Grandfathering & the eligibility criteria for MREL

26 April 2017

Introduction

The Association for Financial Markets in Europe (AFME)[1] welcomes the Commission's proposal to amend the Capital Requirements Regulation (CRR). This paper sets out our views on the eligibility criteria liabilities must meet in order to count towards the Minimum Requirement for own funds and Eligible Liabilities (MREL), as set out in the proposal to amend the CRR, but also our views on the need for the grandfathering of existing liabilities. Annexed to this paper are suggested amendments that achieve effective grandfathering as well as amendments to the eligibility criteria.

We strongly support the objectives of the proposals to implement Total Loss-Absorbing Capacity (TLAC) – as set out in the FSB TLAC Principles and Term Sheet[2] (TLAC Standard) – in the EU for Global Systemically Important Institutions (GSIIs), review MREL to increase alignment with TLAC and address certain practical challenges firms face in meeting their MREL requirements.

AFME has been very supportive of the development of an effective recovery and resolution framework in Europe and closely involved in the implementation of the BRRD, development of TLAC and related issues.

Our overarching perspective when addressing the proposals is to:

1) ensure that an effective MREL framework is introduced in which there can be confidence in the credibility and feasibility of resolution strategies;
2) facilitate the establishment of a deep and liquid market in MREL in the European Union to enable banks to achieve the necessary requirements for loss absorbing capacity and enhance market discipline while maintaining financial stability; and
3) to ensure a consistent and transparent framework to establish a level playing field across the EU and internationally.

We hope that the co-legislators and supervisory and resolution authorities share these objectives. In this context, we set out in this paper the key issues which we believe should be addressed within the proposed new Article 72b of the CRR, which sets out the eligibility criteria for MREL eligible liabilities instruments.

Transitional arrangements

The proposal makes significant changes to the eligibility criteria for eligible liabilities and also introduces new criteria for Additional Tier 1 and Tier 2 capital instruments[3]. It is essential that transitional arrangements are provided to grandfather issuances prior to the new legislation coming into force. A significant volume of

[1] AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society. AFME is listed on the EU Transparency Register, registration number 65110063986-76.
[2] See Financial Stability Board, TLAC Principles and Term Sheet available at http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf
[3] Articles 52(o), (p) and 63(o), (n) CRR

liabilities has been issued over the past 12-18 months based on the expectation that the European criteria would follow the international TLAC Standard, with a view to meet the ambitious 1 January 2019 target. These existing liabilities do not comply with the proposed new criteria in their entirety (e.g. restrictions on acceleration, contractual recognition requirements and set-off arrangements) and absent transitional provisions MREL shortfalls would increase very significantly.

It is also essential that banks have clarity that planned issuances prior to the finalisation of the legislation will be eligible in order for them to proceed with issuances over the next year. The importance of a transitional period has been acknowledged by the EBA[4] and a number of European resolution authorities. The US has provided for grandfathering of liabilities issued prior to its Final Rule and the EU should also adopt this approach and signal clearly that there will be grandfathering for liabilities issued prior to entry into application of the new requirements.

In light of the short time frame to meet the minimum requirements by 1 January 2019 it is critical that banks have clarity on their shortfall and are able to proceed with issuances to increase their loss absorbing capacity prior to finalisation of the legislation. Early clarity on grandfathering is therefore necessary to support this objective. It is important to note however, that transitional provisions alone would not resolve a number of important concerns with the proposals where we strongly believe changes are required.

