Implementing Basel III in European and national law

The G20 leaders' direct response to the financial crisis was to adopt an action plan aimed at strengthening the resilience of the financial sector, and thus reinforcing financial stability, as well as eliminating the weaknesses which had become apparent during the crisis, particularly in financial market regulation and international cooperation.

A core element of this package of measures, referred to collectively as the Basel III framework, is a fundamental improvement in institutions' capital and liquidity, thereby fulfilling one of the main aims of the G20 action plan. The banks are required to hold not just higher-quantity but also higher-quality minimum capital reserves, which will also distinctly improve their loss absorbency. Further risks can also be absorbed by means of additional capital buffers which are much more flexible than minimum ratios and through which, for the first time, macroprudential or systemic aspects can also be taken into account in capital regimes. The liquidity rules, which have been established internationally for the first time, represent a further major step towards ensuring that institutions have sufficient liquidity at all times using regulatory means, thereby making the financial sector more crisis-resistant. The strict standards, which build on experience gained during the financial crisis, will replace a patchwork of regimes in Europe and help create a more level playing field in the internal market.

The Basel III framework will be implemented in Europe by the CRD IV package, consisting of a regulation which is directly applicable legislation and a directive which needs to be transposed into national law. This article gives an overview of the interplay and the content of the implementation of Basel III in the EU and the national legal systems. Whereas, for instance, the rules governing minimum capital adequacy and limiting institutions' liquidity risk are largely set by the EU regulation and therefore do not have to be transposed into national law, the capital buffer requirements, for instance, are governed by the EU directive, and therefore require national transposition. Owing to this implementation requirement and the direct applicability of the EU regulation, in Germany the German Banking Act (Kreditwesengesetz) and the associated national regulations are being adapted.

These measures represent, on the whole, a key step towards sustainably strengthening the resilience of the banking system. These extremely tightened rules, however, must be implemented in a balanced manner so as not to have any undesired effects on lending. The CRD IV package and the associated national legal frameworks provide for sufficient transitional periods for implementation by institutions.

Implementing Basel III in the European Union

EU implementation through CRR and CRD IV

The European Union (EU) will implement the Basel standards[1] in European law in two different legislative acts: the Capital Requirements Directive IV (CRD IV)[2] and the Capital Requirements Regulation (CRR).[3] Following the intensive trilogue negotiations between the Council, Parliament and Commission, agreement on the texts of CRD IV and CRR was reached in February 2013. The EU therefore failed to meet the deadline agreed by the G20 countries for the entry into force of the first stage of Basel III – 1 January 2013. CRR and CRD IV will therefore be applicable from 1 January 2014, provided the texts are published in the Official Journal of the EU on schedule, ie prior to 30 June 2013.

Application planned from 1 January 2014

Delayed introduction of CRR means shorter transitional period

The one-year delay in the introduction of CRR, however, will not affect the timetable up until the full application of the rules. Instead, the Basel Committee agreed to shorten the transitional period for those countries that had not introduced the new regime by 1 January 2013.[4]

The vast majority of the Basel rules mentioned at the beginning, but also the large exposures regulations and disclosure requirements, for instance, are now governed by the CRR, which, as a regulation, represents directly applicable law. Transposition into national legislation is therefore not only unnecessary, but also prohibited. The whole purpose behind the regulation as a legislative instrument is to significantly reduce the discretionary scope currently afforded by the directive and prevent differences in national rules from creating competitive distortions. This serves the objective of increased harmonisation by means of uniform rules in the internal market (single rulebook).

Retained national discretionary scope

However, the CRR still contains national discretionary scope, national options or provisions that need to be fleshed out. One of these is the option of exempting CRR investment firms[5] from the liquidity requirements. Moreover, there are supplemental rules governing the approval and examination of the internal approaches for calculating own funds requirements, the transitional regulations for calculating capital and options not to count certain exposures towards the large exposures limit. In addition, the CRR and CRD IV both offer a degree of flexibility with regard to the use of macroprudential instruments (flexibility package). There is a national option to tighten various prudential requirements temporarily (see page 63f). In addition, CRD IV provides for a capital buffer for systemic risk which can generally be used flexibly by member states (see page 65f).

Directive requires national implementation

The directive has retained those rules and provisions which can be dealt with better by national authorities owing to factors specific to individual countries, such as the structure of the banking system, the legal and administrative system and the business cycle. This largely concerns rules for approving and supervising institutions, cross-border cooperation between supervisory authorities, additional capital buffers, internal governance (eg remuneration), the supervisory review and evaluation process and supervisory sanctions.

EBA standards and guidelines represent further detailed regulation

In order to ensure a uniform set of rules valid across national borders (single rulebook), the European Banking Authority (EBA) will develop draft technical implementation and regulatory standards[6] in areas which have been expressly

1 BIS, Basel III: A global regulatory framework for more resilient banks and banking systems, June 2011, www.bis.org/publ/bcbs189.pdf; BIS, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, January 2013, http://www.bis.org/publ/bcbs238.pdf.
2 The directives currently in force, 2006/48/EC and 2006/49/EC, are collectively referred to as the Capital Requirements Directive (CRD).
3 CRD IV and CRR are collectively referred to as the CRD IV package.
4 As at March 2013, this list included, alongside the EU member states, the United States, Brazil, Indonesia, Korea, Russia and Turkey. See BIS, Progress report on implementation of the Basel regulatory framework, April 2013, www.bis.org/publ/bcbs247.pdf.
5 Investment firms pursuant to Article 4 (2) of the CRR, which are required to apply the provisions of the EU regulation directly.
6 See Deutsche Bundesbank, International cooperation in banking regulation: past and present, Monthly Report, September 2011, pp 79-93.

defined in advance. If these standards are adopted by the European Commission by way of a regulation or decision, they become directly applicable law. Since the deadlines for the EBA to develop draft standards mandated by CRD IV and CRR are, in some cases, very short, the EBA already started work last year. Moreover, the EBA was given the power, or in some cases the task, of developing guidelines and recommendations for the harmonisation of supervisory practice. The Bundesbank and the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* or BaFin) are jointly involved in the EBA's work.

This article will continue by initially explaining the CRR's provisions; the section on "Key amendments to the German Banking Act" will discuss the new provisions of CRD IV which have to be implemented nationally.

Improving the quantity and quality of regulatory capital

New definition of regulatory capital is key element of Basel III

One of the core elements of the Basel III package implemented by the CRR is a revision of the definition of regulatory capital. The aim is to improve both the quality and quantity of banks' capital. This is to be achieved through more stringent uniform criteria for recognising regulatory capital components, stricter and harmonised rules for deductions applied in the calculation of the capital base and expanded disclosure requirements for banks.

