COMMENTARY

Thinking ahead for Europe

17 March 2017

Pursuing Multiple Objectives with the Banking Reform Package: Who can still follow?

Karel Lannoo

Multiple objectives are being pursued by the European Commission with its amendments to prudential rules in the banking reform package. On the core capital requirements side, there is the further alignment of EU rules with the Basel rules, in the leverage and net stable funding ratio, for example, and the softening of capital requirements for trading positions. On the resolution side, there is the alignment of bail-in standards TLAC (total loss-absorbing capacity) and MREL (minimum requirement for own funds and eligible liabilities) – an issue for large globally active banks. And on the bank business models side, there is the recalibration of the capital requirements for bank exposures to SMEs and the introduction of proportionality in rules – the first time this has been formally invoked.

As the package is now going through the normal legislative procedure, the question is: Who can still follow? And this is not even the end of it. The review of internal models and their use is still ongoing and, once agreed upon internationally, will require further amendment to the Capital Requirements Directive (CRD). In other jurisdictions, such changes would be part of the discretion of the supervisor, but in the EU they need to go through formal changes to ensure a level playing field in the EU (of 27). With Brexit looming, and the SSM in shape, the competitiveness of EU-based banks needs to be taken into account at European and global level.

The package of measures, adopted on 23 November 2016, comprises amendments to four different measures: the Capital Requirements Directive (CRDIV) and Regulation (CRR), the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Board Regulation (SRBR). The European Commission's justification for the update is the Basel Committee standards, but a detailed comparison between the existing international and draft EU standards is missing. In the changes to the CRD/CRR, it states that it represents "a faithful implementation of international standards into Union law, subject to targeted adjustments in order to reflect EU specificities and broader policy considerations".

In the Q&A release, the Commission addresses some of the differences on, for example, the net stable funding ratio (NSFR) and the trading book, but a detailed assessment would have been useful. It would also been useful as regards the comparison between TLAC and MREL,

Karel Lannoo is Chief Executive of CEPS.

the bail-inable instruments at global and EU level in case of resolution, which is the main reason for the changes to the BRRD.

Capital requirements

The measures on the capital side include a formal introduction of a binding leverage ratio and a net stable funding ratio, following the Basel Committee proposals. A minimum leverage ratio was discussed as early as the start of the financial crisis, but is so far not binding in EU law. There was only the basis for calculating and the requirement to disclose it, as contained in the CRD and CRR. It is now set at 3%, which is largely met by EU financial institutions, according to the EBA data. The proposal also includes some adjustments to deal with public developments banks, which mostly have lower ratios. The net stable funding ratio is another addition of the Basel Committee to the prudential framework. It requires banks to have a minimum level of assets that provide for funding stability, even under stress. It was already contained in the CRR, but is now also made binding, with some adjustments regarding the kind of assets that can be considered stable, such as mortgage loans.

A second set of measures aligns Pillar 2 capital add-ons in the EU, which are additional capital requirements that can be set by national authorities, in view of a bank's risk profile or for macro-prudential reasons. As the interpretation varied across member states, the Commission proposal further clarifies what can be mandated under add-ons, and belongs to the purely micro-prudential domain so as not to confuse them with other macro-prudential tools.

Another amendment that has sparked some controversy concerns the 'maximum distributable amounts'; these are the limitations supervisors can impose on distributions of dividends, variable remuneration and coupon payments if case capital requirements are not met. Stopping interest payments on bonds could ignite quite a spark in the markets, and cut a bank off from market financing altogether.

The measures related to capital requirements for trading positions are probably the hardest to assess. They concern modifications to measures that were taken in the midst of the crisis under the CRDIII package in 2009, but are still a work in progress, as the Basel Committee has not yet finalised its review of the internal models framework. Most important, it introduces a proportional application for banks with small trading books, which can ask for a derogation, and banks with mid-sized trading books, which can use the standardised approach. The proposals also contain a further reduction of capital requirements for SME loans.

Resolution and the TLAC/MREL alignment

Changes to the BRRD are required to create a clear hierarchy in bail-inable instruments to recapitalise a bank and to align the global risk-weighted bail-in standard TLAC with the non-risk weighted EU standard MREL. As the resolution framework created by the BRRD was entirely new, it is understandable that its implementation has raised new issues, especially since it is closely related to insolvency law, which is largely non-harmonised in the EU. But the amendments have rendered the MREL calculation and the bail-in method much more complex. The amendments are spread over two different proposals for amendments; one is limited to Article 108 of the BRRD; the second one amends several articles.