Eligibility criteria

There are some key provisions in the MREL eligibility criteria which go above and beyond the eligibility criteria in the TLAC Standard blurring the distinction between capital and additional loss absorbing capacity available for recapitalisation, notably the restriction on acceleration rights and requirements for contractual write-down or conversion. The proposals risk creating competitive disadvantages for EU institutions in the global market for TLAC funding. Given the absence of well-founded rationales for these additional criteria, we are of the view that a revision of the Commission's proposals is merited. A number of changes to the proposal should be taken forward. These include:

a) **Restrictions on acceleration rights:** the proposed restriction on acceleration rights[5] goes beyond the TLAC Standard and could unnecessarily hamper the market for debt which is eligible to satisfy MREL requirements, making it more difficult and more expensive for banks to issue such debt. Standard acceleration rights such as upon non-payment of principal and interest should be permitted. This is necessary to introduce a clear distinction between regulatory capital and eligible liabilities. Specifically, senior debt investors invest in securities with lower coupons than capital securities due to their relative position in the creditor hierarchy. However senior debt issued by banks offer no covenants to protect senior investors' rights. As a result, investors take comfort from the fact that they can accelerate payment under normal circumstances in the event that a bank withholds payment. If this acceleration right is withdrawn then the senior investors will be left with the same acceleration right as that enjoyed by investors in capital securities and it is unclear whether they will accept lower coupons for similar risks.

[4] See EBA Final Report on MREL, 14 December 2016, at p.22
[5] Article 72b(2)(m) CRR

This is important for both external and internal MREL as in addition to the impact on the market, the proposal also increases the risk that debt instruments would be viewed as equity rather than debt for taxation purposes. This could impact the tax deductibility of interest payments and have a material impact on the cost of issuing both external and internal MREL. Should the co-legislators determine that acceleration rights should be restricted, we would strongly urge them to consider a rule which allows acceleration for non-payment subject to a 30-day cure period, in line with the approach taken in the final US TLAC rules.

It is worth noting that an accelerated (but unpaid) bond liability remains a liability that is subject to the full regulatory toolkit, including the bail-in powers under the BRRD.[6] The powers allow the resolution authority to essentially over-ride the terms of existing liabilities if an entity enters resolution. The law therefore gives the resolving authority the power to over-ride the acceleration provisions noted above. The presence of such safeguards is also accepted by the FSB, as explicitly addressed in the FSB Key Attributes[7] which explicitly recognises that should contractual acceleration or early termination rights be exercisable, the resolution authority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers. For a solvent institution not in resolution, acceleration rights mean that creditors have a means of encouraging issuers to make payments when contractually due. The effective permission for issuers to choose to default on their payment obligations without recourse, while solvent, dilutes the level of market discipline bondholders can exert to encourage an issuer's prudent management of its balance sheet and liquidity.

It should also be noted that any question of MREL "permanence" is already satisfied by the 1 year residual maturity requirement.

b) **Contractual bail-in**: we assume this requirement is a requirement to include contractual acknowledgement of bail-in rather than a contractual bail-in provision *per se*, but we would appreciate the EC's confirmation. The provisions[8] requiring a contractual acknowledgement of bail-in should be deleted or at the very least limited to liabilities governed by the law of a third country and aligned with the requirements of article 55 BRRD. There should be no such requirement for liabilities governed by EU law as this would be inconsistent with the statutory bail-in power already in place under the BRRD and could create confusion in the market and legal uncertainty as to whether the bail-in would be implemented under statute or contract. It would also create a substantial burden on firms to comply with no corresponding benefit.

It is important to note that the contractual requirement contrasts with the specified features included in the CRR2 for Additional Tier 1 and Tier 2 capital instruments, whereby statutory as well as contractual bail-in is envisaged, which would result in inconsistent provisions amongst the various instruments.

c) **Subordination requirements**: As drafted the proposals require instruments to be structurally subordinated as well as either contractually or statutorily. This appears to be contrary to the legislative intention and the TLAC Standard. It should be clarified that all three routes to subordination

[6] Even if all senior bonds had been accelerated those remain good liabilities capable of being bailed-in in resolution.
[7] See section 4 of FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions

[8] Article 72b(2)(o) CRR

should be equally permissible and respected. The requirement under article 72b(2)(e) should be moved to a new 72b(2)(d)(iii) to correct this.

With the introduction of the concepts of resolution entity and resolution group, it is important that the legislation is neutral with regard to different methods of achieving subordination and it should be possible to make use of the 3.5% RWAs exemption from subordination for groups utilising structural subordination as well as those utilising contractual or statutory subordination to ensure a level playing field.

