EU BANKING REFORM PACKAGE

New capital and loss-absorption requirements

Mariken van Loopik and Maurits ter Haar
On 23 November 2016, the European Commission published proposals for the completion of the banking regulation reform that was initiated after the financial crisis. The proposals, referred to as the “banking reform” or “CRR II” package, consist of an extensive set of amendments to the existing EU banking regulation rules.

The Commission’s proposals stem from the new international standards as finalised by the Basel Committee and the Financial Stability Board, and from a comprehensive review of existing EU banking regulation by the European Banking Authority (EBA) and the Commission. In this publication, we highlight the most important amendments to the capital requirements framework and the resolution framework applicable to banks in the EU.

The European Parliament and the Council of the EU have begun to deliberate on the proposals. Entry into force is expected in 2019 or later. Although the final form of the rules remains unknown, the capital requirements proposals will have a significant impact on banks, including on their risk modelling, funding structure and reporting systems. In some instances, the proposals may also require the raising of additional own funds or the reduction of exposures. The proposals introduce a larger degree of proportionality into the rules for smaller banks. For their part, the resolution proposals will also have a significant impact on banks, especially on their funding structure. In some cases, they may also require the raising of additional own funds or eligible liabilities. However, banks have already had several years to prepare for these changes.
Following the financial crisis, ambitious reforms to the regulatory framework for the EU banking sector were implemented. These reforms aimed to bring back and safeguard financial stability and market confidence. On 23 November 2016, the European Commission (Commission) published proposals to complete this reform agenda by implementing a number of outstanding elements (see the Annex for an overview of the proposals). These elements are the result of the finalisation of new international standards as set by the Basel Committee and Financial Stability Board, and of a comprehensive review of existing EU banking regulation by the European Banking Authority (EBA) and the Commission.

**AMENDMENTS TO THE CAPITAL REQUIREMENTS FRAMEWORK**

**New Pillar 1 capital requirements and liquidity standards**
- Binding minimum leverage ratio of 3%
- Binding minimum net stable funding ratio of 100%

**Revised risk-weighting and large exposures standards**
- Implementation of the Basel Committee’s revised market risk framework (the fundamental review of the trading book (FRTB))
- Implementation of the Basel Committee’s revised standards for interest rate risk in the banking book (IRRBB)
- Implementation of the Basel Committee’s standardised approach for counterparty credit risk (SA-CCR)
- Implementation of the Basel Committee’s standard on the treatment of exposures to central counterparties (CCPs)
- Implementation of the Basel Committee’s standard on the treatment of equity investments in funds
- Implementation of the Basel Committee’s revised large exposures regime

**More proportionate rules for smaller and non-complex banks**
- Changes to the frequency and substance of reporting and disclosure
- Exemption from the remuneration deferral rules and requirement for share-linked instruments for small banks and staff with low variable remuneration
- Exemptions from the scope of CRD IV for Dutch credit unions
- Enhancement of the exemption framework
- Investment firms: the amendments to CRR are applicable only to systemic investment firms (G-SIIs and O-SIIs)

**Intermediate holding**
- Requirement to establish an intermediate holding in the EU for non-EU banking groups with two or more banks in the EU that are non-EU G-SIBs or that have total assets in the EU of EUR 30 billion or more
Maximum distributable amount and capital guidance
- Clarification that the Pillar 2 buffer must be included in calculating the MDA
- Introduction of Pillar 2 capital guidance stacking above the MDA trigger point

Other changes to capital requirements framework
- Clarification and tightening of the criteria for applying the Pillar 2 buffer
- Introduction of cross-border group capital and liquidity waivers subject to parent guarantee
- Preferential treatment of AT1 coupon payments in order of distributions
- Five year phase-in implementation of IFRS 9
- Further expansion of SME supporting factor and introduction of preferential treatment of infrastructure exposures

AMENDMENTS TO THE RESOLUTION FRAMEWORK

Revisions to the MREL framework for G-SIBs
- Implementation of the Total Loss-absorbing Capacity (TLAC) standard by incorporating TLAC as a Pillar 1 MREL requirement for G-SIBs
- Changes to the method of calculation of Pillar 2 MREL
- Changes to the eligibility requirements
- Deduction of MREL holdings

Revisions to the MREL framework for non G-SIBs
- Changes to the method of calculating Pillar 2 MREL
- Changes to the eligibility requirements

Requirements applicable to both G-SIBs and non G-SIBs
- Introduction of MREL guidance
- More detailed requirements for internal MREL
- Clarification of the stacking order and consequences of a breach of MREL
- Introduction of reporting and disclosure requirements

Other changes to the bank resolution framework
- Introduction of a new optional “senior non-preferred” category of debt for MREL purposes
- Relaxing of the contractual recognition of bail-in requirement
- Introduction of moratorium tool for payment and delivery obligations
Capital requirements
What can our clients expect?
# CAPITAL REQUIREMENTS FRAMEWORK

## New Pillar 1 capital and liquidity standards

### Pillar 1 leverage ratio

The Commission’s proposals include the introduction of a binding (Pillar 1) leverage ratio (LR) of 3% of Tier 1 capital, which banks must meet in parallel with their risk-based capital requirements.

