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THE FUTURE OF BANK FINANCE – NEW EU RULES FOR LOSS ABSORBENCY, SUBORDINATION AND HOLDING COMPANIES

– THOUGHT LEADERSHIP

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In November 2016, the European Commission published its proposals for a wide-ranging package of new EU legislation amending the Capital Requirements Directive (CRD), the Capital Requirements Regulation (CRR) and the Bank Recovery and Resolution Directive (BRRD). Here, Clifford Chance experts discuss the proposals on loss absorbency, subordination and holding companies and how they are likely to affect EU and non-EU banks and their EU structures.

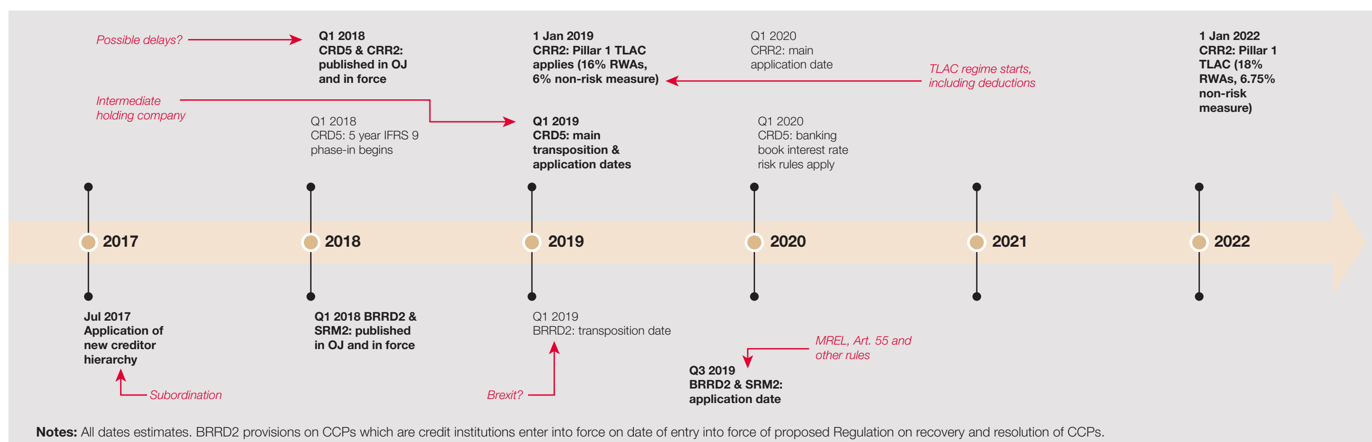
The new EU rules on loss absorbency, subordination and holding companies proposed by the European Commission represent an important change to the EU framework regulating banks and investment firms and form part of wider set of changes proposed by the five separate but interrelated pieces of legislation in the Commission's proposed package (three directives and two regulations). The European Parliament and the Council are already beginning their process of reviewing the package which aims to:

- Implement the Financial Stability Board (FSB) term sheet for total loss absorbing capacity (TLAC) for globally systemically important banks (G-SIBs), including internal TLAC requirements for material EU subsidiaries, and deduction requirements for G-SIBs' holdings of other G-SIBs' TLAC eligible debt;
- Change the existing EU minimum requirement for own funds and eligible liabilities (MREL), so that it operates as an overlay to the loss absorbency requirements for G-SIBs, as well as providing a loss absorbency framework for other EU institutions more aligned with the TLAC framework;
- Alter the creditor hierarchy in bank insolvency to facilitate the creation of a new class of 'non-preferred senior' debt, which will be eligible to meet the TLAC and MREL requirements;
- Require non-EU G-SIBs, and certain other non-EU groups, to organise their EU bank and investment firm subsidiaries under a single EU intermediate parent undertaking, as well as imposing direct authorisation requirements on EU financial holding companies and mixed financial holding companies; and
- Amend other resolution-related requirements of EU law, including Article 55 of the BRRD, to allow banks some added flexibility not to include clauses recognising the bail-in powers of EU resolution authorities in contracts governed by the laws of a non-EEA state.