Supervisors to focus on common equity tier 1 capital in future

In future, supervisors will be paying increasing attention to institutions' common equity tier 1 capital, which is composed of paid-in capital instruments and disclosed reserves. Both components must be available to institutions for unrestricted and immediate use to cover risks or losses. In order to do justice to the heterogeneous nature of the EU banking market, the "substance over form" approach contained in current European directives will be carried over to cover the eligibility of the capital instruments contained in common equity tier 1 capital. This means that any instrument which meets the 13 conditions for recognition intended to model the characteristics of the common equity of a public limited company and contained in the catalogue envisaged by the CRR can be counted as common equity tier 1 capital. For listed public limited institutions, however, in keeping with the Basel III provisions, the recital in the CRR contains the expectation that their common equity tier 1 capital shall consist exclusively of equity capital and disclosed reserves.

Special features of cooperative and savings bank sectors taken into account

Exceptions that are also contained in Basel III take into account the legal restrictions in force in the cooperative and savings banks sectors. These institutions are permitted, within clear confines, to depart from the general conditions for recognising common equity tier 1 capital instruments.

Additional tier 1 capital and tier 2 capital as further classes of capital

Only additional tier 1 capital and tier 2 capital will be recognised as classes of regulatory capital alongside common equity tier 1 capital; this greatly simplifies the capital structure. Like common equity tier 1 capital, additional tier 1 capital should be continuously available for loss absorbency purposes, thereby enabling the bank to continue on a going-concern basis. Some of the key requirements that instruments in this capital class must meet are that they be subordinated, that they be perpetual, and that distributions be fully discretionary. In addition, for additional tier 1 capital institutions have to make it possible for the instruments to be converted to common equity tier 1 capital or to be depreciated once the common equity tier 1 capital ratio falls below a threshold of 5.125%.[7] The CRR does not permit incentives to redeem capital instruments.[8]

The significance of tier 2 capital is reduced significantly and its function is limited to credit

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7 This value is the result of a minimum common equity tier 1 capital requirement of 4.5% plus the capital conservation buffer threshold of 0.625% (2.5% × 0.25) up to which distributions are prohibited altogether.
8 One example is a clause allowing the interest rate to increase if the institution does not exercise a call; this is currently legal for what are known as innovative capital instruments.

Deductions from capital

Position	Current treatment under German Banking Act	Treatment under the CRR
Intangible assets	Deducted from tier 1 capital	Deducted from common equity tier 1 capital
Goodwill	Deducted from tier 1 capital (IFRS banks), capitalised aggregation difference (banks applying the German Commercial Code)	Deducted from common equity tier 1 capital
Non-consolidated holdings in the financial sector	Deducted in equal parts from tier 1 and tier 2 capital if certain thresholds are exceeded	Deducted from the same capital class in which the investment was made if certain thresholds are exceeded[1]
Deferred tax assets	No deduction/no limit	Generally deducted in full from common equity tier 1 capital[1]
Losses in the current financial year	Option of imposing an adjustment item on liable capital	Deducted from common equity tier 1 capital
Value adjustment shortfall (IRBA banks)	Deducted in equal parts from tier 1 and tier 2 capital	Deducted from common equity tier 1 capital
Surpluses from defined benefit pension plans	No deduction	Deducted from common equity tier 1 capital

1 Significant investments in the form of components of common equity tier 1 capital and certain deferred tax assets caused by valuation differences between the balance sheet prepared in accordance with the German Commercial Code and the tax accounts can be exempted from deduction up to 10% of common equity tier 1 capital for each item yet cumulatively only up to 15% of common equity tier 1 capital. A risk weight of 250% is applied to the non-deducted items.

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Repayment of capital instruments only with prior consent of supervisors

protection in the event of a bankruptcy. Tier 2 capital instruments must have a minimum original maturity of at least five years and must be subordinated with respect to repayment if the institution goes bankrupt. In this capital class, too, incentives to redeem are no longer permitted. Repayment of principal by the institution is generally permitted only with the prior consent of supervisors; the redemption of maturing tier 2 capital components is the only exception permitted. The tier 3 funds currently eligible to cover market risk are eliminated entirely in the new capital structure.

The new rules governing capital deductions are also focused on improving the quality of regulatory capital and calculating it in a consistent manner. The principle behind these provisions is that a capital deduction for a position should always be taken from that capital class which was originally increased by the position. This is shown in the table above.

Minority interest in subsidiaries eligible only to extent needed to cover risk

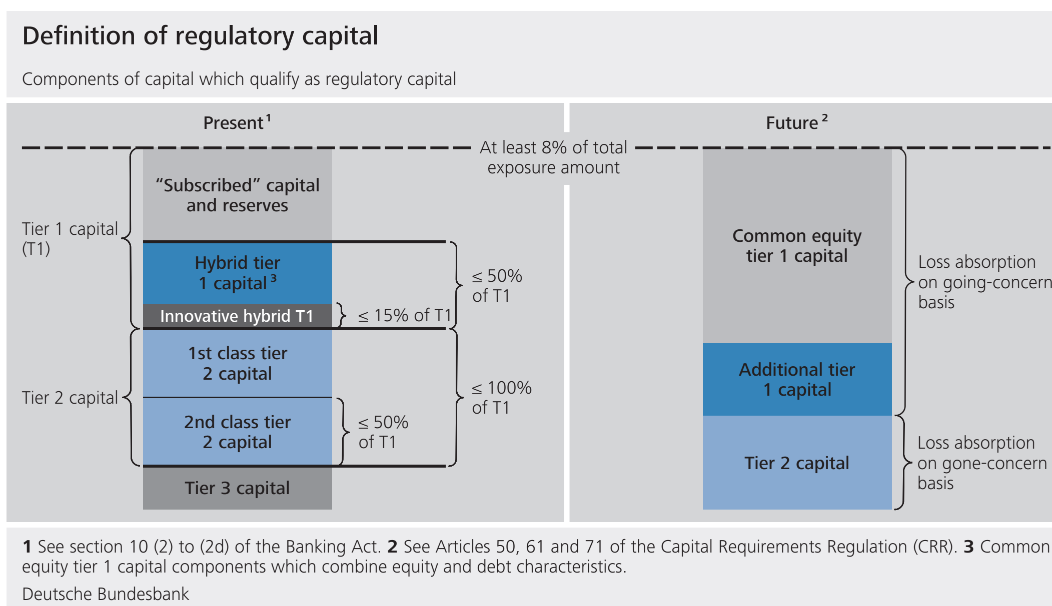
Minority interest arising from common shares in subsidiaries and other capital instruments issued by consolidated subsidiaries and held by third parties may no longer be fully recognised towards capital at group level under the CRR but only to the extent used by the subsidiary to cover the minimum capital requirements, including capital buffers. This addresses the fact that, in a crisis, minority interest is not fully available to the other enterprises in the group. Capital issued out of special-purpose vehicles is generally recognised only as additional tier 1 capital or tier 2 capital.