In its proposals, the Commission follows the design and calibration of the LR as announced by the Basel Committee in January 2016. However, since a 3% LR would constrain certain business models and lines of business, the Commission proposes several amendments to the LR exposure measure set by the Basel Committee. The LR exposure measure may be reduced for, among other items, public lending by public development banks, passing-through promotional loans to other banks, officially guaranteed export credits and initial margin received from clients for derivatives cleared through central counterparties.

Meanwhile, the Basel Committee continues to discuss further calibrations to the LR framework, including the introduction of additional requirements for global systemically important banks (G-SIBs). To that end, a consultation document was published in April 2016. A possible LR surcharge for G-SIBs will be considered in the EU following the conclusion of discussions at the Basel Committee. The Dutch Cabinet has long taken the position that systemically important Dutch banks should pursue an LR of at least 4%. The Dutch Cabinet has indicated that this remains the Dutch position in current discussions at both the Basel Committee and EU levels.

## Determination of capital requirements

<table>
<thead>
<tr>
<th>Current capital requirements</th>
<th>Proposed capital requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Combined buffer requirement</strong></td>
<td><strong>Capital guidance</strong></td>
</tr>
<tr>
<td><strong>Pillar 2 buffer</strong></td>
<td><strong>No quantitative maximum</strong></td>
</tr>
<tr>
<td><strong>Pillar 1 capital requirement</strong></td>
<td><strong>Combined buffer requirement</strong></td>
</tr>
<tr>
<td><strong>No quantitative maximum</strong></td>
<td><strong>2.5-10% of RWA</strong></td>
</tr>
<tr>
<td><strong>8% of risk-weighted assets (RWA)</strong></td>
<td><strong>No quantitative maximum but stricter criteria</strong></td>
</tr>
<tr>
<td><strong>8% of risk-weighted assets (RWA)</strong></td>
<td><strong>Pillar 1 capital requirement</strong></td>
</tr>
<tr>
<td><strong>3% of total exposure measure</strong></td>
<td><strong>G-SIB / O-SIB Leverage Ratio requirement</strong></td>
</tr>
<tr>
<td><strong>Possibly introduced at a later stage</strong> (Dutch government suggests 1%)</td>
<td><strong>Pillar 1 buffer</strong></td>
</tr>
</tbody>
</table>

6 | EU Banking Reform Package
Pillar 1 net stable funding ratio

The Commission’s proposals also introduce a binding net stable funding ratio (NSFR) to combat inappropriate funding structures observed during the crisis. The NSFR is aimed at harmonising how many stable, long-term sources of funding a bank requires to weather periods of market and funding stress over a one-year period. The NSFR is expressed as a percentage, and set at a minimum level of 100%, which indicates that a bank must hold sufficient stable funding to fully cover its funding needs during a one-year period under both normal and stressed conditions.

In its proposals, the Commission closely follows the final NSFR standard as published by the Basel Committee in October 2014. However, in line with the EBA’s report, the Commission proposes certain adjustments to prevent it impeding the proper functioning of EU capital markets and the financing of the European real economy. These adjustments entail the application of an adjusted haircut, for, inter alia, trade finance activities, centralised regulated savings, residential guaranteed loans, credit unions, high quality liquid assets (HQLA), pass-through models in general, and covered bonds issuance in particular.

Incorporation of revised risk-weighting and large exposures standards

Revised risk-weightings following adoption of Basel standards

The Commission’s current proposals implement a number of revised standards on risk-weighting as finalised by the Basel Committee since the adoption of CRD IV and CRR in 2013. The revised standards include:

- the revised market risk framework, also known as the “fundamental review of the trading book” (FRTB), published by the Basel Committee in January 2016. The new standard contains revised rules for the use of internal models to calculate own funds for market risk, as well as a new standardised approach. Moreover, banks must assign each of their trading book positions to one or more “trading desks”, to which various governance requirements apply. Further, the boundary between the trading book and banking book has been clarified to ensure a more proportionate risk-capture and to prevent regulatory arbitrage;

- the revised standards for interest rate risk in the banking book (IRRBB), finalised by the Basel Committee in April 2016. These standards introduce a common standardised approach that banks can, or may be required to, use to capture these risks;

- the standardised approach for counterparty credit risk (SA-CCR), finalised by the Basel Committee in March 2014 as a new standardised method of computing the exposure value of derivatives exposures, replacing the two existing standardised methods;
- the final standard on the treatment of exposures to central counterparties (CCPs), finalised by the Basel Committee in April 2014; and

- the standard on the treatment of equity investments in funds, which was adopted by the Basel Committee in December 2013.

