Regulatory developments in bank solvency, recovery and resolvability

Ignacio Colomer, Sara González Losantos, María López Pérez and Luis Mohedano Gómez

BANCO DE ESPAÑA

The authors belong to the Directorate General Financial Stability, Regulation and Resolution of the Banco de España. This article has benefited from comments by an anonymous referee. Contact form for comments.

Abstract

Most of the amendments to prudential and resolution legislation introduced in the European Union (EU) in 2019 have already been implemented for credit institutions over the course of 2021. These include a broad set of measures aimed at reducing risks in the banking sector, boosting its strength and progressing towards the completion of the Banking Union. These risk mitigation measures give continuity to the substantial change in prudential rules carried out in 2013 in response to the shortcomings identified in the financial sector in the wake of the financial crisis and which prompted the adoption of the Basel III framework in the EU. They also give continuity to the resolution framework introduced in 2014 to ensure the orderly resolution of non-viable banks, minimising the repercussions of banking crises on the real economy, taxpayers and depositors. The fresh revision of European rules here at hand aims to make progress in the pass-through to European regulations of the internationally agreed reforms. It also aims to change certain aspects in light of the experience accumulated and the inefficiencies detected in the years during which the previous regulations were applied. This article reviews the most salient prudential and resolution measures introduced, presents some reforms that have already been rolled out and describes certain aspects that have not yet been addressed.

Keywords: Basel, prudential regulations, solvency, macroprudential, resolution, MREL.

1 Introduction

In June 2013 the European Parliament and the Council of the European Union approved Directive 2013/36/EU[1] on access to the activity of credit institutions and their prudential supervision (known as CRD IV) and Regulation (EU) No 575/2013[2] on prudential requirements for credit institutions (known as the CRR), substantially modifying prudential rules for credit institutions. Thus, the international regulatory framework known as Basel III was introduced (agreed by the Basel Committee on Banking Supervision - BCBS) to respond to the shortcomings identified in the financial sector as a result of the financial crisis. Basel III included new prudential requirements,

1 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, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

2 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012.

such as the leverage ratio, the liquidity ratios or the capital buffers. It substantially improved the quality and quantity of regulatory capital and introduced improvements in the treatment of market and counterparty risks. The goal of all this was to improve the solvency of credit institutions and the stability of the financial system as a whole.

Despite this progress, at end 2015[3] the European Commission recognised the need to implement risk mitigation measures to continue weakening the link between banks and sovereign debt[4] and to adopt the latest internationally agreed regulatory reforms to solve the problems detected during the crisis. In addition to further boosting the resilience of the EU's banking system, these risk-reduction measures would help to continue making progress in the completion of the Banking Union.

The regulatory framework for banking resolution in the EU has been amply developed since the publication in 2014 of Directive 2014/59/EU (BRRD),[5] which equipped the authorities with tools and competencies to ensure the orderly resolution of non-viable credit institutions, with the aim of minimising the repercussions thereof on the real economy, taxpayers and depositors. Following its entry into force, the shareholders and creditors of the institution are the first ones to bear the costs of resolution, while deposits up to €100,000 are exempt from assuming losses and are protected by deposit guarantee schemes. The Single Resolution Fund (SRF) may be used to implement the resolution tools once the shareholders and creditors have borne the losses and recapitalised the institution for an amount equal to at least 8% of its total liabilities, including own funds (TLOF).

In November 2016 the European Commission unveiled the package of legislative proposals which sought to reduce risks in the banking sector, known as risk-reducing measures (RRM). Following a lengthy negotiation between the European Parliament and the Council, on 7 June 2019 the Regulation and Directive amending the CRR and the CRD (CRR II[6] and CRD V[7], respectively) and the Directive amending the BRRD (BRRD II)[8] were published in the Official Journal of the European Union. This revision of the CRD, the CRR and the BRRD had two main objectives:

3 See European Commission (2015).

4 Best known as the bank-sovereign doom loop whereby, in summary, public support to the financial sector is ultimately detrimental for public finances, the economy and, lastly, once again, bank assets.

5 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.

6 Regulation (EU) 2019/876 of the European Parliament and of the Council 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.

7 Directive (EU) 2019/878 of the European Parliament and of the Council 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.

8 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.

— Transposing into European legislation the reforms agreed at international level which had not been completed in the previous reform. These include most notably: introduction of new counterparty and market risk frameworks; certain adjustments to the large exposures regime; introduction of a net stable funding ratio; introduction of a leverage ratio in Pillar 1; introduction of the new interest rate risk framework; and implementation of the total loss-absorbing capacity (TLAC) standard published by the Financial Stability Board (FSB).

— Changing certain aspects of the regulations in light of the experience accumulated and the inefficiencies detected in their implementation, highlighting the following: the treatment of holding companies; the introduction of the need to create an intermediate parent; the introduction of greater proportionality; changes in the supporting factor for SMEs and the introduction of another supporting factor for infrastructures; the Pillar 2 reform and the adjustments to the macroprudential regime, particularly regarding buffer requirements, with notable changes in the systemic risk buffer to incorporate a sectoral component, and with the introduction of a new leverage ratio buffer for global systemically important institutions (G-SIIs); and the introduction of a series of technical improvements to the resolution framework, specifically for determining the minimum requirement for own funds and eligible liabilities (MREL).

After a transposition period allowed for institutions to prepare, at end-2020 most of the provisions of CRD V and BRRD II had been implemented, as was, in general, CRR II in June, with some exceptions.[9]

It is important to note that the following amendment of the CRR and CRD texts (CRR III and CRD VI), which will incorporate into EU law the finalisation of Basel III, is already in motion and, accordingly, the reform to which this article refers did not address many of the main Basel III changes agreed in 2017, such as, inter alia, those relating to credit risk, operational risk or the output floor.

Section 2 details the most important measures introduced by CRR II and CRD V in the prudential framework, their application date and how the transposition is being conducted in Spain. The Basel III finalisation reforms and their pass-through to EU legislation are also discussed. Section 3 describes the most significant reforms introduced regarding resolution, and certain aspects not yet addressed that will, at

9 There have been other partial amendments between the two large prudential reforms mentioned above (in 2013 and 2019). One of the main ones took place in 2017 as a result of the review of the regulatory and prudential treatment of securitisations within the Basel III framework, which aimed to reduce reliance on external credit ratings, simplify and limit the number of methods used to calculate capital requirements and increase the requirements for riskier exposures. Other amendments during this period included, for instance, those concerning the transitional arrangements owing to the introduction of IFRS 9, the minimum loss coverage for non-performing exposures, the liquidity coverage requirement and the leverage ratio.

least partially, be the object of a coming reform (BRRD III). Lastly, Section 4 sets out some conclusions.

2 Reform of the prudential framework

The main developments introduced by CRR II and CRD V, grouped into key issues, are discussed below.

2.1 Parent companies and other issues relating to the scope of application

Financial holding companies are companies whose main activity consists of holding shares and which are the parent of a banking group. Under CRD IV, these companies were subject to prudential requirements on a consolidated basis. However, the subsidiaries of these groups were not always able to ensure compliance with these requirements at group level, nor did the supervisors have powers over these companies at individual level.

The CRD V amendments provide for a specific administrative approval procedure in Article 21a, as well as adequate supervisory measures to ensure compliance with the requirements applicable to the group on a consolidated basis. To obtain such approval, the financial holding company must have both the capacity to manage the group and characteristics allowing for an effective consolidated supervision of the procedures and the assignment of functions within the group, the group's structural organisation, and the suitability of its shareholders and senior officers. If a series of conditions are met (such as not making management or financial decisions with an impact on the group), the company may be exempt from requiring approval.

With this amendment, the scope of application of prudential requirements on a consolidated basis and of the direct supervisory powers envisaged in the prudential regulations is extended to these holding companies. The competent authority may thus directly require the holding company to comply with the group requirements at consolidated or sub-consolidated level, without being subject to additional prudential requirements on an individual basis.

Article 21b of CRD V introduces the requirement of an intermediate parent undertaking (IPU) with the aim of simplifying consolidation and resolution at European level for third-country groups operating in the EU. Thus, when two or more EU institutions are part of a third-country group, they are required to establish an IPU on which all the subsidiaries depend when they jointly exceed a balance sheet threshold of €40 billion (including branches). The IPU must be a credit institution or a holding company. In certain cases, two IPUs will be allowed.

