Linklaters

23 November 2016

CRD and BRRD Reform Proposals

A road-map for DCM practitioners

INTRODUCTION

The European Commission has today published its much-anticipated proposals to amend and supplement certain provisions of, *inter alia*, the Capital Requirements Directive ("**CRD**"), the Capital Requirements Regulation ("**CRR**") and the Bank Recovery and Resolution Directive ("**BRRD**").

The European Commission notes that its proposals are designed to complete its post-financial crisis reform of the financial services regulatory framework by tackling remaining weaknesses and implementing some outstanding elements of the reform that are essential to ensure the resilience of institutions but which have only recently been finalised by the Basel Committee (including its fundamental review of the trading book) and the Financial Stability Board (including its work on the "too big to fail" issue).

The proposals are wide-ranging and will be significant for many EU institutions. They include, among other things:

- a binding leverage ratio;
- a binding net stable funding ratio;
- more risk-sensitive capital requirements relating to the trading book;
- new international standards to implement total-loss-absorbing capacity (TLAC) for global systemically-important institutions (G-SIIs); and
- a new asset class of "non-preferred" senior debt.

The purpose of this note, however, is to focus on certain of the proposals which will be among the most relevant for DCM practitioners and treasury teams at banks.

The European Commission's reforms are contained in a proposed new directive (the "**New CRD Directive**") to amend CRD and a proposed new regulation (the "**New CRR Regulation**") to amend CRR. While the standard minimum level of TLAC for EU G-SIIs will be introduced into CRR by the New

Contents

CRR Regulation (with direct effect to maximise harmonisation), a firm-specific TLAC add-on for G-SIIs and a firm-specific minimum requirement for own funds and eligible liabilities (MREL) for non-G-SIIs in the European Union will mainly be implemented through amendments to BRRD contained in a proposed new directive (the "**New BRRD Directive**"), together with consequential amendments to the Single Resolution Mechanism Regulation ("**SRMR**") relevant to banks in the Banking Union, contained in a proposed new regulation (the "**New SRMR Regulation**"). Finally, a separate new directive (the "**Art. 108 BRRD Directive**") proposes amendments to the BRRD to facilitate the creation of a new asset class of "non-preferred" senior debt which will be eligible to count as TLAC and MREL.

THE LEGISLATIVE PROCESS

The publication of these proposals kicks-off an EU legislative process known as the 'ordinary legislative procedure'. This entails the European Parliament and the Council of the EU each considering their position on the proposals before entering into informal 'trilogue' negotiations facilitated by the European Commission. Once agreement is reached and endorsed by the European Parliament plenary and the Council of the EU, the legislation is published in the Official Journal of the EU. The ordinary legislative procedure typically takes around 18 months, but in the past more complex pieces of legislation (the original versions of CRD IV, CRR and BRRD included) have taken around 24 months. The New CRD Directive, New BRRD Directive and Art. 108 BRRD Directive will also need to be transposed into the domestic law of member states. Accordingly, with the exception of the Art. 108 BRRD Directive, the new proposals are only expected to start entering into force in 2019 at the earliest.

However, given the expected impact of some of the proposals on, for example, the future recognition of some capital instruments and bail-inable liabilities, the proposals will have some important immediate effects.

The text of the Art.108 BRRD Directive contemplates that member states will adopt it by "[June 2017]" and apply it from "[July 2017]". Although it, too, will have to go through the ordinary legislative procedure, it is a short piece of legislation and has been proposed by the European Commission in response to specific calls for it by the European Parliament (in its Report on Banking Union) and by the Council of the EU to do so.

PILLAR 2 CAPITAL

Article 104 CRD currently sets out various supervisory powers which competent authorities have, including to require institutions to hold institution-specific "Pillar 2" capital in excess of the Pillar 1 capital requirement which is applicable to institutions generally under CRD.

The New CRD Directive sets out important changes to Article 104 CRD, together with a proposed new Article 104a, relating to setting an additional own funds *requirement* ("**Pillar 2 Requirement**" or "**P2R**"), and a proposed new Article 104b, relating to the giving of *guidance* ("**Pillar 2 Guidance**" or

"**P2G**") by competent authorities for the maintenance of capital above the institution's Pillar 1 capital requirement, combined buffer requirement ("**CBR**") and Pillar 2 Requirement.