Revised large exposures framework

The reform package proposes to revise the large exposures framework, following the Basel Committee’s final standard for the supervisory framework for measuring and controlling large exposures, published in April 2014, and in line with the EBA’s report on the review of the large exposures regime of October 2016. Changes include:

- an improvement of the quality of capital that must be taken into account to calculate the large exposures limit (Tier 1 capital instead of eligible capital);

- the introduction of a lower limit for G-SIBs’ exposures to other G-SIBs (15% instead of 25%);

- the obligation to use the standardised approach for counterparty credit risk (SA-CCR) for determining exposures to OTC derivative transactions, even for banks that have been authorised to use internal models;

- a mandate for the EBA to carry out further work on reviewing existing exemptions from the large exposure limits.

More proportionate rules for smaller and non-complex banks

Disclosures and reporting

The Commission proposes a more proportionate disclosure regime that takes into account the relative size and complexity of banks. Banks are classified into three categories: large, small and other.

Large banks are:
- G-SIBs;
- O-SIBs;
- the three largest banks in each Member State by total value of assets;
- banks with assets equal to or exceeding EUR 30 billion (on a consolidated basis);
- banks with assets equal to or exceeding EUR 5 billion, and a ratio of total assets, on average, equal to or larger than 20% relative to the GDP of the Member State where it is established.
Small banks are banks with assets equal to or less than EUR 1.5 billion. Other banks are banks that do not qualify as large or small.

The Commission further distinguishes between listed and non-listed banks. A sliding scale of disclosure requirements apply to each category, differentiating in disclosure substance and frequency. Similarly, small banks are required to submit regulatory capital reports (COREP) and financial reports (FINREP) annually instead of semi-annually or more frequently.

The proposals also mandate the EBA to further assess the financial impact of reporting requirements on banks, and include the obligation for the EBA to issue recommendations on how reporting for small banks can be simplified by amending existing reporting templates.

**Remuneration**

Another change in relation to proportionality pertains to remuneration. The amendments included in the Commission's current proposal consist of exemptions from the deferral rules for small and non-complex banks and staff receiving low variable remuneration, and from the requirement to pay out a substantial portion of variable remuneration in the form of instruments. In addition, like non-listed banks, listed banks are allowed to use share-linked instruments (instead of shares).

The amendments aim to address shortcomings in the application of the proportionality principle under the current remuneration rules. According to CRD IV, remuneration principles need to be applied in a manner and to the extent that is appropriate considering a bank’s size, internal organisation and the nature, scope and complexity of its activities. In recent years, however, it has become clear that this proportionality principle raises interpretation issues for banks, competent authorities, the EBA and the Commission. The wording of CRD IV does not in fact permit exemptions or waivers in relation to the remuneration principles, which was found to be the practice in many Member States. In December 2015, the EBA issued an opinion, followed by a more detailed report in November 2016, recommending a more harmonised approach and legislative amendments to CRD IV. In July 2016, the Commission published a report confirming that some of the rules may be too costly and burdensome to apply, compared to their prudential benefits.

**Exempted entities and procedure for further exemptions**

The Commission’s proposals add Dutch credit unions to the list of entities exempted from the scope of the EU banking rules. In doing so, the Commission delivers on a commitment made to the Netherlands regarding the introduction in the Netherlands of a specific regulatory regime for credit unions (Wet toezicht kredietunies).
The Commission also proposes to further fine-tune both the procedure and the criteria for granting further exemptions from the scope of CRD IV and CRR. Historically, public development banks and credit unions in certain Member States have been exempt from the CRD IV and CRR regulatory framework. To ensure a level playing field, the Commission’s proposals make it easier for other Member States to also have the possibility to allow such entities to operate only under national regulatory safeguards, in proportion to the risks involved. The Commission’s proposal provides for legal certainty by specifying clear criteria for additional exemptions for public development banks and credit unions and by replacing the Commission’s current implementing power with a better framed delegated power.

**Treatment of investment firms**

In the Commission’s proposal, a distinction is made between systemic and non-systemic investment firms. Systemic investment firms are subject to the amendments made to the CRR. Non-systemic investment firms, which means any investment firm that falls under the scope of the CRR but is not a G-SII or an O-SII, can continue to apply the version of CRR which existed before the amendments, pending the adoption of further proposals for a specific and more proportionate prudential framework for non-systemic investment firms by the end of 2017. In October 2016, EBA published an opinion on this issue, and in November 2016, it launched a consultation on a discussion paper on a new prudential regime for investment firms.

