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The banking package – on its way to Sweden

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The banking package is the collective name for several coming changes to the European regulations that must be observed by banks wishing to operate in the EU. The final contents of the banking package have recently been adopted after just over two years of negotiation between the EU member states. This Economic Commentary describes on a general level the parts of the banking package that are assessed to have the greatest impact on the regulation of Swedish banks.

What is the banking package?

Since the outbreak of the most recent global financial crisis in 2008, several measures have been taken to strengthen financial stability and increase the banks' resilience to financial stress. This work has been largely initiated at global level and it has led to several measures within the EU and in Sweden.

The banking package is the collective name for a number of amendments to the regulatory framework currently governing banks within the EU, and this includes the introduction of some global agreements in this field.

At the end of 2010 the Basel Committee presented the first parts of the global so-called Basel III Accord that aims to strengthen resilience in the international financial system. The final contents of the global agreement were completed in 2017, but parts began to be implemented within the EU as early as 2013.[1]

At the same time, the Financial Stability Board (FSB) produced a global framework in 2010 for managing failing banks, which was further developed at the end of 2015.[2] Using this as a starting point, the EU then introduced regulations for crisis management of banks in 2014.[3]

At the end of 2016, the European Commission published several proposals as to how existing EU directives and regulations[4] could be amended to include parts of these two new global agreements. It is these proposed amendments that are collectively known as the banking package.

The final contents of the banking package have recently been adopted after just over two years of negotiation within the EU and will now be gradually implemented in the member states. The Swedish government has therefore appointed a committee of inquiry that is to present proposals no later than 1 October 2019 on how to incorporate the contents of the banking package into Swedish law.

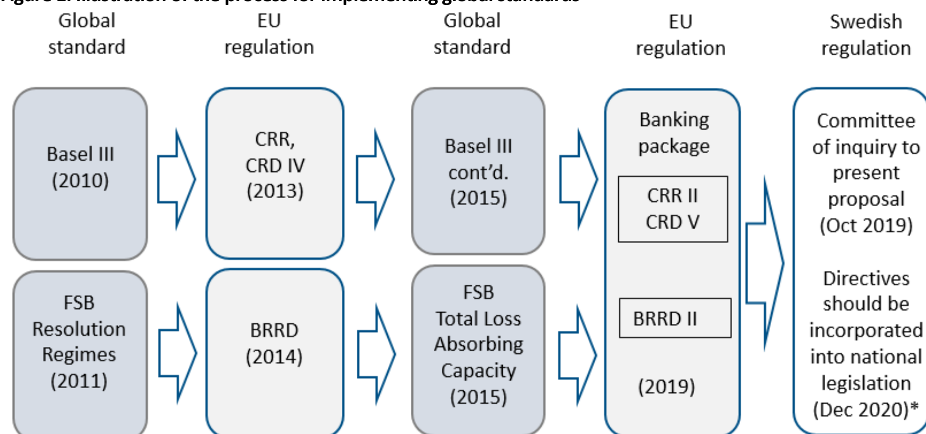
[1] The Capital Requirements Directive 2013/36/EU (CRD IV), the Capital Requirements Regulation 575/2013 (CRR) and the crisis management directive 2014/59/EU (BRRD). These directives were implemented in Sweden in 2014, in for instance the Banking and Business Act (2004:297), the Capital Buffers Act (2014:966), the Special Supervision of Credit Institutions and Investment Firms Act (2014:968), and the Resolution Act (2015:2016).

[2] Key Attributes of Effective Resolution Regimes for Financial Institutions Oct 2010 and FSB Total Loss-Absorbing Capacity (TLAC) Principles and Term Sheet Nov 2015.

[3] 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.

[4] The Capital Requirements Regulation, the Capital Adequacy Directive, the crisis management directive and the Single Resolution Mechanism Regulation 806/2014 (SRMR).

Figure 1. Illustration of the process for implementing global standards



* The Directive has been adopted and is to be implemented in national legislation no later than 18 months after publication. Publication is expected to be in June 2019.

