What's New? The Banking Package[1] (Part I)

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What does the Banking Package stand for

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 amended framework marks an important milestone in the completion of the Banking Union.[9] Building on existing EU banking rules, it aims to complete the post-crisis regulatory agenda by making sure that the regulatory framework addresses any outstanding challenges to financial stability, while ensuring that banks can continue to support the real economy[10]. The Banking Package improves governance and supervision, separates microprudential and macroprudential tasks and instruments as well as introduces targeted changes to the resolution framework. By reducing risks in the European banking sector, it strengthens the resilience and resolvability of banks and makes the financial system more stable. Moreover, it reduces the administrative burden for smaller and less complex banks and it also aims at fostering the competitiveness of the EU banking sector worldwide.

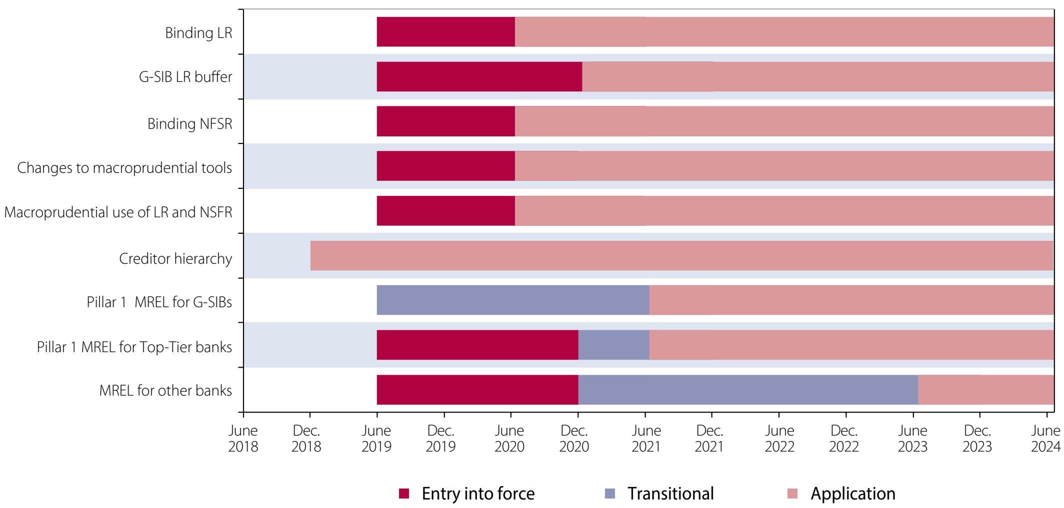
Moreover, the Banking Package implements outstanding elements from international banking standards, agreed by the Basel Committee on Banking Supervision (BCBS) and by the Financial Stability Board (FSB). More specifically, it introduces a binding leverage ratio (LR) and net stable funding ratio (NSFR) and implements a number of Basel III revised standards.[11] Moreover, it aligns the EU framework with the international standards on Total Loss Absorbing Capacity (TLAC) for global systemically important banks (G-SIBs). Some elements of the endorsed international standards have been implemented by the EU with amendments, which are discussed below in more detail.

The Banking Package includes new prudential framework CRR 2[12]/CRD V[13] and the new resolution framework SRMR 2[14]/BRRD II[15]. Reaching a final agreement on these legislative texts was a process that took over two years. The European Parliament adopted the Banking Package on 16 April 2019 and the legislative text was formally adopted by the Council on 14 May 2019. The amendments were published in the Official Journal of the European Union on 7 June 2019 and entered into force 20 days later. The applicability of many new measures, however, is foreseen with a lag of few years (see Chart 1).

Changes to microprudential policy – capital and liquidity requirements

The CRR 2 and the CRD V bring strategic, operational and regulatory challenges for firms. The newly adopted framewor k complements and elaborates on CRR and CRD IV regimes, brings several important amendments in a number of areas, while incorporating Basel III standards, in certain cases taking into account specific aspects of the EU.