**Maximum distributable amount and capital guidance**

CRD IV contains restrictions on distributions, including the Maximum Distributable Amount (MDA). If the capital requirements are not complied with, dividend distributions, variable remuneration, discretionary pension benefits or coupon payments on AT1 instruments cannot take place. The Commission’s proposal also clarifies that the capital requirements will not be met if the Pillar 2 buffer is breached.

The Commission’s proposals also introduce a distinction between the Pillar 2 buffer and the Pillar 2 capital guidance, formalising what is already current practice for many supervisors, including the ECB. The Pillar 2 buffer continues to be treated as a mandatory part of capital requirements. In addition, however, the supervisor can communicate capital guidance to a bank, which would be stacked on top of the combined buffers. The Pillar 2 guidance acts as a softer “expectation”, which means that it is not in itself legally binding and that if there is a breach, formal restrictions, such as the MDA, would not be immediately triggered. The supervisor can, however, convert the guidance into an actual Pillar 2 buffer if a bank repeatedly fails to comply with it.
**Other changes to the capital requirements framework**

**Changes to Pillar 2 buffer**

In addition to the regular CRD IV and CRR capital and buffer requirements that a bank must meet, a bank-specific additional capital requirement, the Pillar 2 buffer, can be imposed to cover risks not sufficiently covered by the Pillar 1 capital requirements. The Pillar 2 buffer is imposed and reviewed annually by the supervisory authority on the basis of the supervisory review and evaluation process (SREP). The Commission’s proposals would introduce stricter criteria for the imposition of a Pillar 2 buffer. For example, its use should be strictly limited to micro-prudential considerations and not to address concerns of systemic risk, which should be left to the various macro-prudential tools.

**Requirement for intermediate EU parent undertakings, and authorisation requirement for financial holdings**

The Commission proposes to introduce a new requirement to establish an intermediate EU parent undertaking for groups of two or more banks established in the EU that have the same ultimate parent undertaking in a third country. This should facilitate the implementation of the Financial Stability Board’s minimum total loss-absorbing capacity (TLAC) in the EU and, more broadly, simplify and strengthen the resolution process of third-country groups with significant activities in the EU. The intermediate EU parent undertaking can be either a bank authorised in the EU or a holding company subject to the requirements of CRR and CRD IV. The requirement would apply only to third-country groups that are identified as non-EU G-SIBs or that have total assets in the EU of at least EUR 30 billion.
The Commission also proposes bringing financial holding companies and mixed financial holding companies directly within the scope of the EU prudential framework by introducing an authorisation requirement along with direct supervisory powers. Additionally, the Commission proposes making these companies responsible for ensuring compliance with requirements on a consolidated level. Financial holding companies are undertakings engaging in non-banking financial activities, whose subsidiaries are exclusively or mainly banks, investment firms or financial institutions.

Waivers from individual capital and liquidity requirements

Currently, CRR generally only allows the waiving of prudential requirements at an individual level for subsidiaries within the same Member State that are overseen on a consolidated basis by the same supervisory authority. Since the adoption of CRD IV and CRR, group supervision has been substantially reinforced as a result of the attribution of supervisory competences to the ECB within the Single Supervisory Mechanism (SSM). This is particularly true for group entities located in those Member States who participate in the SSM. For this reason, the Commission considers it appropriate to also propose allowing cross-border banking groups to benefit from such waivers, subject to certain safeguards. Most importantly, the waiver is subject to the parent guaranteeing to support the cross-border subsidiaries for the full amount of the waived requirement. This guarantee must be at least 50% collateralised.

Additional Tier 1 instruments and order of distributions

Following a period of turmoil on the market for Additional Tier 1 (AT1) instruments, the hybrid instruments also known as contingent convertible bonds (CoCos), the Commission is striving to make AT1 instruments more attractive for investors. The Commission’s current proposals therefore include a provision giving distributions on AT1 instruments preferential status over distributions in connection with CET1 instruments or obligations to pay variable remuneration, if such actions are restricted as a result of a bank’s failure to meet its capital buffers.

Phased-in implementation of IFRS 9

International Financial Reporting Standard (IFRS) 9 was issued as an important new accounting standard in July 2014 and governs the accounting for most assets and liabilities on banks’ balance sheets. It includes a change from an incurred credit loss approach (actual losses) to an expected credit loss approach (expected losses), which can have a significant impact on banks’ capital ratios, as is also clear from the EBA’s impact assessment of November 2016.
The Commission proposes to introduce a five-year phase-in period for IFRS 9 in CRR to prevent the unwarranted sudden impact on capital ratios. Meanwhile, on 30 November 2016, the EBA published its Final draft ITS amending ITS on Supervisory Reporting of FINREP due to IFRS 9 and announced a second impact assessment of IFRS9 on EU banks. IFRS 9 itself is implemented by a separate regulation.

