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WHITE PAPER

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The EU Risk Reduction Package: The Countdown for Restructuring the MREL Base Has Just Begun

The pending EU risk reduction package is highly relevant for the whole EU banking sector. It addresses the capital provisioning required by banks to facilitate potential resolution measures by resolution authorities if a bank is failing or likely to fail. The reform package spells out which instruments banks may use to fulfill these capital provisioning requirements and how to compute their amount in different corporate, group or consolidation structures. Further aspects are reporting and disclosure requirements, the competent authorities' powers in case of breaches, as well as consumer protection, requiring banks to ensure that consumers are not offered instruments that will be bailed-in or written-down first in the issuing bank's resolution.

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To clarify the eligibility criteria for Total Loss-Absorbing Capacity ("TLAC")/Minimum Requirement for own funds and Eligible Liabilities ("MREL") instruments, EU Council and Parliament have agreed on risk reduction measures for the banking sector. The Presidency compromise was issued on 15 February 2019 and implements elements agreed by the Basel Committee on Banking Supervision ("BCBS") and the Financial Stability Board ("FSB"). The changes to the resolution framework will be implemented in the BRRD[1] and the SRMR[2] and thus equally affect banks under the remit of the Single Resolution Board ("SRB"), as well as under the exclusive supervision of the national resolution authorities.

The text will now be finalised. Parliament and Council will then be called on to adopt the package at first reading. The amendments of the SRMR will apply directly within 18 months of its entry into force. Member States will have 18 month to transpose the BRRD amendments from the date of its entry into force. Provisions requiring the public disclosure of instruments will be applied from 1 January 2024.

Once implemented, banks will be required to adapt their MREL stock to the new requirements, and assess the options to optimise capital and resolution planning. This Jones Day *White Paper* summarizes the changes to the bank resolution framework to facilitate long-term planning and to establish certainty regarding the necessary buffers.

KEY ASPECTS OF THE BRRD/SRMR REFORM

The risk reduction package includes changes to the amount and quality of own funds and MREL to ensure an effective bail-in process. It also includes new competences for resolution authorities and requires global-systemically important institutions ("G-SIIs") to have more loss-absorbing and recapitalisation capacity. Key aspects are:

- Revision of existing rules for all banks (MREL stacking order and calibration)
- Harmonisation of creditor hierarchy
- Internal MREL and home/host joint decision
- Harmonisation of moratoria powers
- Waivers on third country bail-in clauses

DEFINITION OF MREL

To align denominators that measure the loss absorbing and recapitalisation capacity of banks with those provided in the Financial Stability Board's TLAC standard,[3] MREL must be expressed as a percentage of the total risk exposure and the leverage ratio. Eligibility criteria for MREL have been closely aligned with those in the CRR[4] for the TLAC minimum requirement, but subject to the BRRD's complementary adjustments and requirements.

ELIGIBLE DERIVATIVES

Debt instruments with an embedded derivative component, such as certain structured notes, are eligible to qualify as MREL to the extent that they have a fixed or increasing principal amount repayable at maturity that is known in advance, while only an additional return is linked to a derivative and depends on the performance of a reference asset, subject to being highly loss-absorbing and easily bail-inable in resolution.

INSTRUMENTS USED FOR THE COMBINED BUFFER REQUIREMENT

With regard to institutions holding assets above €100 billion (top-tier banks) and certain smaller resolution groups which are likely to pose a systemic risk in case of failure, authorities can require that part of the MREL is met with subordinated liabilities and own funds, including own funds which are used to comply with the combined buffer requirement. Authorities can also reduce that requirement within certain limits and—in accordance with the principle of proportionality—require that MREL is met with subordinated liabilities and own funds to the extent that the overall level of subordination does not exceed the higher of (i) the required level of loss absorption and recapitalisation or (ii) the Pillar 1 and Pillar 2 and the combined capital buffer requirement. For specific top-tier banks, authorities can limit the level of the minimum subordination requirement to a certain threshold, taking also into account the risk of disproportionately impacting the business model.

MARKET CONFIDENCE BUFFER

After the implementation of resolution actions, the resolution authority can increase the recapitalisation amount to ensure sufficient market confidence in the bank. Such buffer should also enable the bank to continue to meet the conditions for authorisation for an appropriate period of time, to cover the restructuring costs. The market confidence buffer is set by reference to part of the combined capital buffer requirement and may be adjusted down- or upwards, depending on the bank's situation.

INVESTOR PROTECTION

To ensure that retail investors do not invest excessively in debt instruments in certain eligible liabilities, Member States should ensure that the minimum denomination amount of such instruments is relatively high or that the investment in such instruments does not represent an excessive share of an investor's portfolio.

BANK-SPECIFIC MREL FOR G-SIIS

To enhance their resolvability, resolution authorities may impose a bank-specific MREL on G-SIIs in addition to the CRR's TLAC minimum requirement where the latter is not sufficient to absorb losses and recapitalise a G-SII under the chosen resolution strategy.