Chart 1 Timeline for application



Source: Authors' compilation.

1 *The views expressed are those of the authors and do not necessarily reflect the official stance of the ESRB, SRB, NBS or the institutions to which the authors are affiliated.*

2 *Národná banka Slovenska*

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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 *Still, the Banking Union is far from complete and the banking sector remains largely segmented along national lines. In particular, the third pillar of the Banking Union, the European Deposit Insurance Scheme, and the common backstop to the Single Resolution Fund are still missing.*

10 *European Commission Press Release, EU Banking Reform: Strong banks to support growth and restore confidence, Brussels, 23 November 2016, http://europa.eu/rapid/press-release_IP-16-3731_en.htm*

11 *A number of revised Basel III standards were finalised after the proposal by the European Commission and as a result of this, they were mostly not included in the agreed legislative texts.*

12 *Regulation of the European Parliament and of the Council No 2019/876 of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, reporting and disclosure requirements, and Regulation (EU) No 648/2012 (OJ L 150, 7.6.2019, p. 1).*

13 Directive of the European Parliament and of the Council No (EU) 2019/878 of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (OJ L 150, 7.6.2019, p. 253).

14 Regulation (EU) 2019/877 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 806/2014 as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms (OJ L 150, 7.6.2019, p. 226–252).

15 Directive (EU) 2019/879 of the European Parliament and of the Council of 20 May 2019 amending Directive 2014/59/EU as regards the loss-absorbing and recapitalisation capacity of credit institutions and investment firms and Directive 98/26/EC (OJ L 150, 7.6.2019, p. 296–344).

16 EBA Report on the leverage ratio requirements under Article 511 of the CRR, EBA-Op-2016-13, 3 August 2016, https://eba.europa.eu/documents/10180/1360107/EBA-Op--2016-13+%28Leverage+ratio+report%29.pdf

17 Basel Committee on Banking Supervision, Basel III: Finalising post-crisis reforms, December 2017, p. 140, https://www.bis.org/bcbs/publ/d424.pdf

18 Basel Committee on Banking Supervision, Finalising Basel III in brief, 2017 reforms, https://www.bis.org/bcbs/publ/d424_inbrief.pdf

19 EBA Report on Net Stable Funding Requirements under Article 510 of the CRR, EBA/Op/2015/22, 15 December 2015, https://eba.europa.eu/documents/10180/983359/EBA--Op-2015-22+NSFR+Report.pdf

20 For example see: Basel Committee on Banking Supervision, Fundamental review of the trading book: A revised market risk framework, October 2013, https://www.bis.org/publ/bcbs265.pdf

21 Basel Committee on Banking Supervision, Minimum capital requirements for market risk, January 2019 (rev. February 2019), https://www.bis.org/bcbs/publ/d457.pdf

22 The revised capital requirements for market risk should apply from four years after the date of entry into force of CRR 2 (so ca. from mid-2023).

The main changes to CRR 2 comprise of the leverage ratio, net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures and reporting and disclosure requirements. The major amendments in CRD V regard the exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures.

Leverage Ratio Requirement

The leverage ratio provides a non-risk based backstop to the risk-based capital ratios. While it was included only for reporting and disclosure in CRR, it is introduced as a hard requirement for all institutions in CRR 2, calibrated at 3% of Tier 1 capital, in line with EBA opinion[16] and also BCBS agreement at international level[17]. For global systemically important institutions (G-SIIs), an add-on is adopted, which requires the leverage ratio set at 50% of their risk-based capital buffer (see below under G-SII leverage ratio buffer). It should be met with Tier 1 capital only[18].

