are above the EUR 40 billion threshold. Branches do not have to be organised under an IPU, but will be subject to enhanced reporting.

3.13 Prudential supervisors' role in combating money laundering and terrorist financing

Recent cases involving some EU banks have revealed serious occurrences of money-laundering and underlined that failure to address money laundering could have detrimental effects on the financial soundness of individual institutions, as well as financial stability implications. Prudential supervisors have a clear responsibility in complementing the role of anti-money laundering authorities and participating actively in this fight.

The new rules of the CRD reinforce the cooperation and exchange of information obligations between prudential and anti-money laundering authorities. Moreover, the co-legislators have explicitly highlighted the anti-money laundering dimension in several key prudential instruments enshrined in the CRD, such as authorisation, fit and proper tests, the supervisory review and evaluation process.

Together with the existing EU Anti-Money Laundering rules and the recently agreed reform of the European Supervisory Authorities, which entrusts the European Banking Authority (EBA) with specific anti-money laundering responsibilities, the new rules will contribute to promote the integrity of the EU's financial system and protection from financial crime.

How does this relate to the Commission's AML related proposals in the ESAs review?

Although the Commission did not propose in 2016 changes to the CRD to reinforce the AML dimension of prudential supervision, the Commission immediately reacted to the recent AML-related scandals by publishing in September a Communication and an amendment to ESA's review that would reinforce EBA's competences in ensuring compliance with AML rules.

As highlighted in the Commission Communication, prudential and AML supervision are complementary and need to go hand in hand. The Banking Package establishes an enhanced role for prudential authorities, which goes hand in hand with the reinforced EBA role agreed in the ESA's review.

4. BANK CRISIS MANAGEMENT FRAMEWORK

What is the essence of the political compromise reached by the co-legislators on the MREL subordination policy?

In order to ensure effective and credible application of the bail-in resolution tool to impose losses on banks' creditors in case of a banking crisis, banks are subject to the Minimum Requirement for own funds and Eligible Liabilities (MREL) which are earmarked for bail-in in a crisis. The EU resolution

framework (consisting of the BRRD and the SRMR) requires banks to comply with MREL at all times by holding easily 'bail-inable' instruments, so as to ensure that losses are absorbed and banks are recapitalised once they get into a financial difficulty and are subsequently placed in a resolution.

In order to achieve a credible bail-in tool, the co-legislators agreed to tighten the rules on the subordination of MREL instruments. Beyond, the existing GSII category, they decided to create a new category of large banks, the so-called “top-tier banks” with a balance sheet size greater than EUR 100bn, in relation to which, more prudent subordination requirements are formulated. National resolution authorities may also select other banks (non-GSIIs, non-top tier banks) and subject them to the top-tier bank treatment. Co-legislators agreed an MREL minimum pillar 1 subordination policy for each of these different categories. Moreover, for a sub-set of G-SIIs and top-tier banks and under certain conditions, the resolution authority may also impose an additional Pillar 2 subordination requirement.

For the rest of the banks, the subordination requirement remains a bank-specific assessment based on the principle of “no creditor worse off”.

What is the agreed policy regarding moratorium powers?

In order to avoid excessive outflows of liquidity in a bank resolution, the Commission proposed to give supervisors and resolution authorities the power to impose a moratorium on banks' liabilities. The co-legislators agreed to retain a single moratorium power (as opposed to two different tools for supervisors and resolution authorities as initially proposed by the Commission and the EP), which should be triggered after the bank is declared “ failing or likely to fail”. The power to impose a moratorium includes also covered deposits and could be imposed for a maximum duration of two days, in line with the ISDA (International Swaps and Derivatives Association) agreements.

What is the agreement on the penalties related to breaches of MREL levels (maximum distributable amount (MDA))?

If banks breach their MREL requirements they may be subject to restrictions preventing them from distributing resources to shareholders or employees. The retained approach, which is the outcome of the political negotiations, builds on the concept of framed flexibility for the resolution authorities to define maximum distributable amounts. For the first nine months following a breach of combined buffer requirement due to an MREL breach, restrictions might be applied only if certain conditions which are related to the nature of the breach are met. After nine months, the presumption is that restrictions must be applied, but can be waived if strict conditions (related to market conditions and the broader financial stability) are met.

What is the final political agreement on the home-host elements?

The negotiations on the powers of the home supervisor of a banking group and the supervisors of Member States where a subsidiary of the banking group is located (home-host balance) have led to the following agreement:

- ensuring that subsidiaries in host countries haveresolution resources (MREL);
- a “safe harbour” clause which enables host authorities to request a higher internal MREL, part of which would not be subject to EBA mediation between home and host authorities;
- the deletion of collateralised guarantees in cross border situations and no cross-border waivers;
- the deletion of the “rule of the sum” between internal and external MREL requirements in a given group;
- a bottom-up approach in the process of setting internal/ external MREL targets;
- the exclusion of intra-group liabilities from the bail-in of the parent.

KEY TERMS GLOSSARY

BRRD Bank Recovery and Resolution Directive

CCP Central Counterparty

CRD Capital Requirements Directive

CRR Capital Requirements Regulation

EBA European Banking Authority

FRTB Fundamental review of the trading book

FSB	Financial Stability Board
G-SII	Global Systemically Important Institution (CRR lingo for G-SIB)
G-SIB	Global, Systemically Important Banks
LCR	Liquidity Coverage Ratio
MREL	Minimum Requirement for Eligible Liabilities and Own Funds – MREL
NSFR	Net Stable Funding Ratio
O-SII	Other Systemically Important Institutions (CRR lingo for domestic SIBs)
QCCP	Qualifying Central Counterparty
SRF	Single Resolution Fund
SRMR	Single Resolution Mechanism Regulation
TLAC	Total Loss Absorption Capacity

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