Pillar 2 Requirements

The new Article 104a CRD contemplates that the P2R shall only be imposed where, as a result of its supervisory review and evaluation process (SREP) of an institution, the relevant competent authority ascertains, among other things, that:

- the institution is exposed to risks which the competent authority considers are not sufficiently covered by the Pillar 1 minima; or
- the institution repeatedly fails to establish or maintain its P2G.

Article 104a CRD expressly stipulates that:

- P2R should not be used to cover any macroprudential or systemic risks (only institution-specific risks);
- (similar to the UK PRA's position in relation to the composition of 'Pillar 2A' capital) at least 75% of the P2R should be met with Tier 1 capital (of which at least 75% should be CET1 capital). Put another way, not more than 18.75% of the P2R should be in the form of Additional Tier 1 capital; and
- with one exception, capital used to meet the P2R should not also be used to meet Pillar 1 capital requirements or the CBR. In other words, P2R "sits below" the CBR in the capital stack of an institution and correspondingly raises the trigger level (the "**MDA Trigger**") at which mandatory restrictions on discretionary payments (CET1 and AT1 distributions, for example) apply.

Under the proposals, the EBA will be mandated to develop draft regulatory technical standards specifying how the risks to be covered by P2R shall be measured.

Pillar 2 Guidance

The New CRD Directive proposes competent authorities should be able to communicate to an institution the P2G that they expect such institution to hold in order to cope with forward-looking and remote situations. Such expectations would not be subject to mandatory disclosure and, as discussed further below, P2G "sits above" the MDA Trigger.

Accordingly, the proposed new Article 104b CRD contemplates that, as part of an institution's ICAAP process, it establishes adequate institution-specific levels of capital (above its Pillar 1 capital requirements, CBR and P2R) in order to ensure that the institution is able to absorb potential losses which are either identified by supervisory stress testing or as a result of cyclical economic fluctuations, in each case without a breach of its Pillar 1 capital requirements, CBR or P2R.

Article 104b CRD will require competent authorities regularly to review the level of P2G set for institutions taking into account SREP and stress-testing and communicate to any institution "any expectations for adjustments" to the level of P2G.

As discussed further under "*Mandatory Restrictions on Distributions*" below, any failure to maintain P2G is not an event which triggers any mandatory restrictions on discretionary payments, but repeated failure to comply with P2G would enable the competent authority to take supervisory measures, including imposing an additional P2R.

MANDATORY RESTRICTIONS ON DISTRIBUTIONS

Article 141 of the existing CRD sets out the circumstances in which certain discretionary payments (including CET1 and AT1 distributions) must be cancelled or reduced as a result of an institution's failure to meet its CBR in whole or in part. There has been much discussion as to which elements of its capital should "sit below" the CBR of any institution and therefore raise the MDA Trigger.

The New CRD Directive proposes to clarify this by the introduction of a new Article 141a CRD and amendments to Article 141 CRD itself.

The New Article 141a CRD proposes that an institution shall be deemed to fail to meet its CBR where it does not have own funds and eligible liabilities in an amount and quality to meet all of the following:

- its CBR;
- its 4.5% Pillar 1 and P2R CET1 requirement;
- its 6% Pillar 1 and P2R T1 requirement;
- its 8% Pillar 1 and P2R total capital requirement; and
- its MREL/TLAC requirement (subject to a 6 month grace period).

It is proposed that Article 141 CRD is amended to provide that, where an institution fails to meet its CBR in full but nonetheless makes discretionary payments (in amounts not exceeding the relevant institution's Maximum Distributable Amount), payments on AT1 securities should be prioritised over distributions on CET1 capital or discretionary employee bonus/pension payments.

The New CRD Directive does not take the opportunity to address any of the ambiguities in the methodology set out in the existing Article 141 CRD for calculating an institution's Maximum Distributable Amount or mandate the EBA to do so.

LEVERAGE RATIO

The New CRR Regulation contains a proposal that a binding 3% CET1 leverage ratio requirement is added to Article 92 of CRR (to complement the RWA-based requirements) and would be applicable (subject to limited exceptions) to all institutions subject to the CRD. The potential for the introduction of a leverage ratio buffer for G-SIIs at some point in the future is also noted in the New CRR Regulation.