2.2 Own funds and eligible liabilities

With respect to the changes made to own funds requirements, of note is the change in the name of Part Two of the CRR to “own funds and eligible liabilities”, since a key goal of the CRR II amendments has been to transpose into EU law the FSB’s standard on total loss-absorbing capacity (the TLAC Term Sheet) (see the Section “Reform of the resolution framework”). In this connection, the criteria arising from resolution provisions that ensure the loss-absorbing capacity of instruments have been included in the conditions for calculating own funds and eligible liabilities. As regards other issues, aside from simplifying administrative procedures related to own funds instruments, no substantial changes (only certain adjustments) have been made to the framework defined in the previous reform.

As regards deductions, it is established that new deferred tax assets generated from 23 November 2016 must be deducted from regulatory own funds, even if their recovery does not depend on future income, which does not have a direct impact on previously generated assets.[10] Investments in software, considered as intangible assets, may be exempt from deduction if, based on criteria defined by the European Banking Authority (EBA) and adopted by the European Commission,[11] they have been prudently valued and their value is not negatively affected by procedures of resolution, insolvency or liquidation of the institution.[12]

Under the CRR, the calculation of capital instruments issued by subsidiaries in third countries was hampered, since subsidiaries were required to be institutions or companies subject to the CRD and the trigger for converting Additional Tier 1 (AT1) capital into Common Equity Tier 1 (CET1) capital had to be calculated by applying CRR rules. Following the reform, in issuances outside the EU, the issuer may be a holding company if it is subject to prudential requirements as stringent as those to which third-country credit institutions are subject and the European Commission has decided that these rules are equivalent to those of the CRR. Also, the trigger in AT1 instruments may be calculated in accordance with the national law of a third country if the competent authority of the European institution, after consulting the EBA, is satisfied that the law and the contractual provisions governing such instruments are at least equivalent to those set out in the CRR.

2.3 Proportionality principle

The CRR already provided for the application of some proportionality through risk measurement approaches of varying complexity (standardised approach / internal

10 Article 39 of the CRR.

11 Commission Delegated Regulation (EU) 2020/2176 of 12 November 2020 amending Delegated Regulation (EU) No 241/2014 as regards the deduction of software assets from Common Equity Tier 1 items.

12 Article 36 of the CRR.

models) or in the form of exemption from certain requirements. This would be the case of institutions with small trading books, whose trading exposures are not subject to the market risk framework, but to the credit risk framework.

The amendment made establishes the principle that new prudential requirements should not be overly burdensome for smaller institutions, such that they may be applied in a more proportionate manner. To this end, the definition of a “small and non-complex institution”[13] is introduced based on certain quantitative and qualitative requirements: its total average assets do not exceed €5 billion (Member States may lower that threshold, an option not exercised in Spain); the size of the trading book is considered small; the total value of its derivative positions and the volume of cross-border activity outside the European Economic Area (EEA) do not exceed certain thresholds; it does not use internal models; and it is subject to simplified obligations in relation to recovery and resolution. Even if these requirements are met, the competent authority may exclude an institution from the small and non-complex category.

The foregoing definition is established as the basis for applying the principle of proportionality in several CRR and CRD areas, such as reporting,[14] Pillar 3,[15] the net stable funding ratio and interest rate risk. Other areas of the regulations also address the principle of proportionality, albeit on the basis of criteria other than those addressed in the definition, e.g. the supervisory review and evaluation process (SREP) and remuneration rules.

2.4 Pillar 1

Although the revision of the credit risk framework according to the latest international standards, approved in December 2017, has not been the object of this reform, certain measures have nonetheless been introduced. These include most notably the adjustment for offsetting the effect of losses arising in sales of portfolios in default, from 23 November 2016 to up to three years after the entry into force of CRR II, in estimates of loss-given default (LGD).[16] The purpose of this measure is to make it easier for banks to remove bad assets from their balance sheets and hence improve their lending capacity, preventing bulk sales of these assets from unduly penalising their loss estimates. However, the application of this measure (possible from 27 June 2019) has run into interpretation problems because its wording is not very precise.

---

13 Article 4(1)(145) of the CRR.

14 Part Seven A of the CRR specifically relating to reporting (formerly a chapter of Part Three) has been created, although there are still specific provisions in other parts of the CRR. References to minimum frequencies are eliminated.

15 Part Eight of the CRR on institutions’ disclosures has been reformed to adjust the content and frequency of this information depending on the size and complexity of the institution and to adapt it to international standards.

16 Article 500 of the CRR.

In credit risk, the SME supporting factor has been revised to extend its scope,[17] increasing from €1.5 million to €2.5 million the amount of the exposure to SMEs that benefits from a reduction by applying a factor of 0.7619 to capital requirements, and incorporating a reduction factor of 0.85 for exposures over €2.5 million. A supporting factor of 0.75 has also been introduced for infrastructure projects,[18] provided they meet a series of criteria enabling them to reduce their risk profile and improve cash flow predictability. Both factors are mainly economic policy measures, but their prudential motivation is debatable and some regulators consider they should be eliminated.[19]

A new standardised approach has been introduced for counterparty credit risk (SA-CCR) in replacement of the standardised method and the market price valuation method, with the aim of overcoming their limitations.[20] Also, the possibility of applying simplified methods based on the size of an institution's derivatives business is envisaged. For this purpose, the original exposure method has been recalibrated and a simplified approach (based on the SA-CCR) has been developed. The rule applies from 28 June 2021 and will have an impact on other areas, such as the leverage ratio and the limits to large exposures.

Following the financial crisis, it was observed that the current market risk framework had limitations regarding sensitivity to risk, an aspect which prompted a comprehensive revision to the framework at international level, known as the Fundamental Review of the Trading Book (FRTB). The standardised and internal model-based approaches have been reviewed and redesigned,[21] in an attempt to correct the limitations regarding sensitivity to risk detected during the financial crisis. In the EU, the reporting requirements under the new framework will be implemented first.[22] Capital requirements will be introduced subsequently, with a new legislative proposal. Until then, institutions will continue to apply the current framework for capital requirements and market disclosure purposes. This design has gained preference over the alternative approach of phasing-in the requirements gradually. Also notable is the increase in the trading business volume threshold from €15 million to €50 million as one of the criteria for exempting an institution from applying market risk requirements and replacing them with credit risk requirements.

Regarding the large exposures limit, certain aspects of the Basel framework published in 2014, which were not included previously, have been introduced in the

17 Article 501 of the CRR.

18 Article 501a of the CRR.

19 For instance, the EBA in its recommendations in response to the call for advice on the Basel III reforms (see EBA (2019)).

20 Chapter 6, on counterparty credit risk, of Title II of Part Three of the CRR.

21 Title IV of Part Three of the CRR (Articles 325 to 325bp are created).

22 Reporting under the alternative standardised approach is mandatory from 30 September 2021. Reporting under the new internal model approach will be mandatory three years after the entry into force of the latest regulatory technical standards envisaged in the CRR (Article 430b(3)). At the cut-off date for this article, the EBA had published its proposed regulatory technical standards, but the European Commission had not yet adopted them.

CRR.[23] Thus, the base used to calculate Tier 1 capital limits has been restricted and a lower limit has been set for G-SII exposures to other G-SIIs: 15% compared with the general 25% limit (see the section on macroprudential aspects). Also included are new automatic and other discretionary exemptions for the competent authority, which the latter must justify.

As regards liquidity risk, CRR I incorporated the liquidity coverage ratio (LCR), whereby institutions must hold a volume of liquid assets sufficient to cover net cash outflows over 30 days in situations of stress. In addition, reporting requirements were incorporated for competent authorities to assess whether an adequate long-term funding structure was in place, as were other monitoring tools reflecting the profile, nature and complexity of institutions' activities. CRR II[24] introduces a net stable funding ratio (NFSR) requirement of at least 100%. Also, a simplified metric (sNSFR) and the possibility of applying proportionality in monitoring tools are introduced for small and non-complex institutions. Lastly, certain definitions and concepts are adjusted.

2.5 Leverage ratio

An important development in the previous prudential regulatory reform was the introduction of a leverage ratio based on a simple measure not linked to risk, which aimed to avoid the build-up of excessive leveraging by institutions and to supplement risk-based requirements. At the same time, it would resolve the problem of risk underestimation by institutions' internal models. However, capital requirements were not imposed initially and there were only ratio calculation, supervisory reporting and disclosure obligations. Also, the risk of excessive leverage was introduced as a Pillar 2 risk, which banks should manage and the competent authorities should include in the supervisory review and evaluation process.