Higher minimum capital requirements

In addition to the expanded and tightened rules for deductions, the calibration of future capital requirements will lead to a significant increase in, above all, institutions' common equity tier 1 capital. The ratio will rise from its current level of at least 2% of risk-weighted assets to 4.5%. Banks will also have to hold at least 1.5% in additional tier 1 capital in future. The importance of tier 2 capital is diminishing;

Definition of regulatory capital

Components of capital which qualify as regulatory capital



1 See section 10 (2) to (2d) of the Banking Act. **2** See Articles 50, 61 and 71 of the Capital Requirements Regulation (CRR). **3** Common equity tier 1 capital components which combine equity and debt characteristics.

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it will only be able to contribute 2% (as opposed to 4% at present) to covering the total capital requirement (8%).

New rules to be phased in

The new minimum capital requirements will not be introduced all at once but instead phased in by way of transitional regulations so that ample time to make the required adjustments is provided. As the new capital is being built up, old capital instruments which do not meet the new requirements for recognition will be phased out, also over a relatively long transitional period. Starting with the entry into force of the CRR, capital instruments issued prior to 31 December 2011 will be grandfathered; the eligibility of the total volume of instruments existing as at 31 December 2012 will be gradually phased out in a process lasting until 31 December 2021. The deductions described above will likewise be phased in from 2014 to 2018. The same transitional period will be in force for the application of the new rules governing minority interest in subsidiaries. Finally, under the transitional provisions, the government support provided to ensure institutions' viability on a going-concern basis owing to the financial crisis will remain completely eligible as capital components until 31 December 2017.

Change in the capital charges for counterparty credit risk

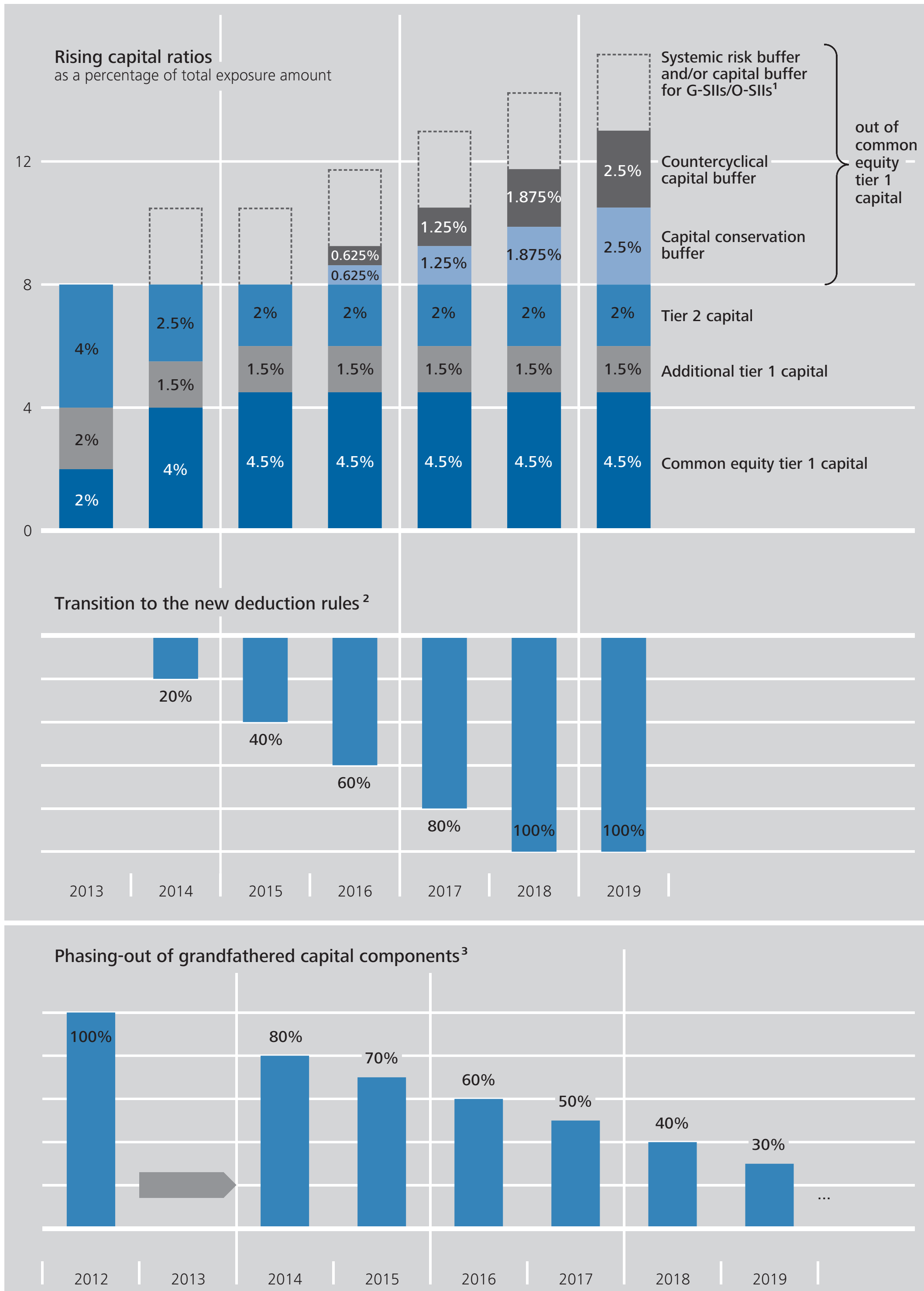
During the financial crisis, it turned out that much of banks' losses from derivatives trading were caused not by the default of a counterparty but by mark-to-market losses resulting from a deterioration in the counterparty's creditworthiness. The Basel III package therefore introduced a new capital requirement to cover such losses: credit valuation adjustments (CVA). Under Basel III, this capital requirement is valid for all derivatives which are not settled via a central counterparty (CCP).

Although this rule is implemented by the CRR, extensive exemptions have also been defined: under certain conditions, transactions with non-financial counterparties can be exempted from this new capital requirement. There are also exceptions for certain intra-group transactions and derivatives business with pension funds, central banks, sovereigns and certain public sector entities.

Capital charge for centrally cleared derivatives

Basel III has not only raised the capital requirement for bilaterally settled derivatives contracts but has also imposed a mandatory capital charge on derivatives contracts settled through a CCP. To date, such transactions had been ex-

Transitional provisions for capital ratios and capital buffers, deductions and components of capital



1 G-SIIs = global systemically important institutions; O-SIIs = other systemically important institutions. Where an institution is subject to more than one of these buffers, only the highest of these buffers shall be applied. However, if the systemic risk buffer is applied only to risk exposures located in the member state that sets the buffer, this requirement shall be additive to any capital buffer that may be applicable to G-SIIs or O-SIIs. **2** Example: in 2016, 60% of a deductible exposure must be deducted from capital. The remaining 40% is treated in accordance with the deduction rules currently in force. **3** Grandfathered eligible components of capital as a percentage of the components of capital that are eligible exclusively under the old rules. Valid for instruments issued prior to 31 December 2011 and/or existing components of capital. Does not include government aid if such aid was provided as part of approved support measures and prior to the entry into force of the CRR. These components of capital are fully eligible up to 31 December 2017 but no longer eligible from 1 January 2018 onwards.