“SME supporting factor” and preferential treatment of infrastructure exposures

The Commission has always been committed to identifying the most appropriate policies and tools to address the funding needs of small and medium-sized enterprises (SMEs). The Commission’s current proposal expands the “SME supporting factor” of CRR. The current SME exposure capital reduction of 23.81% would be maintained for amounts not exceeding EUR 1.5 million. A new SME supporting factor of 15% would be introduced for SME exposures where the amount exceeds EUR 1.5 million.

The Commission also introduces preferential treatment (a capital reduction of 25%) for specialised lending exposures for infrastructure projects. The aim is to encourage private investments in infrastructure projects as outlined in the Capital Markets Union and the Juncker Plan.
Loss-absorbing capacity
What can our clients expect?
RESOLUTION FRAMEWORK

Background of EU bank resolution framework and MREL requirement

Over the past few years, a comprehensive EU bank recovery and resolution framework has been set up for the orderly resolution of failing banks. This should ensure that a bank’s critical functions are continued, financial stability is preserved and the burden of a bank’s losses is shifted from the taxpayer to bank shareholders and creditors (from “bail-out” to “bail-in”). The EU bank recovery and resolution framework is principally based on three pieces of legislation: the Bank Recovery and Resolution Directive (BRRD), the Single Resolution Mechanism Regulation (SRMR) and the Intergovernmental Agreement on the Single Resolution Fund (IGA).

As part of the bank recovery and resolution framework, banks must continuously meet a minimum requirement of own funds and eligible liabilities (MREL) that can be subjected to a bail-in. A bail-in is a resolution tool used to absorb a bank’s losses and recapitalise a bank. The required level of MREL is set by the relevant resolution authority.

As it is based on an EU legal framework, the MREL framework only applies to banks in the EU. On an international level, similar standards such as the minimum Total Loss-absorbing Capacity (TLAC) have been developed by the Financial Stability Board (FSB) for all G-SIBs.

The MREL framework and TLAC standards differ in some important respects. As part of a comprehensive review, the Commission proposes incorporating the TLAC into the EU MREL framework. Below we distinguish the regimes applicable for:

- G-SIBs
- non G-SIBs
- both G-SIBs and non G-SIBs

<table>
<thead>
<tr>
<th>PARAMETERS</th>
<th>MREL (CURRENTLY)</th>
<th>PROPOSED MREL FOR NON G-SIBS</th>
<th>PROPOSED MREL FOR G-SIBS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope</td>
<td>All banks in the EU</td>
<td>All non G-SIBs in the EU</td>
<td>All G-SIBs in the EU</td>
</tr>
<tr>
<td>Denominator of the ratio</td>
<td>Own funds and total liabilities</td>
<td>- Total risk exposure amount</td>
<td>- Total risk exposure amount</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Leverage ratio exposure measure</td>
<td>- Leverage ratio exposure measure</td>
</tr>
<tr>
<td>PARAMETERS</td>
<td>MREL (CURRENTLY)</td>
<td>PROPOSED MREL FOR NON G-SIBS</td>
<td>PROPOSED MREL FOR G-SIBS</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>----------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Calibration</td>
<td>Individual bank-specific requirement (Pillar 2 character)</td>
<td>Individual bank-specific requirement (Pillar 2 character)</td>
<td>Common minimum requirement (Pillar 1 character) + individual bank-specific requirement (Pillar 2 character)</td>
</tr>
<tr>
<td>Subordination</td>
<td>Resolution authority may require on a case-by-case basis</td>
<td>Resolution authority may require on a case-by-case basis. A new non-preferred senior debt class, eligible for MREL, is created</td>
<td>Required but exceptions apply. A new non-preferred senior debt class, eligible for MREL, is created</td>
</tr>
<tr>
<td>Internal MREL</td>
<td>No detailed rules, but resolution authorities can set requirements on a case-by-case basis</td>
<td>Internal MREL requirement for all banks that are subsidiaries of resolution entities</td>
<td>All material subsidiaries of non-EU G-SIBs must comply with an internal MREL requirement, equal to 90% of the G-SIBs Pillar 1 MREL requirement</td>
</tr>
<tr>
<td>Third-country contractual bail-in recognition</td>
<td>Broadly scoped requirement for contractual recognition clause</td>
<td>A waiver may be granted if inclusion is legally, contractually or economically impracticable for banks, and if it does not impede the resolvability</td>
<td>A waiver may be granted if inclusion is legally, contractually or economically impracticable for banks, and if it does not impede the resolvability</td>
</tr>
<tr>
<td>MREL Guidance</td>
<td>Not defined</td>
<td>Imposed on a case-by-case basis to cover potential losses and to ensure market confidence</td>
<td>Imposed on a case-by-case basis to cover potential losses and to ensure market confidence</td>
</tr>
</tbody>
</table>
Regime for G-SIBs

The new rules for G-SIBs comprise of a Pillar 1 MREL, a Pillar 2 MREL, eligibility requirements and the treatment of MREL holdings.