AT1 TERMS AND CONDITIONS

Certain amendments to the requirements for AT1 securities are proposed in the New CRR Regulation. These include the following:

- New CRR Article 52.1(a) proposes that issues must be made directly by institutions (not through SPVs, for example). This requirement is subject to certain transitional provisions, pursuant to new Articles 83(1) and 494a CRR, until 31 December 2021;
- New CRR Article 52.1(p) proposes that, either by law or by contract, the instrument must be capable of being written down or converted to equity at the discretion of the resolution authority at the point of non-viability (under Article 59 BRRD);
- New CRR Article 52.1(q) complements 52.1(p) and proposes that AT1 securities governed by non-EEA laws must either contain contractual bail-in recognition language or otherwise exist in a legal regime which will give effect to a write-down or conversion under Article 59 BRRD; and
- New CRR Article 52.1(r) proposes that there should be no set-off arrangements or netting rights which might compromise loss-absorbency.

Save for Article 494a CRR in relation to SPV issues (see above), there are no transitional provisions.

Article 82 CRR currently provides for the recognition of qualifying own funds (AT1 and T2 securities) of consolidated subsidiaries which are subject to CRD/CRR. A proposed amendment to Article 82 CRR contains a number of textual anomalies but appears designed to extend this concept to subsidiaries which themselves are intermediate financial holding companies in a third (non-EEA) country but which are subject to a regime in that country judged equivalent by the European Commission.

T2 TERMS AND CONDITIONS

Certain amendments to the requirements for T2 securities are proposed in the New CRR Regulation. These include the following:

- New CRR Article 63(a) proposes, as with AT1 instruments above, that T2 instruments must be directly issued by institutions. Again, this requirement is subject to certain transitional provisions pursuant to new Articles 83(1) and 494a CRR, until 31 December 2021;

- New CRR Article 63(d) proposes that T2 claims must rank junior to those relating to "eligible liabilities instruments". As eligible liabilities instruments may themselves, in accordance with CRR Article 72b(d) (see "TLAC and MREL – Eligible Liabilities", below), rank junior to unsubordinated claims of the issuer, it would seem more appropriate for T2 liabilities to be permitted to rank either junior to, or *pari passu* with, all eligible liabilities instruments, provided they are junior to unsubordinated liabilities and deposits.
- New CRR Article 63(n) proposes that, either by law or by contract, the instrument must be capable of being written down or converted to equity at the discretion of the resolution authority at the point of non-viability (under Article 59 BRRD);
- New CRR Article 63(o) complements 63(n) and proposes that T2 securities governed by non-EEA laws must either contain contractual bail-in recognition language or otherwise exist in a legal regime which will give effect to a write-down or conversion under Article 59 BRRD; and
- New CRR Article 63(p) proposes that there should be no set-off arrangements or netting rights which might compromise loss-absorbency.

Save for Article 494a CRR in relation to SPV issues (see above), there are no transitional provisions.

TLAC AND MREL

Overview

A key part of the proposed new legislation seeks to make good on the European Commission's commitment to bring forward a proposal by the end of 2016 to implement the FSB'S TLAC standard for G-SIIs in the EU. To avoid creating a separate TLAC regime running in parallel with the existing MREL regime, the proposals instead seek to integrate the TLAC standard within the MREL regime, such that both requirements can be met with substantially similar instruments. The proposals do not extend the application of the TLAC standard to non-G-SIIs. Instead, proposed amendments in the New CRR Regulation will apply a harmonised minimum TLAC level (known as the "**minimum requirement**" or "**Pillar 1 MREL requirement**" in the legislation) to EU G-SIIs (of which there are currently 13), while proposed amendments in the New BRRD Directive will introduce a firm-specific add-on for G-SIIs and a modified firm-specific MREL regime for non-G-SIIs (each known as the "**firm-specific requirement**" or "**Pillar 2 MREL requirement**" in the legislation).