In the current CRR reform,[25] a minimum requirement of 3% of institutions' total exposure measure, which applies from 28 June 2021, has been introduced. Also, new exemptions are recognised to prevent the new requirement from penalising certain business models and lines (e.g. loans from public development banks, officially supported export credits, exposures between institutions in an institutional protection scheme (IPS)), or to facilitate the application of monetary policies (temporary exemption of certain exposures to central banks under exceptional macroeconomic circumstances). This involves incorporating the Basel III standard on the leverage ratio, in accordance with the December 2017 reform, which specified certain aspects of the ratio's design.

23 Part Four of the CRR.

24 Part Six of the CRR (Articles 428a to 428az are created).

25 Part Seven of the CRR.

In addition, a leverage ratio buffer requirement for G-SIIs has been introduced. It is set at 50% of their risk-based buffer rate (see the section on macroprudential aspects).

2.6 Pillar 2

CRD IV envisaged the possibility of imposing supervisory measures (Pillar 2), including most notably the additional own funds requirement for risks not covered by the CRR. These uncovered risks could be micro or macroprudential.

Pillar 2 has been redesigned in the current reform, splitting it into a requirement (P2R), implemented in Article 104a, and a supervisory guidance (P2G)[26], laid down in Article 104b, that should be limited to covering microprudential risks, since they are both specific to each institution. Thus, the P2R will cover elements not covered or not sufficiently covered by own funds requirements for risks other than excessive leverage. Its minimum composition has also been established. At least three fourths must be covered with Tier 1 capital, of which another three fourths will be CET1 capital. However, the competent authority may require a more stringent composition when necessary, taking into account the specific circumstances of the institution.

The P2G, for its part, is a guidance – not a requirement – on additional own funds for risks other than excessive leverage. This supervisory expectation, for the purpose of addressing prospective stress scenarios, is based on a review of the institution's estimated internal capital and the supervisory stress exercise. As it is a guidance, failure to reach the P2G level would not trigger restrictions on distributions in case of failure to meet buffer requirements (if the combined buffer requirement is met) nor, in principle, have direct consequences. In the event of repeatedly failing to comply with the P2G, the competent authority may convert it into a P2R (requiring the supervisor to submit a compliance restoration plan). Disclosure of P2G will not be mandatory, although the competent authority may require it, nor has a minimum composition been set.

With the introduction of a leverage ratio, an independent P2R and P2G are established (P2R-LR and P2G-LR), as laid down in the aforementioned articles of CRD V, taking as a reference the total exposure measure instead of the total amount of the risk exposure (commonly known as risk weighted assets - RWAs). From this viewpoint, P2R-LR will cover elements not sufficiently covered by own funds requirements for excessive leverage risk, while P2G-LR will be guidance in parallel with P2G for excessive leverage risk.

26 Some of the elements introduced in Pillar 2, such as P2G or the minimum composition of P2R, had already been incorporated by the EBA in its guidelines for common procedures and methodologies for the supervisory review and evaluation process.

The assessment of the risks an institution poses to the financial system is eliminated in the SREP. This gives the exercise a mainly microprudential perspective. New elements are introduced, such as the assessment of the suitability of governance mechanisms, the business model and the institution's diligence regarding the prevention of money laundering and terrorist financing (AML/CTF). Also, the EBA is urged to assess the advisability of including environmental, social and governance risks.

As regards the interest rate risk, under CRD IV institutions were required to assess and manage the interest rate risk arising from non-trading book activities, and provided for the adoption of supervisory measures at least when the economic value of an institution decreased by more than 20% of its own funds in the event of certain interest rate changes.

CRD V introduces a standardised methodology for quantifying the impact of interest rate changes on economic value and on net interest income, as well as a simplified standardised methodology for small and non-complex institutions.[27] Thus, competent authorities may require the use of the standardised approach (or institutions may choose to adopt it) when the internal systems are not satisfactory or when the simplified methodology does not adequately capture the risk. The EBA will have to develop the two methodologies in a regulatory technical standard.

Supervisory measures are also envisaged,[28] at least where an institution's economic value changes by more than 15% of its Tier 1 capital under six supervisory scenarios, or in the event of a large decline in net interest income under two supervisory scenarios. The EBA shall develop in a regulatory technical standard the supervisory shock scenarios, the methodological and parametric assumptions, and the definition of a large decline in net interest income.

Although the mandates expired on 28 June 2020, the work has not concluded and the uniform European regime has not yet been published.

2.7 Macroprudential aspects

The macroprudential policy framework contained in the CRD and the CRR has also changed substantially, driven by the experience gained in recent years in the EU in the use of macroprudential tools. The CRR II and CRD V amendments aim to make the current framework more flexible, improve the delimitation of its scope and ensure that the tools are used in a manner consistent with their purpose. In line with these objectives, and as mentioned previously, Pillar 2 has been restricted to the

27 Article 84 of the CRD.

28 Article 98 of the CRD.

microprudential field, in order to deal only with the risks specific to each regulated institution, discarding its use for addressing systemic risks or vulnerabilities, which is the object of macroprudential policy.

As regards the measures relating to the application of capital buffers, the key new developments are found in Articles 131 and 133 of the CRD, on capital buffers for G-SIIs and other systemically important institutions (O-SIIs) and on the systemic risk buffer, respectively, and in Article 92 of the CRR, which introduces the leverage ratio buffer requirement for G-SIIs.

In the CRD, the most significant change is probably that made to the design of the systemic risk buffer, which can now be applied at sectoral level, as opposed to the previous situation in which it only applied to risk-weighted assets (RWAs).[29] For this purpose, four main sectors are specified: i) retail exposures to natural persons secured by residential property; ii) exposures to legal persons secured by commercial property; iii) exposures to legal persons other than those specified in point ii); and iv) exposures to natural persons other than those specified in point i).[30] Also, the minimum buffer level of 1% required by CRD IV in the event of activation of this tool is eliminated.

If an authority were to activate an overall buffer (on all exposures) and one or several sectoral buffers, the total buffer requirement would be the sum of all the buffers activated. When the combined systemic risk buffer exceeds 3% of any of the exposures to which it is applied, the opinion of the European Commission must be sought; for levels over 5%, its authorisation is required.

Also, it is specified that the systemic risk buffer should not be used to address risks covered by the buffers for G-SIIs or O-SIIs – a practice followed to date by some European national authorities that considered that the maximum limit set for the O-SII capital buffer was too low – or for risks covered by the countercyclical capital buffer.

The CRD V amendments also increase the maximum limit set for the O-SII capital buffer, up to 3% (formerly, 2%) of RWAs; this level may be exceeded with the authorisation of the European Commission. The upper limit for O-SII buffers applicable to the subsidiaries of groups identified as G-SIIs or O-SIIs now stands at the lower of the

29 The possibility of applying this buffer at country level remains, both for exposures located in the Member State that sets the measure and for those located in other countries. It may be recalled that all the buffers envisaged in the CRD – the systemic risk buffer, the capital conservation buffer, the countercyclical capital buffer and the buffers for systemically important institutions – must be calculated as a percentage of RWAs and be met with CET1 capital. They differ from the leverage ratio buffer in both aspects, as explained below.

30 The EBA fulfilled its mandate of defining subsets for each of these sectors by publishing guidelines for the authorities: Guidelines on the appropriate subsets of sectoral exposures to which competent or designated authorities may apply a systemic risk buffer in accordance with Article 133(5)(f) of Directive 2013/36/EU (EBA/GL/2020/13) of 30 September 2020. These guidelines do not identify specific subsets. Rather, they define several dimensions, elements and sub-dimensions on the basis of which each authority may determine the subsets of the most significant exposures in order to address the systemic risks they identify.

G-SII or the O-SII buffer rate applicable to the group on a consolidated basis plus 1 percentage point and 3% of the subsidiary's RWAs (or, as appropriate, the percentage authorised by the European Commission for application to the consolidated group).

Regarding G-SIIs, the main new development relates to the introduction of an additional method for identifying such institutions which differs from the BCBS methodology in that exposures to counterparties in Member States participating in the Single Resolution Mechanism will not be treated as cross-border exposures in the cross-border activity indicator.[31] The systemic importance score resulting from this method may be used, in the exercise of sound supervisory judgment, to re-allocate a G-SII in a lower sub-category from that applicable under the BCBS methodology, with the corresponding change in the capital buffer requirement. Also, the limit of 3.5% that existed for this G-SII buffer is eliminated.

