BOX 2: AN OVERVIEW OF BANK REGULATORY REQUIREMENTS[1]

In line with the regulatory requirements set in the Capital Requirements Directive (CRD V), Capital Requirements Regulation (CRR II), Bank Recovery and Resolution Directive (BRRD II) and the Single Resolution Mechanism Regulation (SRMR II), banks are required to fulfil multiple regulatory requirements on a going concern basis.[2,3,4,5] In this regard, the aim of this box is to outline the interaction of these regulatory requirements which comprise:

i. Risk-based own funds requirements;
ii. Leverage ratio (LR) requirements;
iii. Minimum requirement for own funds and eligible liabilities (MREL).

As highlighted in Table 1 below, the aim of the prudential requirements is to ensure the resilience of each institution at a national level and of the EU banking system, as per CRD V and complemented by the CRR II; which effectively puts the Basel III international standards into EU law. On the other hand, the aim of MREL within the resolution framework is to ensure that banking institutions have, at all times, sufficient eligible instruments to facilitate the successful implementation of the preferred resolution strategy in the event of a bank failure. The resolution framework is based on the BRRD II and the SRMR II.

Table 1
SUMMARY OF REGULATORY REQUIREMENTS

Regulatory requirement	Purpose	Requirement ratio denominator
Risk-based capital requirements	Ensure that institutions are well-capitalised to cover the level of risk and absorb potential losses	Total risk exposure amount (TREA)
LR requirements	Outline the relationship between a bank's capital and its assets and off-balance-sheet items to restrain excessive leverage	Total leverage ratio exposure (LRE)
MREL	Ensure that institutions have sufficient loss absorbing and recapitalization capacity to facilitate the successful implementation of the preferred resolution strategy	Two parallel requirements: MREL-TREA and MREL-LRE

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[2] 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.

[3] 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.

[4] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No. 1093/2010 and (EU) No. 648/2012, of the European Parliament and of the Council.

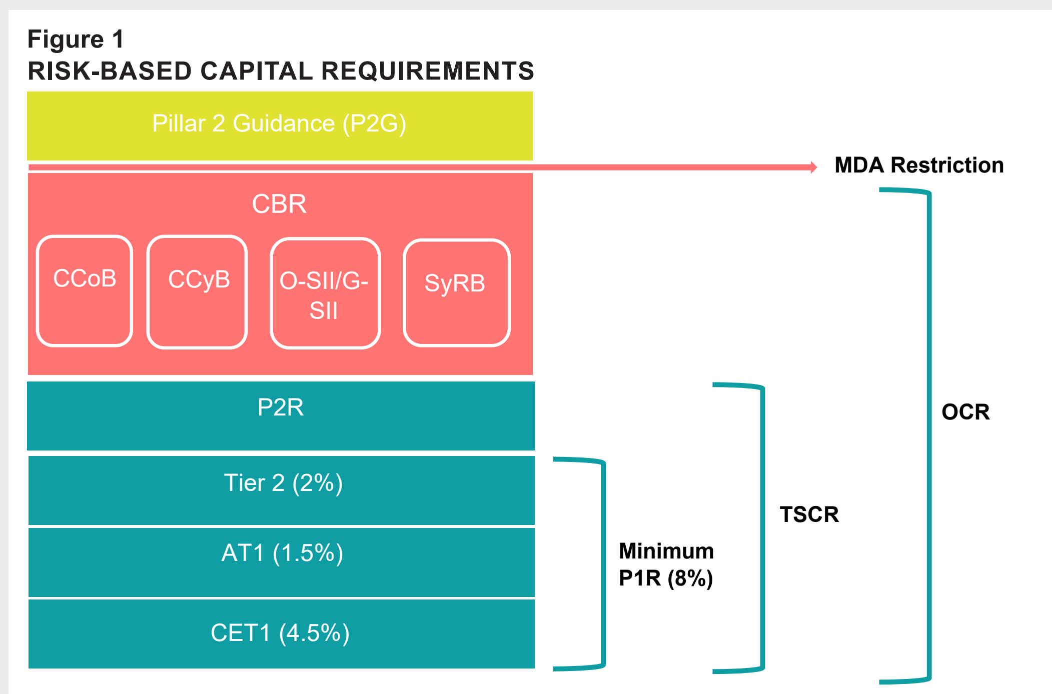
[5] Regulation (EU) No. 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No. 1093/2010.

