Risk Reduction Act – the national implementation of the European banking package

The European banking package contains further essential regulatory provisions designed to eradicate the regulatory gaps and deficiencies identified in the aftermath of the financial crisis and to buttress the resilience of the European banking sector overall. It is precisely in times such as the current COVID-19 pandemic where stringent regulation pays off because institutions with a sound capital base are better able to withstand the capital burden imposed by the pandemic. Within the broader context of the advancement of the banking union, the banking package should be regarded as a further measure to reduce risks in the banking sector. The banking package also envisages administrative relief for small, non-complex institutions without exempting them from quantitative requirements – a development which the Bundesbank had a major role in driving forward and, given the growing complexity of banking regulation and the increasing cost of compliance, an important step towards proportionate and targeted regulation.

The Risk Reduction Act (Risikoreduzierungsgesetz) complements directly applicable European provisions by transposing into German law the provisions of the Capital Requirements Directive (CRD V) and the Bank Recovery and Resolution Directive (BRRD II) contained in the banking package. This has necessitated amendments not only to national legislation but also to national statutory orders. Implementation in the Risk Reduction Act is guided by European standards, which, in keeping with the spirit of broad harmonisation within the European Union (EU), leaves little to no discretionary scope. This approach should be welcomed as a move to create a level playing field within the EU. The discretionary scope was utilised only with respect to the unique features of the German banking market and to the extent explicitly granted to Member States. The fact that German legislators used the scope afforded via the Risk Reduction Act to incorporate relief for factoring and financial leasing institutions appears appropriate against the backdrop of the general debate on proportionality.

Though the banking package and its transposition by way of the Risk Reduction Act represent the regulatory implementation of further key elements of the Basel III framework in the EU and national legislation, it is still not the final item on the post-financial-crisis agenda. One final piece of the jigsaw puzzle is implementation of the package of Basel III reforms from the end of 2017, even if the timeline has been moved back one year owing to the COVID-19 pandemic. Irrespective of the delay, it is important that these standards be implemented consistently and fully. In keeping with the spirit of reliable multilateral cooperation, the current turmoil caused by COVID-19 should not be used to water down the agreed standards during the implementation process. This would tilt the global playing field and thus create undesirable regulatory arbitrage opportunities. At the European level, the key is to adhere to the agenda of further risk reduction. This includes not only the regulatory treatment of sovereign bonds but also the actual achievement of the target requirements for sufficient loss-absorbing capacity available in a resolution event.

Introduction

What is known as the "banking package" was promulgated in the Official Journal of the European Union on 7 June 2019.[1] The banking package is a further key step towards eradicating the regulatory gaps and weaknesses identified in the financial crisis with the goal of strengthening the resilience and stability of the European banking sector. It therefore encompasses numerous amendments to the Capital Requirements Regulation (CRR),[2] the Capital Requirements Directive (CRD),[3] the Bank Recovery and Resolution Directive (BRRD)[4] and the Single Resolution Mechanism Regulation (SRMR).[5,6] Whereas the amended EU regulations (CRR and SRMR) are directly applicable in the EU Member States, the directives (CRD and BRRD) first need to be transposed into national law. In Germany, this is being accomplished through the Risk Reduction Act *(Risikoreduzierungsgesetz)*,[7] most of which will enter into force at the end of 2020.[8]

The Risk Reduction Act is an omnibus act and envisages, in particular, amendments to the Banking Act *(Kreditwesengesetz)* and the Act on the Recovery and Resolution of Institutions and Financial Groups *(Gesetz zur Sanierung und Abwicklung von Instituten und Finanzgruppen)*. Alongside the necessary implementation of EU requirements, further amendments which appeared appropriate in terms of timing and subject matter are also included.

Key amendments to the Banking Act

Approval requirement for (mixed) financial holding companies

Enactment of an approval requirement for (mixed) financial holding companies

Financial holding companies[9] and mixed financial holding companies[10] can be parents of banking groups for which the application of supervisory requirements at the consolidated level is mandatory. However, the supervised institutions controlled by such a holding company cannot always ensure compliance with the requirements at the consolidated level throughout the group. Therefore, the new Section 2f of the Banking Act[11] introduces an approval requirement for (mixed) (EU) parent financial holding companies of a group responsible for meeting prudential requirements at the group level, whilst at the same time an obligation is imposed on the (mixed) financial holding company itself to ensure compliance with prudential requirements on a consolidated basis. Section 2f of the Banking Act transposes the European provision set out in Article 21a of CRD V. The new rule also defines the information and documentation to be submitted to the consolidating supervisor, i.e. the competent authority for the group under the approval procedure. The use of the term "competent authority" here and elsewhere in the Banking Act illustrates that the authority can be either the ECB or the Federal Financial Supervisory Authority (BaFin). For approval to be granted, it is necessary, in particular, for the internal arrangements and distribution of tasks within the group to be adequate for the purpose of complying with the Banking Act and CRR on a consolidated or sub-consolidated basis and to be effective to coordinate all subsidiaries, prevent conflicts and enforce policies set by the parent throughout the group. The competent author-