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empted under certain conditions. In future, there will be a capital charge on these transactions, albeit a small one. In July 2012, the Basel Committee published a transitional arrangement for treating exposures to CCPs which, in its current form, will be incorporated into the CRR in its entirety. These rules are currently being reworked with the objective of completing a final proposal regarding such exposures by the end of 2013. This proposal is likely to be incorporated into the CRR as well.

Introducing quantitative requirements for institutions' liquidity

Minimum quantitative requirements: a first in the international regulatory framework

Minimum liquidity standards serve to strengthen institutions' ability to pay at all times. The Basel III framework requires not only a minimum amount of specific highly liquid assets as a short-term liquidity reserve but also a balanced ratio between the maturity structures of banks' assets and liabilities. This is intended to both strengthen banks' short-term resilience to liquidity shocks and create an incentive to avoid excessive maturity transformation. In introducing quantitative liquidity standards, global and European standard setters have entered uncharted regulatory waters. Directive 2006/48/EC contains barely any minimum or reporting requirements for institutions' liquidity reserves and funding structures. Another way in which the traditional special status of liquidity risk in banking supervision is expressed is that, under Article 41 of Directive 2006/48/EC, the monitoring of liquidity risk at foreign branches has been exempted from the principle of home country control.

Finalisation and introduction of new liquidity rules

The Basel Committee only published its revised framework on the liquidity coverage ratio (LCR) and the monitoring tools in January 2013.[9] The process of revising and reviewing the net stable funding ratio (NSFR) will probably continue until mid-2016. European lawmakers took these delays into account when implementing these ratios in the CRR. The ultimate design of the LCR, which is called liquidity coverage requirement in the CRR, will be defined by the Commission through delegated legislation by no later than 30 June 2014, and the LCR will be phased in as a mandatory minimum standard between 2015 and 2018.[10] With regard to the NSFR, the European Commission will decide by the end of 2016 whether, and how, it will be introduced. In order to specify the monitoring tools, the EBA will present a draft technical implementation standard to the European Commission by 1 January 2014.

New liquidity standards: LCR, NSFR and monitoring tools

In keeping with the international agreements, the regulation of liquidity risk will be fundamentally rewritten at the EU level with the introduction of minimum standards and monitoring metrics in Part Six of the CRR. The LCR will be a core element in future: institutions will have to hold a minimum amount of high-quality liquid assets sufficient to offset net cash flows over a 30-day horizon under a severe stress scenario. On the basis of the nearness to liquidity of the assets and certain off-balance sheet items, the NSFR identifies a bank's need for stable funding and the financing instruments available to cover this requirement. A series of additional monitoring metrics, notably including an extensive gap analysis, are also intended to enable the responsible supervisory authorities to gain a comprehensive insight into institutions' liquidity profiles.

How the CRR differs from the Basel liquidity framework

The CRR varies in some places from the Basel liquidity rules and also contains some additional elements. Whereas the Basel framework primarily addresses the group level of internationally active banks, CRR compliance is mandatory for all institutions which conduct

9 The adequacy of the recognition of central bank funding in the LCR will be reviewed once again in 2013 by a high-ranking Basel Committee project group. In addition, the disclosure rules for the LCR and the market indicators for high-quality liquid assets need to be specified by the beginning of 2014.
10 The implementation plan provides for a minimum LCR of 60% from 2015, to be increased annually in stages to 100% by 2018. Under the delegated legislation on the LCR, the European Commission can postpone full introduction until 2019.

deposit and lending business, as well as CRR investment firms[11] on both a single-entity and consolidated basis.[12] However, if the liquidity management of the consolidated group meets certain conditions, the competent authorities may, pursuant to Article 8 of the CRR, waive application on a single-entity basis in favour of higher levels of consolidation (also called the liquidity waiver).[13] The CRR can differ further from Basel III with regard to the definition of liquid assets during the transitional period, pending a final decision by the European Commission.[14] This addresses those special characteristics of the EU member states' economic and financial market structures which are of relevance to institutions' liquidity risk.

Limiting institutions' debt through the leverage ratio

Leverage ratio being introduced as an additional metric alongside risk-based capital requirements

An additional material element of the Basel III package and its implementation in the EU is the introduction of a leverage ratio, which is a bank's tier 1 capital over total exposure. The balance sheet valuations are oriented to the relevant accounting standard applicable to that particular institution. In order to make the leverage ratio internationally comparable, some special arrangements have been provided for, such as with regard to the rules for netting securities repurchase agreements and derivatives or off-balance sheet transactions.

Unlike the risk-based capital requirements, which are based on model assumptions, in the leverage ratio the individual exposures are not risk-weighted but instead included in the metric value unweighted. The leverage ratio is designed to address regulatory weaknesses which were revealed during the crisis. Not only should the leverage ratio counteract the fundamentally cyclical effect of risk-based capital requirements (known as a backstop function) but, as a risk-insensitive instrument, offset the defects of risk-based capital requirements. Such flaws were exposed in the crisis when banks' losses, in some cases, significantly exceeded the risks calculated with the aid of models. The leverage ratio's insensitivity to risk, however, comes with its own hazards, as it gives banks an incentive to make higher-risk loans and investments.

Interplay between leverage ratio and risk-based capital requirements should initially be analysed

All institutions will be required, from 2015, to disclose their leverage ratio and its components using a standardised template. In keeping with Basel III, supervisors will initially not set a binding minimum requirement. During an observation period lasting until January 2017, supervisors will track the new ratio in order to analyse its impact more closely. This may well lead to changes in the CRR methodology for calculating the leverage ratio, especially as some details regarding the design are still being discussed by the Basel Committee and need to be clarified through consultation with the banking industry. In addition, the interplay between the leverage ratio and risk-based capital requirements, especially for particularly low-risk business models, requires further analysis. Lastly, the leverage ratio should not impair the positive incentive effects of risk-based capital requirements. This observation period will be followed by a decision on whether to set a binding minimum value for the leverage ratio at the European level and, if so, how high that level should be.

Systemic risk

One of the essential lessons from the financial crisis was to interweave microprudential and

11 Until the European Commission issues a report by not later than 31 December 2014, the competent authorities are permitted to exempt investment firms from the requirements (only reporting requirements up to then) pursuant to Part Six of the CRR. This option is exercised in section 2 of the Banking Act.
12 Liquidity-specific exemptions for groups or institutions belonging to a group can generally also be applied to network member institutions.
13 The CRR alternatively gives the competent supervisory authorities the option of making individual inflow or outflow assumptions for certain intra-group cash flows.
14 With regard to cash flow assumptions, the CRR envisages rules deviating from Basel III for promotional loans, open maturity loans, corporate deposits as part of traditional relationship banking, and in exceptions, limits on inflows.

