EU Banking reforms imminent

The Banking Reform Package marks a milestone in the new EU regulatory landscape. **Stuart Willey, Willem Van de Wiele** and **Paul Alexander** provide an update on the most important changes on the road to regulatory reform.

On 27 June 2019, a series of measures referred to as the Banking Reform Package comes into force, subject to various transitional and staged timetables. The adoption of the banking reform package concludes a process that began in November 2016 and marks an important step toward the completion of the European post-crisis regulatory reforms, drawing on a number of international standards agreed by the Basel Committee, the Financial Stability Board and the G20.

The reforms look at SME financing, sustainable financing and infrastructure financing, and treatment of software in recognition of the rise of digitalization.

The banking reform package updates the framework of harmonized rules established following the financial crisis and introduces changes to the Capital Requirements Regulation (CRR), the Fourth Capital Requirements Directive (CRD), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR).

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EU banking reform package came into force

Leverage ratio and implications for G-SIBs

The reform package introduces a binding (Pillar 1) leverage ratio of three percent of Tier 1 capital, in line with the internationally agreed level. Banks must meet this ratio in parallel with their own risk-based capital requirements.

Because a three percent leverage ratio requirement would constrain certain business models and lines of business, leverage ratio requirements may be reduced for certain types of exposures, such as public lending by public development banks and officially supported export credits.

The leverage ratio should not undermine the provision of central clearing services and, as such, the initial margin—which institutions receive from their clients on centrally cleared derivatives transactions and pass on to central counterparties (CPPs)—should be excluded from the calculation of the total exposure measure.

The reform package includes an additional leverage ratio buffer requirement for institutions identified as global systemic important institutions (G-SIBs). This requirement must be met with Tier 1 capital. The ratio is set at 50 percent of the applicable risk-weighted G-SIB buffer.

This leverage ratio was calibrated for the specific purpose of mitigating the comparably high risks that G-SIBs pose to financial stability.

The recitals to the regulation indicate that the European Banking Authority (EBA) should carry out further analysis to determine whether it would be appropriate to apply the leverage ratio buffer requirement to other systematically important institutions (O-SIIs) and, if that is the case, in what manner the calibration should be tailored to the specific features of those institutions.

Pillar 1 net stable funding ratio

The reform package also introduces the concept of a net stable funding ratio (NSFR) in order to prevent overreliance by banks on short-term funding raised in wholesale markets to finance their long-term commitments. The NSFR should be expressed as a percentage and is set at a minimum level of 100 percent, which indicates that an institution should hold sufficient stable funding to meet its funding needs over a one-year horizon under both normal and stressed conditions.

The NSFR introduced by the reform package takes into account “some European specificities to ensure that the NSFR requirement does not hinder the financing of the European real economy.” These adjustments are recommended by the EBA and relate mainly to specific treatments for pass-through models in general and covered bond issuance in particular, trade finance activities, centralized regulated savings, residential guaranteed loans, credit unions, CCPs and central securities depositories (CSDs) not undertaking any significant maturity transformation.

There are also certain transitional measures relating to the treatment of short-term transactions with financial institutions.

In line with the discretion provided by the Basel Committee standards to reduce the required stable funding factor on gross derivative liabilities, the reforms have introduced a five percent stable funding requirement for these types of liabilities.

Treatment of software assets

In the current era of rapid digital transformation, software is becoming a more important type of asset for financial institutions, and this is reflected in the reform package. Generally, banks must deduct the value of software assets from their capital. However, the reform says that “prudently valued software assets, the value of which is not materially affected by the resolution, insolvency or liquidation of an institution,” should not be subject to the deduction of intangible assets from Common Equity Tier 1 items. The technical standards are to be adopted in this respect, and these “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".

Changes to Pillar 2 capital

Pillar 2 capital requirements are bank-specific requirements that the prudential supervisors can impose in addition to the generally applicable minimum Pillar 1 requirements to cover risks a bank faces and which are not adequately addressed by the Pillar 1 requirements to which it is subject. The reform package confirms the conditions for the application of the Pillar 2 capital add-ons and the distinction between the mandatory Pillar 2 requirements and supervisory expectations to hold additional capital, also known as Pillar 2 guidance.

Changes to the macro-prudential toolbox

The reform package introduces a number of improvements to the macro-prudential toolkit in order to enhance its flexibility and comprehensiveness. These changes relate to an increase in the flexibility for regulators in the use of the Systemic Risk Buffer and the Other Systemically Important Institutions buffer; clarification of the scope of application of the Systemic Risk Buffer; clarification of the roles and responsibilities of regulators in tackling financial stability risks linked to exposures secured by mortgages on immovable property; reduction of the burden linked to the activation and reciprocation of macro-prudential instruments; introduction of a leverage ratio for G-SIIs; and introduction of the option to reflect progress with respect to the Banking Union in the calculation of the G-SII score.