1 See Official Journal of the European Union L 150 of 7 June 2019.
2 Regulation (EU) 2019/876 of 20 May 2019 amending Regulation (EU) No 575/2013 (CRR II).
3 Directive (EU) 2019/878 of 20 May 2019 amending Directive 2013/36/EU (CRD V).
4 Directive (EU) 2019/879 of 20 May 2019 amending Directive 2014/59/EU (BRRD II).
5 Regulation (EU) 2019/877 of 20 May 2019 amending Regulation (EU) No 806/2014 (SRMR II).
6 See Deutsche Bundesbank (2019).
7 See http://dipbt.bundestag.de/extrakt/ba/WP19/2656/265687.html. Promulgation in the Federal Law Gazette is scheduled for 14 December 2020.
8 Under EU law, the amended provisions of the BRRD have to be applied nationally as from 28 December 2020; the amendments necessitated by the CRD are applicable beginning on 29 December 2020.
9 See Article 4(1) point (20) of CRR.
10 See Article 4(1) point (21) of CRR.
11 Any and all citations of sections of the Banking Act refer to the version as already amended by the Risk Reduction Act.

ity must notify the applicant of the decision to grant or refuse approval within six months of receipt of the application.

There are individual cases in which approval is not necessary, if, amongst other things, the financial holding company's principal activity is to acquire and maintain holdings in subsidiaries and a CRR credit institution is responsible for ensuring compliance with prudential requirements on a consolidated basis. The competent authority shall monitor compliance with the criteria for approval or exemption on an ongoing basis.

Responsibility for supervision on a consolidated basis

New rules governing responsibility for consolidated supervision

As a complement to the introduction of an approval requirement for (mixed) financial holding companies, the new Section 8b of the Banking Act, which transposes Article 111 of CRD V into German law, reorganises responsibilities for the supervision of groups of institutions or financial holding groups on a consolidated basis. The reorganisation of supervisory responsibilities at the European level will enhance the role of banking supervision relative to securities supervision. In future, once a group contains at least one credit institution, the competent authority for banking supervision is always to assume responsibility for the consolidated supervision of that group. In addition, the new rules increasingly allocate responsibility for consolidated supervision to the competent authority that supervises, at an individual level, the largest part of the group in terms of total assets. It is therefore possible that, going forward, the competent authority which supervises the consolidating entity as defined in Section 10 of the Banking Act[12] will no longer automatically be responsible for consolidated supervision, either. Nonetheless, Section 8c of the Banking Act allows the competent authorities, in particular cases and by common agreement, to deviate from the assignment of responsibility prescribed by law.

Establishment of an intermediate EU parent undertaking in the case of third-country parent undertakings

New requirement for certain third-country banking groups to set up an IPU

Section 2g of the Banking Act introduces a requirement that certain third-country banking groups[13] establish an intermediate EU parent undertaking (IPU). This requirement covers third-country banking groups that have at least two subsidiary institutions established in the EU and whose assets (including those of legally dependent branches) within the EU exceed a threshold of €40 billion. The activities of all EU subsidiary institutions of the third-country banking group are to be supervised on a consolidated basis under this newly established IPU in the EU. The objective is to make it easier to supervise third-country banking groups in the EU as well as to potentially apply resolution regimes to their EU activities.

On a case-by-case basis, supervisors may approve structures with two IPUs. This would be possible, in particular, in those cases where the establishment of a single IPU would violate the third country's ringfencing rules[14] or if the resolution authorities believe that consolidation of all business activities under a single intermediate EU parent would impair resolvability. For those third-country banking groups which, as at 27 June 2019, had been represented by more than one institution in the EU and whose assets within the EU as at that date exceeded €40 billion, the Banking Act provides for an extended transition period ending on 30 December 2023. All other affected third-country banking groups must implement the require-

12 Pursuant to Section 10a of the Banking Act read in conjunction with Article 11 of CRR, the parent institution or the parent financial holding company (where approved pursuant to Section 2f of the Banking Act) is responsible for compliance with the prudential requirements at the group level. If the parent financial holding company of a (sub-) group has not been approved, a subordinated institution must be accordingly designated as the responsible institution instead.
13 If the group's head office is outside the European Economic Area (EEA).
14 Generally understood as the requirement that risky business areas be separated from deposit business.

Introduction of a standard definition of the term "significant institution" in the Banking Act for the purposes of remuneration and corporate governance

For the purposes of regulating remuneration and in connection with the requirements set out in Sections 25c and 25d of the Banking Act *(Kreditwesengesetz)* for management bodies and administrative or supervisory bodies, a standard definition of the term "significant institution" is being introduced in Section 1(3c) of the Banking Act. According to this definition, an institution shall be significant if its total assets exceed €15 billion on average over the respective reporting dates of the preceding four completed financial years. Furthermore, pursuant to Section 1(3c) of the Banking Act, the following institutions shall always be deemed to be significant:

- institutions which meet one of the conditions pursuant to Article 6(4) subparagraph 2 of the SSM Regulation;[1,2]
- institutions categorised as having the potential to pose a systemic threat within the meaning of Section 12 of the Banking Act;
- financial trading institutions within the meaning of Section 25f(1) of the Banking Act.

1 Single Supervisory Mechanism, Regulation (EU) No 1024/2013 of 15 October 2013.
2 This stipulates that an institution is considered significant if, first, the total value of its assets exceeds €30 billion; second, the ratio of its total assets over national GDP exceeds 20% (only applies where the total value of an institution's assets exceeds €5 billion); or third, following a notification by its national competent authority that it considers such an institution of significant relevance with regard to the domestic economy, the ECB takes a decision confirming such significance.

ment when the national implementation enters into force on 29 December 2020.

Pillar 2

Expanded SREP rules, additional own funds requirements and guidance on additional own funds adopted wholesale from CRD V

CRD V clarified a number of points relating to the supervisory review and evaluation process (SREP) as well as the supervisory measures based on it. These have been carried over to the Banking Act via the Risk Reduction Act.