The CRR 2 broadly reflects the Basel standard. Certain EU-specific items are excluded from the exposure measure in line with the CRR 2. Exemptions are put in place for activities that could be disproportionally impacted by the leverage ratio requirement. The leverage ratio is adjusted downwards, or it is not applied, to public development banks, central counterparties, and Central Securities Depositories holding a banking license. Exemptions are also put in place for exposures to officially guaranteed export credits, the initial margins on centrally cleared derivative transactions received by banks from their clients and that they pass on to central counterparties, as well as some exposures to central banks (supervisory discretion in certain circumstances).

Net Stable Funding Ratio

As a long-term liquidity requirement, the Net Stable Funding Ratio (NSFR) complements the Liquidity Coverage Ratio (LCR) which is used as a short-term liquidity risk management measure. NSFR is the minimum amount of required stable funding a bank must maintain based on the liquidity, residual maturity and counterparty of the assets over a one-year time period. It ensures that a bank limits its reliance on short term, more volatile, sources of funding in long term requirements. In general, LCR and NSFR are aiming at limiting the maturity mismatch.

As regards the NSFR, the Basel standards were implemented with certain adjustments recommended by the EBA[19] in order to ensure that the NSFR does not hinder the financing of the European economy. Specific treatment is introduced for European specificities such as covered bonds and trade finance and factoring. Moreover, transitional arrangements are put in place for repos/reverse repos in view of the importance of this activity for market-making and the development of a CMU.

In addition, the CRR 2 NSFR framework deviates from the Basel NSFR regime to make the rules more proportionate to small and non-complex firms. Unlike the Basel rules, a simplified version of the NSFR is introduced in CRR 2, providing a relief for small firms when meeting the funding cost and compliance challenges that the new regime will bring in terms of liquidity. This simplified version will need to be approved by the National Competent Authorities (NCAs), based, for instance, on the amount of assets, trading book and derivative positions. NCAs are allowed to make adjustments to those criteria.

Market Risk – Trading book (FRTB Standard)

The most recent financial crisis revealed that the regulatory capital for market risk was not adequate enough to cover related risks. The level of capital required against trading book exposures proved insufficient to absorb losses. As a result, the BCBS has introduced several consultation papers as a part of Basel III, on the Fundamental Review of the Trading Book Standard (FRTB Standard)[20]. It represents a proposal of a new regime addressing material weaknesses in the market risk framework. Aiming at replacing the old market risk regulation and harmonising the treatment of market risk across the national jurisdictions, it deals with all features of minimum capital requirements for market risk such as the trading book – banking book boundary, a standardised approach and internal market risk models.

The BCBS agreed a set of revisions to the market risk framework in January 2019 only[21] and its incorporation into the Banking Package was not feasible. To avoid implementation of the outdated FRTB Standard, but allowing banks to start preparations, the revised FRTB Standard was implemented in the Banking Package, in the first phase, as a reporting requirement only. Banks should begin reporting their revised standardised approach market risk calculations to their supervisors no later than one year after the CRR2 is amended, and once delegated acts for the standardised approach and regulatory technical standards for the internal model approach, developed by the EBA, are in place (expected from end-2020). The reporting requirement will be turned into the capital requirement in the upcoming revision of CRR/CRD framework. The existing market risk framework continues to apply as a capital requirement in the meantime[22].

Credit Risk

Since a comprehensive review of the framework is planned in the next package, the Banking Package includes several targeted amendments for specific situations only. Above all, it provides an incentive for banks to dispose of the legacy of the crisis. Certain provisions are added in order to help banks with high-levels of NPLs to sell them with only a limited impact on their capital requirements (so-called massive disposals)[23].

The massive disposals refer to the option of a bank to sell a large portion of its NPLs portfolio. The banks are not obliged to include the additional losses caused by a massive disposal of defaulted loans in the internal model calculations under the approval of the NCA. However, this is only a temporary measure and all the general rules on internal models' calculations continue to apply. The allowed adjustment is strictly limited to the additional loss that the massive disposal itself would bring to the bank. The difference between realised losses due to massive disposals and loss estimates for non-disposed exposures in default is an important figure. The banks can only benefit in the case that they would be rid of at least 20% of the bank's portfolio of total defaulted exposures.

