Client Alert | Regulatory & Compliance

Transforming bank prudential regulation – Issue 3 of 3

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On November 23, 2016 European Commission published proposed amendments to the Capital Requirements Regulation and Directive, the Bank Recovery and Resolution Directive, and the Single Resolution Mechanism Regulation.

The proposals, which are wide ranging and significant, address a number of issues. In part the Commission is completing its implementation of the Basel III banking standards. Other parts pick up on some elements of the emerging so-called Basel IV package of reforms the full content and effect of which has yet to be published. Other parts of the CRD V proposals seek to modify and make more proportionate some provisions of the existing CRD and CRR following the Commission's own reviews of how, in practice, CRD IV and CRR have been working. In addition, the Commission is making some significant changes that are concerned with bank resolution to co-ordinate with international developments and integrate its proposal regarding MREL with global TLAC requirements. Most importantly the Commission is proposing to require third country banking groups that have significant European businesses to establish and obtain authorisation for an intermediate EU holding company. This proposal in particular demonstrates a move away from international harmonisation and mutual recognition of bank prudential standards in favour of greater regional fragmentation and ring fencing.

The Commission's stated aims include seeking to increase the resilience of EU institutions and enhance financial stability; measures to improve banks' lending capacity to support the EU economy; and measures to further facilitate the role of banks in achieving deeper and more liquid EU capital markets to support the creation of a Capital Markets Union.

The amendments themselves fall into three main categories:

(I) Amendments to capital and liquidity requirements.

(II) Amendments to the resolution framework.

(III) Amendments to improve proportionality.

The Commission does not foresee these amendments going live before Summer 2019 at the soonest.

We are publishing three separate client alerts that cover all aspects of the Commission's proposals.

A link to our first Client alert that covered:

- Leverage Ratio
- Own Funds and Liquidity requirements
- large exposures
- the Commission's approach to 'proportionality'

- the treatment of SME exposures and
- powers to exempt entities from CRD and CRR

can be found here.

A link to our second Client alert that focuses on the entirely new Commission proposals for the establishment of European financial holding companies can be found here.

This Client alert focuses on the introduction of new MREL and TLAC requirements as well as changes to the resolution framework for banks and proposals to alter the insolvency treatment of instruments used to meet MREL and TLAC requirements.

Resolution Framework

Revision of MREL and implementation of TLAC (CRR and BRRD)

Following the G20 commitment that the Total Loss-Absorbing Capacity (TLAC) standard be transposed into EU law, the proposal merges TLAC with its European cousin, the Minimum Requirement for Own Funds and Eligible Liabilities (MREL). Both the TLAC and MREL elements of the proposal recognise 'external' and 'internal' liabilities that are subject to write down or conversion.

The amendments proposed by the Commission introduce some considerable complexity and extensive cross referencing between the CRD, CRR and the BRRD. The broad division of labour between CRR and BRRD is that the CRR sets out the requirements for G-SIIs that are intended to be conformed with the TLAC term sheet. The CRR also sets out the quantum and criteria for complying "eligible liabilities" that are aligned with the TLAC term sheet and serve as a starting point for MREL for both G-SSIs and non-G-SSIs. The amendments to the BRRD also set out parameters for MREL for non-G-SIIs. For this purpose the BRRD modifies the criteria of "eligible liabilities" and sets out the methodology to be used by resolution authorities in setting the quantum of MREL. The changes to the CRD deal with the interaction between MREL and the Pillar 1 and Pillar 2 capital requirements and the combined capital buffers.

The issues addressed by the amendments to the resolution framework in the CRD, the BRRD and CRR include:

- 5 day pre-resolution moratorium
- Single and multiple entry points for resolution in groups
- External and internal MREL in resolution entities
- Minimum requirements for MREL and TLAC
- The interaction between MREL/TLAC and capital buffers
- The creation of a new class of non-preferred senior debt that can qualify as MREL and provide subordination where this is required and
- Operation of Article 55 of the BRRD in relation to foreign law governed liabilities.

5 day pre-resolution moratorium (Articles 27 and 29a of the amended BRRD)

The Commission is proposing that Article 27 of the BRRD should be amended to confer on relevant competent authorities a power to suspend the payment obligations of an institution where an authority is aware of its 'rapidly deteriorating financial condition'. Such a suspension of payment obligations would also operate to suspend the contractual payment obligations of the bank's counterparties. This suspension could be for a period of up to 5 business days. Such a moratorium could merge with a post-resolution moratorium imposed under Article 69 of the BRRD.

It is unclear what realistic prospect a bank would have of recovering its market credibility were its payment obligations suspended under this new power and then lifted without it entering into resolution. The new suspension period may serve to buy a failing institution and the authorities additional time to find private sector solutions or alternatively to prepare resolution measures.

