Client Alert

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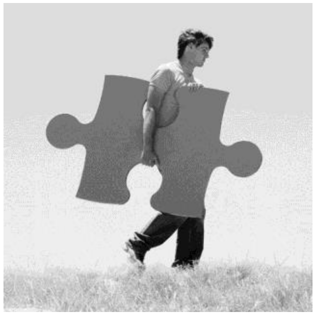

Shaping MREL for European (and non-European) Banks

The European Commission ("**Commission**"), on 23 November 2016, released its legislative proposals to amend the EU's Bank Recovery and Resolution Directive ("**BRRD**") to provide more detailed rules relating to the setting of MREL[1] for European banks, among other things. The availability of sufficient loss-absorbing capacity is crucial to the successful resolution of a bank group, especially where the resolution will entail a bail-in[2] strategy. In order to ensure that a bank has sufficient loss-absorbing funds available to effect a successful resolution in the event of its failure, the BRRD established that all EU banks (whether systemically important or not) would be required to hold a minimum level of loss-absorbing capital and other liabilities – such level to be set on a bank group-by-bank group basis by the relevant EU resolution authority.

The legislative package consists of:

- a proposed directive to amend the BRRD's MREL provisions ("**BRRD2**");
- a proposed regulation to amend the Capital Requirements Regulation ("**CRR**") including implementing the Financial Stability Board's final principles on total loss absorbing capacity ("**TLAC**") for global systemically important banks ("**GSIBs**") into EU law ("**CRR2**");
- a proposed regulation to amend the Single Resolution Mechanism Regulation in essentially the same respects as BRRD2 ("**SRMR2**")
- a proposed directive to amend the existing Capital Requirements Directive including, among other things, in relation to authorisation for financial holding companies and mixed financial holding companies ("**CRD5**"); and
- a proposed directive to amend EU member states' national insolvency laws in respect of the insolvency ranking of certain instruments ("**Insolvency Ranking Directive**").

The most controversial part of the legislative package is the proposal, in CRD5, to require non-EU GSIBs, or other non-EU banks with substantial EU assets, to establish an EU-incorporated intermediate holding company for their EU business. The Commission has justified this proposal as a move to simplify and strengthen the resolution process of third-country groups with significant EU activities, but this does look a lot like a tit-for-tat measure in response to the U.S. Federal Reserve Board's intermediate financial holding company rules.

The three draft directives and the two draft regulations will now be subject to the scrutiny of, and negotiation with, the European Parliament and the Council of the EU before they can become law. The Insolvency Ranking Directive is currently proposed to be implemented by member states into their national laws by July 2017.

[1] MREL is the acronym for the Minimum Requirement for Own Funds and Eligible Liabilities, mandated by the BRRD.
[2] "Bail-in" refers to the compulsory write down of principal of an instrument or its conversion into an equity instrument, each in a resolution scenario.

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BRRD2 is currently proposed to be implemented by member states within one year after it enters into force, and member states are to apply those measures from the date falling six months thereafter. SRMR2 is also intended to apply 18 months after it enters into force. The provisions of CRR2 relating to TLAC/MREL will apply from 1 January 2019 (although the rest of CRR2 will generally apply from two years after it comes into force). The provisions of CRD5 are to be implemented by member states into their national laws and applied from one year after it comes into force.

Relationship of TLAC and MREL

The provisions of the BRRD regarding MREL apply to all EU banks and are set by resolution authorities on a bank-by-bank basis. The proposed new provisions to implement TLAC into EU law are to apply only to GSIIs (the EU equivalent of GSIBs) and are contained in CRR2. MREL is to be set for each bank as an amount considered necessary to absorb losses, plus an amount necessary to restore the bank to a position where it can meet its conditions for authorisation and continue to operate. No minimum level of MREL is prescribed for non-GSIIs, but the TLAC-related provisions effectively set a floor on the level of MREL ("**MREL Floor**") that must be assigned for GSIIs by their resolution authority. Resolution authorities may set MREL levels for GSIIs higher than the MREL Floor in certain circumstances. The eligibility criteria for instruments counting towards the MREL Floor are more stringent than those for instruments counting towards MREL above the MREL Floor and for instruments counting towards MREL for non-GSIIs.

Level of MREL

Currently, BRRD provides that MREL should be set as a percentage of total liabilities and own funds, on a non-risk-weighted basis. The Commission proposes that MREL should be set as a ratio both of risk-weighted assets and of the leverage ratio denominator – for all banks and not just GSIIs.