More favourable treatment is introduced for loans backed by salary and pensions. As these type of loans to natural persons are, in general, of a low default risk, lower capital requirements are introduced for such loans[24]. However, several safeguards are put in place to ensure the status quo regarding the low default risk in these cases.

Pillar 2

While Pillar 1 capital requirements stipulate the maintenance of minimum capital required for three major risk-types (credit risk, market risk and operational risk), Pillar 2 capital requirements serve for managing all other risks connected to the bank's conduct of business (strategic, reputational, concentration, liquidity, systemic, pension and legal risks). It represents a bank-specific capital requirement which can be imposed by the supervisors as an additional capital to Pillar 1, in order to cover the specific risks a bank is exposed to. Pillar 2 framework is reflected mainly in the supervisory review and evaluation process (SREP).

The new framework clarifies the condi tions for applications of Pillar 2 capital requirements and the distinction between the mandatory Pillar 2 requirement (binding) and supervisory expectations for holding additional capital, Pillar 2 guidance (non-binding). More specifically, Pillar 2 capital add-ons are connected purely to a micro-prudential perspective and they cannot be used anymore for macroprudential risks. (see also below under "Changes regarding macroprudential policy").

Intermediate parent undertaking (IPU)

If there is a large, third country banking group with a total amount of EU activities over EUR 40 billion[25] (including those held by third country branches and regardless of whether they are G-SIBs or not) and two or more subsidiaries in the EU[26], the CRD V requires the establishment of an Intermediate EU parent undertaking (IPU) in the EU.[27] Consequently, all EU entities must be restructured under the IPU. This should promote a more holistic supervision of the EU activities and facilitate resolution. In the initial Commission's proposal there was no minimum limit for the size of the EU presence, once the group is present in the EU with two or more subsidiaries. However, the final framework excludes those groups with non-material presence in the EU from its remit. The G-SIBs are not automatically in the scope, once they do not meet the threshold.

The EU branches of credit institutions and investment firms from third countries are not requested to be organised under the IPU. However, they are relevant for determining whether the activities of the group in the EU are significant, in terms of assets. Branches are subject to enhanced reporting. The EBA is requested to monitor the situation and conclude in a report, by June 2021, whether the third country branches should be supervised more closely to avoid regulatory arbitrage.

Sustainable finance (ESG)

For the first time in banking regulation, sustainable finance dimension is introduced. It aims at improving the contribution of finance to sustainable and inclusive growth as well as the mitigation of climate change[28]. At the same time, in the sustainable finance concept, the financial stability is being strengthened by involving environmental, social and governance factors into investment decision-making.

The rising climate-related risks and changes in the environment are reflected in several aspects. Large, listed banks are requested to mandatorily disclose environmental social and governance (ESG) risks connected with their activities. The "green", environmental factors are mirrored also in two requested outcomes of the EBA. The EBA is mandated to conduct a report on the possibility of including the monitoring of ESG-related risks in SREP. The EBA will also report, by June 2025, whether it is possible to introduce a prudential treatment of assets which takes into account the favourable, or detrimental, impact of assets on the environment and social objectives.

Combating money laundering and terrorist financing

As highlighted in Box 1, the anti-money-laundering (AML) agenda was not included in the initial Commission proposal on the Banking Package. The topic was added in September 2018, following a few AML scandals.

The Banking Package includes comprehensive rules, with the aim to contribute to promote the integrity of the EU's financial system and protection from financial crime[28]. Regarding the role of prudential supervisors' in AML and CTF, as introduced in the Banking Package, the enhancement of the cooperation and the exchange of information between both the prudential supervision as well as the AML authorities is of high importance. The role of AML authorities should be complemented by the activities of prudential supervisors. AML aspects are explicitly involved in several key pruden-

23 The European Commission Fact sheet, Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) and resolution (BRRD/SRM), Brussels, 16 April 2019. http://europa.eu/rapid/press-release_MEMO-19-2129_en.htm

24 For salary and pension backed loans lower capital requirements, down from 75 percent up to 35 percent under certain conditions, are introduced.