Single and multiple points of resolution (Article 2(1)(83a) of the amended BRRD)

The new resolution framework widens the categories of entities in respect of which the resolution powers could be exercised to include EU parent entities established in the EU. This would include the proposed intermediate EU parent undertakings that third country groups may be required to establish. The changes to BRRD provide more flexibility for resolution authorities to determine whether the resolution of financial groups would be best accomplished through the resolution of a single parent entity (which may be a financial holding company) or via potentially multiple resolution actions directed at more than one group entity. The proposal introduces in the BRRD the term "resolution entity" to refer to any entity established in the EU that is identified as an entity for which a resolution plan provides for resolution action.

External and internal MREL (New Articles 45f and 45g of the amended BRRD)

A bail-in of creditors is feasible only, where there are enough liabilities which can be made subject to such conversion and/or write-off. Accordingly, the proposed amendments of EU-Commission provide for a power of the resolution authority to require loss absorbing liabilities to be held by a parent or holding entity and for subsidiaries to hold liabilities owed to the parent or holding entity that could, in the event of a subsidiary failing or threatening to fail, be bailed-in. In such a structure the parent or holding entity would hold externally sourced loss absorbing liabilities whilst the group subsidiaries would, through the liabilities due to the parent or holding entity, hold 'internal' loss absorbing capacity.

External MREL are accordingly eligible liabilities that are subscribed for by external third parties. External MREL in a resolution group facilitates resolution via a 'single point of entry' at say a parent or holding company or parent institution level.

Internal MREL on the other hand comprise liabilities that are put in place between entities within the same group such that if an entity in the group reaches the point of non-viability it can be recapitalised through its losses being transmitted up through the group to an entity that can absorb the losses. This could, for example, be achieved via a debt instrument or intragroup guarantee being written down. Internal MREL may allow groups to avoid the insolvency of operating entities, where the regulators determine that resolution is the appropriate way forward for that group.

MREL and TLAC compared

Eligible liabilities that (together with own-funds) qualify as MREL are defined by reference to the proposed eligibility criteria in article 72b of the CRR which for G-SIIs are intended to be TLAC compliant, however:

- There is no overarching requirement that MREL liabilities for non-G-SII's be subordinated. Instead, resolution authorities will consider the need for subordination on a case by case basis and in particular against the risk that without subordination creditors could make claims under the No Creditor Worse Off ("NCWO") principle (and see further below *Harmonised Insolvency Framework for MREL/TLAC)*.

- The Commission is proposing to allow a derogation from the TLAC requirement for the subordination of eligible liabilities in an amount of up to 3.5% of an entity's total risk exposure. This compares with the subordination derogation of 2.5% permitted in the TLAC term sheet. To qualify for exclusion from the requirement for subordination the liabilities must rank *pari passu* with the entity's lowest ranking excluded liability and the resolution authority must be satisfied that the exclusion is compatible with the objective of mitigating the possible effect of the NCWO principle. Also an institution may decide not to include such liabilities in its MREL but such liabilities may nevertheless qualify as MREL (in certain circumstances). An institution that elects not to take advantage of the derogation must disclose its decision in its annual report (Article 72b(3)-(5) of the CRR)

- Structured notes could qualify as MREL but not for TLAC.

- There is no prescribed minimum quantum for the amount of MREL that must be held by non-GSII's but instead an institution's own funds Pillar 1 and Pillar 2 requirements set by the CRR and CRD provide an upper bound

Quantum of MREL for EU G-SII's (Article 92a of the amended CRR and Article 45d of the amended BRRD)

The Pillar 1 MREL requirement for G-SIIs is set consistently with the TLAC terms sheet and is 16% of the total risk exposure amount and 6% of the leverage exposure measure. These limits will apply from 1 January 2019 until 31 December 2021 at which point they rise to 18% risk exposure and 6.75% leverage. The eligibility criteria for the Pillar 1 MREL for G-SIIs is largely in line with the criteria already specified in BRRD with the added requirement that the liabilities must be subordinated through statutory, structural or contractual means.

Where a non-EU G-SII has material EU subsidiaries that are institutions but are not resolution entities (for example an US banking group with EU subsidiaries that has a resolution plan that foresees the US parent entity as the single-point resolution entity) then the EU subsidiaries will be required to hold eligible liabilities that equal 90% of the requirement for own funds and eligible liabilities laid down in new Article 92a of the CRR. This contrasts with the TLAC term sheet that contemplates such subsidiaries holding only between 75% and 90% of the requirement.

For G-SII's there will be the possibility, under Article 45d of the BRRD, of an additional requirement for MREL being imposed by a resolution authority where it is considered that the level of MREL held in compliance with Article 92a of the CRR will not be sufficient to bring about the recapitalisation of the resolution entity and the restoration of its leverage ratio.

Quantum of MREL for non-G-SII resolution entities (Article 45c of the amended BRRD)

The minimum requirements for MREL are based on the principle that a resolution entity should hold sufficient eligible own funds and qualifying eligibilities that would enable institutions to be recapitalised to an extent that would allow them to continue to meet the conditions for their authorisation. This is subject to an upper bound that is set by reference to an institution's Pillar 1 and Pillar 2 own funds requirements and also the institution's (group's) leverage ratio. Setting MREL in this way foresees it being equal to an institution's required capital. New Article 45c, in line with the existing provisions in Article 45 (6) of the BRRD, contemplates that in setting MREL the resolution authority may take into account the amount the relevant Deposit Guarantee Scheme could contribute to the financing of resolution.