Revised market risk framework: A staggered approach

The Basel Committee published its revised market risk framework, known as the Fundamental Review of the Trading Book (FRTB), in January 2016, covering rules for banks using internal models to calculate the own funds for market risk, and revised t again in January 2019.

In light of this, the reform package opts for a staggered approach regarding the introduction of the FRTB, whereby introducing reporting requirements for the FRTB approaches should be considered as a first step toward the full implementation of the FRTB framework in the EU.

€40bn

The requirement to set up an IPU applies when the total value of assets in the EU of the third-country group is at least €40 billion

The European Commission is expected to submit a legislative proposal to the European Parliament and to the Council by June 30, 2020, on how the FRTB framework should be implemented in the European Union to establish the own funds requirements for market risk.

The reform package introduces a number of Basel Committee standards developed over the last years. Notably, these standards relate to large exposures, counterparty credit risk, exposures to central counterparties, exposures to collective investment undertakings and interest rate risk in the banking book.

In addition to the proportionality introduced to the regulations on the treatment of market risk and NSFR requirements, small and non-complex institutions should be required to produce less frequent and detailed disclosures than their larger peers to reduce their administrative burden. The EBA shall be required to "make recommendations on how to reduce reporting requirements at least for small and non-complex institutions, to which end EBA shall target an expected average cost reduction of at least 10 percent but ideally a 20 percent cost reduction." It is worth noting that the reform package also introduces additional proportionality in the rules relating to remuneration.

Financial holding companies and intermediate parent undertakings (IPUs)

The reforms call for third-country groups operating in the EU to set up an intermediate parent undertaking (IPU) to allow for a holistic supervision of their activities, and if necessary to facilitate resolution within the EU.

Two or more institutions in the EU, which are part of the same third-country group, must have a single intermediate EU parent undertaking that is established in the EU.

The intermediate holding company shall be an authorized credit institution or a financial holding company or mixed financial holding company or (subject to certain conditions) a regulated investment firm.

Regulators may allow institutions to have two intermediate EU parent undertakings in instances when the establishment of a single IPU would be incompatible with the requirement for a separation of activities imposed by the rules or supervisory authorities of the third country in which the ultimate parent undertaking of the third-country group has its head office. This also includes instances when having a single IPU would make resolution less efficient than in the case of two intermediate EU parent undertakings.

The requirement to set up an IPU applies when the total value of assets in the EU of the third-country group is at least €40 billion regardless of whether or not such institutions are defined as G-SIBs. Institutions have until December 30, 2023, to comply with the IPU requirement.

EU branches of third-country credit institutions and investment firms are relevant for determining whether the activities of third-country groups exceed the €40 billion threshold. Branches do not have to be organized under an IPU, but will be subject to enhanced reporting.

Loss-given defaults on massive disposals

Massive disposals refer to situations in which banks sell large parts of a

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The reform package introduces measures to support financing for SMEs and infrastructure projects

portfolio of non-performing loans (NPLs), typically as part of a multi-year program to reduce the bank's non-performing exposure on its balance sheet.

A number of banks use internal models to quantify their own Loss-given Default (LGD)—the amount of money a bank loses when a borrower defaults on a loan)—and the higher these observed losses are, the higher the capital requirements they will face.

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 the 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, hence improving their lending capacity.

Banking reforms and ESG-related risks

The banking reform packages incorporates ESG-related risks to reflect the rise of sustainable finance and includes new mandates for the EBA.

- The European Banking Authority must report on how individual regulators should incorporate environmental, social and governance (ESG) risks into the supervisory process. The EBA's assessment should include (i) the development of a uniform definition of ESG risks (including physical and transition risks), (ii) the development of appropriate qualitative and quantitative criteria for the assessment of the impact of ESG risks on the financial stability of financial institutions in the short, medium and long term, (iii) the arrangements, processes, mechanisms and strategies to be implemented by the financial institutions to identify, assess and manage ESG risks and (iv) the analysis and methods and tools to assess the impact of ESG risks on lending and financial intermediation activities of financial institutions. EBA shall submit this report by June 28, 2021.
- The EBA must also prepare an assessment of whether a dedicated prudential treatment of exposures related to assets and other activities associated with environmental and/or social objectives would be justified. This assessment should be made on the basis of available data and the findings of the Commission Expert Group on Sustainable Finance.
- In particular, the EBA shall assess (i) methodologies for the assessment of the effective riskiness of exposures related to such assets compared to the riskiness of other exposures, (ii) the development of appropriate criteria for the assessment of physical and transition risks and (iii) the potential effects of a dedicated prudential treatment of exposures related to such assets on financial stability and bank lending in the EU. The EBA will submit its report by June 28, 2025 and on the basis of that report the European Commission shall, if appropriate, submit to the European Parliament and to the Council a legislative proposal.
- New disclosure
  As of June 28, 2022, large institutions that have issued securities that are admitted to trading on a regulated market of any Member State are required to disclose information on ESG risks, including physical risks and transition risks (the EBA report referred to above shall define such risks). Such information shall be disclosed on an annual basis for the first year and biannually thereafter.

