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NOTE

From:	Presidency
To:	Permanent Representatives Committee
Subject:	Banking package *- General approach*

I. INTRODUCTION

1. On 17 June 2016, the Council adopted Conclusions on the Roadmap to complete the Banking Union, in which it stressed the importance of pursuing risk reduction and risk sharing measures in an appropriate sequence.

2. Pursuant to the Council's 2016 Roadmap, the Commission presented on 23 November 2016 a package of Banking legislative proposals (the "Banking Package") with amendments to the CRR, the CRD, the BRRD and the SRMR.

3. The Financial Services' Working Party met 37 times under the Slovak, Maltese, Estonian and Bulgarian Presidencies to examine the Banking Package proposals. The Working Party meetings were initially structured in two separate work-streams: prudential requirements (capital, liquidity and supervision of financial institutions) and resolution (bank resolution and the single resolution mechanism), however at the end the Presidency decided to bring together discussions on both parts of the package.

4. The work of the Financial Services' Working Party during the Bulgarian Presidency built on the progress made by the Estonian Presidency as set out in document 14896/1/17 REV 1, which noted the preliminary agreement reached on a wide range of issues, subject to an overall compromise.

5. The Bulgarian Presidency has made considerable progress on the Banking Package with a view to reaching a balanced overall compromise acceptable to a broad majority of delegations.

6. The progress made is now reflected in the compromises prepared by the Presidency on the CRR, the CRD, the BRRD and the SRMR proposals (as set out in documents 6614/18, 6615/18, 6616/18 and 6617/18 respectively).

7. The Presidency believes that the above-mentioned legal texts now reflect a balanced package and the best possible compromise at this stage. However, three issues **remain outstanding and need to be resolved** in order to reach a general approach.

II. OUTSTANDING ISSUES

A. IMPLEMENTATION OF BASEL REFORMS: FRTB

8. The outstanding issue herein relates to the modalities of implementation of the new market risk capital requirements (the "Fundamental Review of the Trading Book" – FRTB).

9. The FRTB sets out the new international standards on bank capital for market risks as agreed by the Basel Committee in 2016. Market risk capital standards can be defined as the amount of capital that banks must put aside as protection for potential losses resulting from their trading business, thus covering the risks of changes in the value of equity, foreign exchange risk, interest rate risk, etc.

10. In December 2017, the Basel Committee published a statement announcing a three year delay in the implementation of the new FRTB framework. The Committee now regards some of the capital calculations set out in the 2016 standards as inadequate and wishes to undertake a thorough review of them. The deadline to complete this review has been extended until December 2018.

11. In light of these developments, it might not be appropriate to require institutions to comply with certain FRTB requirements as initially set out in the Commission's CRR amending proposal where these requirements are expected to change in the short-term as a result of the on-going review in Basel.

12. Some delegations have advocated removing the entire FRTB-related provisions from the CRR until the Basel review has been completed. Other delegations have, however, advocated to retain those provisions as in the Estonian Compromise Text given that there are sufficiently long transitional arrangements to take account of the review and implement an amendment in level 1 in due course.

13. In light of the above views and to strike a balanced compromise, the Presidency has decided to revisit the way to implement FRTB in Union law. In order not to discard the progress made at Working Party level, the Presidency is proposing to maintain in the CRR text the "stable" elements of the FRTB to the maximum extent possible (i.e. those aspects of the FRTB which can be regarded as "final" because they have not been subjected to the review in Basel). Such stable elements will provide the basis for a reporting requirement as explained below.

14. Under the Presidency's approach, those other aspects currently under review in Basel will be implemented initially through a Commission delegated act by no later than end 2019 for reporting purposes only. Institutions will therefore be required to make the capital calculations and report the figures to their supervisors, but will not be under an obligation to hold the amount of capital resulting from such calculations or to disclose them to the market.

15. In addition, a review clause will invite the Commission to present a report by end 2020, accompanied by any appropriate legislative proposals, assessing the appropriateness of converting this reporting requirement into a capital requirement.

16. The existing market risk framework, as currently in force under the CRR, will thus continue to apply as a capital requirement in parallel to the new FRTB reporting requirement, until the new level 1 text is adopted.

17. There are precedents for this approach. It was used in the past to introduce newly agreed international prudential requirements such as the leverage ratio (also for reporting purposes only at the initial stage) and the liquidity coverage ratio.

18. Nevertheless, during the discussion of the Presidency's approach those delegations that preferred to retain the FRTB provisions as per the Estonian Compromise Text suggested a different option to introduce the reporting requirements based on the calculations already present in the Estonian Level 1 Text.