MREL AT CONSOLIDATED AND INDIVIDUAL LEVEL

Banks identified as resolution entities, i.e. the entity or entities (depending on whether a "multiple-point-of entry" or "single-point-of-entry" resolution strategy is envisaged) at the level of which resolution action is envisaged, are subject to MREL only at consolidated resolution group level and obliged to issue eligible instruments and items to external third party creditors that would be bailed-in under resolution. Banks that are not resolution entities must comply with MREL at individual level with loss absorption and recapitalisation needs provided by their respective resolution entities through the acquisition of own funds instruments and eligible liabilities issued by those banks and their write-down or conversion into instruments of ownership at the point where those banks are no longer viable. If both the resolution entity or the parent and its subsidiaries are established in the same Member State and are part of the same resolution group, the resolution authority may fully waive the MREL requirements for non-resolution entities or permit them to meet the MREL with collateralised guarantees between the parent and its subsidiaries, that can be triggered when the timing conditions equivalent to those allowing the write down or conversion of eligible liabilities are met. The collateral backing the guarantee should be highly liquid and have minimal market and credit risk.

COOPERATIVE NETWORKS

To take account of the specificities of cooperative networks, resolution authorities are able to waive the application of MREL for such credit institutions and the central body under similar conditions to those set out in the CRR where credit institutions and the central body are established in the same Member State. Resolution authorities may treat credit institutions and the central body as a whole when assessing the conditions for resolution, depending on the features of the solidarity mechanism.

BREACH PROCESS AND RESTORATION PLANS

Given that a breach of TLAC/MREL requirements could constitute an impediment to resolvability, the existing procedures to remove such impediments are shortened. Authorities may require banks to modify the maturity profiles of eligible instruments and items and to prepare and implement plans to restore the level of those requirements and prohibit certain distributions where they regard a bank as failing to meet the combined capital buffer requirements when considered in addition to MREL. For example, if a bank breaches its combined capital buffer requirement ("CCBR") due to an inability to replace MREL instruments for more than six months while simultaneously continuing to comply with its capital requirements, the authorities may impose restrictions to the maximum distributable amount ("MDA"). If MREL and capital requirements are both breached, MDA restrictions kick-in immediately. In addition to the power to address resolvability impediments, authorities may impose penalties and early intervention measures.

REPORTING AND DISCLOSURE

To ensure a transparent application of the MREL, banks should report to authorities and disclose regularly to the public their MREL requirement, the levels of eligible and bail-inable liabilities and the composition of those liabilities, including their maturity profile and ranking in normal insolvency proceedings. Total or partial exemptions from reporting and disclosure obligations for specified entities are allowed in certain cases but must not limit the powers of authorities to request information.

WAIVERS ON THIRD COUNTRY BAIL-IN CLAUSES

To ensure that counterparties contracting with EU financial institutions under third-country law are also subject to the bail-in rules and powers exercisable in the EU, banks must include a recognition of the bail-in tool clause in contracts governed by third country laws. Exemptions may apply in cases where it is impracticable or where it is illegal in the third country to include such clause. This may be due to contractual terms imposed by internationally agreed standard terms or where the liability is contingent on a breach of contract or arises from guarantees, counter-guarantees or other instruments used in the context of trade finance operations. Banks must inform the authorities regularly of the progress towards implementing contractual recognition terms and indicate where the bail-in recognition clause is impracticable, indicate a reason for this assessment, and be prepared to justify their view if asked by the authority. Liabilities for which the relevant contractual provisions are not included are not eligible for MREL.

MORATORIA TOOLS

The package introduces two separate moratoria tools by which authorities may suspend certain contractual obligations, including counterparties' rights to close out, accelerate or otherwise terminate financial contracts:

(1) The **pre-resolution moratorium**, which may be applied for up to a maximum of two business days where necessary for the decision on early intervention measures and for conducting a valuation to determine the condition for "failing or likely to fail".

(2) the **resolution moratorium**, which may be applied where necessary for the purpose of valuation/effective application of the resolution tools. The suspension can continue to apply after the resolution decision is taken for another two days.

The scope of the moratorium may be tailored to the needs of each case—for example, excluding administrative expenses. Payment or delivery obligations to securities settlement systems ("SSS") and their operators, central banks, and CCPs are *per se* exempted from suspension.

While a moratorium cannot be directly applied to contracts under third country law, in the absence of a statutory cross-border recognition framework, Member States should enact laws requiring banks to include a contractual term in financial contracts recognising a moratorium.

CONCLUSIONS

With the one and only exception of Banco Popular, which was declared failing or likely to fail by the ECB on 7 June 2017—the resolution tools set out in the BRRD framework have not been put into practice yet. It may or may not have come as a surprise that the BRRD could not change what was already experienced in bail-in actions prior to it: parties subject to resolution measures challenge them in court. Against this backdrop, it appears to be a logical consequence from the regulator's perspective to enhance the requirements to prepare for and facilitate resolution, including the operationalisation of resolution plans. This means now that in addition to the implementation of enhanced prudential rules under the CRD/CRR, banks will have to increase their efforts to facilitate potential resolution measures. This requires more analytical work on critical functions, strategies, and impediments.

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ENDNOTES

1 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms.

2 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund.

3 Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution Total Loss-absorbing Capacity (TLAC) Term Sheet of 9 November 2015. See also the BCBS Standard TLAC holdings – Amendments to the Basel III standard on the definition of capital of October 2016.

4 Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms.

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