ANNEX 1 - Grandfathering

We support the following amendments, proposed by the European Banking Federation, to the Commission's proposal amending Regulation 575/2013 (CRR):

Article 52(1): Additional Tier 1 instruments	
Original text: 19. Article 52(1) is amended as follows: ... (c) in paragraph 1, the following points (q) and (r) are added: "(q) the instruments may only be issued under, or be otherwise subject to the laws of a third country where, under those laws, the exercise of the write down and conversion power referred to in Article 59 of Directive 2014/59/EU is effective and enforceable based on statutory provisions or legally enforceable contractual provisions that recognise resolution or other write-down or conversion actions; (r) the instruments are not subject to any set-off arrangements or netting rights that would undermine their capacity to absorb losses.".	Proposed amendment: 19. Article 52(1) is amended as follows: ... (c) in paragraph 1, the following points (q) ~~**and**~~, (r) **and the exemption subparagraph** are added: "(q) the instruments may only be issued under, or be otherwise subject to the laws of a third country where, under those laws, the exercise of the write down and conversion power referred to in Article 59 of Directive 2014/59/EU is effective and enforceable based on statutory provisions or legally enforceable contractual provisions that recognise resolution or other write-down or conversion actions; (r) the instruments are not subject to any set-off arrangements or netting rights that would undermine their capacity to absorb losses.~~".~~ **By way of derogation from Article 52(1), conditions (p), (q) and (r) shall not be applicable to instruments issued prior to [*date of application of the regulation amending the CRR]".***
Justification We regard it as essential that the EU legislators introduce as a matter of priority transitional arrangements ensuring the continued eligibility of issuances made prior to the new eligibility criteria under articles 52 (Additional Tier 1) and 63 (Tier 2) CRR coming into force, and communicate this clearly to the public and the markets. This is necessary to provide clarity for banks on their current shortfall and enable them to continue issuance over the next months without uncertainty as to whether further issuances will ultimately be eligible. These recommend changes provide for permanent grandfathering of existing issuances and future issuances prior to the revised CRR coming into effect. This would extend eligibility to capital issuances which meet the existing eligibility criteria for AT1 and T2 but may not meet the changes to the eligibility criteria for AT1 and T2 in articles 52(1) and 63 CRR.	

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Specifically;

- Art. 52(1)(p) & 63(n) – which introduces the requirement for both statutory and contractual Point-Of-Non-Viability (PONV) provisions (i.e. to permanently write down or convert instruments/liabilities to CET1 as per exercise of Art. 59 of BRRD);
- Art. 52(1)(q) and 63 (o) – which introduces the requirement that instruments issued under 3rd country law be subject to statutory/contractual PONV provisions (similar to the point above), which duplicates the requirements already in place under Article 55 of BRRD;
- Art. 52(1)(r) & 63(p) – which restricts the presence of set-off arrangements or netting rights –capital instruments are not currently subject to any set-off/netting rights restriction under CRR.

Article 63: Tier 2 instruments	
<u>Original text:</u> 23. Article 63 is amended as follows: ... (d) the following points (o) and (p) are added: "(o) the instruments may only be issued under, or be otherwise subject to the laws of a third country where, under those laws, the exercise of the write down and conversion power referred to in Article 59 of Directive 2014/59/EU is effective and enforceable based on statutory provisions or legally enforceable contractual provisions that recognise resolution or other write-down or conversion actions; (p) the instruments are not subject to any set-off arrangements or netting rights that would undermine their capacity to absorb losses.".	<u>Proposed amendment:</u> 23. Article 63 is amended as follows: ... (d) the following points (o) ~~and~~ **,** (p) **and the exemption subparagraph** are added: "(o) the instruments may only be issued under, or be otherwise subject to the laws of a third country where, under those laws, the exercise of the write down and conversion power referred to in Article 59 of Directive 2014/59/EU is effective and enforceable based on statutory provisions or legally enforceable contractual provisions that recognise resolution or other write-down or conversion actions; (p) the instruments are not subject to any set-off arrangements or netting rights that would undermine their capacity to absorb losses.". **By way of derogation from Article 63, conditions (n), (o) and (p) shall not be applicable to instruments issued prior to [*date of application of the regulation amending the CRR*]".**
Justification	
As above	