In all circumstances under the new framework the G-SII and O-SII buffers and the systemic risk buffer become additive, up to a limit of 5%; over that limit, the authorisation of the European Commission will be necessary.

As regards the amendments to CRR II, the change with the greatest impact is probably the introduction of a new leverage ratio buffer for G-SIIs, included in the Basel III reform of 2017. This buffer is calculated by multiplying the total exposure measure of an institution's leverage ratio by 50% of the G-SII buffer rate, which, like the leverage ratio, must be met with Tier 1 capital.[32] Failure to meet this new requirement is associated with restrictions on distributions; the farther the institution is from compliance, the greater the restrictions, in line with those associated with failure to comply with the combined buffer requirement.

The powers conferred in Articles 124 and 164 of the CRR – which, respectively, allow increasing credit risk weights on mortgage portfolios subject to the standardised approach and increasing the loss given default (LGD) parameter for institutions authorised to use internal ratings-based (IRB) approaches – previously lay with the competent (microprudential) authority in CRD IV. Under the new regulations, Member States may assign responsibility for these buffers to the national authority designated to use macroprudential tools. In the case of Spain, this responsibility falls to the Banco de España.[33]

---

31 This additional method for identifying G-SIIs has been implemented in Commission Delegated Regulation (EU) 2021/539 of 11 February 2021 amending Delegated Regulation (EU) No 1222/2014 supplementing Directive 2013/36/EU of the European Parliament and of the Council with regard to regulatory technical standards for the specification of the methodology for the identification of global systemically important institutions and for the definition of subcategories of global systemically important institutions.

32 For example, in the case of Banco Santander (the only Spanish G-SII at present), whose G-SII buffer is 1% of its RWAs, the leverage ratio buffer would be 0.5% of its total leverage exposure.

33 In accordance with Article 15(1)(d) of Royal Decree 102/2019 of 1 March 2019 creating the Spanish macroprudential authority (AMCESFI), establishing its legal regime and implementing certain aspects relating to macroprudential tools.

A change is also introduced in the large exposures framework, following, as mentioned earlier, the Basel 2014 framework: the limit for exposures between G-SIIs is reduced to 15% of the Tier 1 capital of the lending institution, compared with the general 25% limit. The aim is to reduce systemic risks deriving from interconnections between large institutions and the impact a G-SII's default may have on financial stability.

As regards Article 458 of the CRR, known as "the flexibility package", which allows designated authorities to apply stricter macroprudential measures than those envisaged in the CRD or the CRR to address systemic risks in their jurisdiction, under certain conditions (in particular, the Council of the EU's authorisation), the most significant development is the extension from one to two years of the period during which these measures (or their extensions) remain in force.

In the institutional realm it should be noted that the coordination and oversight role of the European Systemic Risk Board (ESRB) in connection with the macroprudential measures adopted in the EU by the various authorities is strengthened, with the aim of ensuring its sufficiency, consistency and lack of overlaps. The ESRB's dissemination of information in this respect is also reinforced.[34]

Lastly, of note is the renewal of the European Commission's mandate to review the macroprudential framework, by virtue of which it must submit a report to the European Parliament and the Council and, if appropriate, a legislative proposal in December 2022. The current mandate adds new aspects to be assessed. Notable among these are the possibility of adding new types of instruments, such as those targeting borrowers (e.g. limits on lending), to the macroprudential tools available, and the possible extension of the leverage ratio buffer requirement to institutions other than G-SIIs (in particular, O-SIIs). The European Commission should conduct this review every five years. Also, the fallout from the COVID-19 crisis has provided more food for thought in this review of the adequacy of the macroprudential framework, such as the advisability of increasing the share of releasable buffers, as opposed to structural buffers, or the practical difficulties faced by institutions when using their buffers.

2.8 Restrictions due to failure to meet buffer requirements and calculation of the maximum distributable amount

CRD IV restricts the distribution of CET1 items, the payment of AT1 coupons and variable remuneration in the event of a failure to meet the combined buffer requirement. Any institutions finding themselves in this scenario must calculate the

34 ESRB (2020).

maximum distributable amount (MDA), thereby capping any distributions that may be made by any of the above means.

The changes introduced by CRD V include adjustments aimed at ensuring that earnings generated throughout the year (and not simply since the last distribution) can be included in the MDA, thereby increasing the amount of the profits to be factored in.[35] Moreover, the combined buffer requirement is not met where an institution does not have own funds in an amount and of the quality needed to meet at the same time the combined buffer requirement, and the Pillar 1 and Pillar 2 requirements.[36]

Meanwhile, following the introduction of a leverage ratio buffer, leverage-based restrictions have also been placed on Tier 1 capital distributions.[37] This requirement will not be met where an institution does not have Tier 1 capital in an amount and of the quality needed to meet the leverage ratio, the P2R covering the risk of excessive leverage and the G-SII leverage buffer.[38] Institutions must calculate the leverage ratio related maximum distributable amount (L-MDA), using a calculation methodology almost identical to that for the MDA, as well as the distribution percentages.

Figure 1 sets out a summary of the order in which the various requirements must be met, and of the two visions (risks and assets) present in Pillar 1, Pillar 2 and the capital buffers.

The guidance on additional own funds (P2G) constitutes a capital target on top of the minimum requirements for own funds (P1), the additional own funds requirements (P2R) and the combined buffer or leverage ratio buffer requirements. Failure to meet this target does not trigger any distribution-related restrictions.

The leverage-based own funds requirement is a requirement parallel to the risk-based own funds requirements. The requirement of additional own funds to cover the risk of excessive leverage (P2R-L) must be added to the 3% minimum leverage ratio (P1), and not the risk-based minimum own funds requirement.

While own funds may be used interchangeably for either stack of requirements, they cannot be used to comply with several requirements simultaneously within a single stack.

2.9 Governance and remuneration

The current legislation requires some clarification as regards the suitability requirements for members of the board of directors, the scope of such requirements

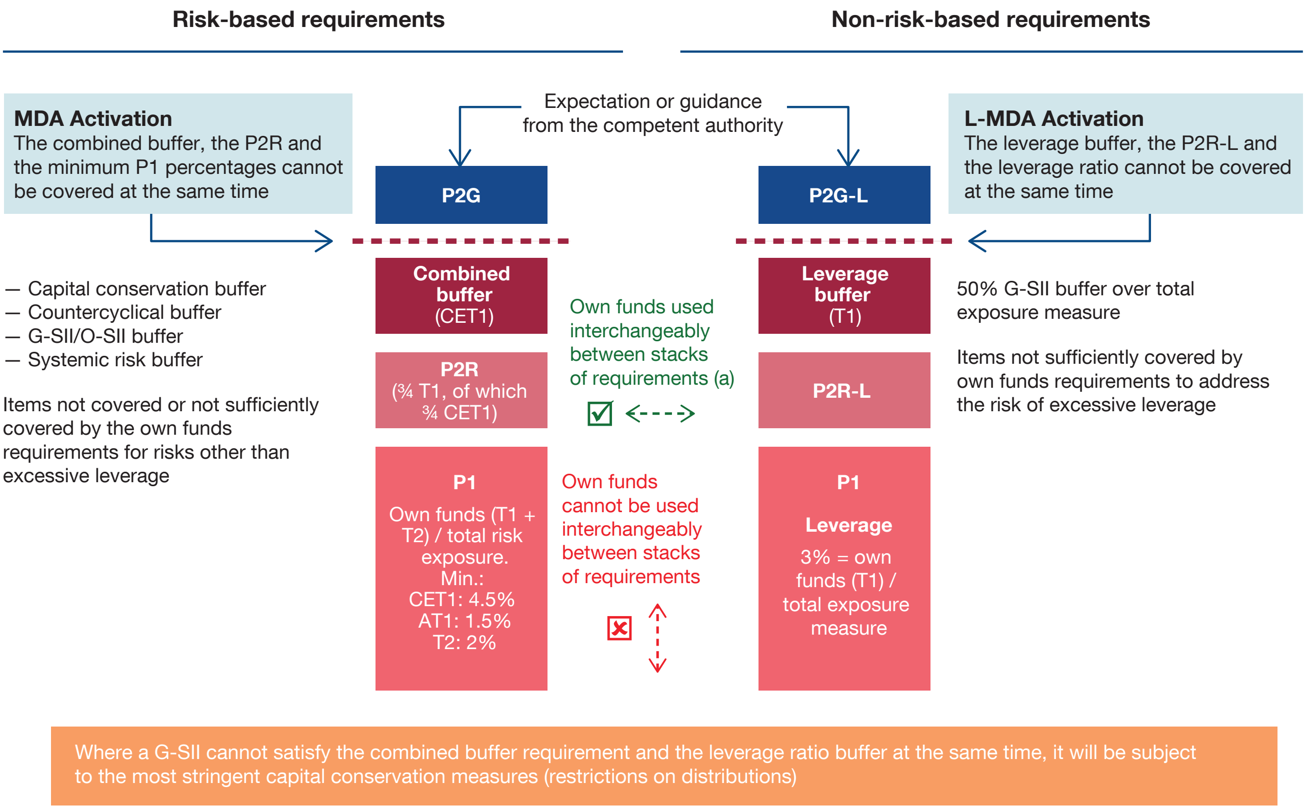
35 Article 141 of the CRD.