19. Under this option, no Level 1 provisions would be left open for a delegated act to fill in and institutions would be required to report those calculations to their supervisors earlier than under the Presidency's proposal. When Basel has completed its review, the reporting requirements would then be converted into capital requirements via a level 1 amendment taking into account the outcome of the review, as with the Presidency's proposal.

20. Such an alternative approach would result in institutions reporting on figures which are being reviewed by the Basel Committee. Under that approach institutions would be required to use calculations which are likely to be incorrect given that the reporting will be based on Basel Committee figures subject to amendment. Such an approach would lessen the value of the reporting for supervisors and the benefit for the reporting requirement to act as a transition towards a full capital requirement.

21. On the other hand, while stressing that introducing dual reporting requirements is not a preferred option, the delegations supporting this approach find that the progress of discussions in the Council on the implementation of the FRTB during the Estonian Presidency should continue to be reflected in the Council text, and that the approach enhances legal clarity by eliminating the need for a delegated act and could ensure swifter implementation of all parts of the FRTB as well as signalling this through the level 1 text.

22. The Presidency invites Coreper to confirm that it agrees with the manner set out herein to implement FRTB: that is, frontload the reporting requirements and implement the new market risk capital requirements through a level 1 amendment that would be proposed by end-2020.

23. **In particular, Coreper is asked to give guidance on its preferred approach to frontloading the reporting requirements, either:**

    i. **through a delegated act based on the final Basel figures, in the manner described in paragraphs 13 to 16 above, as suggested by the Presidency; or**

    ii. **based on the current calculations as set out in the Estonian Presidency's Progress Report, in the manner described in paragraphs 18 to 21 above, as suggested by some delegations.**

B. MINIMUM REQUIREMENT FOR OWN FUNDS AND ELIGIBLE LIABILITIES (MREL): CALIBRATION OF SUBORDINATION REQUIREMENTS

24. The Financial Stability Board (FSB) adopted in November 2015 a standard for Global Systemically Important Banks (G-SIBs) which aims at providing for an adequate loss-absorbing capacity when those banks fail: the Total Loss Absorption Capacity (TLAC). In resolution, bail-in implies that certain liabilities of a bank be written down or converted into equity in order to cover for banks' losses and to recapitalise the bank.

25. The TLAC standard should be implemented on 1 January 2019. The Commission has proposed that TLAC be transposed as a MREL Pillar 1 (mandatory capital and subordinated debt requirement) for G-SIBs.

26. A proper implementation of the TLAC standard relies upon an adequate level of own funds and subordinated liabilities. Subordinated instruments are those designed to be bailed in before senior liabilities. Due to the increased risk of potential losses, such subordinated instruments are more costly for banks to issue.

27. In addition to Pillar 1, resolution authorities have the discretion to require an additional layer of MREL for G-SIBs, so called MREL Pillar 2 (discretionary requirement) which is to be met with MREL eligible instruments that can be both subordinated and non-subordinated.

28. MREL Pillar 2 is applicable to all banks. The overall quantity of the MREL Pillar 2 requirement should allow for an appropriate loss absorption capacity and for recapitalisation of a bank up to the level that would allow the bank to comply with prudential authorisation requirements and to have a sufficient market confidence buffer (MCB), in accordance with measures included in the resolution plan.

29. In order to establish a proportionate ladder of intervention measures available to resolution authorities at the time of an MREL breach, the Commission has proposed to introduce guidance for MREL Pillar 2 so that restrictions to discretionary distributions (e.g. dividends and variable remuneration) would be applied at a later stage when the breach of MREL reaches a certain level.

30. In addition to MREL Pillar 1, the Commission proposed that the resolution authorities have the discretion to require subordination for MREL Pillar 2 where and to the level that this is necessary to ensure that creditors do not receive worse treatment in resolution than in insolvency proceedings. This is known as no creditor worse off principle (NCWO).

31. To take into account the concerns of many delegations who asked for stricter requirements and further flexibility for the resolution authorities, the Bulgarian Presidency has proposed to remove the concept of Guidance and place the MCB within the MREL requirement. In addition, in view of the risk reduction nature of this package, the Bulgarian Presidency has proposed to increase the flexibility for resolution authorities as regards setting the level of the MCB. When setting the requirement the authority should also be required to take into account the 8% of Total Liabilities and Own Funds (TLOF) rule for access to the Resolution Fund. To compensate for these higher requirements, framed flexibility has been afforded to Resolution Authorities in terms of imposing restrictions on discretionary distributions when MREL levels are breached.

