Client Alert

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New EU Banking Legislation Reforms

On 23rd November 2016, the European Commission released a package of banking legislation reforms. Some of these were expected – in particular those related to the minimum requirement for eligible liabilities and own funds (**MREL**) under the Bank Recovery and Resolution Directive (**BRRD**) and the implementation of the Financial Stability Board's (**FSB**) total loss absorbing capacity (**TLAC**) principles into the MREL requirements. Other changes, however, have been less telegraphed, such as the proposed new requirement for non-EU banks with a large European Union (**EU**) presence to establish intermediate financial holding companies within the EU.

We have set out below a high level overview of some of the key changes being introduced by the proposed reform package.

BRRD

The BRRD establishes powers and tools for EU resolution authorities to apply in the context of the resolution of a failing or failed bank in the EU, and it applies to all EU banks, not just systemically important ones. Among the recovery and resolution powers given to the authorities, there are included certain powers to take early intervention measures where a bank is suffering from a rapidly deteriorating financial condition. The European Commission has proposed an additional early intervention power, to be exercised by the competent authority in the relevant member state, to suspend any payment or delivery obligation of a resolution entity or another group entity subject to the BRRD for a period not exceeding five working days. Excluded from this moratorium power are payments and delivery obligations owed to central clearing counterparties, payment and securities settlement systems, as well as deposits covered by a deposit guarantee scheme and eligible claims under investor compensation schemes.

Similarly to the FSB's TLAC principles, the BRRD establishes that an EU bank must maintain MREL that can be easily bailed-in (i.e., converted into equity or written down) in the event of that bank's resolution. MREL is to be set on a bank by bank basis by the resolution authority of each EU member state and calculated expressed as a percentage of the total liabilities and own funds of the institution. The Commission has proposed that MREL should be expressed not only as a percentage of total liabilities and own funds (the leverage ratio exposure) but also as a percentage of the total risk weighted exposure amount calculated in accordance with the EU Capital Requirements Regulation. In addition, for entities designated as global systemically important institutions (**GSII**), of which there are currently 13 in the EU, there will be introduced a minimum harmonised MREL requirement (also referred to as the MREL Pillar 1 requirement) which, in line with the TLAC principles, will be set at 18% of risk weighted assets and 6.75% of the leverage ratio exposure measure. In addition to the MREL Pillar 1 requirement, there will be a so-called MREL Pillar 2 requirement that will be set on a bank by bank basis, by resolution authorities following their analysis of the resolvability of a given GSII, in particular its loss absorption and recapitalisation needs.

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In line with the TLAC principles, the MREL principles will provide that common equity Tier 1 capital used towards meeting the capital conservation buffer and any countercyclical capital buffer (“**combined capital buffer**”) may not also be counted towards the MREL requirements. Therefore, in a circumstance where there is a shortfall in the required MREL, common equity Tier 1 capital forming part of the combined capital buffer will then instead be counted as meeting the MREL requirements to the extent of the MREL shortfall. Where this results in a shortfall in the combined capital buffer, this will trigger restrictions on discretionary payments to employees and distributions to the holders of stock and other regulatory capital instruments. However, the Commission’s proposal envisages a six-month grace period before such restrictions would kick in, where such breach of the combined buffer is due to a temporary inability to issue new debt that is eligible for MREL.

In addition to the MREL Pillar 1 and Pillar 2 requirements, it is proposed that resolution authorities should be able to set higher MREL requirements for individual entities, although it is proposed that these higher requirements would take the form of MREL recommendations and as such breach of these would not be sanctioned in the same way as a breach of the Pillar 1 or Pillar 2 requirements.

In terms of what is eligible for MREL, there is some good news for the structured products industry. Derivatives and structured notes have previously been ineligible for the MREL requirement. However, the Commission now proposes that structured notes may be included towards MREL where the amount of the liability arising from the debt instrument is fixed and not affected by a derivative feature, and where the debt instrument is not subject to any netting agreement. This should mean that principal protected structured notes should be eligible to be counted towards MREL to the extent of the principal protection.

In terms of the loss absorbing qualities of MREL, the Commission proposes, in line with the TLAC principles, that GSIIs should ensure that eligible liabilities counting towards MREL should be subordinated to all liabilities that are excluded from bail-in, when complying with the MREL Pillar 1 requirements. There is more flexibility as regards the MREL Pillar 2 requirement, where subordination is only required where the resolution authority considers it necessary to guard against creditor claims that they have been treated worse under the resolution than they would have been if a formal liquidation had been carried out. This principle is known as the “no creditor worse off,” or “NCWO,” safeguard and allows a creditor to claim compensation where this principle is breached.