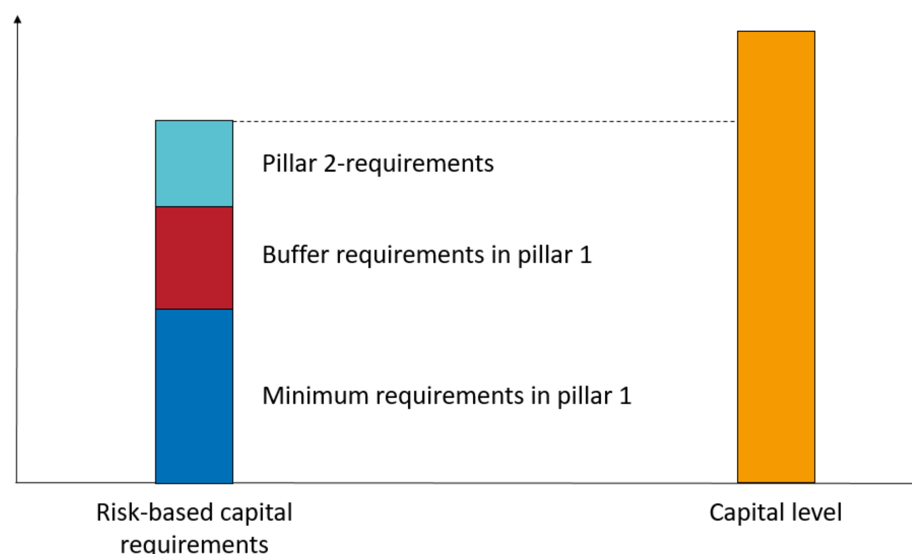
This Economic Commentary describes the parts of the banking package that we assess will have the greatest impact on the regulation of Swedish banks. We describe on a general level how the regulations for the banks' capital adequacy requirements will change, and the regulations regarding the maturities for the banks' funding. We also describe how the contents of the banking package may affect the requirements regarding future management of a Swedish bank in distress. In conclusion, we discuss the plans for the continued work on introducing the final parts of the Basel III Accord in the EU.

Swedish banks' capital requirements today

A bank must have a sufficient level of capital to conduct banking operations. One reason for this is that a bank must be able to cover losses in its day-to-day operations without becoming insolvent, that is, the value of the bank's underlying assets are less than the value of its liabilities.

At present, the banks must meet several different capital requirements. The exact formulation of these requirements is relatively complex but somewhat simplified they say that all Swedish banks must meet the *risk-based capital requirements* that we illustrate in Chart 1 below. These are often divided up into so-called *Pillar 1* and *Pillar 2 requirements*. The banks' Pillar 1 requirements entail not falling below a certain minimum level established by law. The requirements are also divided up into *minimum requirements in Pillar 1* and *buffer requirements in Pillar 1*. The banks' Pillar 2 requirements are specific to each individual bank and determined by the supervisory authorities concerned. Moreover, they can be divided up into the Pillar 2 requirements that have been formally agreed and those that have not been formally agreed. In Sweden, none of the Pillar 2 requirements has been formally agreed.

Chart 1. Illustration of the current capital requirements and capital levels for Swedish banks



If a bank does not meet the Pillar 2 requirements the supervisory authorities can deal with this in several different ways. For instance, the bank may need to establish a plan to restore its capital level in the short term. On the other hand, if a bank does not meet the buffer requirement in Pillar 1, the bank will automatically face restrictions regarding the payment of dividends to the bank's shareholders and the possibility to pay bonuses to employees. If a bank is in breach of the minimum requirements in Pillar 1, it is probable that it will become the object of a so-called resolution procedure if it is considered to be systemically important. We write more about this in the section Resolution and debt conversion.

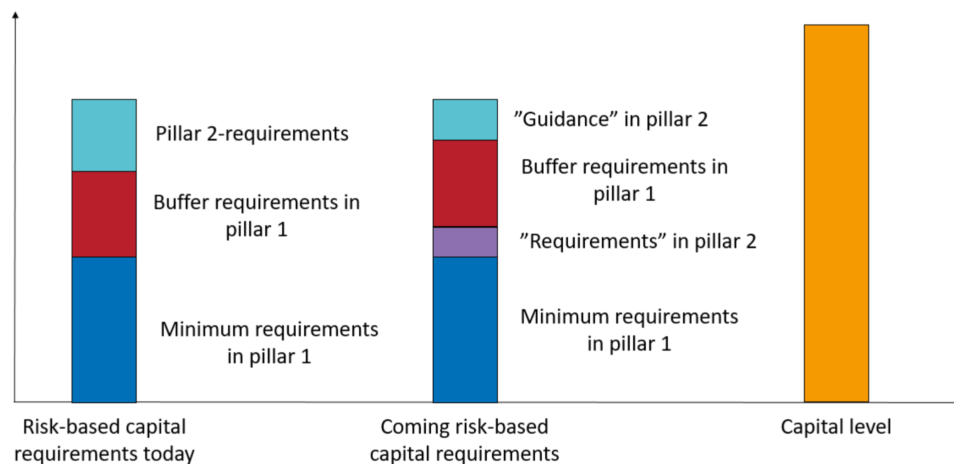
New capital requirements for Swedish banks

When the content of the banking package is implemented in Sweden, the banks' capital requirements will change. At present, Finansinspektionen can justify parts of a bank's Pillar 2 requirements on the basis of the risks the bank entails for the banking system, so-called macroprudential risks.[5] But when the banking package comes into force, this will no longer be possible. On the other hand, Finansinspektionen will be allowed to a greater extent than before to increase the buffer requirements in Pillar 1 to manage macroprudential risks. Finansinspektionen will still be able to made Pillar 2 requirements of the banks, however, if this is justified on the basis of other risks than macroprudential ones.