Chris Bates, head of Clifford Chance's financial regulatory practice in London, says: "We have a group of measures around loss absorbency and resolution, with no fewer than three pieces of legislation solely focused on resolution issues. However, when it comes to the timetable, the proposal that the stand-alone directive altering the creditor hierarchy gets implemented first, by July 2017, seems to be hopelessly ambitious."

An overview of the proposals

The key to the proposed changes is the EU implementation of the FSB TLAC term sheet, which envisages that all G-SIBs should maintain minimum levels of debt and equity that can be used to absorb losses and to facilitate recapitalisation in resolution. The EU already has the MREL regime in place, which applies to all EU banks, investment firms subject to the BRRD and their parent undertakings. Simon Gleeson, Clifford Chance financial regulatory partner, says: "The Commission has looked and decided it wants both regimes; so it is broadly writing the FSB TLAC term sheet into EU law to apply to G-SIBs only, while still retaining the MREL regime for both G-SIBs and other institutions."



Notes: All dates estimates. BRRD2 provisions on CCPs which are credit institutions enter into force on date of entry into force of proposed Regulation on recovery and resolution of CCPs.

This means that the two rule sets will overlap, in that G-SIBs that are also EU institutions will also be subject to MREL. Further, TLAC will be imposed as a form of requirement under the CRR, and policed by the prudential regulator, while MREL is imposed as a resolution measure under the BRRD, policed by the resolution authorities. The required level of TLAC will be set in the CRR, while resolution authorities will set MREL for individual institutions according to the resolution strategy for the individual institution and the rules in the BRRD. However, the new legislation will more closely align the MREL regime with the FSB TLAC term sheet. For example, it will require resolution authorities to set MREL as a percentage of risk weighted assets rather than as a percentage of the institution's total liabilities and own funds.

The TLAC and MREL regimes will impose requirements for internal, as well as external, loss-absorbing capacity. The resolution strategy will dictate which entities will be regarded as resolution entities to which resolution tools will be applied in the event of the group's failure. Resolution entities will have to maintain external loss absorbing capacity under both regimes.

The MREL regime will also require all EU subsidiary institutions that are not resolution entities to maintain internal loss absorbing capacity in the form of subordinated instruments held by the resolution entity and certain own fund instruments. In addition, the TLAC regime will require material subsidiaries of non-EU G-SIBs that are not resolution entities to satisfy a requirement for loss absorbing capacity of at least 90% of the requirement that would have applied to the subsidiary if it were an EU G-SIB. Material subsidiaries are those with more than 5% of the group risk weighted assets or operating income or whose total leverage exposure measure is more than 5% of the group as a whole.

The new TLAC and MREL eligibility requirements

For TLAC and MREL resources to fulfil their intended purpose, it is critical from a regulatory perspective that it is straightforward to apply stabilisation powers to them. That means they must have an easily ascertainable value and can be used to absorb losses in resolution without triggering claims that this leaves the holders worse off than they would have been in liquidation.

Loss absorbency requirements can be met with Common Equity Tier 1, Additional Tier 1 and Tier 2 and a newly defined class of eligible liabilities instruments. Proposed new Article 72b of the CRR sets out the eligibility requirements under the TLAC regime which are based on – but are somewhat more restrictive than – the requirements in the FSB TLAC term sheet. The MREL eligibility requirements are set out in a new Article 45b of the BRRD, based on Article 72b CRR but with some differences.

In particular, the proposed EU TLAC rules impose a strict requirement that eligible liabilities instruments are subordinated to senior liabilities, albeit with some flexibility for limited volumes of direct issues of senior debt and of issues of senior debt by 'clean holding companies' where this does not affect the institution's resolvability. In contrast, the MREL regime

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—**MARC BENZLER, Partner,**
Frankfurt

will not impose a general subordination requirement, although the resolution authority can impose this requirement in particular cases.