As a result of the integration of the TLAC standard into the MREL regime, a number of important structural reforms to the existing MREL regime are proposed to be made. In particular, consistent with the approach adopted in the FSB's TLAC term-sheet and as a recognition of the existence of both single- and multiple-point of entry resolution strategies, the proposed New BRRD Directive introduces to the BRRD (in Article 2) the concept of "resolution entities" (an entity to be resolved) and "resolution groups" (resolution entities and their subsidiaries). Proposed amendments to BRRD Articles 12 and 13 would expressly require resolution authorities to identify the resolution entities and resolution groups within a financial group.

Further, it is proposed that the key provision relating to MREL in the BRRD, Article 45, is repealed and replaced with a series of new articles (Articles 45, 45a… 45l). In contrast to the existing Article 45 BRRD, it is proposed, in the new Article 45 BRRD, that both the (TLAC) minimum requirement and the firrm-specific requirement will be calibrated not as a function of total liabilities but rather, consistent with the TLAC term-sheet and the EBA's view in its July 2016 Interim Report on MREL, as a function of both total risk exposure amount and leverage ratio exposure amount.

Finally, the new Article 45b BRRD very substantially aligns the qualitative requirements for instruments eligible to meet the firm-specific requirement applicable to resolution entities with those eligible to meet the (TLAC) minimum requirement.

(TLAC) minimum requirement for G-SIIs – the basic requirement

The New CRR Regulation proposes a new Article 92a CRR to apply the TLAC Standard to EU G-SIIs by introducing a minimum harmonised requirement for own funds and eligible liabilities on the basis of both:

- an RWA-based ratio of, ultimately, 18%; and
- a total leverage-based ratio of, ultimately, 6.75%

These ratios correspond to the fully-implemented minimum ratios in the FSB's TLAC term-sheet. On a transitional basis (see new Article 494 CRR), the respective ratios are 16% and 6% from 1 January 2019 to 31 December 2021. Firm-specific add-ons of TLAC are then covered in amendments to the BRRD (See "*Firm-specific requirements for non-G-SIIs and G-Siis*", below).

Standalone EU G-SIIs should comply with the requirements on a solo basis and resolution entities which are part of a group designated as an EU G-SII should comply with them on a consolidated basis.

New Article 92a CRR would also introduce conformance periods for new or recapitalised G-SIIs comparable to those in the FSB's TLAC term-sheet.

Article 92b CRR would require those institutions which are not themselves resolution entities but which are material subsidiaries of a non-EU G-SII to satisfy an internal MREL requirement equal to 90% of the Article 92a CRR requirement.

(TLAC) minimum requirement for G-SIIs – eligible liabilities

The New CRR Regulation introduces new Articles 72a to 72l in the CRR which define those eligible liabilities items which, taken together with own funds, may satisfy the minimum requirement applicable to G-SIIs.

An institution's "eligible liabilities items" should not include "excluded liabilities". The definition of "excluded liability" in the New CRR Regulation overlaps with the existing definition of "excluded liability" in BRRD but also includes certain deposits (short-term deposits less than one year and certain retail/SME deposits) and liabilities arising from derivatives or debt instruments with embedded derivatives.

New Article 72b(2) CRR sets out what can qualify as an eligible liabilities instrument. The definition is more restrictive than the existing definition of eligible liabilities in Article 45 BRRD in a number of important respects, including:

- the liability must be directly-issued;
- the liability must be subordinated (see further below) to all excluded liabilities;
- there must be no set-off arrangement or netting rights;
- no issuer calls with any form of incentive to redeem are permitted;
- early redemption requires supervisory approval as contemplated in Articles 77 and 78 CRR. See, further, "*Permissions for reducing own funds eligible liabilities*", below;
- interest payments should not correlate with movements in the credit-standing of the issuer;
- there should be no early repayment or acceleration rights for holders other than in the liquidation of the issuer. This precludes instruments with events of default giving rise to a right to accelerate – even for non-performance of any of the obligations under the relevant liability – from counting; and
- "the contractual provisions governing the liabilities" require their conversion or write down upon bail-in under Article 48 BRRD.

The final two requirements above are particularly noteworthy. First, many bank notes will contain some events of default (e.g. non-payment of sums due under the notes) which would give holders a right to accelerate principal. Secondly, given the statutory powers to bail in liabilities in resolution which exist pursuant to Article 43 BRRD, it is not clear why the "contractual provisions governing the liabilities" need expressly to provide for this, at least in the case of liabilities governed by the laws of an EEA member state. Few such liabilities will currently contain such a clause. Among others, the tax and listing impacts of including such a clause should be considered before adding it.