Furthermore, the banks' total Pillar 2 requirements will be divided up into two different parts, and called *requirements* and *guidance* respectively. We illustrate this division in Chart 2 below. The requirements part, which is illustrated in the purple field in the chart, will in practice be equal to the banks' current minimum requirements in Pillar 1. This means that the larger the share of the banks' Pillar 2 requirements that is a requirement instead of guidance (the light blue field in the middle column), the sooner the banks will be in breach of the buffer requirements in Pillar 1 when they make losses. In other words, the banks will face automatic restrictions when their capital levels decline at an earlier stage than before.

[5] For instance, Finansinspektionen currently makes greater Pillar 2 demands of the three major Swedish banks than the other Swedish banks.

Chart 2. Illustration of how the capital requirements might change.



In addition to these changes, the banks will need to meet a so-called *leverage ratio requirement*. This means that a bank must always have capital[6] equivalent to more than 3 per cent of the bank's total exposures[7]. These leverage ratio requirements will be even greater for banks that are assessed as having a negative effect on the global financial system if they suffer problems, that is, banks that are globally systemically important.

The above changes in the banks' capital requirements are largely due to the contents of the new global agreements on how banks should be regulated. However, the banking package contains some deviations from the final Basel III Accord. Some of these deviations are aimed to promote lending to small and medium-sized enterprises and to benefit certain infrastructure projects. The banking package also contains changes that aim to make the regulations more proportional, which means that they are adapted to the size and complexity of the banks. For instance, small banks may have less extensive requirements for what should be reported to the supervisory authorities than the larger banks have.

New regulations for maturities of banks' financing

During the most recent global financial crisis it became clear that even banks that are well capitalised can suffer problems. For instance, many banks had far too much short-term liabilities in relation to the maturity of their lending. This became particularly serious during the crisis, when much of the banks' short-term borrowing suddenly could not be refinanced, which meant that several banks were threatened with bankruptcy.

The Basel Committee therefore produced a regulatory framework that shall prevent the banks relying too much on short-term borrowing to finance their lending at long maturities. This regulatory framework is called the Net Stable Funding Ratio (NSFR) and large parts of it are to be introduced in the EU now in connection with the implementation of the banking package. [8] However, the EU has chosen to ignore some parts of the Basel Committee's original agreement, which will make it easier for banks in the EU to follow the new regulations.

Somewhat simplified, the NSFR regulations means that a certain share of the banks' lending with a maturity of longer than one year must be funded by deposits or by market funding with a maturity of more than one year.[9] The introduction of the NSFR does not mean

[6] Capital refers here to a bank's Tier 1 capital, which somewhat simplified is its own capital and certain perpetual debt instruments.
[7] Total exposures refers, somewhat simplified, to assets on the balance sheet and parts of the off-balance sheet commitments.
[8] The EU has previously introduced the Basel Committee's regulations on banks complying with so-called liquidity coverage ratios (LCR). These regulations aim to ensure the banks have sufficient liquidity to manage a 30-day period of financial stress.
[9] Or is assessed to be longer than one year.

that the risks linked to the banks' funding will disappear altogether, but it will lead to the banks' financing probably not needing to be renewed as often. This benefits financial stability.

Resolution and bail-in

During the financial crisis in 2008, several foreign banks were saved using tax revenue, as parts of them were considered so important to society that they should not be allowed to go bankrupt. As a result of this and other factors, the Financial Stability Board[10] (FSB) introduced a procedure known as *resolution*. Regulations regarding resolution were introduced in the EU in 2014, through the European Bank Recovery and Resolution Directive (BRRD), and they entailed overall that a resolution authority (which in Sweden is the Swedish National Debt Office) takes control over the systemically important bank and restructures it so that the parts important to society can function as normal.

Resolution is to be used when the consequences of a bank's problems risk having negative consequences on the real economy or the financial system, that is, when the bank is assessed as systemically important. The idea behind resolutions is to ensure that tax-payers will not need to inject capital to save a bank, but that its losses will instead affect shareholders and creditors.