The expanded rules governing the additional own funds requirements (Pillar 2 requirement, or P2R) have been consolidated in Section 6c of the Banking Act, which also contains the new rule on the quality of the own funds needed to meet the additional own funds requirements. Under the new rules, this capital requirement – in keeping with the minimum capital requirements under Pillar 1 – no longer has to be met exclusively with common equity tier 1 (CET1) capital.

The basis for the guidance on additional own funds (Pillar 2 guidance, or P2G) is transposed by Section 6d of the Banking Act. This additional capital buffer is intended to allow institutions to cover losses incurred in day-to-day business operations during stress periods – one example being the current COVID-19 situation – without breaching prudential minimum capital requirements. In order for this stress buffer to function properly, it makes sense to meet this guidance on additional own funds using CET1 capital.

EBA to give more detailed guidance on IRRBB

For the majority of German institutions, interest rate risk in the banking book (IRRBB) is the most significant risk for which there is no provision for own funds requirements under Pillar 1. In line with the European requirement, two indicators are being introduced for assessing the materiality and, thus, the necessity of additional own funds requirements for IRRBB. Accordingly, interest rate risk is regarded as material, in particular, if there is a decline in the economic value of equity of more than 15% of

Supervision of promotional banks

Since the entry into force of the Capital Requirements Regulation (CRR) II on 27 June 2019, Germany's 14 legally independent promotional banks have no longer been CRR credit institutions. By virtue of the amendment to Article 2(5) point (5) of the Capital Requirements Directive (CRD) in CRD V, they have been specifically exempted from the scope of EU banking regulation. For this reason, they have since returned to supervision at a solely national level, i.e. by the Federal Financial Supervisory Authority (BaFin) and the Bundesbank. As they are no longer CRR credit institutions, they also no longer fall within the scope of the Single Supervisory Mechanism (SSM) and are therefore no longer subject to supervision under the SSM. There was no immediate need for German legislators to act, given that the promotional banks concerned are credit institutions within the meaning of the Banking Act *(Kreditwesengesetz).* The European supervisory rules, first and foremost the CRR and CRD, still generally apply to these credit institutions via a reference to that effect in Section 1a of the Banking Act. The Risk Reduction Act *(Risikoreduzierungsgesetz)* stipulates that the reporting requirements set out in the ECB Regulation on the reporting of supervisory financial information[1] also apply to promotional banks as non-CRR credit institutions. Additionally, the insertion of Section 12 of the Banking Act ensures that these promotional banks can also be classified as institutions posing a potential systemic threat (PSIs). An institution's significance relative to the population of all institutions in Germany is used as the basis for assessing its systemic importance. The new Section 12 of the Banking Act makes it possible for promotional banks to be taken into account as part of the population for determining the systemic importance of institutions in Germany in the context of the methodology applied by BaFin and the Bundesbank (PSI method).

In the area of remuneration regulation, a different balance sheet threshold applies to promotional institutions with respect to their classification as significant institutions: they are only considered significant if the total value of their assets exceeds €70 billion.[2] Only then do they have to comply with the special requirements of the Remuneration Regulation for Institutions *(Insti-*

List of legally independent promotional banks*

– Bremer Aufbau-Bank GmbH
– Hamburgische Investitions- und Förderbank
– Investitionsbank Berlin
– Investitionsbank des Landes Brandenburg
– Investitionsbank Schleswig-Holstein
– Investitions- und Förderbank Niedersachsen – NBank
– Investitions- und Strukturbank Rheinland-Pfalz
– Landeskreditbank Baden-Württemberg – Förderbank
– Landwirtschaftliche Rentenbank
– LfA Förderbank Bayern
– NRW.BANK
– Saarländische Investitionskreditbank AG
– Sächsische Aufbaubank – Förderbank
– Thüringer Aufbaubank

* See Article 2(5) point (5) of CRD V; the KfW banking group (Kreditanstalt für Wiederaufbau) was already exempted from the scope of EU banking regulation prior to the entry into force of CRD V.

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1 Regulation (EU) No 2015/534 of 17 March 2015, as amended by Regulation (EU) No 2020/605 of 9 April 2020.
2 On average over the respective reporting dates of the preceding four financial years. As a general rule, a threshold of €15 billion applies pursuant to Section 1(3c) of the Banking Act.

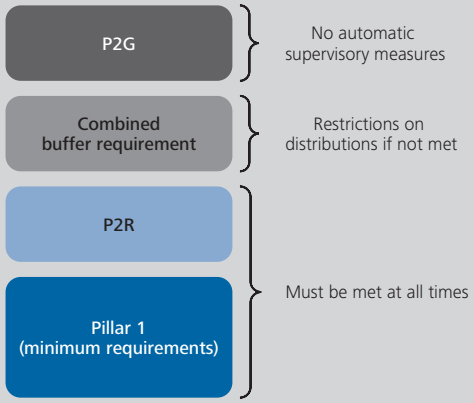
tutsvergütungsverordnung), whereas promotional banks with total assets below this value still only have to meet the general requirements. As a result, the regulation of remuneration for promotional banks that has so far effectively been in place will continue.

Under the Risk Reduction Act, the Banking Act will now exempt promotional banks from disclosure requirements. The main reason for this is presumably that the decisive factor for buyers of financial instruments when making their purchases is likely to primarily be the explicit guarantee provided by the public sector rather than the promotional bank's risk assessment. The market-disciplining effect induced by disclosure would thus be redundant.