As of 28 June 2022, large institutions with securities admitted to trading on a regulated market of any Member State are required to disclose information on ESG risks

Lending exposure for SMEs and infrastructure projects

The capital requirements regulation (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 €1.5 million by 23.81 percent. The banking reform extends this reduction of 23.81 percent to exposures of up to €2.5 million and introduces a new SME supporting factor reduction of 15 percent for the part of SME exposures exceeding €2.5 million.

The reforms also introduce preferential treatment for infrastructure projects, lowering the capital requirements of specialized lending exposures by 25 percent.

Such investments must comply with a number of criteria to reduce their risk profile and enhance the predictability of cash flows. The lender must carry out an assessment of whether the assets being financed contribute to a number of environmental objectives, such as climate change mitigation and adaption, sustainable use and protection of water and maritime resources, transition to a circular economy, pollution prevention and protection of healthy ecosystems. The Commission will report on the impact of the own funds requirements laid down in the new CRR on lending to infrastructure project entities by June 28, 2022, and shall submit that report to the European Parliament and to the Council, together with a legislative proposal, if appropriate.

Anti-money laundering and combatting terrorist financing

Some recent incidents highlighted the importance of continued efforts to prevent money laundering and to combat terrorist financing. As part of the reform package, the revised CRD stresses the role of prudential supervisors in identifying weaknesses within financial institutions and imposing appropriate sanctions.

In particular, the revised CRD states that "competent authorities should consistently factor money laundering and terrorist financing concerns into their relevant supervisory activities, including supervisory evaluation and review processes, assessments of the adequacy of institutions' governance arrangements, processes and mechanisms and assessments of the suitability of members of the management body, inform accordingly on any findings the relevant authorities and bodies responsible for ensuring compliance with anti-money laundering rules and take, as appropriate, supervisory measures".

The new regulations stress the importance of the role played by supervisors in AML and the importance of the exchange of information between the regulators and financial intelligence units. The European Commission has also launched a proposal to reinforce the competencies of the European Banking Authority with respect to AML.

Amendments to the Resolution Framework – MREL

The concept of MREL for banks—the minimum requirement for the own funds and eligible liabilities that each bank is required to meet and maintain in order to ensure that the capital structure of a bank is such as to render the bail-in tool effective upon resolution—had already been introduced by the BRRD. The reform package adds significant detail on the criteria for what constitutes "eligible liabilities", the methodology for determining the MREL for a particular bank and the way in which information is reported and disclosed.

Introduction of the TLAC requirement to EU G-SIBs

CRR II implements the Financial Stability Board's total loss absorbing (TLAC) requirement for Global Systemically Important Institutions (G-SII), which is the EU equivalent of a G-SIB. The transitional requirement—the higher of 16 percent of RWA or six percent of the leverage ratio exposure measure—shall apply immediately. The higher requirement—18 and 6.75 percent, respectively—comes into effect as of January 1, 2022.

Additional changes to the MREL subordination policy

Beyond the existing GSII bracket, the reforms have created a new category of so-called "top-tier banks" with a balance sheet greater than €100 billion, facing stricter subordination requirements. In addition, national resolution authorities may select other banks (non-GSII, non-top-tier banks) and subject them to top-tier bank treatment. The reform package contains MREL minimum Pillar 1 subordination policy for each of these categories. Under certain conditions, the resolution authority may now also impose an additional Pillar 2 subordination requirement.

€100bn

A new category of "top-tier" banks with a balance sheet greater than €100 billion

Certain changes to the MREL eligibility criteria

Certain debt instruments with an embedded derivative component, such as certain structured notes, should be eligible—subject to certain conditions—to meet the MREL to the extent that they have a fixed or increasing principal amount repayable at maturity that is known in advance while only an additional return is linked to that derivative component and depends on the performance of a reference asset. The reform package also introduces certain other amendments to the MREL eligibility criteria.

Penalties related to MREL breaches

The breach of MREL requirements by banks will result in restrictions on the distribution of resources to shareholders or employees. The reform package includes the following compromise: For the first nine months following a breach, restrictions might be applied only if certain conditions that are related to the nature of the breach are met. After nine months, the presumption is that the restrictions must be applied, but can be waived if strict conditions—related to market conditions and the broader financial stability—are met.

