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SAFE Regulatory Radar special edition on the EU Banking Package

European Commission proposes reforms to the Capital Requirements Directive and Capital Requirements Regulation

On 27 October 2021, the European Commission has adopted the EU Banking Package that consists of a legislative proposal to amend the Capital Requirements Directive (CRD6), a legislative proposal to amend the Capital Requirements Regulation (CRR3), and a legislative proposal to amend the Capital Requirements Regulation in the area of resolution (the so-called “daisy chain” proposal). Each of the proposed amendments reflects the Basel III reforms and aims to strengthen banks’ resilience to potential economic shocks.

The changes also strive to better integrate environment, social, and governance (ESG) risks in the prudential framework as well as to ensure stronger supervision across the EU. Notably, the proposed rules introduce the output floor (OF), or capital minimum, that will limit banks in using their own internal calculations to decide the size of their capital base. Although the OF will be applicable only at the highest level of consolidation in the EU, it must be determined for each EU subsidiary. In the implementation of the OF, the Commission follows a so-called “single-stack” approach which means that the OF will apply not only to the internationally agreed capital requirements but also to the EU-specific ones. However, the phased five-year transition period for the implementation of the OF will start in 2025.

Capital Requirements Directive: addressing ESG risks

The proposal to amend the CRD clarifies the interaction between the prudential and the resolution frameworks by changing Article 18 CRD. National competent authorities (NCAs) would be able to withdraw the banking authorization to the bank determined as failing or likely to fail declaration (FOLTF). In case a FOLTF bank does not meet requirements to initiate bank resolution, it must be wound up under national laws.

To enhance appropriate focus on sustainability issues, credit institutions must include short, medium, and long-term horizons of ESG risks into their strategies and internal governance. Moreover, NCAs are empowered to review banks’ alignment on the management of ESG risks. In detail, the NCAs must evaluate banks’ exposures, arrangements, strategies, processes, and mechanisms to manage ESG risks. A new supervisory power addressing ESG risks should facilitate the supervisory review and evaluation process (SREP).

Capital Requirements Directive: new powers to treat third-country branches

As a response to the Wirecard scandal, supervisors obtain more powerful tools for the supervision of the groups. To establish a uniform approach for the treatment of third-country branches (TCBs), the legislative proposal introduces new provisions on authorization, minimum regulatory requirements, reporting requirements, and supervision of TCBs. TCBs currently operating in the EU will need to be reauthorized in newly introduced class 1 and 2 to ensure that the NCAs have necessary supervisory powers. Following the introduction of the OF for the calculation of the total risk exposure amount, the proposal sets out some adjustments to the Pillar 2 requirement (P2R) and the systemic risk buffer (SyRB) requirements.

The amendments should avoid unjustified increases in the P2R and the SyRB requirement and should ensure that the P2R and the SyRB requirement cannot be used to cover risks that are already fully covered by the OF. Finally, two types of approaches to calculate own funds requirements for the purpose of supervisory benchmarking were added.

Capital Requirements Regulation: updated definitions

The proposal to amend the CRR updates the definitions of entities subject to consolidated supervision, namely “ancillary services undertaking”(ASU), “financial holding company” and “financial institution” as well as the terms “parent undertaking” and “subsidiary”. For the own funds’ calculation, the legislative proposal foresees threshold exemptions from deduction from Common Equity Tier 1 items. The definitions of “indirect holding” and “synthetic holding” are also clarified. A new article for the determination of minority interests covers also subsidiaries located in a third country.

Regarding the OF, new rules explain the calculation of floored risk-weighted assets (RWAs). Thus, the floored total risk exposure amount (TREA) is to be used only by the EU parent institution, financial holding company or mixed financial holding company of a banking group. At the same time, the un-floored TREA applies to any group entity for the calculation of own funds requirements at the individual level.

Capital Requirements Regulation: revised standardized approach

The revision of the standardized approach for credit risk leads to the increased risk sensitivity in relation to exposure value of off-balance sheet items, exposures to institutions and corporates, specialized lending exposures, retail exposures, exposures with currency mismatch, exposures secured by real estate, subordinated debt exposures, equity exposures, and defaulted exposures.

Capital Requirements Regulation: fund requirements

Further amendments cover own funds requirements for credit risk that are based on institutions’ internal ratings-based approaches (IRB). They limit the exposure classes for which internal models can be used and introduce a new exposure class for regional governments and local authorities as well as the public sector. New provisions, among others, set out minimum values for institutions’ estimates of IRB parameters that are used as inputs to the calculation of RWAs (“input floors”), risk parameters under the foundation IRB approaches, revised scope and calculation methods for own estimates of credit conversion factors.

Amendments regarding credit risk mitigation techniques cover the revised supervisory haircuts applicable to financial collateral under the financial collateral comprehensive method and clarifications to the eligibility criteria for guarantees. Following the fundamental review of the trading book (FRTB), the proposal introduces some adjustments to own funds requirements for market risk. Some targeted changes were made in relation to the credit valuation adjustment risk framework and minimum haircut floor framework for securities financing transactions as well as to operational risk and leverage ratio calculation.

To promote sustainability considerations in institutions’ risk management, the legislative proposal provides new definitions of the different types of ESG risks. Further, institutions must disclose their exposure to ESG risks to the NCAs. New provisions also extend the requirements related to the disclosure of ESG risks to all institutions. Currently, only large institutions with publicly listed issuances are subject to this obligation.

Capital Requirements Regulation: the daisy chain proposal

The daisy chain proposal provides some targeted changes to the CRR to address the issues of resolution of banking groups. The changes implement the approach of indirect subscription of internal MREL (Minimum Requirement for Own Funds and Eligible Liabilities) eligible instruments within resolution groups (also called “daisy chain” approach). The proposal aligns the CRR regime with the deduction regime under the Bank Recovery and Resolution Directive (BRRD). The proposal incorporates in the CRR the provision that MREL eligible instruments issued by subsidiaries to the resolution entity through an intermediate parent must be fully deducted from the amount of the intermediate parent’s own internal MREL capacity (deduction regime). Furthermore, it proposes some targeted clarifications for the requirement for own funds and eligible liabilities for institutions that are material subsidiaries of non-EU G-SIIs (“internal total loss-absorbing capacity”, TLAC) as well as for the calculation of the TLAC/MREL surplus of a subsidiary.

In terms of next steps, the legislative proposals will be considered by the European Parliament and Council. The legislative proposals will come into force on 1 January 2023, whereas the provisions will apply from 1 January 2025.

Anastasia Kotovskaia is Research Assistant at the SAFE Policy Center and currently pursuing a Ph.D. in Law at Goethe University.

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Leibniz Institute for
Financial Research SAFE

Theodor-W.-Adorno-Platz 3
60323 Frankfurt am Main

Phone: +49 69 798 30080
Fax: +49 69 798 30077
Email: info@safe-frankfurt.de

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