Overall, it is a welcome development that promotional banks will continue to be subject to a level of supervision comparable to the one provided under EU banking supervision law. Moreover, the basic approach of the Banking Act, according to which all credit institutions within the meaning of the Banking Act are subject to the same rules, is not being called into question.

Tier 1 capital in any of the six supervisory interest rate shock scenarios or a large decline in net interest income in any of the two supervisory scenarios.

Stacking order of the various capital requirements



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How these indicators are going to work in practice will be enshrined in regulatory technical standards (RTS), which are mandated by CRD V and are yet to be drawn up by the European Banking Authority (EBA). This challenging work for the EBA involving, for example, the development of an earnings-based indicator that breaks new ground in regulatory terms, will therefore not be completed before 2022. Owing to the fact that the provision in the Banking Act is linked to the new indicators and the RTS, these requirements of the Banking Act will not yet be applied until the RTS enter into force after they are adopted in the form of a Regulation by the European Commission.

No automatic application of additional own funds requirements for IRRBB

The Bundesbank welcomes the introduction of supervisory indicators covering both an economic value and earnings-based perspective along the lines of the Minimum Requirements for Risk Management (MaRisk). Regulatory ratios can give no more than an indication of the risk at an individual institution, however.

Therefore, a positive feature to be highlighted is that there is no provision for an automatic link between overstepping the indicators' threshold values and additional own funds requirements. Seen in that light, decisions on additional own funds requirements for IRRBB will continue to be made with due consideration given to institution-specific aspects.

Leverage ratio

National implementation of the additional requirements of the leverage ratio framework

The Pillar 2 framework for an institution-specific risk-based capital requirement is now also being applied to the non-risk-weighted leverage ratio. As the European requirements do not provide for any explicit national discretionary leeway for legislators regarding the new requirements for the leverage ratio, their implementation in the Banking Act will closely follow the wording of the European regulations.

Introduction of the possibility of a supplementary own funds requirement and of own funds guidance

One particular feature to be highlighted is that there will be supervisory discretion with the possibility – mirroring the risk-based framework – of supplementing the 3% minimum requirement for the leverage ratio (LR) under Pillar 1[15] – which will be binding as of 28 June 2021 – with additional own funds requirements and guidance. The additional own funds requirement (LR Pillar 2 requirement, or LR-P2R) is calculated by the supervisory authorities as part of the SREP for an individual institution especially for uncovered or inadequately covered risks arising from excessive leverage. By contrast, the own funds guidance (LR Pillar 2 guidance, or LR-P2G) is calculated on the basis of supervisory stress tests. This additional own funds guidance is designed to enable institutions to cover losses in crisis situations without first eating into other own funds items. Like the requirements of CRD V, national legislation, too, envisages that own funds used to meet LR-P2R and LR-P2G cannot be used to fulfil other leverage ratio own funds requirements.

Another key change is the introduction of more detailed requirements regarding the application of the leverage ratio buffer. This buffer is to be maintained by global systemically important institutions (G-SIIs) from 2023 and amounts to 50% of the risk-based G-SII capital buffer.[16] In particular, the national legislation will, in future, contain requirements regarding the (restricted) permissibility of distributions if the buffer requirement is not fulfilled, with the details being regulated by statutory order (Solvency Regulation – *Solvabilitätsverordnung*). Furthermore, for cases where the buffer requirement is not fulfilled, the Banking Act will contain provisions with regard to the necessity of and procedure for preparing a capital conservation plan that is intended to ensure (renewed) compliance with the requirement within an appropriate time period.

Constraints when undershooting the LR buffer for G-SIIs

Final implementation of the supplementary requirements of the LR framework

The wholesale transposition of the CRD V requirements into national law finalises the implementation of the LR framework as a backstop for the risk-based framework at the national level, too. The elements which this introduces are to be welcomed from a supervisory perspective, as they create consistency with the existing regulatory possibility of setting targeted own funds requirements or guidance for an individual institution in the risk-based framework. Seen in that light, they incorporate a tried and tested concept into the non-risk-based framework.

Exclusion rules on the use of CET1 capital

Exclusion rules regarding the backing of the capital buffers will be regulated centrally in future

In fulfilling a capital buffer requirement, institutions are not allowed to use any CET1 capital that is needed to back other risk-based capital requirements, such as the minimum capital requirements and bank-specific add-ons or one of the other capital buffers. This provision is

15 This ratio is calculated as the ratio of a bank's regulatory Tier 1 capital (numerator) and its total exposure measure, essentially comprising all balance sheet and off-balance-sheet items (denominator).
16 For instance, if the risk-weighted G-SII buffer is 1%, the corresponding LR buffer amounts to 0.5% of the total exposure measure.

now regulated centrally in the new Section 10b of the Banking Act. This incorporates a technical amendment from CRD V which merges the individual provisions concerning the capital buffers and places them in a central position. Listing the relevant capital requirements in Section 10b of the Banking Act does not imply a sequence or "stacking order" in which the individual requirements are to be fulfilled. Rather, it makes clear that there must be no multiple use of CET1 capital to back risk-based capital requirements.