Tightening of requirements at the national level …

macroprudential oversight more tightly and, accordingly, to establish macroprudential institutions and create macroprudential instruments.[15] It is for this reason that the flexibility package mentioned on page 56 was inserted into the CRR and CRD IV.[16] In order to address systemic risk at the national level, the member states will, in future, be able to impose stricter regulatory measures to tighten the requirements for own funds, large exposures, disclosure or the like (Article 458 of the CRR). Any member state wishing to impose such a measure has to inform the European Parliament, the European Commission, the Council, the ESRB and the EBA and submit justification. Upon a proposal by the Commission, the Council may reject the measure under certain conditions by a qualified majority. However, the following temporary measures may be imposed by any member state – and may not be rejected by the Council: an increase in the risk weights for residential and commercial real estate loans and for intra-financial sector exposures by up to 25 percentage points, and a reduction of up to 15 percentage points in the upper limit for large exposures.

… and at EU level

In the case of systemic risk which affects all member states, the European Commission is empowered to impose stricter prudential requirements in some areas (level of own funds, large exposures and disclosure) for a period of one year (Article 459 of the CRR).

Capital relief for exposures to small and medium-sized enterprises

The CRR introduces a reduction in the capital charges for exposures to small and medium-sized enterprises (SMEs). In future, the capital requirements for such exposures shall be multiplied by a supporting factor equal to 0.7619.[17] This is intended to neutralise the increase in the minimum own funds requirement resulting from the phase-in of the capital conservation buffer (see page 65); in other words, after the phase-in of the capital conservation buffer, institutions will be required to hold the same amount of capital as before.

This rule applies to all exposures to SMEs with up to €50 million in annual turnover, irrespective of the exposure class to which borrowers are assigned. It is also predicated on the total sum of a given credit institution's exposures to an SME not exceeding €1.5 million.

Within three years after the entry into force of the CRR, the European Commission, supported by the EBA, shall report on the impact of this new provision on lending to SMEs and analyse the default risk inherent in such exposures across this period of time.

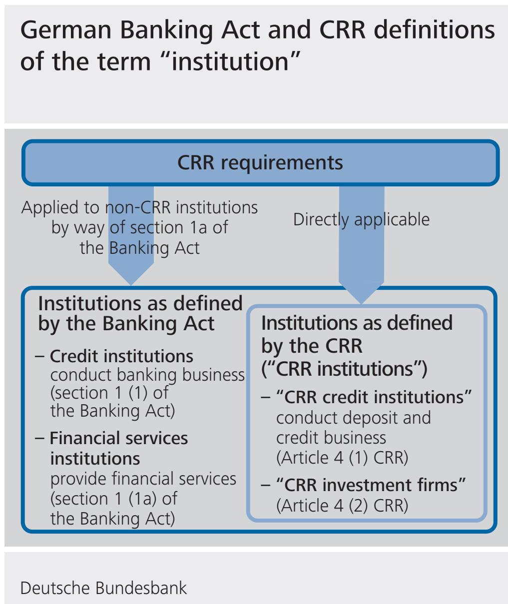
Key amendments to the German Banking Act

Banking Act to be revised

The stricter European regime introduced by CRD IV and the new harmonised European banking supervisory legislation built around a directly applicable EU regulation have necessitated fundamental amendments to the existing national legislation; in Germany, changes will need to be made to the Banking Act *(Kreditwesengesetz)*. This will be done by means of the CRD IV Implementation Act *(CRD IV-Umsetzungsgesetz),* which not only implements CRD IV in German law but also repeals national provisions on matters which will be directly governed by the CRR in future or contradict the new legislation. For instance, the CRR mostly contains provisions specifying institutions' capital adequacy, which is why the definition of own funds currently set forth in section 10 of the Banking Act will be repealed and the provision will be essentially reduced to the

15 See Deutsche Bundesbank, Macroprudential oversight in Germany – framework, institutions and tools, Monthly Report, April 2013, pp 39-54.
16 See pp 65-66 for more on the capital buffers contained in CRD IV.
17 This factor is derived by dividing the current solvency ratio (8%) by the sum of the future minimum capital requirement (8%) and the capital conservation buffer (2.5%).

German Banking Act and CRR definitions of the term "institution"



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authority to issue a regulation regarding solvency rules – which still need to be fleshed out at the national level – as well as rules governing the imposition of stricter capital adequacy requirements by BaFin. Furthermore, the implementing legislation exercises the few remaining national options in the CRR and specifies the existing scope for discretion. The date on which the amendments to the Banking Act come into effect will depend on the date of application of the CRR.

Bundesbank designated as a competent authority

The EU directive requires member states to designate the competent authority responsible for performing the tasks and functions set forth in CRD IV and inform the European Commission and the EBA thereof. CRD IV expressly makes special allowances for cases such as Germany with two competent authorities. In fulfilling its statutory mandate to monitor institutions on an ongoing basis, the Bundesbank performs activities assigned to a competent authority and will therefore be designated as a competent authority alongside BaFin in section 6 of the Banking Act.

Enshrining the supervisory review and evaluation process

Greater prominence is given to the provisions governing the supervisory review and evaluation process (SREP), which are significant in terms of preventive supervision, by explicitly anchoring them in a new section 6b of the Banking Act. In this respect, BaFin is to work closely with the Bundesbank to reach a summary, forward-looking assessment on whether the rules, strategies, procedures and processes implemented by a given institution are compliant with the supervisory requirement to ensure appropriate and effective risk management and sound risk coverage. Their assessment takes account of factors such as the outcome of stress tests and the risks that an institution poses to the financial system.

EU regulation applied to all institutions …

The definition of credit institutions in the CRR is confined to enterprises that conduct deposit and lending business, while the Banking Act term is broader in scope. Likewise, the definition of financial services institutions in the Banking Act is wider than that of investment firms in the CRR. Germany has no plans to amend its broad national definition of the term "institution", which it used to successfully contain the unregulated shadow banking sector; hence, the corresponding terminology used in the Banking Act will remain unchanged. Section 1a of the Banking Act envisages that all enterprises falling within the broad scope of the term "institution" pursuant to the Banking Act will have to comply with the CRR.

… with exceptions

Although section 1a of the Banking Act extends the reach of the CRR, a number of exceptions will be permitted. Owing to their business model, guarantee banks will not need to comply with the rules governing liquidity adequacy, the leverage ratio and the countercyclical capital buffer. Moreover, the CRR regime will not be applicable to housing enterprises with savings facilities. These enterprises, which receive deposits on a small scale, will be subject to special rules that are closely aligned with their business structure and take account of the fact that they only conduct banking business on a very limited scale. In addition, exceptions will continue to be made for certain financial services institutions.