**Pillar 1 MREL**

The MREL requirement is currently set on a purely bank-specific (Pillar 2) basis. No minimum (Pillar 1) standard applies. The TLAC standards, by contrast, consist of a combination of a Pillar 1 minimum and a bank-specific Pillar 2 add-on. The Commission therefore proposes to introduce a minimum Pillar 1 MREL requirement calibrated at the same level as the TLAC standard:
- a risk-based ratio of 18% (as a percentage of risk-weighted assets); and
- a non-risk-based ratio of 6.75% (as a percentage of the exposure measure of the Leverage Ratio).

Until 2022, each is subject to a transitional regime of 16% and 6%, respectively.

**Pillar 2 MREL**

In addition, G-SIBs are subject to a bank-specific Pillar 2 MREL. The resolution authority may only impose this additional Pillar 2 MREL if the Pillar 1 MREL is not sufficient to ensure that the bank can be resolved in a way that meets the resolution objectives, and only to the extent necessary to do so.

**Eligible liabilities and subordination requirements**

As part of the incorporation of the TLAC requirements, the proposal introduces changes to the eligibility requirements for MREL liabilities. An important new requirement is that the liabilities must be subordinated, either contractually or on the basis of the law governing the liabilities. This should mitigate problems in the context of the “No Creditor Worse Off” (NCWO) principle in case of resolution. Under certain conditions, part of MREL (3.5% of risk-weighted assets) may be unsubordinated.

**Treatment of MREL holdings**

The net amount of liabilities that may count for the MREL requirement is subject to deductions. G-SIBs must deduct holdings of own eligible liabilities instruments, and holdings of eligible liabilities of other G-SIBs (that is, liabilities issued by other G-SIBs). The proposal also sets out a proportionate deduction for holdings of liabilities that rank equally with excluded liabilities. Deductions are made from eligible liabilities, and from own funds, on the basis of a corresponding deduction approach.

**Regime for non G-SIBs**

The new rules for non G-SIBs consist of a Pillar 2 MREL and eligibility requirements.

**Pillar 2 MREL**

For non G-SIBs, the MREL requirement will remain a bank-specific Pillar 2 requirement set by the resolution authority on a case-by-case basis. The Commission’s proposal changes the methodology for determining a bank’s MREL as currently laid down in the Commission’s RTS. The maximum amount of MREL that can be imposed will decrease to twice the amount of Pillar 1 and Pillar 2 CRR capital requirements, and will no longer include the
**Proposed capital requirements**

2.5-10% of RWA

No quantitative maximum but stricter criteria

8% of risk-weighted assets (RWA)

**Combined buffer requirement**

**Pillar 2 buffer**

**Pillar 1 capital requirement**

**Capital guidance**

No quantitative maximum

2.5-10% of RWA

No quantitative maximum but stricter criteria

8% of RWA

**Default**:

- Combined buffer requirement + Pillar 2 buffer + Pillar 1 capital requirement

**Current MREL requirement**

**MREL recapitalisation amount**

**MREL loss absorption amount**

**MREL minimum requirement**

**MREL market confidence buffer**

**MREL loss absorption buffer**

**MREL Pillar 2 buffer**

**MREL market confidence buffer**

**No quantitative maximum**

**Default**:

- Combined buffer requirement + Pillar 2 buffer + Pillar 1 capital requirement

**Proposals (G-SIBs)**

Maximum:

- Capital guidance

Maximum: Combined buffer requirement (unless higher necessary)

Fixed:

- 18% of RWA

**Proposals (non G-SIBs)**

Maximum:

- Pillar 2 buffer + Pillar 1 capital requirement

Maximum:

- Pillar 2 buffer + Pillar 1 capital requirement

Maximum: Combined buffer requirement (unless higher necessary)

**MREL recapitalisation amount**

**MREL loss absorption amount**

This example assumes full recapitalisation, a Pillar 2 buffer of 2% and a combined buffer requirement of 5.5%
capital buffers. However, as capital counting towards the capital buffers can no longer also count towards MREL, the capital buffers are as a result stacked on top of the MREL requirement.

Like the MREL requirement for G-SIBs, the MREL for non G-SIBs is aligned with the TLAC standard in that it consists of a dual requirement: a risk-based ratio (a percentage of the total risk-weighted assets) and on a non-risk-based ratio (a percentage of the exposure measure of the Leverage Ratio).