Risk-based capital requirements

Banks are required to meet Pillar 1 and Pillar 2 requirements in line with the Basel framework.[6] Pillar 1 requirements (P1R) apply uniformly to all banks and act as minimum capital requirements to cover for developments related to market, credit and operational risk, whereas Pillar 2 requirements (P2R) are bank-specific, depending on the risk profile of the bank, and are intended to cover those risks which are not covered under P1R. Banks are required to hold a minimum P1R of 8% of its TREA at all times. This is segregated into a Common Equity Tier 1 (CET1) ratio of 4.5%, an additional Tier 1 (AT1) ratio of 1.5% and a Tier 2 ratio of 2%.[7] On top of the P1R sits the P2R which is bank-specific and determined through the Supervisory Review and Evaluation Process (SREP).[8] This involves a supervisory assessment conducted either by the ECB or national competent authorities (NCAs), whichever is the case, of each bank's specific risks covering its business model, governance framework and overall risk management practices.[9] The sum of the minimum P1R and P2R is referred to as the Total SREP Capital Requirement (TSCR) as highlighted in Figure 1.

The Overall Capital Requirement (OCR) is then calculated by adding the TSCR and the Combined Buffer Requirement (CBR) which sits on top of P1R and P2R. The CBR includes the Capital Conservation Buffer (CCoB) which is set at 2.5% for all banks, the CCyB, the Global Systemically Important Institutions (G-SII) Buffer, the O-SIIs Buffer and the Systemic Risk Buffer (SyRB)

Figure 1
RISK-BASED CAPITAL REQUIREMENTS



[6] The Basel Framework comprises of the full set of standards of the Basel Committee on Banking Supervision (BCBS), which acts as the primary global standard setter for the prudential regulation of banks.

[7] CET1 instruments comprise of a bank's core capital and mainly include common shares and retained earnings. AT1 instruments include preference shares and high contingent convertible securities whereas Tier 2 instruments may include subordinated debt, undisclosed reserves, general provisions and loss reserves.

[8] As per CRD V, banks can fulfil P2R with a minimum 75% of Tier 1 capital, out of which a minimum of 75% should be held in CET1 and the rest can be met with AT1. The other 25% can be met with Tier 2 instruments.

[9] If a bank is classified as a Significant Institution (SI) for Single Supervisory Mechanism (SSM) purposes, the SREP process is performed by the ECB and the respective Joint Supervisory Teams (JSTs) together with representatives from the domestic NCA. The SREP process for Less Significant Institutions (LSIs) is conducted solely by the respective domestic NCA.

if applicable.[10] These buffers are to be held entirely of CET1 capital. The P2G sits on top of the P1R, P2R and CBR as highlighted in figure 1 and comprises of a bank-specific recommendation on the optimal level of capital a bank should maintain to ensure that it absorbs potential losses resulting from stress testing calibration approaches used to gauge adverse scenarios. The P2G is non-binding and is to be met with CET1 capital instrument types.

LR requirements

In conjunction with the risk-based capital requirements, banks are also requested to maintain an LR P1R of 3% which can be held in Tier 1 capital.[11] When conducting the SREP process, the ECB or NCAs may additionally impose a P2R LR requirement if they determine that a supervised bank has a particularly high risk of excessive leverage.[12] This P2R LR requirement sits on top of the 3% LR P1R, is legally binding and is to be met using CET1 capital as a percentage of the banks' total leverage exposure amount. On top of the P2R LR requirement sits the LR buffer for G-SIIs which is equivalent to 50% of the G-SII buffer imposed by macroprudential authorities on G-SIIs in terms of TREA and is to be held using Tier 1 capital as a percentage of the bank's total leverage exposure amount.[13] Similar to the risk-based capital requirement, on top of the G-SII LR buffer, banks are expected to follow the P2G LR Guidance which is non-binding and is based on individual bank performance in the EU-wide stress tests. This is to be held using CET1 capital as a percentage of the bank's total leverage exposure amount.