When it comes to what is excluded from eligible liabilities, Simon Sinclair, head of capital markets at Clifford Chance in London, says: "Derivatives have proved to be a thorny issue. The proposed TLAC regime – like that in the US – excludes liabilities from derivatives and debt instruments with embedded derivatives, but the amendments to the BRRD would allow liabilities arising from debt instruments with derivative features to count towards an institution's MREL, if a given amount of liability is known in advance, is fixed and is not affected by a derivative feature."

There are also a few key differences between the proposed EU eligibility requirements and the TLAC term sheet. Unlike the TLAC term sheet, new Article 72b CRR would exclude instruments where the holders have rights to accelerate future payments of interest or principal other than in the case of the insolvency or liquidation of the resolution entity. Furthermore, Article 72b requires eligible liabilities instruments to include a contractual provision recognising the powers of the resolution authority to write-down and convert the debt into equity, even if the debt instrument is governed by the law of an EU Member State. Unless grandfathering provisions are added in the course of the legislative process, these requirements would disqualify many existing instruments issued by banks in anticipation of the new rules.

Subordination and changes to creditor hierarchy

The proposed amendments to Article 108 of BRRD would alter the creditor hierarchy for both banks and other entities subject to the EU resolution regime. They require Member States to introduce a new category of non preferred senior debt which will meet the subordination eligibility criterion for TLAC and (where relevant) MREL by ranking behind other senior liabilities (and ahead of contractually subordinated debt) in ordinary insolvency proceedings. The new class of debt must have an initial contractual maturity of one year, have no derivative features and include a contractual provision specifically referring to its ranking under the new provisions.

Some Member States already have legislation which creates a class of senior non-preferred debt instruments. But the solutions under national laws vary, according to Marc Benzler, a regulatory partner with Clifford Chance in Frankfurt, who says: "There is a need for harmonisation at European level. The French solution – like the EU proposal - requires the relevant issuer explicitly to trigger non-preferred status by a corresponding reference in the terms of the relevant instrument, while the German solution is quite different, because all senior unsecured debt instruments (including previous outstanding issues) automatically rank as non preferred if they do not have derivative features - there is no option to opt out of this status."

The Commission proposes that the new creditor hierarchy would apply from July 2017. Outstanding liabilities issued before the date of application would continue to be governed by the laws of the relevant Member State on 31 December 2016. The proposal seems to envisage that the new designated non-preferred debt instruments would rank pari passu with those debt instruments which rank as non-preferred under existing national regimes. So the two forms of subordination may co-exist for a period until legacy debt is repaid or redeemed.

Holding company regulation

The proposed new Article 21a of CRD would introduce a new requirement for EU financial holding companies of banks and investment firms subject to CRR to be directly authorised by the consolidating supervisor of the group. A similar requirement would apply to mixed financial holding companies of groups that are regarded as 'financial conglomerates'.

In addition, the proposed new Article 21b of CRD would introduce a requirement for significant non-EU groups to hold their EU banks and investment firms under a single EU intermediate parent undertaking

(IPU) authorised as a bank or as a holding company under new Article 21a. A non-EU group would be required to establish an EU IPU if:

- it has two or more EU subsidiaries that are authorised as banks and/or investment firms subject to CRR;
- Those subsidiaries do not already have a qualifying common EU parent undertaking; and
- Either the group is a G-SIB or the total value of its branch and non-branch assets in the EU is at least €30bn.

The Commission's stated rationale for the requirement is to facilitate the implementation of internationally-agreed standards on internal loss-absorbing capacity for non EU G-SIBs and to simplify and strengthen the resolution process of third country groups in the EU. However, many commentators see this as a response to the recent US rules requiring foreign banks to set up intermediate holding companies for their US operations, which had been strongly criticised by the Commission.

One key issue is the timing challenge presented by the UK exit from the EU. If the legislative package is adopted and comes into force in early 2018, the IPU requirements would apply one year later, which is about the time that the UK is expected to exit the EU. It would present challenges for some non-EU groups if prior implementation of the new rules meant that they had to include their UK and EU27 banks and investment firms under a single IPU even if only for a short period.