The MREL Floor for GSIIs will be 16% of risk-weighted assets and 6% of the Basel III leverage ratio denominator as from 1 January 2019, rising to 18% of risk-weighted assets and 6.75% of the Basel III leverage ratio denominator from 1 January 2022 (subject to extensions in certain cases). As such, it brings the minimum level of MREL for GSIIs into line with the FSB TLAC principles.

For EU subsidiary institutions of non-EU GSIIs, that are not themselves resolution entities, MREL ("**internal MREL**") is to be set at a level equal to 90% of the above levels and must be met by instruments held by the non-EU parent undertaking. This figure is at the top end of the percentage range specified by the FSB in the TLAC principles. Such internal MREL must meet essentially the same criteria as for external MREL of resolution entities, including that it must be subordinated to MREL-excluded liabilities. Subject to the agreement of the resolution authorities for the parent and subsidiary entities, the internal MREL requirement may be met by the parent providing a guarantee to the subsidiary, so long as such guarantee is at least 50% collateralised.

For non-GSIIs, MREL is to be set at a level equal to the amount determined to be necessary to absorb losses as well as restore the total capital ratio and leverage ratio of the bank to the level necessary to enable them to comply with the conditions for their authorisation and continue their authorised activities.

Those amounts may not exceed the greater of:

- an amount equal to twice the bank's Pillar 1[3] and Pillar 2[4] capital requirements (once for loss absorption and once for recapitalisation)
- an amount equal to twice the bank's leverage ratio requirement[5] (once for loss absorption and once for recapitalisation).

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[3] This is the minimum required capital ratio of 8% of risk weighted assets set by the CRR, reflecting the Basel III minimum capital requirements.
[4] This is the additional required capital that is set by bank supervisors on a bank-by-bank basis
[5] Pursuant to CRR2, this will be set at 3% of the bank's total exposures.

MREL Eligibility

The Commission proposes that, for liabilities to be eligible for MREL, they must meet various criteria. Firstly, they must not be regulatory capital instruments, or, alternatively, they may be Tier 2 instruments with a residual maturity of at least one year, to the extent that such instruments do not count towards the entity's required Tier 2 capital during the final five years of the instrument's maturity, in accordance with the CRR.

The required MREL criteria reflect the TLAC-eligibility criteria, with certain additions and variations. For instance, secured liabilities can be MREL-eligible, so long as no security or guarantee is provided by the resolution entity itself, any of its affiliates, or any undertaking with close links to it or any of its affiliates.

The FSB's TLAC principles allow for TLAC-eligibility for instruments in respect of which the resolution authority can trigger a bail-in, either by virtue of a statutory mechanism or by the contractual terms of the instrument providing such a right ("contractual bail-in bonds"). However, the Commission's proposal specifies that only contractual bail-in bonds will be acceptable for MREL.

In terms of maturity, the MREL eligibility criteria mirror the TLAC requirement that the instrument must have a remaining maturity of at least one year. In this regard, both the TLAC and the proposed MREL requirements provide that an investor put option will be permitted to the extent that it does not breach the minimum remaining maturity criterion. In other words, an instrument containing a holder put option may still be MREL-eligible until the date falling one year before the first date on which the holder put option could be exercised.

Callable Bonds

An instrument containing a call option can be MREL-eligible, so long as it can be exercised only at the sole discretion of the issuer and does not contain any incentive to redeem (such as an interest rate step-up).

These proposed rules would therefore still allow for full MREL eligibility for a bond callable by the issuer one year prior to its scheduled maturity (assuming no incentive to redeem). Such bonds have recently proved popular with U.S. issuers, due to them giving the issuer flexibility to retire such bonds before they become uneconomical due to their final year TLAC-ineligibility. These proposals are consistent with the Bank of England's recently released MREL Statement of Policy, which prescribes that such a bond will remain MREL-eligible until called (or until one year prior to its scheduled maturity, whichever occurs first). It is worth noting that there is no proposal, either of the Commission or the Bank of England, for an otherwise eligible instrument to start losing a portion of its eligibility after it has a residual maturity of less than two years, unlike the Federal Reserve Board's proposed TLAC rules.

In order to exercise such a call, the prior approval of the bank's supervisor is required, and the retired liability must be replaced with an instrument that is at least equally loss absorbing, unless the supervisor agrees that the bank would continue to meet all its regulatory requirements by an acceptable margin.