Amendment of provisions relating to loans to related parties

Additional provisions governing loans to related parties based on Basel principles and EU requirements

The changes in the provisions relating to loans to related parties in Section 15 of the Banking Act are due to an amendment of Article 88(1) of CRD and to the Basel Core Principles for Effective Banking Supervision.[17] In line with the amended European provisions, there is now a wider group of persons to whom the special decision-making requirements pursuant to Section 15 of the Banking Act are applicable. In future, loans to a parent or the adult children of a member of the management board or of the supervisory board will also require approval from the management board and the supervisory board of the institution. This amendment originates from the Basel Core Principles for Effective Banking Supervision, according to which adult children and parents are also to be understood as "close family members". Furthermore, as part of its 2016 Financial Sector Assessment Program (FSAP) of Germany, the International Monetary Fund made the criticism that persons with potential conflicts of interest were not excluded from decision-making on granting related party loans. Furthermore, the Fund maintained that the existing provisions of Section 15 of the Banking Act were inadequate because they fail to take into account conflicts of interest that can arise in service contracts, asset purchases and sales, and construction contracts or the write-offs of exposures. These shortcomings will be remedied with the Risk Reduction Act.

Remuneration

Proportionality: exemptions from ex post risk adjustment …

The new European regulations necessitate changes in the national remuneration rules, including in relation to the proportional application of specific remuneration requirements as well as the need for gender-neutral remuneration systems.

The recast uniform definition of significant institutions in the Risk Reduction Act takes due account of the approach prescribed in CRD V, where institutions above a given balance sheet threshold may not be exempted from ex post risk adjustment.[18] The European rules in this regard set a general proportionality threshold of €5 billion for total assets on a four-year average. In Germany, however, legislators have made full use of the option contained in CRD V which allows Member States to raise the threshold to up to €15 billion, From the Bundesbank's perspective, this makes it possible to take due account of conditions in the German banking market.

… and "light-touch" risk taker identification

At the same time, all CRR institutions now have to identify risk takers. So far, only significant CRR institutions have had to do this. Only "light-touch" risk taker identification is required of non-significant CRR institutions. This applies only to members of the management board and members of the administrative or supervisory board – who, by law, are necessarily categorised as risk takers – as well as certain other groups of employees in management pos-

17 See https://www.bis.org/basel_framework/standard/BCP.htm

18 In CRD V, exemption from ex post risk adjustment explicitly covers the rules on the pro rata pay-out of variable remuneration in instruments as well as a pro rata deferral over a number of years. According to the draft amendment to the Remuneration Regulation for Institutions *(Institutsvergütungsverordnung)* published by BaFin, there is also to be an exemption with regard to the requirement for the ex post contraction of variable remuneration components through malus and clawback arrangements.

itions.[19] The further, more detailed examination of additional criteria for identifying members of staff whose professional activities have a material impact on the risk profile pursuant to Delegated Regulation (EU) No 604/2014 as last amended[20] is to be performed only by significant institutions. For institutions which are not CRR institutions, no identification of risk takers is necessary, as hitherto, unless they are deemed to be significant.

Gender-neutral remuneration now enshrined in law

The principle of gender-neutral remuneration for members of the administrative or supervisory board is being incorporated in the new Section 25d(5) of the Banking Act. Remuneration reporting requirements will also be expanded to include information on the gender pay gap. Details of this will only be available after amendments of the relevant EBA Guidelines.

Supplementary amendment to Remuneration Regulation for Institutions required

In tandem with the implementation of the remuneration requirements in the Banking Act, amendments to the Remuneration Regulation for Institutions will be necessary. This concerns changes, for example, to the scope of application, the minimum length of the deferral period and the regulations for groups as well as the incorporation of the need for gender-neutral remuneration for employees and members of the management board.

Corporate governance

In the area of corporate governance, the implementation of the European banking package has brought clarification of certain points, granted relief measures and enshrined current supervisory practices in law.

Primary responsibility of the institutions

Under current law, the primary responsibility for both the initial and ongoing suitability of members of the management body already lies with the institutions. The Banking Act therefore now makes it clear that new facts which have a considerable impact on the initial "fit and proper" assessment also have to be notified by the institutions without undue delay as soon as they become known. In the notification procedure for new members of the management board, the outcome of the "fit and proper" assessment is also to be communicated by the notifying reporting institution in future.

Collective suitability of the management board

Furthermore, as a result of the Risk Reduction Act, the Banking Act stipulates that members of the management board should, collectively, possess an appropriately broad range of knowledge, skills and experience that allows them to understand the institution's activities, including the main risks. As before, each individual member of the management board shall also have the knowledge, skills and experience necessary for fulfilling their respective tasks.

Relief for institutions at subordinated level within a group in appointing committees

Relief is provided for institutions at subordinated level within a group which, on an individual basis, do not meet the definition of a significant institution pursuant to Section 1(3c) of the Banking Act. Depending on the size, internal organisation and the nature, scope, complexity and riskiness of the institution's activities, they can decide in future on (not) setting up the committees mentioned in the Banking Act.

