# Remarks on the E.U. Banking Reform Package

## MREL/TLAC and the New Resolution Framework

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**Joanna Perkins,** Chief Executive, FMLC

The first thing to mention is that there is much that is sensible about the new E.U. Banking Reform package (the "Reform Package") and much besides that is fairly unobjectionable. It is a shame, then, that these aspects may get drowned out by the more controversial proposals.

The second thing to highlight is that we have been guided today towards the unobjectionable elements which consist of the way in which relatively the new requirements on Total Loss Absorbing Capacity ("TLAC") established by the Financial Stability Board ("FSB") have been implemented by the E.U. Commission. The storm clouds of controversy are much more likely to gather over the structural reform proposals concerning the requirements to establish Financial Holding Companies ("FHCs") and Intermediate Holding Companies ("IHCs") for Third Country banking groups.

Turning then to the TLAC component, the proposal here to introduce Basel-aligned requirements for global systemically-important institutions ("GSIIs") into the Capital Requirements Regulation ("CRR"), leaving the existing minimum requirement for own funds and eligible liabilities ("MREL") regime in the Bank Recovery and Resolution Directive ("BRRD") largely untouched, is not an intellectually clean solution—it would arguably have been better to scrap MREL and start again—but it probably is practicable.

Perhaps the biggest uncertainty here may be how competent authorities and resolution authorities are going to allocate responsibility for determining whether conditions have been satisfied, exercising the statutory discretions and setting policy. That is because TLAC under the CRR is a matter for the competent authority in consultation with the resolution authority but MREL, which doesn't magically disappear, remains a matter for the resolution authority. There is, as I mentioned, a requirement to consult but the way in which the reforms have been designed appears to contemplate a shift in responsibility, which one can imagine potentially causing some discomfort among resolution authorities.

In brief, other uncertainties are also practical rather than legal. One question we might legitimately ask is whether this proposal puts E.U. GSIIs at a disadvantage given that some of the requirements appear to be more stringent than the international standards. In this, I am thinking chiefly of the new rule that issuers can only redeem or repurchase the CRR version of TLAC with the permission of their supervisor but under the FSB term sheet they would be allowed to redeem or repurchase it provided that in so doing they weren't likely to breach their own TLAC requirements. Another example is the case of debt instruments containing acceleration provisions. Last December, the Federal Reserve Board ("FRB") announced that its Long-term Debt ("LTD") requirement could be satisfied by instruments which provide for acceleration on payment default while, under the CRR, instruments are excluded if they contain a provision for acceleration other than in the event of insolvency.

Finally, I would draw attention to the fact that under the CRR TLAC instruments must contractually acknowledge their liability to be written down or converted, which may mean that some debt issued in the expectation of being TLAC compliant will not in fact be so under the CRR.

Another TLAC-related aspect of the Reform Package is the decision to introduce a new creditor hierarchy for insolvency purposes. Several Member States, when faced with the TLAC proposals, passed laws which statutorily subordinated issuers' existing stock of debt so that it would be TLAC eligible. That is in contrast to the U.K. approach which generally required banks to issue new subordinated debt. The divergence between different national approaches, coupled with the complication caused by the fact that institutions were able to satisfy the MREL requirement with unsubordinated liabilities ranking *pari passu* with other excluded, preferred and senior liabilities (which would not be bailed in), had led to fears of legal uncertainty and of litigation over creditor outcomes. The new creditor hierarchy is intended to address this by creating a new class of senior non-preferred debt which is subordinated to senior debt but takes priority over other instruments which may be subject to write-down or conversion. Resolution authorities may decide that MREL should be satisfied entirely by debt of this priority level or below. It is in effect a harmonisation measure for bank insolvency law and should ultimately reduce complexity and eliminate creditor outcomes which are manifestly unfair as between creditors ranked *pari passu.* The transitional arrangements, however, are likely to cause difficulty while the market reaches maturity and debt instruments of varying seniority co-exist.

Turning to the requirement for internal TLAC: this affects E.U. non-Resco subsidiaries of E.U. and non-E.U. parents. There is not a great deal to say here from the perspective of legal uncertainty other than to point out that the E.U. requirements have slightly different dimensions than the Basel requirements which may 1) undermine the ideal of a level playing field and 2) mean that some arrangements entered into on the strength of the term sheet will no longer satisfy the applicable E.U. requirements. First, there is a strict 90% requirement under the BRRD and CRR for internal TLAC issuance, whereas the FSB term sheet contemplates a range and certain requirements may be as low as 75%. Second, however, the E.U. requirement may apparently be substituted by a guarantee from the parent company which is only partly collateralised, whereas the TLAC term sheet requires collateral which is "sufficient fully to cover the amount of the guarantee".

On the uncertainties relating to TLAC, I will only mention one other here, which is the proposed deduction rules. To prevent contagion, GSIIs are discouraged under new CRR provisions from entering into arrangements which amount to cross-holdings of TLAC instruments. For that reason, an institution which holds another institution's instruments which have been issued for TLAC purposes OR which rank *pari passu* with instruments issued for TLAC purposes must make an equivalent deduction from its own TLAC. The policy is clear. What is unclear is how an institution will be able definitively to know whether it is holding a deductible instrument. That is because, while a new Article 437a of the CRR requires disclosure of eligible liabilities, it does not require disclosure of instruments which rank *pari passu* with those liabilities.

Finally I said I would offer a word or two about IHCs. This is a new requirement which has been fed into Capital Requirements Directive IV ("CRD IV") requiring Third Country groups with two or more E.U. subsidiaries which are credit institutions or investment firms to establish an IHC which will be authorised and supervised in the E.U. This is causing controversy, of course, because of the cost and other compliance challenges of meeting the requirement. But it is also an issue of the conflict of regulation. The requirement has swiftly run up against regulations in Third Countries which require the separation and/or ring fencing of certain protected activities from investment banking activities and requiring these activities ultimately to be amalgamated in a single holding company will likely cause a very serious restructuring headache for the group. It may mean the group is forced to withdraw from providing certain socially useful services in the E.U.