As part of the resolution, the authority can let some of the bank's liabilities to bear the losses by using the so-called bail-in tool[11]. This means that some of the banks' lenders will have their claims written-down or converted into shares in the bank.

To ensure that it is possible to use the bail-in tool, the resolution authorities require that the banks should have a certain amount of capital and liabilities of a particular type. In Europe these are known as MREL requirements.[12] The level of these MREL requirements can be described in simple terms as twice the current capital requirement. The idea behind the MREL requirement is that the bank needs to have both sufficient capital to cover losses and sufficient eligible liabilities that can be converted into new capital if the bank is in distress.

MREL requirements changed

As we mentioned initially, the banking package involves further parts of the FSB's framework for managing banks in distress being introduced in the EU. This means, for instance, that binding minimum levels are introduced regarding systemically important banks' MREL requirements and how they should be met. In addition, certain amendments are made to the rules on how institution-specific MREL requirements in addition to the minimum level are set and fulfilled. All in all, this may entail changes with regard to both the levels and to which instruments may be used to meet the requirements. We describe this in more detail below.

Minimum required loss-absorbing capacity

As we mentioned above, the resolution authorities currently set the MREL requirements for the banks. When the banking package is introduced, however, the MREL requirements will be supplemented with minimum requirements that set a lowest limit for them.

There are two parallel quantified minimum levels, and a further level that the resolution authority needs to take into account. These minimum levels are designed in a relatively complex way and the one that is relevant for an individual bank will depend on the size of the bank and an assessment of the risks in its lending.

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[10] FSB Key Attributes of Effective Resolution Regimes for Financial Institutions.

[11] So-called bail-in.

[12] Minimum Requirement for Own Funds and Eligible Liabilities, MREL.

Instruments that may be eligible as loss-absorbing

When the banking package is introduced, the minimum levels described above shall be met in full with so-called subordinated instruments. When an instrument is subordinated, this means that it must come *after* the liabilities in the insolvency hierarchy that the resolution authority is unable or unwilling to write down, such as retail deposits. Subordinated instruments include the banks equity, in addition to the debt instruments that meet these criteria.

Furthermore, the resolution authority can with some limitations require that the banks meet institution-specific MREL requirements over and above the minimum level with subordinated instruments.

To make it easier for European banks to meet these requirements, EU introduced rules in 2018, harmonising the creditor hierarchy in the case on bank insolvency and creating a new category of subordinated debt instruments.[13]

Investments in eligible liabilities

If a bank invests too large amounts in another bank's eligible liabilities it may lead to major losses for the investing bank if these liabilities need to be written down in a crisis situation. In other words, problems in one bank could then easily spread to another. The Basel III Accord therefore contains rules to limit global banks’ holdings of other global banks’ eligible liabilities. When the banking package is introduced, similar rules will be introduced in the EU, although they will not be as strict as those in the Basel III Accord.

The member states shall also introduce, for reasons of consumer protection, various regulations to avoid retail investors holding this type of eligible liability and risking the loss of their savings in the event of resolution.

How are the major Swedish banks affected by the banking package?

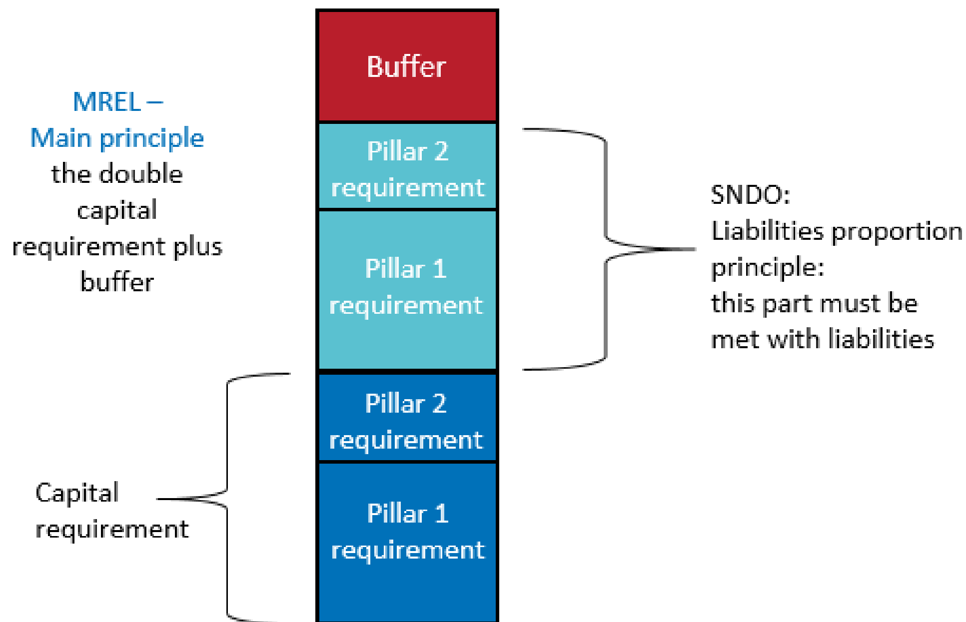
When the banking package is introduced in Sweden the *structure* of the risk-based capital requirements for Swedish banks will change, as we have described in the section New capital requirements for Swedish banks. The size of the banks’ Pillar 2 requirements are determined by Finansinspektionen, who can also affect the size of the banks’ buffer requirements in Pillar 2. Finansinspektionen thus determines how much higher the banks’ total risk-based capital requirements shall be than the minimum level described above. The level of the minimum requirements in Pillar 1 will not change as a result of the banking package being introduced. Swedish banks will also need to meet a leverage ratio requirement of at least 3 per cent of their total exposures, but Finansinspektionen can also choose to set a higher requirement. At present, the three major Swedish banks have a leverage ratio requirement of around 4.5 per cent of their total exposures.