<table>
<tr><th colspan="2">Article 72b(2): Eligible liabilities instruments</th></tr>
<tr><td><u>Original text:</u>

Article 72b
Eligible liabilities instruments

…

2. Liabilities shall qualify as eligible liabilities instruments provided that all of the following conditions are met:

…</td><td><u>Proposed amendment:</u>

Article 72b
Eligible liabilities instruments

…

2. Liabilities shall qualify as eligible liabilities instruments provided that all of the following conditions are met:

…

A new subparagraph 2 is added:

By way of derogation from this paragraph and articles 72b (3)(a) and 72b (4)(b) below, instruments issued by entities referred to in points (a), (b), (c) and (d) of Article 1 (1) of Directive 2014/59/EU prior to [date of application of the regulation amending the CRR] shall qualify as eligible liabilities instruments where they at least meet the conditions laid down in points (a), (b), (c), (e), and, where applicable, (d).</td></tr>
<tr><td colspan="2">Justification

We regard it as essential that the EU legislators introduce as a matter of priority transitional arrangements ensuring the continued eligibility of issuances made prior to the new eligibility criteria under article 72b (MREL) CRR coming into force, and communicate this clearly to the public and the markets. This is necessary to provide clarity for banks on their current shortfall and enable them to continue issuance over the next months without uncertainty as to whether further issuances will ultimately be eligible.

These recommended changes provide for permanent grandfathering of existing issuances and future issuances prior to the revised CRR coming into effect. This would extend eligibility to MREL eligible issuances where these meet the existing MREL criteria and those set out in (a), (b), (c), (e), and (d) where applicable.

Please note however that references here to points (a) through to (e) reflect the changes set out in our amendments on the eligibility criteria in Annex 2 (below), whereby (e) is reclassified as (d)(iii) thus moving up consequent sub-paragraphs one letter. For ease we have addressed each grandfathered criterion below in the current lettering classification.</td></tr>
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Specifically;

- Art. 72b(2)(g) – restrictions to set off arrangements and netting rights are not present in the current MREL eligibility criteria, and therefore instruments will have been issued which include such arrangements;
- Art. 72b(2)(h) – restrictions on incentives to redeem are not set out in the FSB Term Sheet, as such issuances will not have factored this in;
- Art. 72b(2)(i) – introduces the stricter criteria whereby the liability cannot be redeemable by the holders prior to the maturity of the instrument, whereas existing MREL eligibility criteria permits this but takes the maturity of the instrument to be the first date where such a right arises;
- Art. 72b(2)(j) – introducing restrictions on call options to be held only by the issuer are, as stated above, in contrast to the current MREL eligibility criteria in the BRRD;
- Art. 72b(2)(k) – can only call, redeem, repurchase or repay early where regulatory approval is provided as per Art 77 and 78. The FSB Term Sheet, Section 12, only requires approval where redemption would lead to a TLAC breach;
- Art. 72b(2)(l) – specific restriction required to be reflected in the terms around early call/redemption/repurchase (FSB Term Sheet silent although this is common to current capital instruments);
- Art. 72b(2)(m) – Restrictions on acceleration rights for TLAC instruments (not required in the FSB Term sheet and going beyond the FSB key attributes);
- Art. 72b(2)(n) – specific restriction required to be reflected in the terms around credit sensitive features (FSB Term Sheet silent although again, common to capital instruments);
- Art. 72b(2)(o) – Contractual provisions to permanently write down or convert instruments/liabilities to CET1, going beyond the FSB term sheet.