Minimum requirements for own funds and eligible liabilities

With regard to requirements for resolution purposes, MREL is set by resolution authorities and follows the Total Loss Absorbing Capacity (TLAC) standard developed by the Financial Stability Board (FSB). This framework seeks to ensure that institutions have sufficient loss absorbing and recapitalization capacity in case of resolution. Overall, MREL ensures the continuity of the bank's critical functions which, in turn, provides better protection to depositors, minimises the recourse to public funds and maintains financial stability. Whilst it is a separate minimum requirement which institutions are required to meet in parallel to its prudential minimum capital requirements, its calibration is linked to the prudential requirements (Pillar I, Pillar II and capital buffers). Instruments eligible for MREL purposes include both own funds which are held by banks to meet their prudential requirements as explained above, and eligible liabilities that are subordinated to all claims arising from excluded liabilities.[14] In addition, similar to the risk-based capital requirements, MREL is expressed as two ratios that have to be met in parallel: (i) as a percentage of TREA (MREL-TREA); and (ii) as a percentage of LRE (MREL-LRE).

As for its calibration, MREL is made up of a loss-absorption amount (LAA) and a Recapitalisation Amount (RCA) for institutions that have resolution as their preferred resolution strategy. The LAA reflects the losses that the bank should be capable of absorbing in the event of failure. In the case of MREL-TREA, it consists of the sum of the Supervisory P1R and P2R, whereas in the case of MREL-LRE, it consists of the LR requirement. In the case of the RCA, it is the amount necessary for an institution to restore compliance after the resolution strategy is implemented so as to continue to comply with its conditions for authorisation and carry on the activities for which it is authorised under the relevant legislation. Similar to the LAA, in the case of MREL-TREA it consists of the sum of the Supervisory P1R and P2R, whereas in the case

[10] The main objective of the CCoB is to have an additional capital layer above the minimum requirements; the CCyB would be applicable to all banks and addresses cyclical risks emanating from excessive credit growth; the G-SII/O-SII buffer would be imposed on either global or domestic 'too big to fail' banks whose failure would have a considerable impact on the financial system and the SyRB may be applied to target different sources of systemic risk and given its flexibility can be applied to different sectors, classes of exposures and to specific institutions.

[11] A bank's LR may be calculated by dividing its Tier 1 capital by its total LRE measure. This 3% LR requirement became binding on 28 June 2021.

[12] This is mainly intended to cover for leverage risk originating from banks using derivatives, securities financing transactions and off-balance-sheet items in their business operations.

[13] As an example, if a specific bank's risk-based G-SII buffer is 1%, its LR G-SII buffer would be 0.50%.