25 The limit for total value of assets (definition in Article 21b(5) of the CRD V) was not included in the Commission's initial proposal.

26 As stipulated in Article 21b(7) of the CRD V, the EBA shall publish on its website a list of all third-country groups operating in the Union and their intermediate EU parent undertaking or undertakings, where applicable.

27 Taking into account separation requirements in certain third countries as regards supervision over institutions, a derogation is put in place in order to permit the establishment of two IPUs, where such separation is warranted, or it would bring more effective resolution.

28 EU high-level expert group on sustainable finance, Financing a sustainable European economy, final report 2018 by the high-level expert group on sustainable finance. https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf

28 European Commission, Adoption of the banking package: revised rules on capital requirements (CRR II/CRD V) and resolution (BRRD/SRM), 16 April 2019, http://europa.eu/rapid/press-release_MEMO-19-2129_en.htm

29 Directive (EU) 2017/2399 of the European Parliament and of the Council of 12 December 2017 amending Directive 2014/59/EU as regards the ranking of unsecured debt instruments in insolvency hierarchy (OJ L 345, 27.12.2017, p. 96–101).
30 Regulation (EU) 2017/2395 of the European Parliament and of the Council of 12 December 2017 amending Regulation (EU) No 575/2013 as regards transitional arrangements for mitigating the impact of the introduction of IFRS 9 on own funds and for the large exposures treatment of certain public sector exposures denominated in the domestic currency of any Member State (OJ L 345, 27.12.2017, p. 27–33).
31 Commission measures to address the risks related to NPLs, 14 March 2018, https://ec.europa.eu/info/publications/180314-proposal-non-performing-loans_en
32 Regulation (EU) 2019/630 of the European Parliament and of the Council of 17 April 2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures (OJ L 111, 25.4.2019, p. 1–337). See also the current status of the Proposal for a Directive on credit servicers, credit purchasers and the recovery of collateral underhttps://eur-lex.europa.eu/procedure/EN/2018_63?qid=1564061532454&rid=12.
33 Communication from the Commission to the European Parliament, The European Council, The Council and the European Central Bank, Fourth Progress Report on the reduction of non-performing loans and further risk reduction in the Banking Union, 12 June 2019.
34 For example see: The Guardian, Danske Bank money laundering 'is biggest scandal in Europe', 20 September 2018.
35 Communication from the Commission to the European Parliament, the European Council, the Council, the European Central Bank, the Economic and Social Committee and the Committee of the Regions.
36 The enhanced rules (i) give the EBA the competence to request that breaches of AML rules are consistently investigated (by the national AML supervisors), (ii) provide that the national AML supervisors comply with EU rules and cooperate properly with prudential supervisors, (iii) enhance the quality of supervision, (iv) enable the collection and exchange of information on AML risks and trends, (v) facilitate cooperation with non-EU countries, (vi) establish a new permanent committee that brings together national AML supervisory authorities.
37 Amended proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 1093/2010 establishing the European Banking Authority; Regulation (EU) No 1094/2010 establishing the European Insurance and Occupational Pensions Authority; Regulation (EU) No 1095/2010 establishing the European Securities and Markets Authority; Regulation (EU) No 345/2013; Regulation (EU) No 346/2013; Regulation (EU) No 600/2014; Regulation (EU) 2015/760; Regulation (EU) 2016/1011; Regulation (EU) 2017/1129; and (EU) Directive 2015/849, 12 September 2018.
38 European Commission, Proposal for a regulation, Review of the European Supervisory Authorities, https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2017-1546860_en

tial instruments, above all authorisation procedures, fit and proper assessments of members of the management bodies of banks and SREP.

