Bank+InsuranceHybridCapital Briefing

Banking turbulences in a Covid world: ECB, SRB & EBA on supervisory priorities

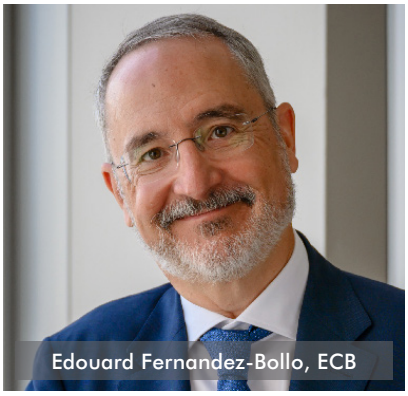
Crédit Agricole CIB hosted a web conference themed "Banking turbulences in a Covid world: the regulatory angle", with delegates hearing from European Central Bank (ECB) supervisory board member Edouard Fernandez-Bollo, Delphine Reymondon, head of the liquidity, leverage, loss absorbency and capital unit at the European Banking Authority (EBA), and Sebastiano Laviola, board member and director of strategy and policy coordination at the Single Resolution Board (SRB).

ECB supervisory board member Edouard Fernandez-Bollo stressed the ongoing flexibility of the European banking supervisory framework at a Crédit Agricole CIB (CACIB) web conference on 1 October, underlining that banks will not have to start rebuilding buffers before peak capital depletion is reached.

The ECB supervisory board member was speaking under the web conference theme "Banking turbulences in a Covid world: the regulatory angle", with delegates also hearing from Delphine Reymondon, head of the liquidity, leverage, loss absorbency and capital unit at the European Banking Authority (EBA), and Sebastiano Laviola, board member and director of strategy and policy coordination at the Single Resolution Board (SRB).

As a recent example of the relief continuing to be given to banks, the ECB's Fernandez-Bollo noted the decision, announced on 17 September, to allow the temporary exclusion of certain central bank exposures from the leverage ratio in the exceptional circumstances of the coronavirus pandemic.

"I wanted to cite this to show that we are still in the mode of using all the possibilities that are given by the framework," he said.



Edouard Fernandez-Bollo, ECB

The latest move comes on top of a raft of major relief measures undertaken by the ECB and other European bodies that Fernandez-Bollo discussed, such as flexibility in the treatment of non-performing loans, delays and easing in supervisory measures, and reductions in capital requirements — alongside the central bank's recommendation that dividend payments (but not AT1 coupons) for 2019 and 2020 be ceased.

According to ECB estimates, the aggregate impact of such mitigating measures is equivalent to €120bn of CET1 capital, of which €30bn is from unpaid dividends, potentially able to finance up to €1.8tr of loans to households and corporates in need of extra liquidity. Fernandez-Bollo said this has clearly improved the resilience of the banking sector.

"Everybody is now saying that one of the really significant characteristics of this crisis is that up to now the banks have been part of the positive reaction function to the crisis," he said. "We've seen in fact that the banks have not restricted lending in Europe, in particular.

"This is clearly for us due to the resilience that was built in, but also to the effect of these mitigating measures."

Prominent among these has been the possibility for banks to fully use capital and liquidity buffers, operating below the level of capital defined by Pillar 2 Guidance (P2G) and the capital conservation

ECB TAKEAWAYS

Buffers

- The buffer framework is the innovative element of bank regulation since the Global Financial Crisis (GFC) and it was put in place to provide banks with the tools to react to a crisis, by using the buffers in a crisis and replenishing them during a recovery
- In order to facilitate buffer usage, the ECB disclosed publicly for the first time ever a Forward Guidance: there is no expectation from the ECB of buffer rebuild before peak capital depletion and even the indicative deadline of end-2022 can be adapted in light of circumstances
- The ECB thinks that buffer usage may be necessary for some banks should a second Covid-19 wave materialise
- At the same time, the ECB is fully aware of the stigma effect of using the buffers, particularly for the first banks to do so
- From the current buffer set, the ECB sees the Pillar 2 Guidance (P2G) as the least problematic to use as it does not trigger MDA
- The ECB also thinks the countercyclical buffer (CCyB) potentially should have been higher, in order to increase buffer usability
- Potentially, a buffer capacity utilisation greater than the sum of CCyB and P2G may be required and the regulator is thinking about measures that may enable such usage

buffer (CCB), and below the Liquidity Coverage Ratio (LCR).