With regard to the regulations regarding the maturities for the banks’ funding as described above (NSFR), the three major Swedish banks already meet these minimum requirements.

The level of future capital requirements also has a direct impact on what the MREL requirements will be. As we mentioned earlier, a bank’s MREL requirements may somewhat simplified be described as its double capital requirement.

[13] In Sweden the legal amendments came into force on 29 December 2018, see Government Bill 2017/18:292. These are usually known as “senior non-preferred”.

Figure 2. Relationship between capital requirements and MREL requirements



The size of the MREL requirements, that is to say their quantity, is thus largely determined by the capital requirements the supervisory authority sets for the banks. The resolution authority has the opportunity to adjust the quantity the banks must hold to some extent, and can also within certain boundaries affect what type of instrument may be included, that is to say the quality. Below we describe the implications of the Swedish National Debt Office's current requirements regarding subordinated debt instruments, followed by the minimum requirements for subordination introduced in the banking package.

The Swedish National Debt Office decided as early as 2017 on a national method that means Swedish banks must meet a *liabilities proportion principle*.[14] Put simply, this means that about half of the Swedish National Debt Office's MREL requirement must be met with debt instruments, that is, not with capital. The Swedish National Debt Office has also decided that the liabilities proportion principle shall be met with subordinated liabilities no later than 1 January 2022. However, the Swedish banks have not yet begun to issue any subordinated liabilities. With the Swedish National Debt Office's current MREL method, that is, not taking into account potential changes ensuing from the banking package, Swedish banks need to issue subordinated debt instruments corresponding to around SEK 400 billion prior to 2022, according to the Debt Office's calculations. One way of doing this would be to replace senior non-secured debt with subordinated debt as the senior non-secured debt matures. The three major Swedish banks alone have at present around SEK 800 billion in senior non-secured debt.

If the Swedish National Debt Office's MREL requirements are lower than the coming minimum levels in the banking package, however, it will be the minimum levels that apply. Given that the banks have a large share of lending against collateral in property (which is regarded as relatively low risk) on their balance sheets, there may be cases where the non-risk based level is the binding one.

[14] See Tillämpning av minimikravet på nedskrivningsbara skulder (Application of minimum requirement for subordinated liabilities), Swedish National Debt Office, Ref.no. RG 2016/425

What happens next?

The intention is that the contents of the banking package will be implemented gradually in the EU member states. Some parts (the regulations) of the banking package will be directly binding in the member states, while others (the directives) must first be incorporated into national legislation.[15] The more technical details of some of the regulations are to be further developed in the coming years by the European Banking Authority (EBA).

When the banking package is introduced in Sweden a lot of the contents of the international agreements that we have described above will finally be implemented in Sweden, but the final parts of the Basel III Accord will still remain to be introduced.[16] These changes are instead intended for inclusion in a similar legislative project within the EU usually entitled *banking package 2*. The plan is to begin negotiations between EU member states in 2019.

[15] The directives shall be implemented in the member states' national legislation within 18 months.
[16] See for instance the Riksbank's Economic Commentary "Basel III and the major Swedish banks' capital requirements", https://www.riksbank.se/globalassets/media/rapporter/ekonomiska-kommentarer/engelska/2017/basel-iii-and-the-major-swedish-banks-capital-requirements.pdf