Exclusions from MREL

The existing BRRD exclusions of certain instruments from MREL-eligibility have been broadly maintained, but have also been extended to include those instruments excluded from TLAC. Also proposed to be excluded are those deposits that are not covered by a deposit guarantee, but are either (a) those parts of deposits from natural persons, and micro, small, and medium enterprises, that are in excess of the deposit guarantee coverage level; or (b) deposits from such persons that would have been eligible for the deposit guarantee if they had not been made with non-EU branches of EU banks. These types of deposits are already required by BRRD to be given a preferential status under member states' insolvency laws (ranking in priority after guaranteed deposits but ahead of other unsecured unsubordinated liabilities) but currently are eligible to count towards MREL. This proposed new exclusion reflects the reality that such deposits are less likely to be bailed in than other unsecured liabilities. This is because their preferred status in insolvency would mean that, if they were bailed in without all other unsecured liabilities (including derivatives) having been bailed in first, the depositors would probably have a claim for compensation, due to breach of the BRRD principle that no creditor should end up worse off in resolution than they would have in normal insolvency proceedings (the "**NCWOL**" principle).

Structured Products

Derivatives liabilities have always been excluded from MREL eligibility, though liabilities from securities embedding a derivative, such as structured notes, are not currently excluded. In harmonising the MREL requirements with the TLAC requirements, the expectation was that structured notes would also be excluded from MREL eligibility, as they are excluded for TLAC eligibility. The Commission's proposals in this regard are different for GSIIs and non-GSIIs. Structured securities will not be eligible for a GSII's MREL Floor requirements, although they will be eligible for any additional MREL requirements imposed on the GSII by the relevant resolution authority and also for a non-GSII's MREL requirements, in each case so long as they meet certain conditions. These are that: (a) a given amount of the liability is known at the time of issuance, is fixed, and is not affected by a derivative feature; and (b) neither the instrument, nor its derivative feature, is subject to a netting agreement, and its value would therefore not be determined on a net basis under BRRD. However, only that part of the instrument meeting the requirements in (a) may be counted towards MREL.

This appears to mean that, if the current proposals are enacted, principal-protected structured notes should be eligible to count towards a non-GSII's MREL and towards any GSII's MREL requirements above the MREL Floor, in each case to the extent of the principal-protected amount. This reflects the fact that the principal-protected part (if any) of a structured note does not suffer from the valuation difficulties that exclude other derivatives and derivative-linked liabilities from being considered easily bail-inable in a bank resolution.

It is not immediately clear from the proposals why the Commission would make a distinction between GSIIs and non-GSIIs in terms of whether these types of structured notes should count towards MREL requirements. If it considers that such notes have good loss absorbing capacity, one would expect that to remain the same, whatever the type of bank issuing them. The current proposals place GSIIs at a competitive disadvantage to non-GSIIs in terms of raising MREL.

Subordination

In line with the FSB's TLAC principles, the proposed MREL rules specify that, in order for a liability to be eligible for a GSII's MREL Floor, it must be wholly subordinated (in normal insolvency proceedings) to claims in respect of liabilities that are excluded from MREL eligibility. Such subordination may be achieved contractually (by specific provisions in the terms of the instrument), statutorily (by the relevant member state providing for such subordination in its national laws), or structurally (by the instrument being issued by a resolution entity that does not have any MREL-excluded liabilities ranking pari passu or junior to its MREL). Such subordination is required to minimise the risk of compensation claims from bailed-in holders of MREL-eligible liabilities, under the NCWOL principle. The flexibility as to the manner of subordination is essential to cater for the range of different banking models operated in the EU and the consequent prevalence of both single point of entry and multiple point of entry resolution strategies that are likely to be applied by different EU resolution authorities.

The proposals do not mandate such subordination for non-GSIIs or for additional MREL for GSIIs above the MREL Floor, although resolution authorities are to be given the power to require such subordination for a particular bank group, where the bank has non-subordinated liabilities ranking pari passu with liabilities that are excluded (or are anticipated by the resolution plan to be excluded) from a bail-in and give rise to a risk of creditor claims under the NCWOL principle. In such circumstances, the level of subordination required by the relevant resolution authority should not be in excess of the amount needed to avoid breach of the NCWOL principle.

The FSB's TLAC principles provide for an exception to the subordination requirement where (a) the amount of excluded liabilities ranking pari passu or junior to eligible liabilities does not exceed 5% of the resolution entity's external TLAC, (b) the resolution authority has authority to differentiate between pari passu creditors in a resolution, (c) such differentiation would not give rise to a material risk of successful legal challenge or compensation claim, and (d) such exception would not have a material adverse effect on the bank's resolvability.