"One of the lessons we learned from the financial crisis is that we had to be able to adjust the possibilities of banks to react to the crisis and different types of buffers were then built into the framework," said Fernandez-Bollo.

No such flexibility was available at the time of the financial crisis, where the choice was binary: either a bank complied with capital requirements or it did not.

An ECB vulnerability analysis in July found that although a second Covid-19 wave would have no significant impact on the euro area banking system as a whole, there would be "pockets of difficulty", and Fernandez-Bollo noted that the need for caution going forward had prompted the central bank to use "forward guidance" for the first time in respect of banking supervision, namely to allow banks to operate below P2G and the combined buffer requirement until at least end-2022, and below the LCR until at least end-2021, without automatically triggering supervisory action.

"We are very conscious that it's not easy for a bank to use the buffers and that there's a stigma linked to that, to be-

ECB TAKEAWAYS (cont.)

Dividends

- Dividend ban was an extraordinary measure underlining the uncertainty in respect of the Covid-19 crisis
- The ECB clarified that that payments in kind (scrip dividends) and dividend payments within banking groups are allowed
- The ECB is acutely aware of the impact of the dividend ban on banks' valuations and perception
- The ECB cannot say when it will publish new elements on its dividend recommendation ban, but the ECB will eventually come back to the normal course of evaluating dividend distribution plans on an individual basis, with a new publication on the topic in the near future
- The ECB underlined that AT1 coupons are not impacted by the dividend ban recommendation

Basel IV

- The ECB continues to recommend faithful implementation of Basel IV in the EU, assuming that a more robust risk measurement framework will eventually benefit the banking system as a whole, with e.g. lower funding costs
- Given the Covid-19 crisis, the deadline has already been postponed to 2023
- The deadline may be reviewed for further delay if warranted by circumstances
- For the ECB, it is of critical importance that any delays and other modifications to the Basel IV framework remain coordinated and implemented at the international level

Consolidation

- The ECB sees consolidation as a credible way to tackle some of the structural challenges of Eurozone banks, such as overcapacity and low profitability
- The ECB wanted to have clear and transparent guidelines for consolidation in order to eliminate the incorrect perception of regulatory roadblocks, independent of the Covid-19 crisis
- Having said that, only sustainable mergers resulting in overall risk reduction in the system will be allowed
- National consolidation is of course easier due to cost synergies, but the ECB sees over time scope for international consolidation, where the main benefits come from business/geographical diversification
- One possible way is to see firstly domestic consolidation creating strong national champions, followed by international consolidation
- Badwill is prudentially recognised, but it is there in the first place to provide the capital to enable necessary measures for the consolidation, followed by eventual distribution of excess capital to owners once the combined entity is established on a sustainable basis

AT1 and Tier 2 instruments

- In terms of facilitating buffer usage, a key measure from the ECB was the anticipation of the measure enabling banks to fill the Pillar 2 Requirement partially with AT1 and Tier 2 capital
- As such, the ECB sees positively the issuance of AT1 and Tier 2 funds by banks, as they contribute to enhancing the CET1 capacity of the banking sector
- Yet, these instruments do not share the loss absorbing characteristics of CET1
- For the time being the ECB assessment of AT1 and Tier 2 instruments is positive ("played the role"), and this must be taken into account in an eventual rethinking of the capital framework post crisis