ANNEX 2 – Eligibility criteria

Suggested amendments to the Commission's proposal amending Regulation 575/2013 (CRR)

Article 72b(2)(d), (e): subordination requirement	
Original text:	Proposed amendment:
(d) the claim on the principal amount of the liabilities under the provisions governing the instruments is wholly subordinated to claims arising from the excluded liabilities referred to in Article 72a(2). This subordination requirement shall be considered to be met in any of the following situations: (i) the contractual provisions governing the liabilities specify that in the event of normal insolvency proceedings as defined in point 47 of Article 2(1) of Directive 2014/59/EU, the claim on the principal amount of the instruments ranks below claims arising from any of the excluded liabilities referred to in Article 72a(2); (ii) the law governing the liabilities specifies that in the event of normal insolvency proceedings as defined in point 47 of Article 2(1) of Directive 2014/59/EU, the claim on the principal amount of the instruments ranks below claims arising from any of the excluded liabilities referred to in Article 72a(2); (e) the instruments are issued by a resolution entity which does not have on its balance sheet any excluded liabilities as referred to in Article 72a(2) that rank pari passu or junior to eligible liabilities instruments;	(d) the claim on the principal amount of the liabilities under the provisions governing the instruments is wholly subordinated to claims arising from the excluded liabilities referred to in Article 72a(2). This subordination requirement shall be considered to be met in any of the following situations: (i) the contractual provisions governing the liabilities specify that in the event of normal insolvency proceedings as defined in point 47 of Article 2(1) of Directive 2014/59/EU, the claim on the principal amount of the instruments ranks below claims arising from any of the excluded liabilities referred to in Article 72a(2); (ii) the law governing the liabilities specifies that in the event of normal insolvency proceedings as defined in point 47 of Article 2(1) of Directive 2014/59/EU, the claim on the principal amount of the instruments ranks below claims arising from any of the excluded liabilities referred to in Article 72a(2); **or** **~~(e)~~(iii)** the instruments are issued by a resolution entity which does not have on its balance sheet any excluded liabilities as referred to in Article 72a(2) that rank pari passu or junior to eligible liabilities instruments;
Justification	
This appears to be contrary to the legislative intention and the TLAC Standard. It should be clarified that all three routes to subordination should be equally permissible and respected. The requirement under article 72b(2)(e) should be moved to a new 72b(2)(d)(iii) to correct this.	

Article 72b(m): restriction on acceleration rights

Original text:	Proposed amendment:
(m) the provisions governing the liabilities do not give the holder the right to accelerate the future scheduled payment of interest or principal, other than in the case of insolvency or liquidation of the resolution entity;	~~(m)~~**(l)** the provisions governing the liabilities do not give the holder the right to accelerate the future scheduled payment of interest or principal, other than**;** **(i)** in the case of insolvency or liquidation of the resolution entity; **or** **(ii)** **upon the expiry of 30 days following the failure of the institution to meet a payment of interest or principal when due;**

Justification

The proposed restriction on acceleration rights goes beyond the TLAC Standard. Should the co-legislators determine that acceleration rights should be restricted, we would strongly urge them to consider a rule which allows acceleration for non-payment subject to a 30-day cure period, in line with the approach taken in the final US TLAC rules.

Senior debt investors take comfort from the fact that they can accelerate payment under normal circumstances in the event that a bank withholds payment. If this acceleration right is withdrawn then the senior investors will be left with the same acceleration right as that enjoyed by investors in capital securities.

Article 72b(o): contractual write down

Original text:	Proposed amendment:
(o) the contractual provisions governing the liabilities require that, where the resolution authority exercises write down and conversion powers in accordance with Article 48 of Directive 2014/59/EU, the principal amount of the liabilities be written down on a permanent basis or the liabilities be converted to Common Equity Tier 1 instruments.	**Delete (o); or,** ~~(o)~~**(n)** the **applicable law or** contractual provisions governing the liabilities require that, where the resolution authority exercises write down and conversion powers in accordance with Article 48 of Directive 2014/59/EU, the principal amount of the liabilities be written down on a permanent basis or the liabilities be converted to Common Equity Tier 1 instruments.

Justification

This requirement, as set out in our arguments above, duplicates the statutory regime that applies in the EU and the contractual provisions that are required under Article 55 BRRD for third country liabilities.