The proposed MREL provisions mirror the FSB TLAC principles in this respect but also provide an alternative de minimis exception, where the amount of proposed MREL that ranks pari passu with excluded liabilities is limited to 2.5% of the bank's total risk-weighted exposure amount until 31 December 2021, and thereafter 3.5%.

The MREL proposals are also aligned with the FSB's TLAC principles, in that they exclude from MREL-eligibility Additional Tier 1 and Tier 2 instruments issued by group special purpose entities, as from 1 January 2022.

The proposed MREL provisions also direct resolution authorities to consider, in consultation with bank supervisors, what classes of bail-inable liabilities might actually be exempted by a resolution authority from bail-in under its powers of exclusion under Article 44(3) of BRRD, in addition to those liabilities automatically excluded. That consideration should extend to ensuring that there is sufficient other MREL (i.e. bail-inable liabilities not likely to be excluded) to restore the capital of the entity in resolution to the point at which it can meet its conditions for continued authorisation and carry on its authorised activities (the "point of viability").

Insolvency Ranking

In connection with the MREL provisions on subordination, the Commission's proposals in the Insolvency Ranking Directive mandate EU member states to 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 and 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. Several member states have already made, or are making, similar changes to their national laws.

The new sub-class of debt will not constitute the only type of debt instrument eligible for MREL. Other methods of subordination are acceptable for MREL instruments, as mentioned above, and subordination is not compulsory for non-GSIIs or for additional MREL above the MREL Floor. However, for this type of plain vanilla non-preferred senior unsecured debt, these changes effectively negate the risk of creditor compensation claims under the NCWOL principle, upon their bail-in.

Pillar 2 MREL provisions

In addition to the required MREL Floor for GSIIs, each resolution authority is given the power, under the Commission's proposals, to impose an MREL requirement for non-GSIIs, as well as an MREL requirement for GSIIs over and above the MREL Floor. This MREL requirement must be met with instruments that meet the MREL Floor requirements except for the subordination requirement, and subject also to the exception for certain structured securities, as mentioned under "Structured Products" above. However, for GSIIs, this add-on MREL requirement can be imposed only where the MREL Floor is considered insufficient to restore the entity to the point of viability and only to the extent of the perceived shortfall, and it must be accompanied by the reasoning for that decision. Where the GSII group contains more than one resolution entity, the above Pillar 2 requirement must be calculated both for each individual resolution entity and also for the EU parent entity as if it were the only group resolution entity.

The MREL provisions also give power to a resolution authority to give non-binding "guidance" as to desirable levels of MREL in excess of the MREL Floor and Pillar 2 requirements to cover potential additional losses not already factored in and to restore capital levels, post-resolution, to a level necessary to restore "market confidence" in the resolved entity. The amount of that additional "guidance" may not exceed the amounts of its CRR capital conservation buffer, plus any GSII buffer and systemic risk buffer, unless a higher level is necessary to ensure continued compliance with its conditions for authorisation for up to one year post-resolution. Such guidance must be accompanied by the reasoning behind such guidance. Although it is initially non-binding guidance, a consistent failure to follow that guidance could result in the resolution authority turning that guidance into a binding requirement.

The MREL requirements are proposed to be met by resolution entities on a consolidated basis at the levels of the resolution group. Those requirements will take into account whether any non-EU subsidiaries are to be resolved separately, according to the group's resolution plan.

Those banks that are subsidiaries of a resolution entity, but not themselves resolution entities, must meet the MREL requirements on an individual basis. In addition, resolution authorities, in consultation with the relevant bank supervisor, may impose MREL requirements on subsidiaries that are financial institutions, financial holding companies, or mixed financial holding companies of the bank but are not themselves resolution entities.

Financial Contagion Measures

In order to reduce the possibility of financial contagion resulting from the resolution of a GSII, the Commission proposes that a GSII holding an MREL-eligible instrument issued by another GSII must make a corresponding deduction of the amount of that instrument from its own MREL instruments and must therefore issue further MREL as necessary to ensure compliance with its MREL Floor and any Pillar 2 MREL requirements.

However, this proposal is less stringent than that of the Basel Committee of Banking Supervisors ("**BCBS**") issued in October 2016, which recommended that any holdings by a GSIB of TLAC instruments of another GSIB should be deducted from the first GSIB's Tier 2 capital, meaning that any compensatory issuance by the first GSIB would potentially need to meet the more stringent Tier 2 requirements.