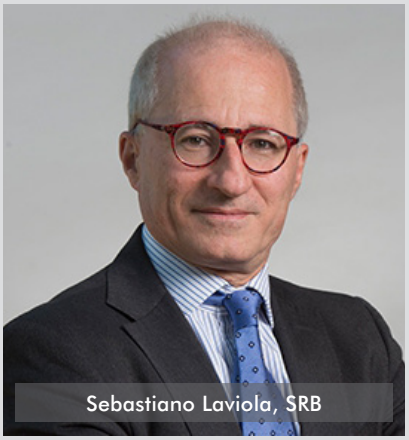
NPL management

- It is clear that the Covid-19 crisis will result in a second wave of NPLs post the one from the GFC, perhaps not in a massive way, but this will very much depend on the recovery path
- For the ECB the operational readiness of banks for careful identification, measurement and management of NPLs from a medium term perspective is key
  - It is clear that some companies will not survive the crisis
  - The expiration of moratoria and state guarantees will have different impact on sectors and geographies
  - In this context, banks must be prepared to recognize and manage NPLs from an early stage
  - Here a similar process to the one put in place for the implementation of IFRS 9 will be helpful
- In terms of supervisory response, the ECB is prepared to provide flexibility in terms of operation of the ECB Guidance on NPLs, but such flexibility will only be provided upon credible evidence that the risk analysis is working well

SRB to provide intermediate MREL ramp-up relief, benchmarks banks' MREL trajectory

Sebastiano Laviola presented an overview of the SRB 2020 MREL policy, timeline for MREL build-up, MREL market conditions monitoring, relief measures in the context of Covid-19 and SRB views on banking consolidation.

Whilst the SRB 2020 MREL policy and MREL build-up deadlines are now well known to investors and bank management teams, the SRB outlined in more detail some specific MREL adjustments applicable to MPE-resolution banks and also to cooperative bank groups under certain circumstances.


Sebastiano Laviola, SRB

Beyond that, the following elements appear of particular importance:

Covid-19-related modifications to MREL ramp-up framework

Element 1: "Forward looking approach"

- Existing binding MREL targets set on TLOF basis, as required under BRRD 1 (MREL calculated as per EBA MREL RTS on RWA basis, then translated into TLOF)
- Banks without a shortfall must normally comply with the binding MREL target at all times
- As a result of the Covid-19 impact on banks, i.e. (i) market closure for MREL debt at acceptable cost and (ii) balance sheet expansion due to credit line usage and TLTRO, the TLOF MREL target may have been more difficult to respect in certain cases
- It is with reference to such difficulties on TLOF basis that the SRB applies its "forward looking approach", i.e. the SRB will look at the new MREL decisions determined on the basis of the 2020 MREL Policy

Element 2: Adaptation of BRRD 2 MREL decisions in light of Covid-19 effects on banks:

- BRRD 2 MREL targets for 2021 (to be fulfilled on 1 January 2022, binding intermediate target per BRRD 2) will be set based on the revised capital requirements (relief primarily from (i) reduced buffers and (ii) lower RWA under CRR Quick Fix)
- For a limited number of banks, the intermediate 1 January 2022 MREL target will be adjusted (i.e. lowered), leading to a non-linear MREL ramp-up path until 2024 (additional temporary relief)
- The SRB is (i) monitoring market access and cost of MREL Eligible Liabilities for individual banks and (ii) analysing key balance sheet metrics (RWA, TLOF, LRE) as of June 2020, when deciding which banks benefit from this MREL "backloading" relief — the SRB anticipates this relief to be provided in a limited number of cases
- What is important in this context is that (i) delayed MREL build-up does not mean cancelled MREL build-up and (ii) the MREL build-up trajectory must also ensure that the Combined Buffer Requirement is respected, as otherwise there may be consequences, such as the imposition of Maximum Distributable Amount limits due to MREL breach (so-called M-MDA)

SRB views on consolidation

- In terms of banking M&A, Laviola stated that when deciding on the parameters of the project, banks must also take into account the resolvability perspective of the combined entity. In this context Laviola referred to the Expectations for Banks SRB document

ing a first mover," said Fernandez-Bollo. "We really want to destigmatise use of the buffers — to us it really makes sense to use them when you are in a transition period like this.

"That's why it's very important for us to use all the flexibility we have in our supervisory approach to facilitate the use of buffer."

Given the uncertainty over the shape of the recovery, he said the end-2022 date will be subject to review, while the ECB will also monitor whether further measures will be required to encourage banks to use their buffers. There could also be an update on dividend distribution in the near future, he added.

"For the time being, what is happening is rather more benign than what we had in our stress scenario," said Fernandez-Bollo, "but of course, we are supervisors, so we have to prepare for the worst. That's why the word caution is still very much the order of the day in our supervisory response to the crisis."