Phase-in of capital buffers

In addition to the capital buffers already contained in Basel III – the capital conservation buf-

fer[18] and the countercyclical capital buffer[19] – as well as the global systemically important institution (G-SII) buffer[20] and the other systemically important institution (O-SII) buffer[21] based on the Basel frameworks[22] governing global and domestic systemically important banks, the European trilogue negotiations also agreed to incorporate the systemic risk buffer[23] into CRD IV.

Capital conservation buffer and countercyclical buffer …

Unlike the fixed capital conservation buffer, which is set at a uniform rate of 2.5% for all institutions, each institution is required to calculate and apply its own institution-specific countercyclical buffer rate. The idea behind the countercyclical buffer is to enable institutions to build up additional capital in times when excessive credit growth is judged to be associated with the emergence of systemic risk. To take account of the setting in which institutions operate, the buffer rate is set according to the jurisdiction in which the exposure is located. Institutions with domestic exposures must calculate their buffer rate using a rate set by BaFin for Germany, while the buffer rate for foreign exposures is generally based on the rate applicable there. Reciprocity is mandatory within the EU for buffer rates of up to 2.5%; in other words, the buffer rates set by other member states must be accepted as given. Buffer rates set by other member states in excess of 2.5% are to be respected by domestic institutions, provided that BaFin recognises these rates. The same goes for buffer rates set by third countries. If a third country has not set a buffer rate for exposures in that country, BaFin may do so; additionally, it may require domestic institutions to apply a buffer rate to exposures located in a third country that is higher than the buffer rate set by that country if it deems such action necessary to shield domestic institutions against the risks of excessive credit growth in that third country.

… to be gradually phased in from 2016

The capital conservation buffer and the countercyclical buffer will phased in from 2016 in four equal steps, and the full rate will only be applicable from 2019 onwards.

Systemic risk buffer …

The systemic risk buffer gives member states the ability to address long-term, non-cyclical systemic or macroprudential risk at a national level. The use of this buffer is predicated on the risk in question potentially having serious negative consequences for the national financial system and the real economy and not already having been adequately mitigated or prevented by other measures included in the CRD IV package. The imposition of the systemic risk buffer may not entail disproportionate adverse effects on the whole or parts of the financial system of other member states or of the EU as a whole; ie it should not create an obstacle to the functioning of the internal market.

… can be deployed flexibly

The systemic risk buffer amounts to at least 1% and can be deployed flexibly. It can, for instance, be set for all institutions, one or more subsets of institutions, and for exposures located in the domestic market, in other member states or in third countries, and different requirements can also be set for different subsets. However, depending on the amount and location of the exposures to be covered by the systemic risk buffer, a number of different procedures need to be followed before a national authority is allowed to apply this buffer. In any event, the authority is required to notify and justify the planned measure to the European Commission, the EBA, the ESRB and the foreign authorities affected. For buffer rates of up to 3%, notification will suffice for the imposition of the buffer.[24] Buffer rates above that

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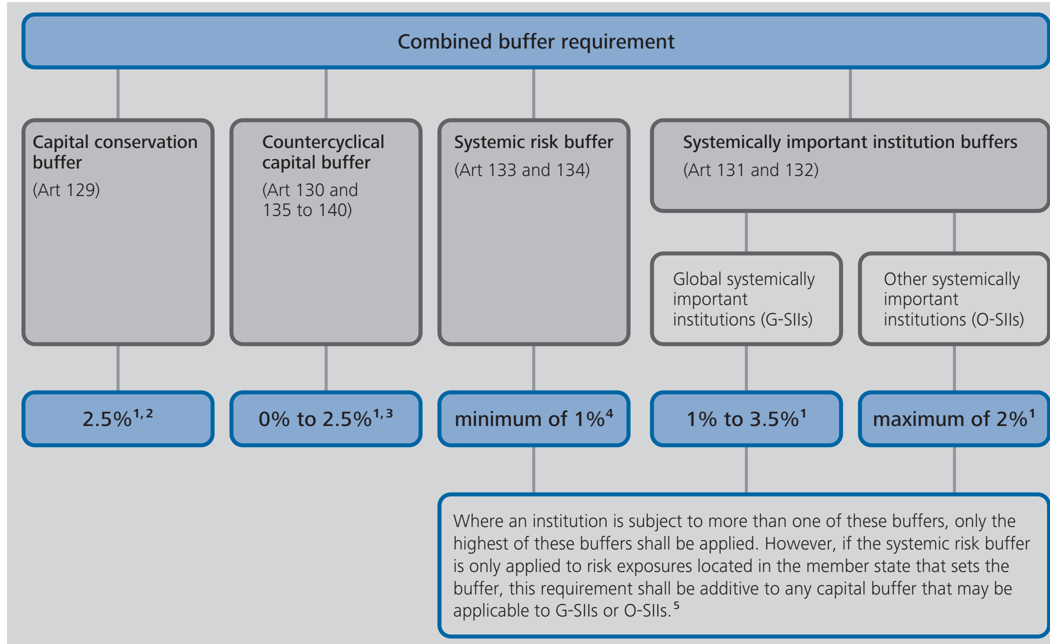
18 Article 129 CRD IV, transposed in section 10c of the Banking Act.
19 Articles 130 and 135-140 CRD IV, transposed in section 10d of the Banking Act.
20 Articles 131 and 132 CRD IV, transposed in section 10f of the Banking Act.
21 Articles 131 and 132 CRD IV, transposed in section 10g of the Banking Act.
22 BIS, Global systemically important banks: assessment methodology and the additional loss absorbency requirement – Rules text, November 2011, www.bis.org/publ/bcbs207.pdf; A framework for dealing with domestic systemically important banks, October 2012, www.bis.org/publ/bcbs233.pdf.
23 Articles 133 and 134 CRD IV, transposed in section 10e of the Banking Act.
24 If exposures located in other member states are affected, note that the buffer must then be set at the same rate for all exposures in the European Union.

Capital buffers in Capital Requirements Directive IV



1 As a percentage of the total exposure amount. **2** National authorities can increase this rate pursuant to Art 458 CRR as appropriate. **3** May be higher; cross-border reciprocity is generally mandatory up to a buffer rate of 2.5%. **4** As a percentage of the risk-weighted exposure values of those risk exposures in respect of which the systemic risk buffer is imposed. The procedures for imposing the buffer vary depending on the amount and location of the risk exposures to which the buffer is applicable. **5** If an O-SII is the subsidiary either of a G-SII or an O-SII domiciled abroad that is subject to an O-SII capital buffer on a consolidated basis, the capital buffer for O-SIIs may not exceed 1% on a consolidated basis for these subsidiaries.