Consistent with the FSB's TLAC term-sheet, the requirement for eligible liabilities instruments to be subordinated which is referred to above can be satisfied by appropriate contractual or statutory provisions. Although the text in the final version of the proposal contains some anomalies, the requirement can, alternatively, be satisfied by issuing through a resolution entity which "does not have on its balance sheets any excluded liabilities" that rank *pari passu* or junior to eligible liabilities instruments – i.e. structural subordination. Even a very "clean" holding company is likely to have some excluded liabilities on its balance sheet but new Article 72b(4) CRR goes on to note that the requirement for subordination does not need to be satisfied by an institution where, among other things:

- the amount of *pari passu* or junior ranking excluded liabilities on its balance sheets is, consistent with the TLAC term sheet, less than 5% of its own funds and eligible liabilities;
- the inclusion of such liabilities in eligible liabilities items does not have a material adverse impact on the resolvability of an institution; and
- the institution does not rely on the exception described in the next paragraph.

For a discussion of a proposed new asset class of statutorily-subordinated instrument, see "*New "Non-Preferred" Senior Debt*" below.

In addition to those instruments described above, other liabilities which satisfy all the requirements to be an eligible liability instrument, save for the subordination requirement, may nonetheless be treated as eligible liability instruments up to 3.5% of the institution's RWAs, provided such inclusion does not have a material adverse impact on the resolvability of the institution. Some national regulators may be expected to eschew this flexibility.

New Article 72c CRR stipulates that eligible liabilities instruments must have a residual maturity of at least one year otherwise they fully cease to count. For these purposes, any bondholder put date shall be treated as if it were the maturity date. Liabilities issued through special purpose entities may not count with effect from 1 January 2022.

New Articles 72e to 72j CRR set out various deductions from eligible liabilities items which must be made for, *inter alia*, direct, indirect or synthetic holdings of liabilities issued by the institution itself and certain other G-SII entities. These deductions are designed to reduce systemic risk by disincentivising cross-holdings.

Firm-specific requirements for non-G-SIIs and G-SIIs

New Article 45c BRRD stipulates the firm-specific requirement for all institutions; the general approach being an amount sufficient both to absorb the expected losses in resolution and, where liquidation is not the chosen resolution strategy, to recapitalise the institution (or the surviving part thereof) post-resolution in a manner consistent with the chosen resolution strategy. Subject to the resolution authority's discretion to adjust the recapitalisation amount to reflect adequately the relevant institution's risk profile, the firm-specific requirement for resolution entities should not exceed the greater of:

- (in respect of the loss absorption element) the institution's consolidated Pillar 1 risk-weighted capital requirements and P2R plus (in respect of the recapitalisation element) the surviving group's Pillar 1 Total capital ratio requirements and P2R; and
- (in respect of the loss absorption element) the institution's consolidated leverage ratio requirement plus (in respect of the recapitalisation element) the surviving group's consolidated Pillar 1 leverage ratio requirements.

Similar requirements are set-out in relation to entities which are not themselves resolution entities.

Where a resolution entity and a subsidiary within its resolution group are established in the same EU member state, there is provision for resolution authorities to waive the application of the firm-specific requirement in whole or in part to that subsidiary subject to certain safeguards being met.

New Article 45d BRRD provides, in the case of EU G-SIIs, for a firm-specific add-on to the (TLAC) minimum requirement in Article 92a of the New CRR Regulation (see "*(TLAC) minimum requirement for G-SIIs – the basic requirement*", above) but only where the minimum is not sufficient to absorb losses and recapitalise the G-SII in accordance with its chosen resolution strategy. The add-on can be satisfied with liabilities of the issuer of the type described in Article 45b BRRD (see "*Firm-specific requirements - eligible liabilities*", below).

Firm-specific requirements – eligible liabilities

Finally, the new Article 45b BRRD very substantially aligns the qualitative requirements for instruments eligible to meet the firm-specific requirement applicable to resolution entities with those eligible to meet the (TLAC) minimum requirement.