*Eligible liabilities and subordination requirements for non G-SIBs*

The conditions for eligibility of liabilities to count towards MREL are generally the same as for G-SIBs, with two exceptions. First, subordination is not required, although it can be imposed by the resolution authority on a case-by-case basis. Second, debt instruments with derivative futures, such as structured notes, can be included if the given amount of the liability arising from the instrument is fixed, known in advance and not affected by the derivative feature, and not subject to any netting agreement instruments.

*Requirements applicable to both G-SIBs and non G-SIBs*

The new rules common to both G-SIBs and non G-SIBs consist of MREL guidance, internal MREL, stacking orders and consequences of a breach of MREL, and reporting and disclosure requirements.

*MREL guidance*

The Commission introduces the option for resolution authorities to impose bank-specific MREL guidance supplementary to the Pillar 1 and Pillar 2 requirements, subject to certain conditions. The purpose of this MREL guidance is to cover potential losses - in addition to those foreseen under the regular MREL requirements - and to ensure sufficient market confidence in case of resolution. MREL guidance is in principle not legally binding; however, the resolution authority can transform the MREL guidance into a hard Pillar 2 requirement in cases of consistent non-compliance.

*Internal MREL*

To improve the resolvability of banking groups, resolution authorities should be able to upstream the losses of subsidiaries to the resolution entities, the entity to which resolution tools are applied (and to which external MREL applies), without placing that subsidiary into resolution itself. To this end, the Commission proposes that resolution authorities impose MREL requirements as an “internal MREL” requirement on all banks that are subsidiaries of resolution entities. Internal MREL may, at the resolution authority’s discretion, also be imposed on other subsidiaries.
Internal MREL instruments must fulfil the same eligibility conditions as external MREL instruments. In addition, they must be issued to and bought by the resolution entity; must rank below liabilities issued to entities other than the resolution entity; and must contain a trigger clause allowing conversion and write-down without entry into resolution of the subsidiary itself. Subject to strict conditions, the internal MREL requirement may be met with a guarantee of the resolution entity granted to its subsidiary or may be fully waived.

Further, in line with the TLAC requirement, the Commission proposes that all material subsidiaries of non-EU G-SIBs, to the extent that they are not themselves entities to which resolution tools are expected to be applied, must comply with an internal MREL requirement. The Commission proposes setting this requirement at a level equal to 90% of the G-SIBs’ (external) Pillar 1 MREL requirement, which is at the higher end of the range prescribed by the TLAC standards. Internal MREL instruments are only eligible if they are held by the third-country parent undertaking of the bank.
Stacking order and consequences of an MREL breach

According to the Commission’s proposal, the combined capital buffer will be stacked above the MREL requirement. This means that if a breach of MREL occurs because a bank does not have a sufficient amount of eligible liabilities, the resultant shortfall is automatically filled up with Common Equity Tier 1 (CET1) capital. This may result in a breach of the combined buffer requirement and trigger the MDA regime (maximum distributable amount). As a result, dividend distributions, variable remuneration payments to employees and coupon payments on AT1 instruments may be restricted. However, if the breach of the combined buffer requirement is due to an MREL shortage caused by a temporary inability to issue new eligible debt for MREL, a six-month “grace period” would apply before restrictions to discretionary payments became applicable. During the grace period, other powers available to authorities may be exercised to restore the bank’s MREL.

Reporting and disclosure requirements

Per the proposal, banks would have to report and publicly disclose the levels of available MREL items and the composition of these items, including maturity profile and ranking in normal insolvency proceedings on, at a minimum, an annual basis.

Other changes to the bank resolution framework

Review of creditors’ hierarchy

The current MREL framework does not require mandatory subordination of eligible instruments (those which can be “bailed-in”) for MREL, although resolution authorities are able to require this on a case-by-case basis. In insolvency, a liability eligible for bail-in may, therefore, rank equally with liabilities that are not eligible for bail-in under the BRRD. This could lead to a breach of the No Creditor Worse Off (NCWO) principle, under which creditors can claim compensation from a resolution fund if it becomes apparent that they were put in a worse position under resolution than under insolvency. The risk of breaching the NCWO principle can be reduced if liabilities which are most credibly contributable to loss absorbency are subordinated.

The TLAC standard does contain such a subordination requirement. To ensure that G-SIBs can comply with the TLAC standard, a number of Member States have amended (or are in the process of amending) the ranking of certain bank creditors in insolvency under their own national insolvency laws. However, so far, these (draft) national rules diverge significantly, which will make the application of the bail-in tool difficult for cross-border banks and may lead to competitive distortions. The Commission therefore deems it urgent to put in place harmonised EU rules on bank creditors’ insolvency ranking.
The Commission’s proposal entails a change to the insolvency hierarchy and introduces a new statutory category of unsecured debt, available in all Member States. This category will rank just below the most senior debt and other senior liabilities for the purposes of resolution, but will still rank as part of the senior unsecured debt category (only as an unpreferred tier senior debt). The proposal would not affect the existing stock of bank debt and would only apply to debt when designated as such by the issuing bank.