36 Article 141a of the CRD.

37 Article 141b of the CRD.

38 Article 141c of the CRD.

Figure 1
HIERARCHIES OF CAPITAL REQUIREMENTS AND GUIDANCE



SOURCE: Devised by authors.

a There are certain TLAC/MREL-related restrictions.

or the ability of the competent authorities to remove members where they fail to meet them. Such requirements will be assessed, in particular, where the authorities have reasonable grounds to suspect that money laundering or terrorist financing has taken place or where there is an increased risk of such activity.[39] Institutions must now document any loans to members of the management body or related parties, and such information must be kept at the disposal of the competent authorities.

New AML/CFT requirements have been introduced in various aspects of the CRD; for example, in the assessments by competent authorities of the adequacy of institutions' corporate governance and of the suitability of members of the board of directors.[40]

In terms of remuneration, greater proportionality has been sought in certain variable remuneration requirements, such as deferral and payment in instruments or the

39 Article 91 of the CRD.

40 Article 97 of the CRD.

retention of discretionary pension benefits, since these could prove excessively punitive for smaller institutions.[41] Thus, such requirements will not apply to an institution that does not meet the definition of large institution under the CRR[42] and whose total assets are valued at €5 billion or less, or to staff members whose annual variable remuneration does not exceed €50,000 and does not represent more than one third of their total annual remuneration. Member States may lower or increase the asset threshold, provided it is appropriate to do so in light of the nature, scope and complexity of an institution's activities, its internal organisation or the characteristics of the group to which it belongs (where increased, the institution must meet certain requirements as regards the definition of small and non-complex institution, and the threshold may on no account exceed €15 billion). In Spain, the amendment to Law 10/2014[43] has empowered the Banco de España only to lower the asset threshold (i.e., to tighten the restriction). Member States may also decide that staff members that do not exceed the above thresholds are not subject to the exemption, given the specific features of the national market in terms of remuneration practices or owing to the nature of the responsibilities and job profile of such staff members.

Thus, based on a series of requirements, Article 92 of the CRD determines who must, at least, be included among the "identified staff", i.e. staff whose remuneration is subject to conditions under the CRD, because their activities have a material impact on an institution's risk profile. The requirements for including as identified staff personnel who are not members of the board of directors or senior management, or who do not have managerial responsibility over the institution's control functions or material business units, must now be met cumulatively, representing an easing of the criteria on classification as identified staff. Also, remuneration policies now include a gender-neutral requirement, as well as related reporting obligations.

2.10 Date of implementation and transposition in Spain

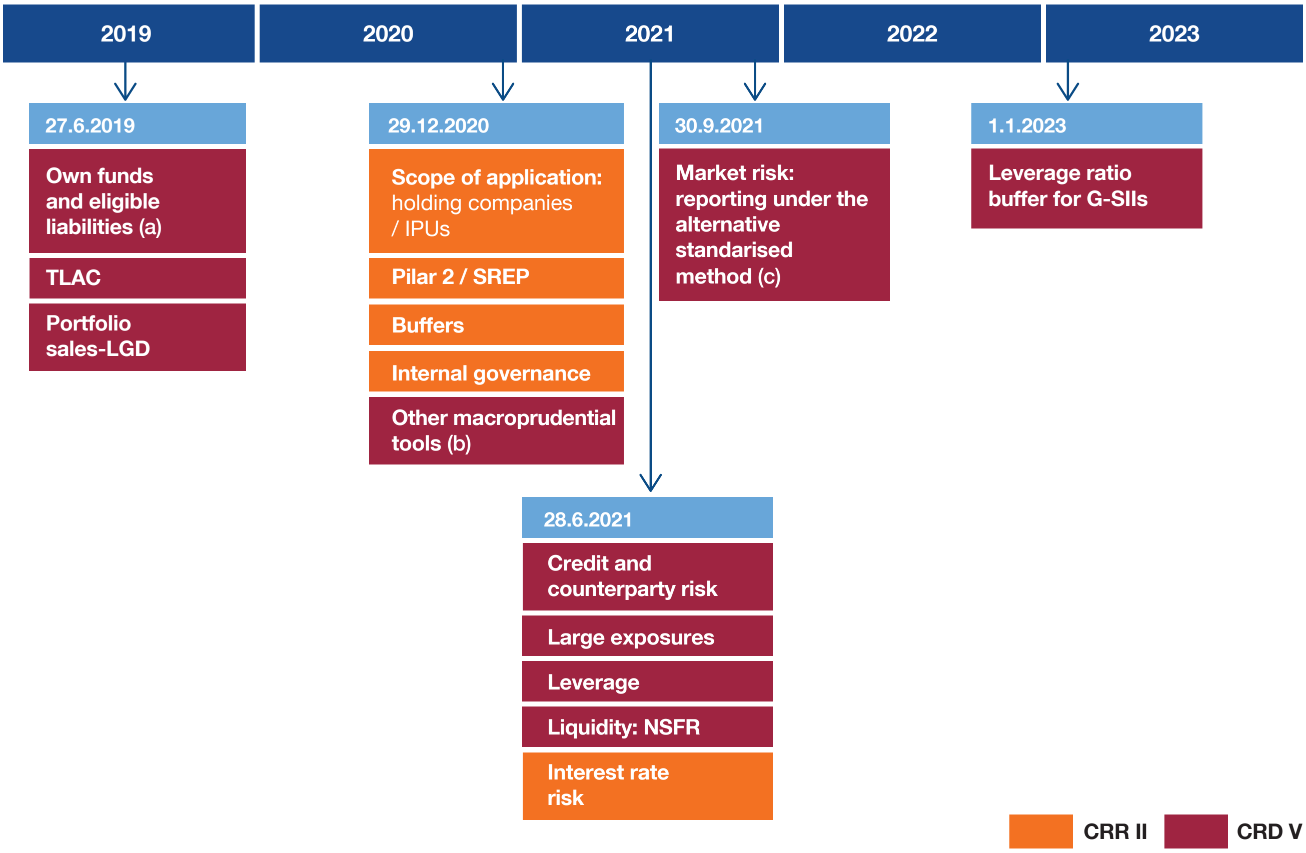
While both the Regulation and the Directive entered into force on 27 June 2019, the dates of implementation of the different measures envisaged vary. The general date of implementation of the changes to the CRR falls two years after the date of entry into force (i.e. as from 28 June 2021), although some aspects, essentially those relating to own funds, are applicable from the date of entry into force. Meanwhile, the changes made to the CRD generally apply 18 months after it enters into force (as from 29 December 2020), once the deadline for its transposition into the different

41 Article 94 of the CRD.

42 Large institution means an institution that meets any of the following conditions: a) it is a G-SII; b) it has been identified as an O-SII; c) it is, in the Member State in which it is established, one of the three largest institutions in terms of total value of assets; d) the total value of its assets on an individual basis or, where applicable, on the basis of its consolidated situation, is equal to or greater than €30 billion (Article 4(1)(146) of the CRR).

43 Law 10/2014 of 23 June 2014 on the regulation, supervision and solvency of credit institutions.

Figure 2
MAIN CHANGES IN CRR II AND CRD V AND IMPLEMENTATION DATES



SOURCE: Devised by authors.

a Except for the exemption from deduction of software, which will be applicable from the date of entry into force of the regulatory technical standards drawn up by the EBA.
b Applicable from 28.12.2020.
c Reporting under the new internal model approach will be mandatory three years after the entry into force of the latest regulatory technical standards envisaged in the CRR (see footnote 22).

domestic legal systems has elapsed. There are nonetheless certain exceptions, such as the interest rate risk, which will apply at the same time as the modifications to Pillar 1 risks envisaged in the CRR, i.e. as from 28 June 2021 (see Figure 2).