Two principal distinctions however remain:

- structured notes which have a fixed principal amount repayable at maturity may, to the extent of such fixed component but not any additional variable return, count as liabilities for resolution entities to meet the firm-specific requirement. They do not count towards the (TLAC) minimum requirement.
- whereas the (TLAC) minimum requirement *must* be met (largely) by subordinated debt instruments (see "*(TLAC)*

minimum requirement for G-SIIs – eligible liabilities", above), new Article 45b BRRD, although not that clearly drafted, seems to imply eligible liabilities for resolution entities to meet the firm-specific requirement *may* be required to be subordinated to the extent necessary to uphold the principle of "no creditor worse off" than in liquidation. Again, however, some national regulators may be expected to eschew this flexibility.

Firm-specific guidance

New Article 45e BRRD introduces a concept of 'guidance' on top of the applicable firm-specific requirements. Failure to comply with such guidance would not give rise to the same consequences (including MDA restrictions) as would a breach of the applicable firm-specific requirements. Guidance could be deployed where resolution authorities consider the required loss-absorption and/or recapitalisation elements to be insufficient. The guidance level should, typically, not exceed P2G (in the case of the loss absorption element) or the CBR (in the case of the recapitalisation element). Consistent failure to meet the guidance could result in an increase in the firm-specific requirement.

Internal down-streaming

New Article 45g BRRD contains a requirement, which may be applied by resolution authorities to entities which are not themselves resolution entities, to maintain eligible liabilities on a solo basis. This requirement may be met with either eligible own funds which are issued to entities other than the resolution entity (subject to certain restrictions) and certain other instruments which are issued to the resolution entity but which otherwise satisfy all the requirements for "eligible liabilities instruments" in Article 72b(2) in the New CRR Regulation (see "*(TLAC) minimum requirement for G-SIIs – eligible liabilities*", above). Further, such instruments must be subject to the statutory power of write-down or conversion in Articles 59 to 62 of BRRD (see "*Statutory write-down and conversion*", below) in a way which does not affect the resolution entity's control over the subsidiary contrary to the resolution strategy for the group. Finally, there is a requirement in new Article 45g (3) (a) (iii) BRRD, for such instruments to rank junior to all liabilities of the subsidiary except those own funds instruments issued by it to third-parties.

Reporting and Disclosure

New Article 45i BRRD mandates the EBA to produce draft implementing technical standards and templates for the periodic public reporting by relevant entities of the level, composition, maturity profile and ranking of the liabilities available to meet their applicable requirements.

Further, in the case of G-SIIs subject to the (TLAC) minimum requirement, Article 437A in the New CRR Regulation prescribes similar public disclosures in relation to both their eligible liabilities and their own funds.

This is also an area which remains under consideration at a Basel level.

Consequences of breaching MREL

In order to ensure compliance with MREL requirements (as opposed to firm-specific *guidance*), the proposal requires that if a bank does not have a sufficient amount of eligible liabilities to comply with its MREL, the resultant shortfall is automatically filled up with CET1 which, until that point, counted towards meeting the CBR. This , therefore, may lead to a breach of the CBR, triggering restrictions on discretionary payments to the holders of regulatory capital instruments and employees. Other potential consequences are set out in new Article 45k BRRD.

Breaches of the CBR (while still complying with Pillar 1 and Pillar 2 capital requirements) may be due to a temporary inability to issue new eligible debt for MREL. For these situations, the proposal envisages a six month grace period before restrictions to discretionary payments apply. During the grace period, authorities will be able to exercise other powers available to them that are appropriate in view of the financial situation in a bank.

NEW "NON-PREFERRED" SENIOR DEBT

The Art.108 BRRD Directive proposes some very specific amendments to the existing Article 108 BRRD to facilitate the issue of a new asset class of so-called non-preferred senior debt. The proposals are similar to those recently legislated for in France. Such debt would be bail-inable during resolution only after capital instruments but before other senior liabilities. As such, it is designed to meet (by statute) the requirement in the TLAC term sheet for "subordination" and also to be eligible to count as MREL.

The Art.108 BRRD Directive requires member states to provide for ordinary unsecured senior claims to rank in liquidation (and therefore also in resolution in a way which does not offend the no creditor worse off principle) ahead of those under debt instruments which:

- have an initial maturity of [at least] one year;
- are issued after the implementation of the Art.108 BRRD Directive i.e. no retroactive effect on existing seinor liabilities);
- have no derivative features; and
- are documented in a way which explicitly refers to their statutory ranking.