Article 55 of the BRRD requires that for certain contracts that give rise to a liability of the bank and that are governed by a non-EU law, the bank must include in those contracts an express provision whereby the counterparty acknowledges that those liabilities may become subject to bail-in action and agrees to be bound by such bail-in action. In light of the difficulties that banks have had in complying with these provisions, especially in respect of business conducted by branches in non-EU countries, the Commission proposes an amendment to the Article 55 to allow resolution authorities, in respect of liabilities that do not count towards MREL, to grant a waiver from compliance where the authority determines that it is legally, contractually or economically impracticable for the bank to include such a bail-in recognition clause and where granting such a waiver would not impede the resolvability of the bank. The relevant resolution authority has full discretion as to whether or not to grant such a waiver.

The Commission has also mandated that member states must make changes to their national insolvency laws to provide for a new sub-class of senior unsecured debt instruments. Such instruments will rank behind other senior unsecured debt instruments, but ahead of all regulatory capital instruments and subordinated instruments. This new sub-class of debt must have an initial contractual maturity date of at least one year, must have no derivative features and the contractual documentation in relation to the issuance of such instrument must explicitly refer to the ranking of the instrument under national insolvency law. This new sub-class of debt is designed to ensure that it is available to be bailed-in, with a minimal likelihood of a successful claim that a holder has suffered from breach of the NCWO principle. Several member states have already made, or are making, similar changes to their national laws. Member states will be obliged to implement and apply those measures (provisionally) from July 2017, though these changes will not affect any instruments issued prior to that date.

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The above MREL Pillar 1 requirement that applies to EU GSIIs is reduced in relation to institutions that are material subsidiaries of non-EU GSIIs, but not themselves resolution entities. Those types of institutions must satisfy a MREL Pillar 1 requirement equal to 90% of the requirement that applies to an EU GSII. Instruments will only count towards such entities' MREL when they are held by the parent undertaking of the institution in the third country.

CRD 4

The Commission also proposes various changes to be made to the Capital Requirements Regulation and the Capital Requirements Directive. One of the biggest changes affecting foreign banking groups is the proposal that where a non-EU banking group has two or more bank affiliates in the EU, there must be established an intermediate financial holding company in the EU. That intermediate financial holding company must obtain authorization either as an EU bank or as an EU financial holding company or mixed financial holding company. There is however a *de minimis* exception to this, where the total value of all EU assets of the non-EU banking group is lower than EUR 30 billion, and the non-EU country group is not a non-EU GSII. For the purpose of calculating the value of EU assets, there must be included assets of all EU subsidiaries and all EU branches of the non-EU banking group. This provision closely mirrors the intermediate financial holding company provisions that apply to certain (non-U.S.) foreign banking organizations in the United States, and is designed to ensure that the EU operations of the group are sufficiently capitalised that in the event of the failure of the foreign banking group there should be sufficient capital, available locally, to contribute to the absorption of losses of the European operations.

The Commission also proposes that where the same EU competent authority supervises parents and subsidiaries that are established in different member states, it should be allowed to waive the application of own funds and liquidity requirements, so long as there exists a parent guarantee for the full amount of the waived requirement, and where that guarantee is at least 50% collateralised.

As envisaged by the Capital Requirements Regulation, the Commission has separately proposed implementing a binding 3% leverage ratio to be observed by EU banks, as well as the net stable funding ratio envisaged by the Basel III principles.

The Commission also proposes to amend the rules of calculating capital requirements for market risk, following the Basel Committee's Fundamental Review of the Trading Book.

The EU's large exposures framework is proposed to be amended also to fall into line with Basel standards.

In addition, in relation to capital, a new distinction is being made between different types of capital pronouncements made by EU bank supervisors – so-called Pillar 2 capital add-ons. The proposal distinguishes between Pillar 2 capital requirements that are mandatory and those that are intended only as guidance.

Lastly, the Commission has also proposed various provisions dealing with proportionality for certain types of entity in relation to reporting requirements, disclosure, and remuneration. It has also proposed measures reducing risk weightings assigned to exposures to small and medium sized enterprises, as well as establishing a more risk-sensitive regulatory environment for private investments in infrastructure projects.

The Commission's proposals will now begin the process of consideration by the European Parliament and the EU Council.

Conclusion

Overall, the package contains few negative surprises for EU banking groups, though the requirement for intermediate financial holding companies will trouble many non-EU banking groups with significant EU operations. We will expand further on some of the above issues in the near future.

References:

- The Commission's fact sheet may be accessed here: http://europa.eu/rapid/press-release_MEMO-16-3840_en.htm?locale=en
- The text of the amending directive may be accessed here: http://ec.europa.eu/finance/bank/docs/regcapital/crr-crd-review/161123-proposal-amending-directive_en.pdf
- The text of the amending regulation may be accessed here: http://ec.europa.eu/finance/bank/docs/regcapital/crr-crd-review/161123-proposal-amending-regulation_en.pdf

Authors

Peter Green London +44 20 7920 4013 pgreen@mofo.com	Jeremy Jennings-Mares London +44 20 7920 4072 jjenningsmares@mofo.com

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