Relief regarding the maximum number of directorships

Further relief measures are envisaged with regard to the maximum number of directorships. For one thing, the existing narrow concept of a "group of institutions" will be brought into line with the newly introduced definition of a "group" in the CRR. This means that, in future, directorships can be added up and counted as a single directorship if they are exercised within a single group of undertakings, of which at least one is an institution and the other under-

19 See Section 1(21) of the Banking Act and Section 25a(5b) sentence 1 of the Banking Act.

20 Commission Delegated Regulation (EU) No 604/2014 prescribes qualitative and quantitative criteria for determining risk takers at institutions. It was revised by the EBA in parallel with the national implementation of CRD V, sent to the European Commission and published (https://eba.europa.eu/eba-publishes-revised-standards-identify-staff-material-impact-institution%E2%80%99s-risk-profile). It will enter into force only upon adoption by the European Commission and subsequent publication in the Official Journal of the European Union.

takings belong to the same consolidated group. Furthermore, directorships as a member of the management board and as a member of the administrative or supervisory board within a group are not to be counted separately in future but together as a single management board directorship. As this brings the counting of directorships into line with the practice in other SSM Member States, this long due change is to be welcomed in terms of harmonisation. For members of the management body of German institutions, this amendment is also likely to make it considerably easier for them to hold directorships. However, an additional administrative or supervisory board directorship approved in an individual case by the supervisory authority may be accepted only after it has been approved.

Further changes in the area of governance

For the purpose of harmonisation within the SSM, a new legal basis is being created for interviews to assess the suitability criteria conducted by the supervisory authority.[21] Furthermore, there is now an explicit legal basis for reprimanding members of the management board.[22]

Transitional arrangement for securities trading firms

In the transitional provisions, Section 64(3) of the Banking Act now makes clear that what have thus far been referred to as securities trading firms, which, from 26 June 2021, will be subject to the prudential regime for investment firms,[23] will not be governed by the requirements of CRD V during the transitional period of six months following the entry into force of the Risk Reduction Act. With the exception of the requirement to set up an IPU under Section 2g of the Banking Act, the provisions of the Banking Act as last amended before the entry into force of the Risk Reduction Act shall continue to apply.

Further amendments to the Banking Act

The amendments relating to the macroprudential instruments represent a further essential component of CRD V and thus also of its national transposition into the Banking Act.[24] These instruments are now distinguished more clearly from the microprudential instruments; overlaps between the macroprudential buffers are being adjusted. Their implementation in Sections 10c to 10i of the Banking Act is in line with European requirements.

Furthermore, the Risk Reduction Act introduces a number of editorial changes required by the substance or context. For example, the wording of Section 45 of the Banking Act, which governs measures to improve the adequacy of own funds and liquidity, has been partly recast. This includes the clarification that the supervisory authority is able to take early measures to effectively avert a potential emergency situation. This is designed to define more clearly their difference from the early intervention measures contained in the Act on the Recovery and Resolution of Institutions and Financial Groups. The use of the term "supervisory authority" now also makes clear that the ECB is able to directly apply these powers under the Banking Act in relation to the German institutions which are under direct ECB supervision.

Accompanying amendments to existing statutory orders

To complete implementation of the EU banking package, amendments to national legislation must also be accompanied by changes to exist-

21 According to the ECB's Guide to fit and proper assessments, interviews will be conducted in the case of new appointments to the CEO (or equivalent) and Chair positions at stand-alone banks and the top banks of groups.
22 See Section 36(2) of the Banking Act.
23 Regulation (EU) 2019/2033 and Directive (EU) 2019/2034 of 27 November 2019.
24 See the detailed account in Deutsche Bundesbank (2019) pp. 40 and 42.

ing statutory orders, notably the Regulation Governing Large Exposures and Loans of €1 Million or More (*Großkredit- und Millionenkreditverordnung* – GroMiKV), the Solvency Regulation and the Remuneration Regulation for Institutions. In some cases, changes are necessitated as a direct result of CRR II or CRD V, and in other cases they are required as a consequence of amendments made to the Banking Act. For this reason, BaFin held public consultations on five pieces of draft amending regulations between 12 November 2020 and 4 December 2020.[25] Due to the later entry into force of the leverage ratio buffer with effect from 1 January 2023, it was deemed necessary to draft two separate amending regulations in each case for the Solvency Regulation and the Remuneration Regulation for Institutions. The Fourth Regulation Amending the Solvency Regulation separately transposes into national law details on the calculation of G-SIIs' maximum distributable amount, such amount depending on the degree to which the leverage ratio buffer requirement is met.

The regulation amending the Regulation Governing Large Exposures and Loans of €1 Million or More is scheduled to enter into force on 28 June 2021, and the other amending regulations[26] are not expected to enter into force this year either.

Adjustments to national bank resolution law

On the whole, the Risk Reduction Act's implementation of bank resolution law sticks very closely to the wording of BRRD II and thus also of SRMR.

Minimum requirement for own funds and eligible liabilities (MREL)

The new and stricter rules added to bank resolution law as a result of the banking package[27] and its national implementation through the Risk Reduction Act will enhance the resolvability of institutions overall. This will be achieved primarily through the amended rules on creating sufficient loss-absorbing capacity in order to reduce the risk of institutions seeking public financial support.

Consistent with the TLAC standard,[28] a statutory minimum MREL requirement is being introduced for G-SIIs for which the calibration parameters are based on two variables: a risk-based ratio based on risk-weighted assets (RWAs) and the non-risk-based ratio based on the leverage ratio exposure measure (LRE). Moreover, European legislators have also decided to widen the group of banks to which a statutory minimum MREL requirement is applicable beyond G-SIIs to include "top-tier" banks. This new category of top-tier banks includes banks which are not G-SIIs but have total assets above €100 billion. In addition, the resolution authority can classify institutions with total assets lower than €100 billion as top-tier banks if it assesses them as posing a systemic risk in the event of their failure ("fishing option"). In addition, a further statutory minimum MREL requirement of 8% of total liabilities and own funds (TLOF) has been introduced for G-SIIs and top-tier banks, effective from January 2024. This ensures consistency with the BRRD requirement that losses totalling no less than 8% of TLOF shall be met by shareholders and subordinated creditors before losses can potentially be covered by the Single Resolution Fund (SRF).[29] For G-SIIs and top-tier banks, the statutory minimum MREL requirement should generally be met with subordinated MREL instruments.[30] For the other banks,