Before issuing any such instruments for the first time, institutions will have to consider whether the creation of such a layer of debt is compatible with the terms of their existing capital instruments. Some older-generation Tier 2 obligations, for example, contractually rank as the most senior form of subordinated obligation.

The creation of this new form of asset class would not be the only way in which the "subordination" requirement for TLAC and (to the extent required by regulators) MREL can be met. It remains open for the requirement to be met by either structural or contractual subordination (see "*(TLAC) minimum* *requirement for G-SIIs – eligible liabilities*") and, in response to questions on the topic on 22 November 2016, the Executive Director, Resolution at the Bank of England reiterated the advantages of holding companies and structural subordination over the other forms of subordination, including this proposed new asset class.

STATUTORY WRITE-DOWN AND CONVERSION

Proposed new Articles 59 and 60 BRRD would extend the existing pre-resolution statutory powers to write down or convert into equity liabilities at the point of non-viability from just relevant capital instruments (AT1 and T2) to instruments issued to resolution entities by other entities which are not themselves resolution entities in order to meet their solo firm-specific requirements as described above at "TLAC and MREL – Internal down-streaming".

PERMISSIONS FOR REDUCING OWN FUNDS AND ELIGIBLE LIABILITIES

Articles 77 and 78 CRR (relating to the conditions which must be satisfied, and the permissions obtained, in order for an institution to redeem or purchase its capital instruments early), have been amongst the most scrutinised provisions in the existing CRR.

It is proposed, in the New CRR Regulation, that certain provisions of both Articles be extended to cover not just own funds but also certain eligible liabilities instruments. As such, supervisory permission (from the competent authority after consultation with the resolution authority) will be needed for any redemption or repurchase of eligible liabilities instruments prior to the date of their contractual maturity. Such permission shall be granted (as is the case now for own funds) where either eligible liabilities instruments of equal or higher quality are being issued by the relevant institution or such institution is able to demonstrate its eligible liabilities exceed the applicable requirements by a margin which is considered necessary by the competent authority.

To have to seek permission each time for the early retirement of own funds and eligible liabilities can be a disproportionately burdensome requirement and it is proposed, in new Article 78(1) CRR, that the resolution authority and the competent authority in consultation with each other may grant a "general prior permission" to an institution where it, among other things, provides sufficient safeguards as to its capacity to operate above the applicable requirements for own funds and (presumably) eligible liabilities. The text in this part of the proposal is somewhat unclear as to which authority takes the lead in granting general prior permissions, among other things. Such general prior permissions would be capped and extend for no more than one year, subject to renewal. The pre-determined capped amounts should not exceed:

- in the case of CET1, 3% (with a further cap of 10% of the CET1 which is in excess, by a margin satisfactory to the competent authority, of all applicable CET1 requirements); and

- in the case of AT1, and T2, 10% of the relevant issue (with a further cap of 3% of the total outstanding amount of AT1 or, as appropriate, T2 capital).

The existing restrictions in Article 78(4) CRR on redeeming AT1 or T2 securities during the five years following their date of issue have been retained. The drafting of Article 78(4) CRR has also been broadened expressly to cover not just early redemptions but also those circumstances where the institution wishes to “call”, “repay” or “repurchase”. This addresses any uncertainty which currently exists in the scope of the original text and would mean, for example, that tender offers or exchange offers within the first five years of issue are covered by the restrictions. Significantly, however, the list of circumstances in which AT1 and T2 may be retired during the first five years has been extended (from just tax and regulatory issues) to include:

- (by way of update to EBA Q&A 2013_290) AT1 or T2 securities which are grandfathered under Article 484 CRR (but not Article 483 – state aid instruments);
- AT1 or T2 securities repurchased for market-making purposes; and
- the situation where “earlier than, or at the same time as, the action referred to in Article 77, the institution replaces the instruments referred to in Article 77 with own funds [or eligible liabilities instruments] (sic) of equal or higher quality at terms that are sustainable for the income capacity of the institution and the competent authority has permitted this action based on the determination that this action would be beneficial from a prudential point of view and justified by exceptional circumstances”.