32. With respect to MREL subordination, the Bulgarian Presidency has introduced a new minimum mandatory subordination requirement for Top Tier Banks (with consolidated balance sheet at resolution group level above EUR 75 bn). This floor ensures that such institutions have a minimum level of subordination based on recommendations by the EBA.

33. With regard to discretionary subordination, the Bulgarian Presidency has also put forward a number of proposals. These aim to accommodate both those Member States who would like resolution authorities to be able to have broad discretion to require subordination in excess of Pillar 1 requirement for GSIIS and Top Tier banks and those Member States who would like some safeguards or backstops for how much MREL institutions can be required to meet with subordinated instruments.

34. Specifically, this would imply discretion for the resolution authority to require additional subordination of up to 8% TLOF or a formula based on the risk profile of the institutions. For G-SIIS and Top Tier Banks, the discretion is broad, while for all other banks, is based on assessment of the potential breach of the NCWO principle. Furthermore, higher levels of subordination can be required for the riskiest banks or where substantive impediments to resolvability have been identified.

35. Regarding transition periods, some delegations argued that the existing MREL framework based on the current BRRD, which is applicable since 2016, should be applied without any need for particular transition periods, except where this is necessary for specific banks. Other delegations argued that the new stricter rules would require explicit minimum transition periods for all banks as well as the possibility for authorities to set longer transitional periods for particular banks such as largely deposit-funded institutions, as appropriate.

36. As a compromise, taking into account the amount of shortfalls for MREL eligible instruments in the market, the Bulgarian Presidency has proposed that some transitional periods are granted with the flexibility for the authority to require compliance earlier than the end of the transitional periods.

37. **Despite the Presidency's efforts to reach a compromise, there are still three main outstanding issues to be resolved. The Presidency is asking for Coreper's guidance on the following issues:**

1. **Should the flexibility of the resolution authority to require MREL Pillar 2 subordination be framed? If so, should there be a maximum level of subordination required?**
2. **What should be the threshold to define the scope of Top tier banks:**
   i. **EUR 75 bn - in current Presidency Proposal, or;**
   ii. **EUR 100 bn with a possibility to lower it, based on criteria in level 1 text?**
3. **Regarding the framing of the transitional periods: the Bulgarian Presidency considers that the compromise described above would represent the best way forward on this issue.**

C. EXEMPTIONS FROM THE CRR/CRD SCOPE

38. Under current Article 2(5) of the CRD, there are a number of legal entities explicitly exempted from both the CRD and the CRR, and as a result also from the resolution framework. These legal entities are for the most part credit unions and promotional and development banks, all of which would likely qualify as a "credit institution" and in the absence of such exemption they would need to be licensed and supervised as such under the CRR/CRD framework.

39. The Estonian Presidency's Progress Report concluded that there is large support to exempt the Croatian, Irish and Maltese development banks, as well as the credit unions from Croatia and the Netherlands from the scope of the CRR/CRD for consistency with other currently exempted entities.

40. Germany's federal development bank, KfW, is already exempted from the CRR/CRD but the German delegation requested to have 16 (regional and federal) development banks exempted as well.

41. The Estonian Presidency proposed to grant the exemption to 11 of those banks on the grounds that they have assets not exceeding EUR 30 billion, one of the applicable thresholds to trigger ECB’s direct competence under the Single Supervisory Mechanism (SSM). This proposal did not gather sufficient support within the Working Party. The impact of exempting additional German development banks, when taken together with KfW, is of concern to many delegations, which view this proposal as contrary to the overarching risk-reducing purpose of the legislative package as well as a level playing field and a fair competition issue. Those delegations argue that the list of exclusions in the CRD level 1 text should remain narrow and that no extension should be allowed.

42. Other delegations consider that the list of exemptions in the CRD should be based on certain objective criteria, such as a public and transparent State guarantee. Those delegations underlined that promotional banks typically do not compete with private sector banks because their activities are restricted to meeting certain public policy objectives. On this basis, those delegations would be willing to grant the requested exemption for the German development banks.

43. **In view of the above, Coreper is invited to express its preference among the following three options:**

   i. **No new exemption for German development banks.**

   ii. **Exempt only those German development banks currently not supervised by the Single Supervisory Mechanism (11 banks).**

   iii. **Exempt all of the proposed German development banks (16 banks).**

III. <u>CONCLUSION</u>

44. The Presidency invites the Committee of Permanent Representatives to consider the outstanding issues with a view to reaching a general approach.