A hierarchy for bail-in was missing in the BRRD, as it had excluded certain elements from bail-in, but required that no creditor would be treated worse (*pari passu* treatment of creditors). This could lead to situations whereby bailed-in bond holders would go to Court claiming that they were treated worse than others. Moreover, some member states had adapted their national insolvency legislation to align it with TLAC, leading to a very uneven landscape at EU level. The provisions create a new asset class of non-preferred senior debt that should be bailed-in after other capital instruments but before other senior liabilities. The Commission hopes that this amendment can be adopted by July 2017, which is a very ambitious timeframe.

The second amendment is the most important of the entire package as it proposes to integrate the TLAC standard into the existing MREL rules and ensure that both requirements are met with largely similar instruments. They are spread over different articles of the BRRD and the SRBR, principally. The problem is that TLAC only applies to global active banks (G-SII), and are standards, whereas the European rules apply by law to all EU-based banks. Moreover, TLAC is a combination of a Pillar 1 minimum and a bank-specific Pillar 2 add-on, whereas MREL is currently set on a bank-specific basis only (Pillar 2). The Commission now proposes to introduce a minimum harmonised TLAC requirement, applicable to EU G-SIIs only. This is composed of a risk-based ratio of 18% (risk-weighted), and a non-risk-based ratio of 6.75% under Pillar I, and a bank-specific Pillar 2. For non G-SIIs, the MREL remains a bank-specific Pillar 2 requirement only, but, as with TLAC, has a dual requirement: a risk-based ratio (a percentage of the total risk-weighted assets) and a non-risk-based ratio. In addition, the Commission introduces the option for resolution authorities to impose bank-specific supplementary MREL guidance.

Furthermore, amendments change the CRD and CRR with regard to the requirement to establish an intermediate holding company within the EU where two or more institutions established in the EU have the same ultimate parent undertaking in a third country. This measure was rapidly interpreted as a way to penalise large non-EU banks based in the UK, in view of Brexit. The problem exists irrespective of this, however, as the existence of a holding company in the EU facilitates resolution but does not block the continuing operations of a bank.

Another series of amendments to the BRRD strengthens the single point of entry (SPE) for resolution. The BRRD had not made financial support within a group a prerequisite, and thereby kept both single and multiple points of entry open as possible resolution strategies (Art. 18 BRRD), potentially inviting disagreements among authorities, and messy resolutions. The amendments proposed require resolution authorities to take a joint decision on the removal of material impediments to the effective application of the resolution tools, with the EBA having to mediate among them and decide. But this still leaves the way open for disagreement among authorities – an issue that does not apply to the euro area, which has the single resolution board. The BRRD changes also require resolution authorities to set an internal MREL for subsidiaries, however, to allow the losses of subsidiaries to the resolution entities to be upstreamed.

Remuneration

Another element where proportionality is applied is remuneration, where it is proposed that EU rules on the deferral of the variable element of remuneration should not be applied to small and non-complex banks. This seems more of a distraction than central to these proposals, however. Proportionality is also invoked in another amendment, which requires the EBA to make recommendations on how to simplify reporting for small institutions through changes to existing EBA reporting templates.

All in all, the greatest significance of the banking reform package is that it renders certain key elements of the Basel III package binding in EU law, such as the leverage ratio and the net stable funding ratio, and that it clarifies how a bail-in will affect different balance sheet items. But since the package is going through the normal decision-making process, it is extremely difficult for lawmakers to assess these technical changes, above all with regard to the BRRD and the MREL.

What was initially a fairly straightforward directive, with a minimum of 8% MREL not risk-weighted, has now become much more complex, certainly for EU-SII. It could have benefited from more explanation. What is justified on the grounds of creating a level playing field could become extremely constraining for resolution authorities, for example if a bank needs to be resolved over a weekend. Moreover, certain amendments have further confused the task of resolution authorities with that of bank supervisors. Both can require additional 'capital' levels, both can withdraw a bank licence, and both will have to resolve a bank in trouble.