Proportionality

The Banking Package, inter alia, aims to reduce the administrative costs and compliance burden for smaller banks. Proportionality is a key word in this area. CRR 2 introduces a set of measures intended to reach this goal.

Large and listed institutions are required to provide disclosures on a semi-annual and quarterly basis while smaller non-listed firms shall make disclosures on an annual basis. In terms of regulatory reporting and Pillar 3 disclosures, the NCAs are allowed to impose additional reporting requirements if the relevant requirement is proportionate and not duplicative.

In general, in areas where new complex standards are introduced, simple, however conservatively calibrated, alternatives for smaller, less complex banks, are put in place. This regards the market risk, NSFR, counterparty credit risk and interest rate risk in the banking book. In addition, simplified obligations on remuneration for smaller, less complex players are also put in place.

Other changes to the prudential framework

Further changes are introduced in the framework as regards the own funds – the exemption of certain intangible software assets from deduction from own funds if specific conditions are met; rules on capital requirements for counterparty credit risk and for exposures to central counterparties; exclusion of certain banks from the scope of the Banking Package; financing of SMEs; definition of a consolidating supervisor; integration of the EU banking sector – home/host balance, and an option for the supervisors to consider the Banking Union as a single geographic area when computing the G-SII score.

Box 1

Additional risk-reduction initiatives

Since 2016, when the Banking Package was proposed by the Commission, additional risk-reduction initiatives complementing the new framework have been introduced. Moreover, some of the original proposals from 2016 were fast-tracked and implemented separately.

At end-2017, an agreement was reached on first key measures of the Commission's proposal, namely changes to the BRRD to amend the **hierarchy of unsecured creditors in insolvency**,[29] and changes to CRR/CRD to align capital requirements with the introduction of International Financial Reporting Standard (**IFRS 9**).[30] Both legislative acts were published on 12 December 2017 and entered into force the following day, while the regulation became applicable as of 1 January 2018. The amendments to BRRD introduces a new category of unsecured debt in the insolvency ranking, establishing thus a harmonised approach across the EU on the priority ranking of bank bond holders both in insolvency and in resolution and facilitating the application of the bail-in tool. The amendments to the CRR/CRD framework introduced a five-year phase-in period, helping to mitigate the impact of IFRS 9 standards on EU banks' capital and lending capacity. It also added new transitional period for large exposure limits in prudential rules, targeting primarily banks with large holdings of government bonds not denominated in local currency.

A comprehensive **package on non-performing loans** (NPLs) was proposed by the Commission on 14 March 2018.[31] The package contains policy actions aiming at a decrease of the remaining stocks of NPLs and preventing the further build-up of NPLs in the future, including measures in bank supervision and regulation, reforms of national restructuring, insolvency and debt recovery frameworks, developing secondary markets for distressed assets, and fostering restructuring of banks. For the regulatory measures, a political agreement was reached between the European Parliament and the Council in December 2018 and the final regulation was published and entered into force in April 2019.[32] As stated by the Commission, NPL levels are continuing their downward trajectory towards pre-crisis levels. The ratio of NPLs in EU banks has come down by more than half since 2014, declining to 3.3% in the third quarter of 2018 and down by 1.1 percentage points year-on-year.[33]

The **Anti-Money Laundering (AML) Package**, introduced by the European Commission as a complementary dimension to the Banking Package in September 2018, reflects on several AML scandals in the banking sector[34]. It is noted that a failure in addressing these issues could have detrimental effects on the financial soundness of that particular institution as well as that of financial stability. The Commission adopted a communication[35] and a proposal to foster the powers and competencies of EBA[36] in terms of enforcing the AML and combating terrorist finance (CTF)[37], complementing the proposal from 2017 on reviewing the functioning of ESAs.[38] The agreement between the European Parliament and the Council was reached during the interinstitutional negotiations on 21 March 2019. For detailed information to the AML Package was incorporated into the Banking Package (for details, see above under "Combating money laundering and terrorist financing").