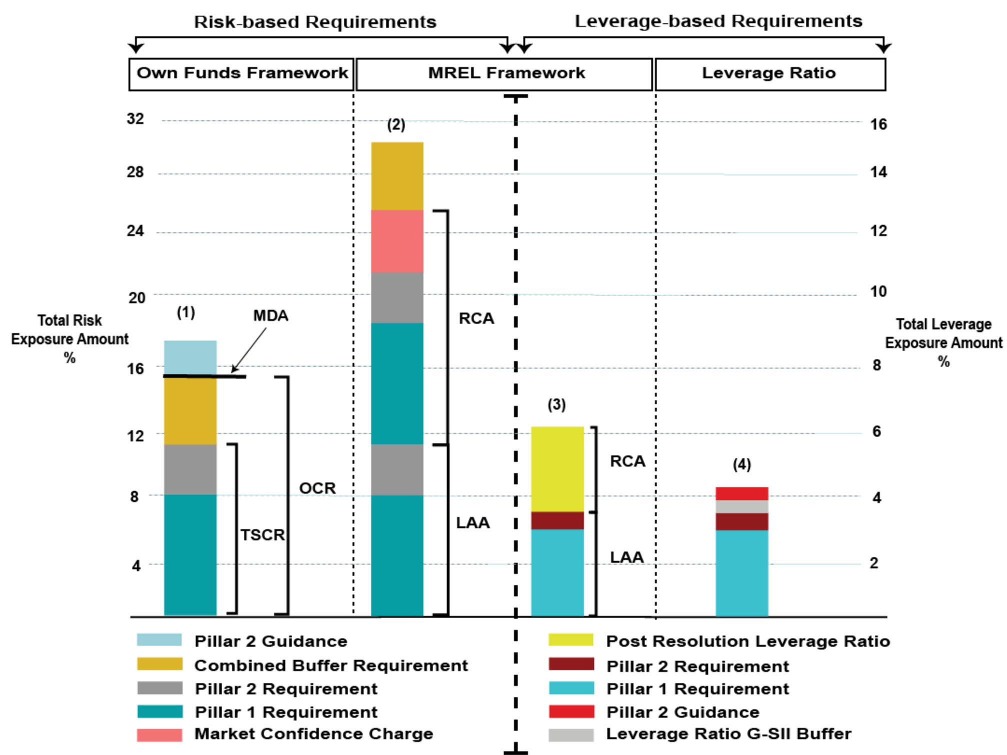
[14] Article 72b (2)(d) CRR for G-SIIs and Article 12d(4) and Article 12d(5) SRMR for Top Tier banks and Other Pillar 1 banks.

of MREL-LRE it consists of the LR requirement. However, in addition, in the case of the RCA the legal framework sets conditions under which this can be adjusted upwards or downwards. One such instance is by applying a Market Confidence Charge (MCC) to ensure that, following resolution, the resolution entity sustains sufficient market confidence. This adjustment relates to the MREL-TREA only and is equal to the CBR minus the CCyB.

On the other hand, entities that would be wound up in normal insolvency procedures have an LAA, but no RCA. In such instances, MREL will be covered by the same own funds which institutions use to meet their prudential capital requirements and hence no additional instruments would be required to be issued.[15] An important consideration is that, in the case of MREL-TREA, CET1 instruments used to meet the latter cannot be used to meet the CBR. Thus, the CBR should be met with CET1 instruments over and above the MREL-TREA requirement.

In conclusion, Figure 2 below highlights how the three regulatory requirements interact with each other. Bar graph (1) outlines the capital requirements banks are required to hold under the risk-based framework in terms of TREA whilst bar graph (4) shows the capital requirements banks are required

Figure 2
INTERACTION OF REGULATORY REQUIREMENTS



Note: The figure depicts a stylised example of risk-based capital requirements, leverage ratio requirements and MREL, as the amounts of requirements and buffers depicted in the figure will vary per bank depending on the bank's risk profile. Key: G-SII – Global Systemically Important Institutions; MDA – Maximum Distributable Amount; TSCR - Total SREP Capital Requirement; OCR – Overall Capital Requirement; RCA – Recapitalisation Amount; LAA – Loss Absorption Amount.

[15] The SRB MREL policy allows in specific instances for an upward adjustment to the LAA for liquidation entities if it is determined that there is any possible impact on financial stability and on the risk of contagion to the financial system.

to meet under the leverage-based framework. As highlighted previously, banks are required to meet in conjunction both a P1R of 8% in terms of TREA and a 3% LR requirement. Subsequently, on top of the P1R sits the P2R, CBR and P2G which, unlike the P1R, differ across banks. In the case of the risk-based requirements, as outlined under Bar graph (1), if a bank's capital level falls below the OCR, a capital conservation plan would need to be submitted to the ECB or respective NCA in line with CRD requirements, outlining the timeframe and set of measures to be implemented to increase the capital ratio. Moreover, the Maximum Distributable Amount (MDA) would be automatically triggered limiting the amount of distributions (such as dividends, share buybacks and bonuses) that a bank can make. For banks which are subject to a resolution action, bar graph (2) depicts the risk-based MREL requirements which banks must hold. As explained before this is made up of LAA and RCA with the CBR sitting on top. On the other hand, bar graph (3) depicts MREL in terms of the leverage-based framework whereby, similar to the risk-based MREL, is made up of the LAA and RCA.