Having said that, the Commission will be asking the European Banking Authority for advice on alternative options for the treatment of holdings of GSII-issued MREL, including on the BCBS proposal and will consider, on the basis of such advice, whether a different treatment is warranted.

Intermediate Holding Companies

The CRD5 proposals provide that, where a non-EU banking group has two or more subsidiaries in the EU that are banks or investment firms, it must establish an intermediate financial holding company in the EU. The European entities would then be consolidated under the intermediate financial holding company, forming a European sub-group. That intermediate financial holding company must obtain authorisation 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 bank 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 mirrors to some extent the intermediate financial holding company provisions that apply to certain (non-U.S.) foreign banking organisations in the United States and is designed to ensure 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.

It seems that the intermediate holding company would need to comply with the BRRD's MREL requirements (and possibly be subject to the MREL Floor) on a consolidated basis. It will also need to meet the CRR2 capital, liquidity, and other requirements on a consolidated basis.

MREL Disclosure

The proposed CRR2 provides that GSIIs will disclose, on a semi-annual basis:

- the composition of their own funds and eligible liabilities, their maturities and main features;
- the ranking of their eligible liabilities in the insolvency creditor hierarchy;

- the total amount of eligible liabilities issued and the amount of those eligible liabilities relying on the 2.5%/3.5% risk weighted assets exception referred to under "Subordination" above; and
- the total amount of liabilities excluded from MREL.

Non-GSIIs will be required to disclose, on an annual basis, the levels of their eligible MREL and the composition of that MREL, including its maturity profile and ranking in normal insolvency proceedings.

Contractual Recognition of Bail-in

Where the terms of bail-inable instruments are governed by an EU law, the bail-in actions of an EU resolution authority should be given effect in the courts of any EU member state. The situation is less certain where the relevant instrument is governed by a non-EU law, and therefore Article 55 of BRRD already requires the insertion, into many such instruments, of express language by which the beneficiary of the bail-inable liability agrees to be bound by an EU bail-in action.

BRRD2 proposes to amend Article 55 to provide that such contractual bail-in recognition language is not mandatory where:

- the EU bail in of the liabilities covered by Article 55 will be recognised by the laws of the non-EU country, or by a binding agreement of that non-EU country;
- it is legally, contractually, or economically impracticable to include such a term in certain liabilities; and
- the waiver of Article 55 provisions for those certain liabilities would not impede the resolvability of the bank.

This exception will not apply to unsecured liabilities or regulatory capital instruments and will only apply to liabilities that are senior to MREL – it will not apply to liabilities to be counted towards MREL.

The exception has been proposed to acknowledge the difficulties that EU banks have been experiencing in obtaining agreement of their creditors and counterparties to the Article 55 required wording, especially for EU banks dealing with non-EU creditors and counterparties.

Effects of MREL Shortfall

In line with the FSB's 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 the amounts of 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.

Where such discretionary payments are made by a bank at a time when it has a combined capital buffer shortfall, no distributions on common equity Tier 1 capital or payments of variable remuneration or discretionary pension benefits may be made until all payments due on Additional Tier 1 instruments have been made. This provision partly counteracts the inability of Additional Tier 1 instruments to create "dividend stoppers" under CRR.

Conclusion

The intermediate financial holding company provisions of the legislative proposals have so far created the biggest headlines in the press. If enacted in their current form, they will apply both to non-GSIIs and GSIIs and to non-globally systemic bank groups that have a significant EU presence, and they will give rise to an enormous amount of planning and restructuring of existing EU operations of non-EU bank groups.

In the wake of the UK's Brexit vote, it is not clear that a UK-incorporated holding company will meet the requirements for an EU intermediate financial holding company following Brexit. This will depend entirely on the negotiations of the post-Brexit relationship between the UK and the EU over the next couple of years and in particular the level of continued access to the EU single market.

In terms of the integration of TLAC into the MREL requirements, some distinctions have been drawn between MREL for GSIIs and for non-GSIIs that do not appear to be driven by their systemic nature. Subordination of MREL to excluded liabilities is mandated for GSIIs, but not non-GSIIs. However, one might expect that where a bail-in strategy is likely to be employed in resolution, subordination should be mandated, in order to avoid breach of the NCWOL principle. Certainly, this is the approach that the Bank of England is taking to MREL. In addition, if principal protected structured notes are considered to have good loss-absorbing capacity for non-GSIIs, the same should logically be true for GSIIs.

The market now eagerly awaits the final TLAC rules to be issued on 15 December 2016 by the Federal Reserve Bank in the United States, which has, no doubt, been studying the Commission's proposals carefully.

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