Deutsche Bundesbank

level are subject to complex procedures involving the European Commission, the ESRB and the EBA. Much like the countercyclical capital buffer, the systemic risk buffer also gives national authorities the option of recognising buffer rates set in other member states. Domestic institutions with exposures in other member states would then have to apply the same systemic risk buffers set in the countries in question.

Global systemically important institution buffer

As from 2016, G-SIIs will be required to maintain, on a consolidated basis, an additional systemic risk buffer which, depending on the systemic importance of the group in question, is between 1% and 3.5%. G-SIIs are identified annually using an internationally agreed methodology which takes account of the following criteria: size, interconnectedness with the financial system, substitutability, complexity and cross-border activities.

Other systemically important institution buffer

National supervisory authorities likewise have the option of imposing an additional capital buffer of up to 2% on O-SIIs as from 2016. The criteria used for identifying O-SIIs each year are similar to those for G-SIIs but offer authorities a little more leeway. A national authority wishing to impose a capital buffer on O-SIIs must notify and justify the planned measure to the European Commission, the EBA and the ESRB as well as to the competent authorities of any member states affected.

How capital buffers interact

The G-SII and O-SII capital buffers are not generally intended to be additive because they are designed to cover the same risk. Bearing this in mind, an institution that is subject to both a G-SII and an O-SII capital buffer needs only to apply the higher of the two buffers. An institution that is subject to a G-SII or an O-SII capital buffer as well as a systemic risk buffer likewise needs only to apply the higher buffer unless the systemic risk buffer only applies to exposures located in the member state setting the

buffer. In this case, both the systemic risk buffer as well as the G-SII or O-SII capital buffer must be complied with because it can be assumed that different risks are being addressed. The interaction between the capital buffers is governed by section 10h of the Banking Act.

Combined buffer requirement

All capital buffers shall be made up of common equity tier 1 capital. The sum of all the buffers applicable to a given institution is known as the combined buffer requirement (section 10i of the Banking Act). Restrictions on distributions may be imposed on an institution that fails to comply with the combined buffer requirement, or is in danger of failing to comply. Moreover, such an institution shall be required to submit a capital conservation plan to BaFin and the Bundesbank within five working days. BaFin shall assess this capital conservation plan, and shall approve this plan if it considers that its implementation would be reasonably likely to enable the institution to meet its combined buffer requirement within a period which BaFin considers appropriate.

Obligation to submit a capital conservation plan if combined buffer requirement is not complied with

Reduced reporting threshold for "Millionenkredite"[25]

Alongside the implementation of CRD IV in German law, amendments will also be made to the reporting requirements for loans of €1.5 million (as from 2015: €1 million) or more as per section 14 of the Banking Act; these are purely national rules for which there are no harmonised minimum standards at the European level. Besides reducing the reporting threshold to €1 million, the amendments include broadening the definition of the term "credit" and introducing independent rules governing the creation of groups of connected clients for the purpose of reporting these loans. The modifications take account of the greater need for information – particularly in the wake of the financial crisis – in both macroprudential oversight and microprudential banking supervision. Longer and more detailed reports will allow microprudential supervisors to conduct more thorough analyses of institutions' credit portfolios. The ability to identify and analyse risk concentrations in the banking sector more accurately, meanwhile, will improve the analytical scope available in macroprudential surveillance. The current reporting threshold of €1.5 million will not be reduced to €1 million until 2015, thereby giving industry and supervisors alike sufficient advance warning and planning certainty.

Enhanced internal governance requirements

The new internal governance regime reflects the lessons learned from the financial crisis and is designed to enhance institutions' corporate governance and internal control mechanisms. In future, section 25d of the Banking Act will require institutions' management and supervisory bodies to set up risk, audit, nomination and remuneration committees whose tasks will include advising the supervisory body on the institution's overall risk appetite and strategy, assisting it in overseeing the implementation of the risk management system, in remedying any deficiencies identified by auditors, and in identifying suitable candidates to fill vacancies in senior management. The remuneration committee has the task of overseeing the appropriateness of the remuneration policies. According to the principle of proportionality, these committees do not have to be set up, however, if the size and systemic importance of the institution as well as the nature, scope, complexity and riskiness of its business activities so permit. Additionally, institutions are required to set up a compliance function which, as part of the internal control system, is responsible for the assessment, quality assurance and monitoring of internal arrangements designed to ensure compliance with material legislation. Institutions are moreover required to set up an internal whistle-blowing system which allows employees to report breaches of supervisory law and any criminal acts without divulging their identity.

Creation of committees

Restriction of bonus payments

The Banking Act now includes, for the first time, rules restricting the variable remuneration paid to employees and members of the man-

25 Defined in the current version of the Large Exposures Regulation *(Großkredit- und Millionenkreditverordnung)* as loans of €1.5 million or more.

agement bodies of institutions. Section 25a (5) of the Banking Act sets an upper limit for the ratio of variable to fixed remuneration. There is a limit on variable remuneration of 100% of the fixed remuneration, which may be raised to 200% of the fixed remuneration with shareholder approval. Added to this, institutions are required to base their remuneration policies on sustainability. The rules governing the structure of remuneration policies, particularly regarding the retention, reduction or cancellation of bonus payments, are be fleshed out in the Regulation Governing Remuneration at Institutions *(Institutsvergütungsverordnung)*, which is to be amended during the course of this year.

Country-specific disclosure of business data

The country-specific disclosure requirements set forth in CRD IV will be transposed into German law in section 26a of the Banking Act. In future, institutions covered by the CRR will be required to disclose information, broken down by member state of the European Union and third country in which they operate a branch, *inter alia* on their turnover, profit or loss and taxes as well as any public subsidies they have received.

Stiffer fines

The transposition of CRD IV will expand the list of administrative offences set forth in section 56 of the Banking Act and also significantly increases the level of fines. BaFin will have the power to impose fines of up to €5 million if certain prudential supervisory requirements are breached. Furthermore, legal entities could face fines of up to 10% of the institute's annual net turnover in the previous year or twice the amount of the benefit derived from the breach. The new section 60b of the Banking Act will allow the German national authorities to publish all the measures and fines which BaFin has imposed against natural persons or legal entities and have become legally enforceable, and final and absolute in law, on BaFin's website.

Key amendments to regulations

Since many regulatory areas currently enshrined in national law will in future be covered by the CRR, both the Solvency Regulation *(Solvabilitätsverordnung)* and the Large Exposures Regulation *(Großkredit- und Millionenkreditverordnung)* will become much less substantial in scope.

Solvency Regulation

Scope of revised Solvency Regulation to be much less substantial

The rules currently contained in the Solvency Regulation requiring institutions to maintain adequate capital to cover credit, market and operational risk will in future mostly be governed by the directly applicable CRR. The Solvency Regulation will therefore be recast on a much smaller scale. Among other things, the recast Solvency Regulation will contain procedural rules on the application and notification obligations set forth in the CRR, particularly those dictating the format of notifications and reports and the manner in which they are submitted to the supervisory authorities.