It is also worth noting that the CRR was again amended in June 2020[44] in response to the COVID-19 crisis, bringing forward the application of certain measures, such as the SME and infrastructure supporting factors, as well as the new prudential treatment of software assets. Elsewhere, the application of the leverage ratio buffer (initially enforceable as from 2022) has been pushed back to 1 January 2023.

44 Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic (known as the "quick fix").

Directives must be transposed into the domestic legislation of the different EU Member States, whereas regulations apply directly. Thus, work on transposing CRD V in Spain has begun with the publication of Royal Decree-Law 7/2021[45] of 27 April 2021, amending, inter alia, Law 10/2014 and Law 11/2015,[46] followed by the publication of Royal Decree 970/2021,[47] amending Royal Decree 84/2015 of 13 February 2015, implementing Law 10/2014. The process will come to an end with the amendment of Circular 2/2016.[48] Matters have been somewhat delayed by the COVID-19 pandemic, as well as by the process of transposition in Spain in the form of three pieces of legislation (using legal instruments of increasing technical complexity).

In addition to transposition of the changes to the CRD into domestic law, the national discretions and options contained in both the Regulation and the Directive must also be reviewed, both at Member State and competent authority level, also entailing the amendment of Circular 2/2014.[49] Moreover, in order to ensure that such regulations are applicable in full, the European Banking Authority has been mandated to prepare numerous technical standards and guidelines.

2.11 Incorporation of the finalisation of Basel III into EU law

2021 has seen the first application of most of the measures set in place by CRR II and CRD V, as well as the recent publication of the European Commission's legislative proposal that will transpose the finalisation of Basel III agreed at end-2017 into EU legislation. This will represent a further far-reaching review of the CRR and the CRD.

One of the aims of this new reform is to restore the credibility of RWA calculations and improve their comparability. A key reform has been made to the standardised approach to credit risk, while also restricting the use of IRB approaches by placing limits on some of the parameters used to calculate capital requirements. The robustness and risk sensitivity of standardised approaches to credit valuation adjustment (CVA) risk have also been enhanced, while eliminating the possibility of using internal models to capture such risks. Meanwhile, the current floor for aggregated results of capital requirements under Basel I has been replaced by a

45 Royal Decree-Law 7/2021 of 27 April 2021, transposing European Union Directives on matters of competition, anti-money laundering, credit institutions, telecommunications, tax measures, prevention and repair of environmental damage, postings of workers providing cross-border services and consumer protection.

46 Law 11/2015 of 18 June 2015 on the recovery and resolution of credit institutions and investment firms.

47 Royal Decree 970/2021 of 8 November 2021, amending Royal Decree 1644/1997 of 31 October 1997, concerning the rules on administrative authorisation and solvency requirements of reguarantee companies, Royal Decree 2660/1998 of 14 December 1998 on currency exchange services at establishments open to the public, and Royal Decree 84/2015 of 13 February 2015, implementing Law 10/2014 of 26 June 2014 on the regulation, supervision and solvency of credit institutions.

48 Banco de España Circular 2/2016 of 2 February 2016, to credit institutions, on supervision and solvency, completing the transposition into Spanish legislation of Directive 2013/36/EU and Regulation (EU) No 575/2013.

49 Banco de España Circular 2/2014 of 31 January 2014, to credit institutions, on the exercise of various regulatory options contained in the CRR.

more robust, risk-sensitive floor based on the revised standardised approaches under Basel III (output floor). This reform will also include the capital requirements under the new market risk framework following the fundamental review (FRTB) conducted by the BCBS, which was only included in CRR II for reporting purposes.

3 Reform of the resolution framework

Among the key modifications ushered in by BRRD II[50] was the review of the methodology for determining MREL, to ensure that institutions maintain at all times instruments with loss-absorbing and recapitalisation capacity in the event of failure. Moreover, the MREL requirement is now expressed in terms of the total amount of an institution's risk exposure (RWAs)[51] and of the total exposure measure (TEM),[52] in line with the rules on total loss-absorbing capacity published by the FSB in 2015 (TLAC Term Sheet). BRRD II also introduces a requirement akin to TLAC[53] for G-SIIs, while also bringing the criteria to be met by liabilities deemed eligible for MREL purposes[54] into line with the TLAC Term Sheet, with the aim of ensuring their loss-absorbing and recapitalisation capacity in resolution. Nonetheless, one of the key differences is that some of the European requirements (far more stringent, in general, than the TLAC) may be covered with unsubordinated instruments.[55]

The MREL requirement must be met at consolidated resolution group level, which does not necessarily coincide with the consolidated group for prudential purposes. For this purpose, the own funds instruments eligible at a consolidated level and the liabilities mainly issued by the resolution entity (i.e. the "point of entry" to which the resolution tool chosen in each case is to be applied) are admissible. Moreover, the subsidiaries of the resolution group must issue their internal MREL, directly or indirectly, to the resolution entity, thereby ensuring, in the event of failure, that such instruments contribute to the loss absorption and recapitalisation of the subsidiary, which will remain under the group's control, without entering resolution.

BRRD II also introduces reporting obligations for both supervisory and resolution authorities and the markets, with a view to promoting transparency, and the consequences in the event of a failure to meet the MREL requirement. These include a prohibition on making dividend distributions or interest payments associated with Tier 1 capital instruments and the payment of variable remuneration or discretionary

50 Certain aspects, such as the eligibility criteria and the TLAC requirement for G-SIIs, are regulated in Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 (CRR II).

51 Calculated according to Article 92(3) of Regulation (EU) 575/2013.

52 Calculated according to Articles 429 and 429a of Regulation (EU) 575/2013.

53 18% RWAs and 6.75% TEM as from 1 January 2022 (16% and 6%, respectively, since 27 June 2019, according to the transitional provision of Article 494 of CRR II).

54 Introduced by Articles 72a to 72c of Regulation (EU) 575/2013.

55 There are other differences, such as the eligibility of structured notes or liabilities issued by subsidiaries to third-party shareholders, under certain conditions.

pension benefits where an institution is unable to meet its MREL requirement in addition to its combined buffer requirement.[56]

With a view to limiting institutions' dependence on retail customers and better protecting such customers, BRRD II has placed restrictions on the marketing of financial debt instruments that are eligible subordinated liabilities,[57] which, when transposed in Spain,[58] have been extended to all debt instruments that constitute eligible marketable liabilities.

Lastly, the resolution authorities have the power to suspend an institution's contractual obligations, for up to two business days, with a view to ensuring the time required to ascertain whether the resolution is necessary in the public interest and, in such case, to select and effectively implement the most suitable resolution tool. The suspension of such obligations extends to eligible deposits,[59] although the authorities may permit depositors to draw a minimum daily amount, to be established on a case-by-case basis.

The co-legislators have nonetheless avoided addressing certain aspects that have for some time been up for debate in European circles, such as the uneven playing field for depositors in the different Member States or the possibility that winding up small institutions under national insolvency proceedings may have a serious impact on financial stability.

3.1 Liquidity in resolution

In an ideal world, a post-resolution institution will have regained the confidence of the markets, which it can therefore access to finance itself. In practice, the various agents (among them, the ratings agencies) may need some time to reassess the financial situation of the institution. Unless it has been acquired by another institution that can provide such confidence, it will have limited access to markets and, in all likelihood, few assets that can be used as collateral in dealings with the European Central Bank (ECB). It may also have suffered significant liquidity outflows, particularly in the form of a bank run.

Against this backdrop, the SRF is the first port of call for post-resolution institutions. In December 2020, the Eurogroup reached an agreement to bring the

56 CET1 capital required to meet the obligation to have in place a capital conservation buffer, plus, where applicable; a) a countercyclical capital buffer specific to each institution; b) a G-SII buffer; c) an O-SII buffer, and d) a systemic risk buffer.

57 Financial debt instruments envisaged in section a) point 2 of the Annex to this Law, which are, in turn, bail-inable liabilities for resolution and non-resolution entities per the provisions of section 4.ª of Chapter VI of Law 11/2015.

58 Royal Decree-Law 7/2021 of 27 April 2021.

59 Eligible deposits are those not excluded from protection per Article 5 of the Directive of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes.

creation of a common backstop for the SRF forward to 2022, and the European Stability Mechanism (ESM) will therefore back the SRF for an amount equal to the size of the fund, up to a limit of €68 billion, in the form of a line of credit that may be drawn on once the funds in the SRF have been used in full. The support provided by the backstop will be recovered in the form of ex post contributions from institutions.