25 See https://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Konsultation/2020/kon_15_20_Konsultation_Rechtsverordnungen_ba.html
26 Draft Third Regulation Amending the Solvency Regulation and draft Third Regulation Amending the Remuneration Regulation for Institutions.
27 See Deutsche Bundesbank (2019), pp. 43 ff.
28 Total loss-absorbing capacity; see corresponding Basel Committee standard: https://www.bis.org/fsi/fsisummaries/tlac.htm
29 The highest of the three requirements (RWA, LRE or TLOF) is binding on the bank.
30 Alongside an institution's own funds, liabilities are only eligible if they are subordinated to certain other liabilities (e.g. deposits or derivatives).

Eased requirements for factoring and financial leasing institutions

Asset-leasing vehicles for multiple leased assets now join asset-leasing vehicles for single leased assets in being exempt from the authorisation requirement. These are undertakings whose only financial service is financial leasing where they act as asset-leasing vehicles for one or multiple leased assets of a single lessee. From a risk perspective, it is appropriate to subject asset-leasing vehicles for multiple leased assets, which finance and transfer to a particular lessee ownership of leased assets, to the same regulatory treatment as asset-leasing vehicles for single leased assets, which finance and transfer to a particular lessee ownership of just a single leased asset. This is because, besides a management board, neither type of asset-leasing vehicle normally has any staff of its own. An asset-leasing vehicle for multiple leased assets holds only a small number of large-volume leased assets in order to shield against risk, but – as with asset-leasing vehicles for single leased assets – it is managed by one managing leasing company. Another key prerequisite for exemption from the authorisation requirement is that no business policy decisions are made by the asset-leasing vehicle. It must also be managed by an institution that is already under supervision, is established within the European Economic Area and is authorised to engage in financial leasing in its state of origin. Furthermore, all factoring and financial leasing institutions are now exempt from the requirement to identify risk takers. The exemption of factoring and financial leasing institutions from the obligation to appoint committees will remain unchanged. The introduction of a definition of the term "significant institution" had necessitated a revision in this regard. However, the general order requiring that, depending on the size, internal organisation and the nature, scope, complexity and riskiness of the activities of the institution, the administrative or supervisory bodies of factoring and financial leasing institutions shall appoint from among their members committees to advise and support them in their tasks, will remain in effect. In addition, the Federal Financial Supervisory Authority (BaFin) has the power to require the appointment of committees. On the grounds of equal treatment and due to the fact that there appears to be no increase in risk associated with the shift from asset-leasing vehicles for single leased assets to asset-leasing vehicles for multiple leased assets, this solution appears appropriate.

Overview of the new MREL framework

	G-SIIs	Top-tier banks (>€100 billion total assets and "fishing" option)	Other banks (for which resolution is envisaged[1])
As of applicability of the banking package[2]	16% of RWAs 6% of LRE Higher institution-specific requirement as appropriate[3]	Institution-specific requirement[3]	Institution-specific requirement[3]
From 1 January 2022	18% of RWAs 6.75% of LRE Higher institution-specific requirement as appropriate[3]	13.5% of RWAs 5% of LRE Higher institution-specific requirement as appropriate[3]	Institution-specific requirement[3]
From 1 January 2024	18% of RWAs 6.75% of LRE 8% of TLOF Higher institution-specific requirement as appropriate[3]	13.5% of RWAs 5% of LRE 8% of TLOF (but not more than 27% of RWAs) Higher institution-specific requirement as appropriate[3]	Institution-specific requirement[3] 8% of TLOF at discretion of resolution authority
Subordination requirement[4]	In principle, yes[5]		Case-by-case decision[6]

1 For banks for which insolvency proceedings are envisaged, the resolution authority can set MREL equal to the loss absorption amount (= minimum capital requirements). **2** BRRD II to be transposed by 28 December 2020, SRMR II applicable from 28 December 2020, CRR II applicable in principle from 27 June 2019. **3** Starting prudential formula for calculating the institution-specific requirement: 2 × Pillar1 + 2 × Pillar2 + market confidence amount or 2 × leverage ratio. **4** The subordination requirement is capped by law (8% of TLOF or "prudential formula", see footnote 3); see Article 45b(7) of BRRD II. **5** Exceptions are possible pursuant to Article 72b(3) to (5) of CRR II. **6** At the discretion of the resolution authority under Art. 45b(5) of BRRD II (especially: yes if there is a risk that creditors whose claims arise from non-subordinated liabilities incur greater losses than they would otherwise have incurred in the winding-up under normal insolvency proceedings in accordance with the "no creditor worse off" (NCWO) principle).

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both the amount of the MREL requirement and the decision on whether this must be met with subordinated instruments are at the resolution authority's discretion.

Protecting retail clients

Protecting retail clients by introducing a minimum denomination amount

In principle, retail clients should not hold any instruments that are part of the banks' primary loss-absorbing capacity, except for equities. The new Article 44a of BRRD II has therefore introduced two options to protect retail clients from non-risk-appropriate investments in MREL-eligible liabilities. These are either a minimum initial investment amount of €10,000, though retail clients – where their financial instrument portfolio does not exceed €500,000 – are permitted to invest up to a maximum of 10% of their financial instrument portfolio in such liabilities, or alternatively a minimum denomination amount of €50,000.