Cécile Bidet, head of DCM solutions and advisory at Crédit Agricole CIB, and co-host of the web conference, said that in spite of the rather good results and resilience of the banking system thus far in the crisis, the one known element at present is indeed continued uncertainty.

"In the absence of clarity, prudent banks continue to reinforce their capital basis through AT1 and Tier 2 issuances," she said.

SRB targets intermediate MREL relief

Laviola at the SRB noted that while the resolution authority's responsibilities mean that it is not first in line in providing relief to banks, it has acted in line with other authorities and governments.

"Our aim has been to maintain our goal of achieving the resolvability of all the banks under our remit, but at the same time being mindful not to put in place procyclical measures or to create an obstacle to the funding of the economy that was and is still needed," he said.

"Therefore, there have been a number of relief measures in terms of lengthening the deadlines for the various papers and data banks had to submit.

"We are also using the flexibility in the legislation to adapt the transition period for MREL to the actual situation on a case by case basis."

The SRB has announced that, as regards existing BRRD1 binding targets, it will take a forward-looking approach to banks that may face difficulties in meeting those targets before new MREL decisions under the banking package take effect.

Regarding BRRD2, which comes into force at the turn of the year, the SRB is using June 2020 data to review banks' intermediate MREL targets, which have to be hit by January 2022. This is a move away from the anticipated linear build-up of MREL.

"If there are important reasons to deviate from this linear path, then one can choose a non-linear path," said Laviola, "and this is exactly what has been done in a number of specific cases, although not many.

"Why have we done this? Because if we are lowering the binding intermediate targets for banks that might show difficulties in fulfilling the 2022 targets, then this downward adjustment is a relief measure for the banks — notwithstanding that the target remains ambitious, because we do not deviate from the goal of achieving resolvability."

He noted that final MREL targets are not being changed now, but are anyway due to be recalibrated each year.

Michael Benyaya, DCM solutions, Crédit Agricole CIB, noted that the SRB has provided relief to the banking system on the basis of the possibilities contained within regulations, although such relief measures may have been less visible than those of the ECB.

Delphine Reymondon, EBA

AT1, Tier 2 'play a role'

A key mitigating measure highlighted by the ECB's Fernandez-Bollo was the front-loading of banks being able to use AT1 and Tier 2 instruments to partially meet Pillar 2 Requirements (P2R).

He further noted that although the issuance of AT1 and Tier 2 was "completely frozen" in March and April, the market has since restarted.

"So this possibility that was given to use the AT1 and the Tier 2 instruments for the Pillar 2 Requirement was indeed very useful for the banking system, allowing the banks today to build up capital for the next phase," said Fernandez-Bollo.

"Of course, the shock to banks has been limited," he added, "and it's clear that AT1 and Tier 2 do not have the same loss-absorbing capacity as CET1, but for the time being I value their contributions rather positively. We will integrate all that into our forward-looking reflections about the capital framework."

The EBA's Reymondon was also asked about the role and relevance of AT1 and Tier 2 during the CACIB event. She said that some of the questions being raised around AT1 were perennial ones.

"They were already there many years ago even when we finalised the new capital framework back in 2011," she said, "that AT1 instruments should not be in the landscape anymore, that you should have only CET1 and Tier 2. So it's not a wholly new debate, but one that has indeed started again.

"From an EBA perspective, it is not appropriate to start reflecting on changes amid the crisis — we would prefer to wait. We prefer to have some stability in the regulatory framework."

Reymondon noted that in the run-up to CRR2/CRD5 the EBA had recommended avoiding tweaks to the position of AT1 in terms of MDA-related distributions, to avoid any possibility of undermining the AT1 class. She said that similar considerations explain why the regulator is not reviewing AT1 triggers, even if it acknowledges that they are probably too low.

"This would probably also prompt a more thorough discussion on the wider capital framework," she added, "the different buffers and layers, whether they work or not, TLAC and MREL — everything. Also, the Basel Committee has launched the evaluation exercise of the capital framework to see what is and what is not working, and we would need first to have this assessment to see if anything should be changed. This would probably take quite a lot of time."