Additional MREL Guidance (Article 45e of the amended BRRD)

The Commission proposes that resolution authorities should be able to give 'guidance' to a resolution entity that it should hold own funds and eligible liabilities that are additional to the amounts calculated in accordance with the recapitalisation principle. In particular a resolution entity may do so where it is necessary that in the event of resolution an entity is 'sustained through capital instruments' – a so-called 'market confidence buffer'.

The amount of any additional MREL that may be given as 'guidance' must not exceed the amount of the combined buffer requirement to which an entity is subject under Article 128 of CRD (e.g. the capital conservation buffer, a G-SII or O-SII buffer and systemic risk buffer).

An entity that fails to maintain the additional own funds and eligible liabilities specified by way of guidance is not to be subject to the restrictions on making distributions required by Article 141 of CRD. However, a resolution authority may require that the amount of MREL be increased to cover the amount of the guidance, in the event that an entity consistently fails to meet the guidance – Article 45e(3) of the amended BRRD.

Interaction between MREL and the capital stack and buffers (new Article 141a of the amended CRD)

New Article 141a of the CRD provides that an institution will not be considered to be meeting the combined buffer requirements if it does not at the same time satisfy the Pillar 1 and Pillar 2 own funds requirements and also its MREL requirement. By implication this means that, for example, the CET1 maintained by an institution to meet its combined buffer requirement is effectively 'used' first and hence the buffers could be said to sit on top of MREL in the capital stack of the resolution entity. A failure to meet the combined capital buffers would result in a restriction on making distributions under Article 141 of the CRD. Indirectly, a failure to maintain sufficient MREL (other than as given by way of guidance) will result in a restriction on distributions calculated as the 'maximum distributable amount'. This approach is in line with the TLAC term sheet.

The Commission is proposing to allow however a six month grace period where the failure to meet the capital buffers is derived from a failure to satisfy the MREL requirement that is attributable to an inability to replace eligible liabilities.

Review of BRRD – creditor's hierarchy (Article 108 of the amended BRRD)

Article 108 of the BRRD currently contains a provision that requires the insolvency law of member states to afford certain classes of deposit preferred status. The Commission is proposing to enlarge Article 108 by a provision that will require member states to establish in their insolvency law a new class of preferred senior debt thereby distinguishing a class of non-preferred debt that is junior to the preferred class but senior to an institution's capital instruments. The intention is that the new class of non-preferred debt instrument should be MREL eligible leaving an institution able to continue to raise funding on potentially better terms via the new class of senior preferred debt.

The Commission has explained that its approach acknowledges the requirement of the TLAC term sheet for eligible liabilities to be subordinated as well as the divergent approaches taken by some member states to introducing new insolvency hierarchies to facilitate the use of resolution powers. Accordingly, the Commission proposes the creation of the new, harmonised statutory category of non-preferred unsecured senior debt to be available in all EU member states, adopting the model currently being developed in France. As noted above the Commission is not intending that MREL issued by non-G-SIIs should necessarily be subordinated but rather that the extent of subordination should be determined on a case by case basis having particular regard to the desirability of limiting possible NCWO claims.

Debt issued before the application of this amendment of the BRRD will be governed by the national laws of Member States as they were adopted on 31 December 2016. This includes national laws which are adopted by that date but enter into force or apply only at a later date.

Foreign law governed eligible liabilities (Article 55 of the amended BRRD)

The Commission also noted that the rules on MREL are not always applied proportionately. It cited Article 55 BRRD, which requires that contracts a Bank enters into which are governed by the law of a third country contain a clause by which the creditor recognises the bail-in power of the EU resolution authorities. The absolute nature of the rule made it impractical, and the proposal amends it to allow resolution authorities to grant a waiver from compliance for liabilities not counting towards MREL and where it was impractical to include such a clause. It appears the drafting of this clause may incorrectly state that all of the proposed criteria must be met before a waiver from Article 55 can be given whereas it should be sufficient if only one of the criteria is met (see new Article 55(2)). We understand this language is likely to be the result of a drafting error, but having been approved (albeit, we are informed inadvertently) by the Commission, a formal process for its correction will be required.

Links to the Commission's proposals can be found here:

http://ec.europa.eu/finance/bank/docs/regcapital/crr-crd-review/161123-proposal-amending-directive_en.pdf

http://ec.europa.eu/finance/bank/docs/regcapital/crr-crd-review/161123-proposal-amending-regulation_en.pdf

http://ec.europa.eu/finance/bank/docs/crisis-management/161123-proposal-directive-unsecured-debt-instruments_en.pdf

http://ec.europa.eu/finance/bank/docs/crisis-management/161123-proposal-directive-recapitalisation-capacity_en.pdf

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