Nonetheless, even with the backstop, the size of the SRF (1% of covered deposits in the Banking Union from 31 December 2023; it is expected to stand at around €70 billion at that date)[60] would prove insufficient to meet the liquidity needs of certain large institutions, or several institutions simultaneously in the event of systemic crises. Indeed, it is estimated that the liquidity measures arranged in the form of state aid between 2008 and 2012 amounted to over €3,600 billion, of which around €1,300 billion was used.[61]

Given that this issue falls outside the scope of the Directive, and cannot therefore be attributed to an oversight on the part of the co-legislators, it is essential that the Single Resolution Board (SRB) be equipped with sufficient resources should it ultimately need to support the liquidity of an institution under resolution, ensuring that such resources can be accessed immediately given the urgency of such a scenario. With this in mind, various alternatives have been put forward, such as the Eurosystem Resolution Liquidity proposed by the ECB, consisting of a guarantee granted by the ESM to the ECB to cover the SRF, or the loan of bonds issued by the SRF to institutions under liquidation, to be used as collateral (or, alternatively, to be acquired by the ECB). Nonetheless, as things stand, there is no consensus among Member States on the measures that should be taken.

3.2 Legislative framework for small and medium-sized institutions

There are doubts at a European level as to whether the current resolution framework would work for small and medium-sized institutions, financed essentially with deposits. Such institutions have limited (and in all likelihood very costly) access to markets, and would therefore be hard pressed to meet their MREL goals without seriously harming profitability.[62] A state of affairs that could even encourage greater risk-taking in a bid to boost profits, with an undesirable outcome contrary to that sought.[63] Indeed, it is notable that the MREL requirements are applied to all institutions in the EU, regardless of size, while the TLAC Term Sheet applies only to

60 The amount set aside as at 31 July 2021 amounted to €52 billion.

61 Amamou et al. (2020).

62 See EBA (2020). The results show different funding structures: while the liabilities of G-SIIs and O-SIIs that can easily be substituted by eligible liabilities range between 43% and 58%, institutions with assets totalling less than €100 billion fall within the 5%-23% range.

63 Restoy, Vrbaski and Walters (2020).

G-SIIs, whose requirements are for the most part fewer than those of Europe's small and medium-sized institutions.[64]

While such institutions may admittedly be wound up rather than entering a resolution process, domestic insolvency regimes are not best suited to credit institutions, since such processes are extremely slow, leading to great loss of value, and creditors (including uncovered deposits) would have to wait a long time before receiving the recoverable portion of their claims, with the resulting knock-on effect on the real economy.

This issue came to light in 2017 when, having decided that the resolution of Veneto Banca and Banca Popolare di Vicenza could not be justified on grounds of public interest, the Italian authorities designed a bespoke insolvency proceeding to wind them up. Thus, they introduced quasi-resolution tools into the existing domestic insolvency regime, enabling the assets of these institutions to be transferred to Intesa Sanpaolo, at a lower cost for shareholders and creditors than would have been the case under a resolution, thanks to the contribution of guarantees and government support. The Italian solution revealed that, where it is decided that there is no public interest, measures are then adopted at national level and may include government support, thus running contrary to the goal of setting in place a harmonised European framework applicable to institutions across the board, and giving rise to an uneven playing field among Member States. The European market is thus fragmented, without correcting the bank-sovereign doom loop, and creditor protection therefore depends on the financial strength of each Member State.

It seems clear that the solution to managing the failure of these institutions lies in transfer tools (sale of the business or bridge institution). The debate now centres on whether such tools should be introduced under a harmonised insolvency regime, or rather the concept of public interest should be broadened to ensure that these institutions fall under the umbrella of resolution in the event of failure. The aim in both cases is to guarantee the orderly exit of such institutions from the market, albeit requiring, alongside the possibility of using these tools, mechanisms to be set in place to enable such tools to be deployed without the need to seek public support, aside from the use of the SRF (only accessible in the event of resolution), the terms and conditions of which (bail-in on the part of shareholders and creditors in an amount equal to at least 8% of TLOF) would in many cases imply bail-in on the part of depositors, with the contagion risk this entails.

The use of deposit guarantee schemes constitutes the most viable alternative, and one that has already been successfully rolled out in other jurisdictions (such as the United States) to facilitate the sale of such institutions, providing financial support to purchasers in the form of price discounts or loss-sharing arrangements. In practice,

64 Restoy (2018).

however, this is not a viable option in the EU, since use of the fund is limited to the amount payable in a winding-up process to pay covered deposits, and the super-preference of such deposits (deposit guarantee schemes are subrogated to the rights of the depositors, who therefore recover the amount contributed ahead of any other creditor) means that the amount available is very small.[65]

Against this backdrop, the European Commission has commenced its review of the banking crisis management and deposit guarantee framework (known as BRRD III) in order to make it more flexible and guarantee a level playing field for depositors. This review is part of the agenda to complete the Banking Union, which will culminate in the creation of a European Deposit Insurance Scheme (EDIS). The European Commission is also contemplating harmonising insolvency regimes,[66] which would include quasi-resolution tools for the administrative winding-up of credit institutions and would ensure the support of insolvency deposit insurance schemes as an alternative to paying covered deposits.[67] The proposal for a Directive is expected to be published at end-2021.

3.3 Multiple point of entry vs. single point of entry

The BRRD contemplates the possibility of applying a resolution via a multiple point of entry (MPE) or a single point of entry (SPE). The choice of one approach or another depends on a group’s structure and, specifically, on the extent to which its subsidiaries manage their capital and liquidity autonomously and operate with financial and legal independence. From a resolution standpoint, the MPE model, comprising various resolution groups within one single consolidated group, usually coinciding with the geographic distribution of the subsidiaries, is the more desirable, since this reduces the risk of contagion, as intra-group exposures are very limited (essentially restricted to the stake held in the subsidiaries’ capital). The SPE model, meanwhile, maintains one single resolution group at consolidated level, based on a centralised management model in which it is the parent that accesses wholesale funding, and then directly finances its subsidiaries’ local activities. The Spanish financial institutions with the largest international footprint (Santander and BBVA) adopted the MPE model for their expansion outside the EU following the Latin American crisis of the late nineties. Though costlier, this model has proven effective for avoiding contagion risk and encouraging subsidiaries to control their own risk management, since it falls to them to access the markets without the support of their parent.

In an almost verbatim transposition from the TLAC Term Sheet, CRR II provides for a regime of deductions for MPE resolution groups of exposures to other resolution

65 Article 11(6) of Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes.

66 European Commission (2019b).

67 European Commission (2020).

groups, which, based on the deduction of all such exposures, enables the amount of the deduction to be reduced by an amount equal to the subsidiary's surplus over its own TLAC/MREL requirements. However, this formula[68] has caused numerous problems in terms of its practical application, in particular at subsidiaries in third countries that are not technically resolution groups (BRRD II only contemplates European resolution groups), whose jurisdictions have yet to set in place a resolution regime, and which are not therefore subject to requirements equivalent to the European TLAC/MREL.

Meanwhile, CRR II provides for an obligation to compare the sum total of the TLAC/MREL requirements of all an MPE's resolution groups[69] with the requirement that would theoretically correspond to the consolidated group if it were an SPE. Where the first figure is higher than the second, BRRD II[70] obliges the resolution authorities to assess the need to make an adjustment to eliminate the difference, albeit without necessarily requiring that they reach an agreement on the application of the adjustment. This methodology does not ensure a level playing field for MPE and SPE groups, thus creating an incentive for the former to extinguish themselves and reappear in the form of an SPE as a means of reducing their issuance needs. It should be borne in mind that the MREL requirement is always the same in an SPE model, regardless of any existing intra-group exposures, since these are eliminated in the consolidation process.

Moreover, the co-legislators overlooked the fact that the MPE model enables risk to be diversified across different geographic regions, thereby reducing the likelihood that all of the subsidiaries might fail at the same time.

4 Conclusions

The major reform of the prudential framework undertaken in 2013 led to the introduction in the EU of the Basel III response to the shortcomings in the financial sector identified in the wake of the financial crisis. A range of innovative concepts were included, such as the leverage ratio (to avoid the risk of excessive leverage); liquidity ratios (a risk that had hitherto only been addressed by Pillar 2); a rethink of the definition of capital, which was improved qualitatively and quantitatively; and the macroprudential framework, dealing with systemic risks. The approach to law-making also broke new ground, taking the form of not only a directive (i.e. CRD IV), but also a regulation (i.e. CRR I) that applies directly to Member States, thus giving countries less leeway in the transposition process.