Minimum denomination amount of €50,000 or €25,000

Germany has decided to implement the second option, introducing a minimum denomination amount of €50,000 for the subordinated MREL-eligible liabilities of all banks. Furthermore, Article 44a of BRRD II also allows for the introduction of a minimum denomination amount for Additional Tier 1 and Tier 2 capital. In Germany, these instruments are therefore also subject to a minimum denomination amount of €50,000. For small and non-complex institutions, a different minimum denomination amount of €25,000 applies to the latter capital instruments. Legislators did not, then, avail themselves of the possibility of setting a minimum denomination amount higher than €50,000.

The introduction of a minimum denomination amount is intended to ensure that retail clients do not invest their assets excessively in instruments that can be primarily used for a bail-in. Such retail clients should not be in the first line of defence to absorb losses in the event of an

institution's resolution or insolvency. Instead, investment in such instruments should be reserved for institutional investors, who ought to be better able to bear losses and assess the risk-return relationship of such instruments. A retail client is not generally able to assess whether the return on an instrument that constitutes Additional Tier 1 capital, Tier 2 capital or other subordinated capital adequately reflects the risk of default, especially as such instruments, in contrast to equities, tend to be perceived as low-risk fixed income investments.

Particularities with regard to the opening of liquidation proceedings

Changes to German law not required for implementation of Article 32b of BRRD II

The new Article 32b of BRRD II has introduced an additional set of circumstances for opening liquidation proceedings. This is intended to address situations in which an institution has been classified as "failing or likely to fail" (FOLTF) but where a resolution action would not be in the public interest and there are as yet no grounds at the national level for opening liquidation proceedings. However, should such circumstances arise, it is not intended that they end up leaving the institution concerned in limbo because it can neither be wound up nor liquidated under national insolvency proceedings. As legislators were of the view that Section 46 of the Banking Act (moratorium powers) and the grounds for opening insolvency proceedings laid down in Sections 17 to 19 of the Insolvency Code (*Insolvenzordnung* – InsO) already provided supervisors with instruments for handling such institutions, it was not deemed necessary to amend the existing legislation in Germany to avoid such limbo circumstances.

Credit Institution Reorganisation Act repealed

The Credit Institution Reorganisation Act (*Kreditinstitute-Reorganisationsgesetz* – KredReorgG) is being repealed under the amendments introduced by the Risk Reduction Act. This is being done on the grounds that it has not attained any practical relevance and has become obsolete since the introduction of the European resolution regime.

Amendments to other legal acts

Changes to Deposit Guarantee Act concern organisation of compensation schemes

The Risk Reduction Act also amends the Deposit Guarantee Act (*Einlagensicherungsgesetz* – EinSiG). The amendments concern both matters relating to the organisation of compensation schemes and the clarification of issues relating to depositor compensation, for example with regard to non-eligible deposits or the scope and calculation of compensation claims as in the case of trust accounts, for instance.

Of greater significance, however, is that the German promotional banks, having been removed from the scope of EU banking regulation, likewise no longer fall within the ambit of the Deposit Guarantee Act, as only CRR credit institutions are subject to the statutory obligation to provide depositor compensation. This will affect the existing membership of these institutions in the compensation scheme of the Association of German Public Banks (Entschädigungseinrichtung des Bundesverbandes Öffentlicher Banken Deutschlands GmbH). Against this backdrop, the Deposit Guarantee Act now provides for the possibility of revoking membership and for the risk-appropriate transfer of contribution-funded financial resources to a different compensation scheme. The amendment to the Deposit Guarantee Act is also being used to close a gap in the Act. Thus far, the Deposit Guarantee Act has not given protection schemes the ability to levy special contributions to fulfil liability claims pursuant to Section 145 of the Act on the Recovery and Resolution of Institutions and Financial Groups. It is now set to be amended accordingly.

Outlook

Post-crisis agenda still not wrapped up

The banking package and completion of its intended regulatory effect through national implementation represent another major step towards wrapping up the regulatory post-financial-crisis agenda and a significant contribution to a further reduction of risk in the banking sector. However, there is still more to be done. The European Commission is already working on drafts of CRR III and CRD VI, which are intended, in particular, to implement the final Basel III package concluded at the end of 2017.

Postponement of Basel reforms due to COVID-19

In March 2020, the Group of Central Bank Governors and Heads of Supervision (GHOS) agreed to postpone the implementation of the final Basel III reforms by one year in response to the impact of the COVID-19 pandemic.[31] Under the Basel standards, this is now scheduled for completion by 1 January 2023, as is the implementation of the amended Pillar 3 requirements. In light of this, subsequent deadlines are also being pushed back. The phase-in of the output floor will now end on 1 January 2028, and both the Fundamental Review of the Trading Book (FRTB) and the amended Credit Valuation Adjustment (CVA) framework will not have to be implemented until 1 January 2023. In August 2020, the EBA received a second call for advice from the European Commission inviting it to update its analysis under the first call for advice in light of the impact of the COVID-19 pandemic. In response, the EBA published its recommendations on the implementation of Basel III in the EU, which include a quantitative impact assessment based on participating banks' data and a number of policy recommendations. The results provide a basis for the legislative proposal to transpose Basel III into European law (CRR III) that the European Commission is expected to present by mid-2021.

31 See https://www.bis.org/press/p200327.htm

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