The reference to "eligible liabilities instruments" in this context appears to be erroneous. It is not clear, but the drafting of the third bullet above also seems to leave open at least the possibility that accumulated retained earnings, being own funds, may be a satisfactory form of replacement capital.

Under the proposals, the EBA will be mandated to develop regulatory technical standards to clarify the meaning of both “market-making” and “exceptional circumstances” in the context of Article 78(4) CRR.

CONTRACTUAL RECOGNITION OF BAIL-IN

The existing requirements in Article 55 BRRD for the inclusion of contractual clauses which give effect to bail-in in liabilities governed by third country laws have, after much debate in the market, been acknowledged by the European Commission to be difficult to comply with in the case of many types of liability, often with limited added-value for bank resolvability.

Hence, in the New BRRD Directive, resolution authorities will be allowed to waive the requirement for such clauses if (subject to amplification following preparation of draft regulatory technical standards by the EBA) either (i) they determine this would not impede the resolvability of the relevant bank or (ii) it is legally, contractually or economically “impracticable” for banks to include the bail-in recognition clause for certain liabilities. In such cases, the relevant liability will not count towards MREL. New Article 55 BRRD goes on, notably, to provide that such liabilities should also rank senior to those liabilities which count towards the institution’s firm-specific eligible liabilities requirement. It is not clear how this last requirement is intended to apply in the context of, for example, a holding company whose senior liabilities, by reason of their structural subordination, are eligible to count towards the firm-specific requirement.

HOLDING COMPANIES / EU PARENT UNDERTAKING

The New CRD Directive proposes that a new Article 21a is added to CRD to require both financial holding companies and mixed financial holding companies to obtain direct authorisation from the competent authority in their home member state. There would be a specific new authorisation procedure and direct on-going supervision by the relevant competent authority. Holding companies would not be subject to solo prudential requirements but, rather, they would be directly required to meet consolidated prudential requirements. Holding companies must be set up so as not to impinge on the effective supervision of the relevant subsidiary institution(s).

In order to facilitate the implementation of TLAC for non-EU G-SIIs in EU law and to simplify and strengthen the resolution process of third-country groups with significant activities in the EU, the New CRD Directive proposes, in Article 21b CRD, a requirement for the establishment of intermediate EU parent undertakings where two or more institutions established in the EU have the same ultimate parent undertaking in a third country. The intermediate EU parent undertaking can be either a holding company, which is subject to the requirements of the CRR and the CRD, or an EU institution. The requirement will apply to third-country groups that are non-EU G-SIIs or that have entities in the EU with total assets of at least €30 billion. The implications of this for some non-EU headquartered banks have already been widely noted in market commentary.

Linklaters

Key Contacts

David Ballegeer
Partner, Brussels
Tel: +32 2 501 95 93
david.ballegeer@linklaters.com

Iñigo Berricano
Partner, Madrid
Tel: +34 91 399 60 10
inigio.berricano@linklaters.com

Patrik Björklund
Partner, Stockholm
Tel: +46 8665 4130
patrik.bjorklund@linklaters.com

Neil Dixon
Partner, London
Tel: +44 20 7456 3353
neil.dixon@linklaters.com

Jonathan Fried
Partner, Dubai
Tel: +971 4 369 5829
jonathan.fried@linklaters.com

Pim Horsten
Partner, Amsterdam
Tel: +31 20 799 6210
pim.horsten@linkaters.com

Richard Levy
Partner, London
Tel: +44 20 7456 5594
richard.levy@linklaters.com

Claudia Parzani
Partner, Milan
Tel: +39 02 88 393 5248
claudia.parzani@linklaters.com

Luis Roth
Partner, Paris
Tel: +33 1 56 43 58 42
luis.roth@linklaters.com

António Soares
Partner, Lisbon
Tel: +351 21 864 00 13
antonio.soares@linklaters.com

Peter Waltz
Partner, Frankfurt
Tel: +49 69 710 03 457
peter.waltz@linklaters.com

Carson Welsh
Partner, London
Tel: +44 20 7456 4602
carson.welsh@linklaters.com

Linklaters LLP
One Silk Street
London EC2Y 8HQ

Telephone (+44) 20 7456 2000
Facsimile (+44) 20 7456 2222

Linklaters.com