In addition, the requirement for a single EU IPU will cut across the organisational structure of a number of non-EU groups organised in functionally separated 'pillars' because of their home state regulatory regime. In particular, some US, Japanese and - after implementation of the Vickers reforms and the UK exit from the EU - UK bank groups would wish to hold their EU subsidiaries in separate holding chains to reflect home state constraints on their group structure. For example, if US banks hold an EU investment firm subsidiary as a direct or indirect subsidiary of their main US banking entity, US rules will restrict the extent to which the investment firm can engage in equities and other business, but if they do not hold an EU banking subsidiary as a direct or indirect subsidiary of their main US banking entity that will restrict its access to funding from the US bank to support its lending activity.

Caroline Meinertz, a London banking partner, says: "There is work under way to seek to persuade the EU legislators to accept that, rather than just requiring one IPU, it might be acceptable to allow two. That would not overcome all the practical challenges in establishing an IPU structure, but it would mitigate some of the structural issues driven by non-EU bank regulation."

Internal TLAC and MREL

TThe TLAC term sheet recognises that even though resolution tools are to be applied at the level of the resolution entity or entities in the group, the resolution authorities of material sub-groups in other countries have a legitimate interest in the pre-positioning of internal loss absorbing capacity at the level of the sub-group which is available to be written down or converted into equity to recapitalise local subsidiaries. The term sheet envisages that material sub-groups should meet an internal TLAC requirement of at least 75% to 90% of the external TLAC requirement that would apply if the sub-group were headed by a resolution entity.

The EU reforms implement the TLAC standard and seek to avoid duplication by aligning MREL with the TLAC standards.

—**FRÉDÉRICK LACROIX,**
Partner,
Paris

Frédérick Lacroix, head of Clifford Chance's financial services and asset management practice in Paris, says: "The EU reforms implement the TLAC standard and seek to avoid duplication by aligning MREL with the TLAC standards. The package also provides for a clearer articulation, completely absent in the original BRRD text, of the level at which the principal requirements should apply, by introducing the concept of resolution entities as well as requiring material subsidiaries of non-EU G-SIBs to

One of the challenges is going to be how to determine what is eligible TLAC from other institutions in practice.

—**ANDREW COATS,**
Partner,
London

maintain a minimum level of internal loss absorbing capacity in line with the FSB standard."

But differences remain. In particular, the amended BRRD would require all EU subsidiary credit institutions or investment firms of a resolution entity to meet an internal MREL standard as if they were resolution entities, even if they are incorporated and authorised in the same Member State as the resolution entity and regardless of their materiality to the group. These subsidiaries must maintain loss absorbing capacity equal to 100% of the requirement applicable to resolution entities, without any discount to provide flexibility as to the distribution of loss-absorbing capacity within the group, even in the case of material subsidiaries of non-EU G-SIBs that are also subject to EU minimum TLAC requirements set at 90% of the TLAC requirement for EU G-SIBs.

The proposed eligibility criteria for debt instruments for internal TLAC and MREL are the same as for external TLAC and MREL under the CRR and BRRD. However, the proposed rules envisage that internal resources issued by a subsidiary institution to meet the internal MREL standard will be held directly by the relevant resolution entity, even though the FSB has acknowledged that there may be advantages in routing the holding of loss-absorbing instruments through a corporate holding chain to avoid changes of intermediate control on the exercise of resolution powers. The proposed rules would also always require full subordination of instruments issued to meet the internal MREL standard and would give EU resolution authorities powers to write down and convert those instruments into equity - without placing the institution in resolution - similar to their existing powers in relation to Additional Tier 1 and Tier 2 instruments.

The proposals envisage that a subsidiary institution can meet its internal MREL – but not its internal TLAC requirement under the CRR – by holding a guarantee in a corresponding amount from its parent resolution entity, supported by eligible collateral for at least 50% of the guaranteed amount. The proposals also allow resolution authorities to waive the internal MREL of a subsidiary where the subsidiary and the resolution entity are in the same Member State and the relevant competent authority has waived the subsidiary's requirement to comply with solo capital requirements under the CRR.

Deduction rules

There is a policy objective of reducing the risk of contagion in the financial sector by discouraging banks from holding capital instruments issued by other banks. Under Basel III and CRD such holdings are deducted from the corresponding tier of an institution's regulatory capital, subject to certain thresholds.