### Contractual recognition of bail-in requirement

Under the current rules, banks must ensure that the resolution tools, such as bail-in, can be effectively exercised. However, if a liability is governed by the law of a third (non-EU) country, a bail-in of this liability may not be recognised in this third country. Article 55 BRRD therefore requires banks to include a clause in contracts governed by third-country law stating that counterparties recognise that their claims may be converted or written down. This is specifically required for MREL liabilities but is also a broader requirement. However, including contractual recognition clauses has in practice often proved to be difficult to implement. Therefore, this proposal would allow resolution authorities to grant a waiver for this obligation for liabilities not counting towards MREL if it is legally, contractually or economically impracticable for a bank to include the recognition clause.

### Moratorium tool

The Commission’s proposal includes a new moratorium tool which allows supervisory authorities or resolution authorities to suspend a bank’s payment or delivery obligations for a maximum of five days. Supervisory authorities can apply this power when assessing whether a bank meets the conditions for early intervention. Resolution authorities can apply it when necessary to assess whether the conditions for resolution are met, and for the effective application of one more resolution tools.
### TIMING AND NEXT STEPS

According to the Commission’s proposals, the timing of entry into force and applicability is as follows:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Creditor hierarchy</td>
<td>Applicable*</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MREL for non-G-SIBs</td>
<td>Entry into force*</td>
<td>Applicable*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pillar 2 + MDA changes</td>
<td>Entry into force*</td>
<td>Applicable*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New risk-weighting standards**</td>
<td>Entry into force*</td>
<td>Applicable*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MREL for G-SIBs</td>
<td>Applicable</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>IFRS 9</td>
<td>Start of 5 year phase in period*</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Binding LR</td>
<td>Entry into force*</td>
<td>Applicable*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Binding NSFR</td>
<td>Entry into force*</td>
<td>Applicable*</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* At the earliest

** With the exception of certain IRRBB and market risk provisions

It is now up to the Council of the EU and the European Parliament to deliberate on the Commission’s proposals. Member States have largely welcomed the proposals but have also already indicated their opposition to certain aspects. Contentious points in particular include the proposals that would extend the possibility to grant waivers from capital and liquidity requirements, with some Member States fearing that this may mean that bank subsidiaries, particularly in smaller countries, would be insufficiently capitalised. The US and the UK have criticised the requirement for third country banking groups to set up intermediary holding companies, deeming it discriminatory, protectionist, and a tit-for-tat response to similar measures introduced in the US in 2014. The ECB, for its part, voiced its concern that the proposals do not sufficiently address the divergent application of banking rules in Member States through the use of various options and discretions. The Dutch Cabinet considers that the proposals overall provide a good basis for the further reduction
of risk in the EU banking sector, but that certain elements of the rules could be further
tightened, including the leverage ratio, as discussed above.

Meanwhile, other changes to the capital requirements framework are still forthcoming,
including those Basel standards that have yet to be finalised. Some aspects of the
finalisation of the Basel III reforms (or also referred to as Basel IV) have yet to be
agreed upon. The Basel Committee is still discussing a revised, and more risk-sensitive,
standardised approach to credit risk and operational risk and, most controversially, the
design of capital floors. A review of the risk-weighting of sovereign exposures is also still
on the agenda. A further review by the EBA of capital requirements for non-systemic
investment firms (to be proposed in 2017) is also due.

Additionally, the bank resolution framework will see further changes. As set out above, the
Commission will seek the EBA's advice for alternative options for treating holdings of TLAC
instruments issued by G-SIBs. One of these options is the Basel approach to treatment of
TLAC holdings, published in October 2016. The FSB also recently issued a consultative
document with guiding principles for Internal TLAC, which may require changes if it is to be
implemented in the EU framework.
ANNEX

For your convenience, here are links to the five proposals that form part of the banking reform package:

- a directive amending the Capital Requirements Directive (CRD IV)

- a regulation amending the Capital Requirements Regulation (CRR)

- a directive amending the Bank Recovery and Resolution Directive (BRRD) in relation to loss-absorbing and recapitalisation capacity

- a directive amending the BRRD in relation to the ranking of unsecured debt instruments in the insolvency hierarchy, and

- a regulation amending the Single Resolution Mechanism Regulation (SRMR).
EXPERTS

MARIKEN VAN LOOPIK
Partner
mariken.vanloopik@debrauw.com
T +31 20 577 1308

MAURITS TER HAAR
Senior Associate
maurits.terhaar@debrauw.com
T +31 20 577 1841

De Brauw Blackstone Westbroek
Claude Debussylaan 80
1070 AB Amsterdam
The Netherlands

www.debrauw.com