Sale of subordinated eligible liabilities to retail clients

The sale of MREL-eligible instruments to retail clients shall be subject to a number of conditions and limitations, on the understanding that Member States shall not be required to apply these restrictions to liabilities issued before December 28, 2020.

All of the following conditions must be fulfilled: the seller must perform a suitability test in accordance with MiFID II; the seller must be satisfied, on the basis of that test, that such eligible liabilities are suitable for that retail client; and the seller documents the suitability in accordance with MiFID II.

In addition, when the financial portfolio of the retail client does not exceed €500,000 at the time of the purchase, the seller shall ensure that the retail client does not invest an aggregate amount exceeding ten percent, and the initial investment amount invested in one or more of the instruments is at least €10,000.

However, Member States have the right to set a minimum denomination amount of at least €50,000, taking into account local market conditions and practices along with existing consumer protection measures within the jurisdiction of that Member State.

MREL reporting and disclosure requirements

In order to ensure transparency, institutions should report to regulators and make regular public disclosures of their MREL, the levels of eligible and bail-in-able liabilities and the composition of those liabilities, including their maturity profile and ranking in normal insolvency proceedings.

Home-host balance

The reform package contains clarifications regarding 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). These rules include a "safe harbor" clause, which enables host authorities to request a higher internal MREL, part of which would not be subject to mediation between the home and host authorities.

Other amendments to the Bank Resolution Framework

Introduction of the concepts "resolution entity" and "resolution group"

The reform package introduces the concepts "resolution entity" and

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"resolution group". In line with the TLAC standard, the Single Point of Entry (SPE) resolution strategy and the Multiple Point of Entry (MPE) resolution strategy are maintained. Under the SPE resolution strategy, only one group entity, usually the parent undertaking, is resolved, whereas other group entities, usually operating subsidiaries, are not put under resolution, but transfer their losses and recapitalization needs to the entity to be resolved. Under the MPE resolution strategy, more than one group entity might be resolved. Hence, a clear identification of entities to be resolved ("resolution entities"), that is, the entities to which resolution actions could be applied, together with subsidiaries that belong to them ("resolution groups"), is important in order to apply the desired resolution strategy effectively. In addition, that identification is relevant for determining the level of application of the rules on loss-absorbing and recapitalization capacity that institutions and entities should apply. Resolution authorities will be required to identify resolution entities and resolution groups as part of the resolution planning.

Resolution stay

The Bank Recovery and Resolution Directive (BRRD II) allows resolution authorities to suspend certain contractual obligations of institutions and entities for a maximum of two days.

The reforms allow the relevant resolution authority to exercise these powers in a pre-resolution phase, which can be from the moment it determines an institution is failing or likely to fail; if a private sector measure, which it believes will prevent the failure, is not immediately available, and if it believes applying the suspension will prevent a deterioration of the institution's financial condition.

This power cannot include payment or delivery obligations to central banks, central counterparties authorized in the EU and third-country CCPs recognized by ESMA and payment and settlement systems.

Contractual recognition of the resolution stay requirement

In the absence of a statutory cross-border recognition framework, Member States should require that institutions include a contractual term in relevant financial contracts recognizing that the contract may be subject to the exercise of powers by resolution authorities to suspend certain payment and delivery obligations, to restrict the enforcement of security interests or to temporarily suspend termination rights (the resolution stay requirement). A similar requirement already applied with respect to the bail-in tools.

Contractual recognition of the effects of bail-in tools

Under the existing BRRD, banks must already include a clause in contracts governed by third-country laws recognizing the effects of the bail-in tools.

The reform package recognizes that there might be instances, however, where it is impracticable for institutions to include those contractual terms in agreements or instruments creating certain liabilities, in particular liabilities that are not excluded from the bail-in tool under the BRRD, covered deposits or own funds instruments.

Under certain circumstances, it could be considered impracticable to include contractual recognition clauses in liability contracts. These circumstances include cases where it is illegal—under the law of the third country—for an institution or entity to include such clauses in agreements or instruments creating liabilities that are governed by the laws of that third country. Other cases may include instances when an institution or entity has no power at the individual level to amend the contractual terms as they are imposed by international protocols or are based on internationally agreed standard terms, or when the liability that would be subject to the contractual recognition requirement is contingent on a breach of contract or arises from guarantees, counter-guarantees or other instruments used in the context of trade finance operations. However, a refusal by the counterparty to agree to be bound by a contractual bail-in recognition clause should not be considered as a cause of impracticability.

EBA will further determine the conditions under which a waiver can be granted from the requirement to include the contractual recognition clauses. Liabilities, for which the relevant contractual clauses are not included, should not be eligible for MREL.

EC is due to submit a legislative proposal on the implementation of the FRTB framework to the European Parliament

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