The FSB TLAC term sheet envisaged that G-SIBs should deduct from their own TLAC or regulatory capital any exposure to other G-SIBs' TLAC in a manner to be specified by the Basel Committee. In October 2016 (just before the Commission published its legislative proposals), the Basel Committee published its final standard on TLAC holdings. This would require all internationally-active banks, not just G-SIBs, to deduct TLAC holdings from their own Tier 2 capital from 1 January 2019. The aim was to develop a single treatment that can be applied consistently by G-SIBs and non-G-SIBs.

Deduction is subject to a threshold where the holdings do not exceed 10% of the investing bank's common equity, as long as the investing bank does not own more than 10% of the issuer's common shares. To encourage deep and liquid secondary markets, there is an additional threshold allowing the holding of non-regulatory capital TLAC up to 5% of the investing bank's common equity (G-SIBs can only use this for trading book holdings and must sell the holdings within 30 days of acquisition). Reciprocal cross-holdings of TLAC are to be deducted in full.

TLAC holdings are defined by Basel as instruments that are recognised by the issuing G-SIB as TLAC, as well as all instruments that rank *pari passu* with subordinated forms of TLAC.

The EU's proposed deduction rules take a different approach. They only apply to EU G-SIBs and require deduction of holdings of other G-SIBs' TLAC at the same level of the capital structure, so that holdings of other G-SIBs' TLAC are to be deducted from the investing bank's own TLAC issuances. The rules would require deduction of instruments which qualify as eligible liabilities instruments under EU rules (and instruments ranking *pari passu* with subordinated eligible liability instruments), subject to thresholds similar to those envisaged by the Basel Committee's final standard

Andrew Coats, London finance partner, says: "If these proposals go through as drafted, there's not going to be a uniform approach internationally, which is not ideal. And one of the challenges is going to be how to determine what is eligible TLAC from other institutions in practice."

Amendments to Article 55 BRRD

Article 55 BRRD requires EU institutions subject to the BRRD to include in their contracts governed by a non-EEA law a contractual term under which the counterparty recognises the bail-in powers of EU resolution authorities in relation to liabilities arising under the contract. These requirements apply to an extremely broad range of contracts and there are currently few specific exclusions on which institutions can rely to disapply the requirements. This has given rise to significant implementation challenges given the volume of contracts potentially affected.

The legislative package seeks to address these concerns by allowing the resolution authority to waive this requirement for contracts where 'it is legally, contractually or economically impracticable to include such a contractual term', so long as the waiver does not impede the resolvability of the entity. Recital 18 of the draft Directive gives some guidance on how 'legally, contractually and economically' will be interpreted, and the UK Prudential Regulation Authority's Supervisory Statement SS7/16 also sets out a number of examples of where a firm might conclude the inclusion to be impracticable. However, the eventual scope of the exemption will specified by regulatory technical standards to be developed by the European Banking Authority.

The exemption will not be available for unsecured debt instruments, Additional Tier 1 or Tier 2 debt or any liability which ranks *pari passu* with or junior to liabilities counting towards the institution's MREL. Instruments the subject of a waiver cannot count towards the institution's MREL.

C L I F F O R D

C H A N C E

CONTACTS

Chris Bates
Partner
London
T: +44 20 7006 1041
E: chris.bates@cliffordchance.com

Marc Benzler
Partner
Frankfurt
T: +49 697199 3304
E: marc.benzler@cliffordchance.com

Andrew Coats
Partner
London
T: +44 20 7006 2574
E: andrew.coats@cliffordchance.com

Simon Gleeson
Partner
London
T: +44 20 7006 4979
E: simon.gleeson@cliffordchance.com

Frédérick Lacroix
Partner
Paris
T: +33 14405 5241
E: frederick.lacroix@cliffordchance.com

Caroline Meinertz
Partner
London
T: +44 20 7006 4253
E: caroline.meinertz@cliffordchance.com

Simon Sinclair
Partner
London
T: +44 20 7006 2977
E: simon.sinclair@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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