The CRR grants national authorities a degree of discretion with regard to a number of provisions. The Solvency Regulation chiefly uses this scope for the internal approaches for the calculation of capital requirements, notably the implementing legislation governing the approval processes for Internal Ratings-Based (IRB) approaches, market risk models, internal models used for calculating counterparty risk as well as advanced measurement approaches (AMAs) for operational risk. The CRR rules were worded in such a way that the existing Solvency Regulation legislation fleshing out the CRD version that is currently in force will, as far as possible, remain unchanged, thereby also limiting the adjustments that institutions will need to make in order to implement the new provisions.

The new Solvency Regulation likewise specifies what criteria mortgage property values must

meet to be eligible under the CRR, as the CRR allows the mortgage property value of immovable property to be used for calculating the risk weights of exposures secured by mortgages only in those member states that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions.

The new Solvency Regulation additionally specifies some aspects of the transitional arrangements in connection with the introduction of the new capital requirements and the calculation of the new capital buffers.

Regulation governing large exposures and loans of €1.5 million or more (Large Exposures Regulation)

Large Exposures Regulation also set to shrink significantly

The definitions of large exposures and the corresponding upper limits, the methods used for calculating exposure values or the provisions governing capital relief and credit protection instruments which were previously contained in the Large Exposures Regulation will form part of the CRR in future. The Large Exposures Regulation, meanwhile, will transpose the options that the CRR grants to national supervisory authorities as well as national specificities.

Exemptions to the weighting and decision-making requirements

As hitherto, the new Large Exposures Regulation will continue to have separate sections dealing with large exposures and with loans of €1.5 million (as from 2015: €1 million) or more. However, distinct procedures will be reintroduced for the reporting of large exposures and of loans of €1.5 million (as from 2015: €1 million) or more. The first section of the Regulation (large exposures) contains implementing legislation regarding exemptions,[26] decision-making requirements and the reporting procedure. The plan to limit the full exemption currently granted, under certain circumstances, to exposures within a group of institutions to 50% of own funds represents a material change to the existing rules governing exemptions.

The second section of the Large Exposures Regulation will, for the most part, contain the existing rules governing loans of €1.5 million (as from 2015: €1 million) or more as well as extensive rules governing reporting procedures.

Amendments to other regulations

Financial Information Regulation to be introduced

In line with a recommendation by the International Monetary Fund (IMF), the implementation of CRD IV will also see the introduction of the Financial Information Regulation *(Finanzinformationenverordnung)* on the basis of the new section 25 of the Banking Act, which in future will also contain provisions governing the internal capital adequacy assessment information that institutions are required to submit to supervisors. The Financial Information Regulation replaces the Monthly Returns Regulation *(Monatsausweisverordnung)* and the Summarised Monthly Returns Regulation *(Zusammengefasste-Monatsausweise-Verordnung)*. Building on the existing monthly returns, the Financial Information Regulation will allow supervisors to close the data gaps identified during the course of the financial crisis and thus also enhance their macroprudential analytical capabilities. These information requirements will now be covered by what is known as the basic reporting procedure.

Financial Information Regulation directed at individual institutions and groups of institutions

The new reporting requirements under the basic reporting procedure are directed at credit institutions and replace the obligation to submit monthly returns, which will be integrated into the Financial Information Regulation. In future, the Financial Information Regulation will allow authorities to collect intrayear profit and

26 For example, covered bonds or assets in the form of claims on and other loans to institutions in full provided that these loans do not constitute these institutions' own funds, exist for no longer than the following business day and are not denominated in a key trading currency.

loss data as well as further financial information supplemented by target figures on institutions' earnings situation. Individual institutions will also be required to disclose data on their hidden reserves and hidden losses, the risks arising from lending business, the interest rate risk in the banking book and on the terms and structural contribution, thereby enhancing authorities' ability to analyse each institution's risk situation. These new reporting requirements for credit institutions will give supervisors deeper and more timely insight into institutions' business developments. The reporting criteria introduced for financial services institutions under the Financial Information Regulation are essentially identical to the existing monthly reporting obligations.

The disclosure requirements for groups of institutions that are required to report under the Financial Information Regulation are much the same as those for individual institutions insofar as groups of institutions are also obliged to submit intrayear earnings data, target figures and other data. The existing provisions requiring groups of institutions to disclose their investment position on a consolidated basis will likewise be integrated into the Financial Information Regulation and thus replace the corresponding requirements of the Summarised Monthly Returns Regulation.

FINREP users also face new reporting requirements

By contrast, institutions that prepare consolidated financial statements on the basis of the IFRS fall within the scope of the EBA's harmonised reporting requirements. Such institutions are required to submit corresponding reports under the EU financial reporting (FINREP) framework and are exempted from the Financial Information Regulation reporting obligations with the exception of certain data, *inter alia* on the interest rate risk in the banking book.

Liquidity Regulation to remain in place

Until the LCR has been fully phased in as a minimum liquidity standard, the national minimum liquidity criteria and liquidity disclosure requirements can coexist alongside the LCR as legally binding standards. Once the LCR has been phased in, all German banks will be required to comply with the European provisions pursuant to section 1 of the Banking Act. Exceptions will only be made for housing enterprises with savings facilities, guarantee banks, central counterparties and financial services institutions, which will continue to be subject to national standards. Whether and to what extent the LCR will also be mandatory for CRR investment firms is a matter that will be decided at a later date on the basis of a report by the European Commission.

Outlook

CRD IV package and banking union project

Given that a genuine banking union is predicated on the existence of a single rulebook, the CRD IV package can truly be regarded as a key stepping stone towards a more comprehensive banking union project. The simplest and quickest way to create a single rulebook is by enacting regulations – that is, directly applicable European legislation – which, unlike directives, do not need to be transposed into national law by intermediate institutions. The same can be said about the binding technical standards (BTS) produced by the EBA and the European Commission, for which the CRR and CRD IV contain numerous enabling provisions. The European Commission and the EBA are tasked with ensuring the consistent interpretation and application of both the CRR and the BTS throughout Europe.

Single Supervisory Mechanism …

Besides "Europeanising" substantive legislation in the field of banking regulation, the banking union will also partially shift actual banking supervision to the European level. The planned Single Supervisory Mechanism (SSM) will see key prudential powers being transferred to the ECB.

… and harmonisation of bank recovery and resolution legislation

The harmonisation of bank recovery and resolution legislation in the Bank Recovery and Resolution Directive (BRRD) is another initiative that is currently being finalised. Plans are like-

wise under way to also transfer institutional powers in the field of banking resolution (Single Resolution Mechanism, or SRM). However, this legislative initiative is likely to necessitate an amendment to primary legislation, should it lead to the creation of a European resolution authority or fund.