68 Article 72e(4) of CRR II.

69 Article 12a of CRR II.

70 Article 45h(2) of BRRD II.

The reform addressed in this article is the amendment to these pieces of legislation (CRD V and CRR II) approved in 2019, though most of their provisions first apply to institutions in 2021. Unlike the previous reform, no major new concepts have been introduced. Rather, adjustments or improvements have been made to those already in place, drawing on the experience of implementation in the preceding years, while work has continued on bringing the legislation into line with the latest reforms agreed at international level (Basel III). Indeed, some of the reforms introduced (to market or interest rate risk) still require considerable regulatory development before they can be rolled out in full. Other modifications have their origin in the principle whereby requirements must be applied more proportionately to smaller, less complex institutions, thus ensuring that they do not shoulder an excessive burden.

The changes made to the macroprudential framework have enhanced the flexibility and range of the tools available to the authorities under the CRD and the CRR. They have also served to more clearly delimit their scope of application and purpose. The co-legislators were nonetheless aware that such progress is insufficient, and work has therefore continued on further developing and perfecting the framework. All of which explains the European Commission's mandate to present a new review in 2022, a mere three years after the new rules were published and before some of them are yet applicable. The experience gained in recent years will enable work to continue on fine-tuning and developing the macroprudential toolkit available under EU legislation, enhancing its effectiveness, efficiency and reach. Lastly, it is also hoped that further progress will be made, to the extent possible, on streamlining the framework, without burdening institutions with excessive requirements.

The reforms of the prudential framework carried out to date have helped bolster the solvency of the banking system, as borne out during the pandemic, in which bank lending continued unabated, thanks also to the specific measures set in place. Nonetheless, a further modification of the rules is needed to implement the latest Basel III changes in the EU and to continue improving the capitalisation levels of the banking system. This time round, the main aim of the reforms is to restore the credibility of RWAs, reducing the excessive variability of internal models and developing more robust standard models. Their implementation is set for 1 January 2023, which is why the European Commission recently published a legislative proposal to amend the CRR and the CRD.[71] The BCBS and the G20, together with the vast majority of the EU's central banks and supervisors,[72] have argued in favour of the full, timely and consistent implementation of the Basel III reforms, with minimal deviations, to help shore up all of the banking systems (which have proven so

71 For further details, see "Banking Package 2021: new EU rules to strengthen banks' resilience and better prepare for the future", European Commission press release of 27 October 2021.

72 The Banco de España and another 24 central banks and supervisory authorities have requested from the European Commission a full, timely and consistent implementation of Basel III (Various authors (2021b)). See also the ECB and the EBA (2021).

interdependent), while also offering greater support to the real economy in times of crisis.

As for the review of the resolution framework, experience has shown that an absence of effective solutions for certain categories of institutions within the banking crisis management framework has been addressed in various ways, depending on the domestic regime in place, thus raising doubts as to their consistency and suggesting the need for improvement. The restrictive approach to assessments of public interest as a prerequisite for resolution and the difficulties in accessing funding encourage the use of parallel instruments and government support outside of resolution. The existence of different national insolvency proceedings generates discrepancies in the outcomes for shareholders and creditors across Member States. There are also differences as regards the possibility of using deposit guarantee schemes for such purposes, as well as in the scope of depositor protection. The upshot is an uneven playing field among the different countries, and the risk of exposing taxpayers to the cost of a winding-up process. Therefore, a reform of the framework is needed to press forward with the banking union, bolster financial stability, mitigate taxpayer exposure and provide appropriate, proportionate solutions for managing and financing the failure of institutions.

Elsewhere, mechanisms must be set in place to ensure institutions are able to access liquidity post-resolution, thus enabling them to operate as normal, since the capacity of the SRF (even with the backstop) is limited.

Lastly, while this aspect is not expected to form part of the forthcoming reform, resolvability is not simply a matter of ensuring institutions maintain high levels of TLAC/MREL. A group structure based on subsidiaries with operational and financial independence reduces the risk of contagion and facilitates resolution. MPE structures must therefore be afforded non-discriminatory treatment, eliminating any incentives for increasing interconnections in cross-border groups. This aspect could be addressed in a future modification of the CRR.

12.11.2021.

REFERENCES

Amamou, R., A. Baumann, D. Chalamandaris, L. Parisi and P. Torstensson (2020). *Liquidity in resolution: estimating possible liquidity gaps for specific banks in resolution and in a systemic crisis,* Occasional Paper No 250, European Central Bank.

Anguren, R., L. Gutiérrez de Rozas, E. Palomeque and C. J. Rodríguez García (2020). "The regulatory and supervisory response to the COVID-19 crisis", *Financial Stability Review* No 39, November, Banco de España.

Basel Committee on Banking Supervision (BCBS) (2014). *Supervisory framework for measuring and controlling large exposures.*

Basel Committee on Banking Supervision (2017). *Basel III: Finalising post-crisis reforms.*

Ecofin (2010). *Council conclusions on crisis prevention, management and resolution,* Meeting 3054 of the Economic and Financial Affairs Council, Brussels, 7 December.

European Banking Authority (EBA) (2019). *EBA advises the European Commission on the implementation of the final Basel III framework,* press release of 5 August.

European Banking Authority (2020). *EBA Quantitative MREL Report,* 17 February.

European Central Bank (ECB) (2016-2021). *Macroprudential Bulletin.*

European Central Bank and European Banking Authority (2021). "EU implementation of outstanding Basel III reforms", letter of 7 September 2021 co-signed by the Chairperson of the EBA, the Vice President of the ECB and the Chair of the Supervisory Board of the ECB.

European Commission (2015). "Towards the completion of the banking union", Communication from the Commission to the European Parliament, the Council, the European Central Bank, the European Economic and Social Committee and the Committee of the Regions, 24 November.

European Commission (2019a). *Adoption of the banking package: revised rules on capital requirements (CRR II / CRD V) and resolution (BRRD / SRM).*

European Commission (2019b). *Report from the Commission to the European Parliament and the Council on the application and review of Directive 2014/59/EU (Bank Recovery and Resolution Directive) and Regulation 806/2014 (Single Resolution Mechanism Regulation),* 30 April.

European Commission (2020). *Combined evaluation roadmap/inception impact assessment,* 10 November.

European Systemic Risk Board (ESRB) (2020). *A Review of Macroprudential Policy in the EU in 2019, Special Feature A: The ESRB as a coordination and notification hub under CRD V and CRR II.*

Ferreira, E. (2019). *Banking Union: Crossing an Unstable Bridge,* speech delivered at the CIRSF Annual International Conference, Lisbon, 4 July.

Hernández de Cos, P. (2021). *Basel III implementation in the European Union,* speech delivered on a Eurofi panel, Ljubljana, 10 September.

Ibáñez, J. and B. Domingo (2013). "La transposición de Basilea III a la legislación europea", *Financial Stability Review* No 25, November, Banco de España.

Restoy, F. (2018). *Bail-in in the new bank resolution framework: is there an issue with the middle class?,* speech at the IADI-ERC International Conference, Resolution and deposit guarantee schemes in Europe: incomplete processes and uncertain outcomes, Naples, 23 March.

Restoy, F. R. Vrbaski and R. Walters (2020). "Bank failure management in the European banking union: What's wrong and how to fix it", Occasional Paper No 15, Financial Stability Institute.

Sotelo, F. (2021). "A proposal to funding crisis management in deposit taking institutions", seminar organised by the Banca d'Italia, "The crisis management framework for banks in the EU. How can we deal with the crisis of small and medium-sized banks?" 15 January.

Various authors (2021a). "Macroprudential policy in Spain; institutions and instruments", *Información Comercial Española* No 918, 26 February.

Various authors (2021b). *The EU should stick to the Basel III agreement*, letter of 7 September signed by the central banks and banking supervisory authorities of Austria, Belgium, Bulgaria, Croatia, the Czech Republic, Estonia, Greece, Ireland, Italy, Latvia, Lithuania, Malta, the Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain and Sweden.

— [CRR II] Regulation (EU) 2019/876 of the European Parliament and of the Council 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.

— [CRD V] Directive (EU) 2019/878 of the European Parliament and of the Council 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.

— [BRRD II] 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.