Doncho Donchev, DCM solutions, CACIB, noted that the top regulators remain committed to Tier 2 and, more importantly, AT1 instruments.

"However, it cannot be denied that the fear of AT1 coupon cancellation and potential funding cost fallout across the liability structure are one of the major factors inhibiting banks from buffer usage," he added. ●

See pages six to 13 for updates on EBA announcements since the web conference.

Reporting by Neil Day

EBA plans guidance on green AT1, Tier 2, but open to product

The European Banking Authority could issue guidance on Additional Tier 1 and Tier 2 instruments in green bond format around the first quarter of 2021, according to Delphine Reymondon, head of the liquidity, leverage, loss absorbency and capital unit at the EBA.

In July Spain's BBVA issued the first European AT1 to be marketed as "green", and later that month de Volksbank of the Netherlands sold the first European green Tier 2 issue from a bank, later followed by AIB in September.

Speaking at the Crédit Agricole CIB web conference on 1 October, "Banking turbulences in a Covid world: the regulatory angle", Reymondon said the EBA had previously seen MREL/TLAC issuance in green format, but the issuance further down the capital stack had made the need for guidance more pressing.

"Given that during the summer we had now green issuances entering the own funds world, we are considering moving forward with guidance," she said, "relating to the possible risks that need to be assessed."

She said these risks include:

- Reputational risk around the use/allocation of the funds and related risk of earmarking the proceeds for ESG projects and interaction with absorption of losses for own funds/eligible liabilities instruments
- Risk that investors are not made aware that coupons might be skipped due to losses/issues not related to green assets (AT1)
- Risk around a potential disqualification of the original ESG/green assets/lack of new assets to replace and possible perception of an obligation for the issuer to redeem the instrument
- Risk of having the maturity of green assets not matching the duration of the instrument and perception of an obligation for the issuer to redeem the instrument at the maturity of the assets
- Risk of having features of predefined sustainability or ESG objectives directly impacting the regulatory eligibility criteria for OF/EL instruments

Reymondon noted, for example, that sustainability-linked bonds in the corporate bond market have had coupon step-ups if ESG targets are not met and this would compromise their eligibility as own funds.

She said the guidance would probably take the form of best practices, rather than standardised clauses.

"It's too early for that," said Reymondon. "We need to see more issuances.

"But we would also probably say what we would not like to see in some clauses," she added. "The main question is whether we should recommend including additional wording in the risk factors to decrease the risk that investors perceive it first as an ESG or green bond before being a capital instrument — for us, of course, it's first a capital instrument before being an ESG or a green bond."

The emergence of green AT1 has prompted some market participants to question whether it should be used for funding in the same use-of-proceeds model used for other green bonds, or if it should be structured to cover "green" RWAs given the capital nature of the instrument. Reymondon said this is more of a question for issuers and investors to answer.

"Personally, I would say that there are probably other types of instruments more suited to being green," she added, "and it shall be clear to investors that it is capital first. But as long as there is no doubt there and no incompatibility between the two aspects, why not?

"From an EBA perspective, we would not oppose banks wanting to issue AT1 and Tier 2 with green features; we will just have a look. We just need to ensure that our points of attention are clearly understood by everyone, that everything is clear for the investor, and that there would not be too many challenges for the bank in case the instrument has to be activated."

See page 11 for further details. ●

EBA TAKEAWAYS

RTS on Own Funds and Eligible Liabilities

- CRR II requires the EBA to update the RTS on Own Funds and to include also Eligible Liabilities
- EBA basic principle — striving for as much harmonisation as possible between prior regime and current regime under CRR II and alignment of criteria between Own Funds and Eligible Liabilities as both are loss absorbing instruments
- Limited number of responses received on the Consultation Paper and all points raised were anticipated by the EBA
- One part of the responses focused on the four month period required for examination of redemption requests, which may be excessive, in particular in the context of renewals for the general prior redemption permission
  - Here the EBA said that there may indeed be an issue and is looking for ways to potentially shorten such period whilst preserving necessary reflection for prudential purposes
  - Two potential routes can include No Objection statements from relevant authorities and Fast Track procedures
- The other part of responses focused on the 3% limit relative to the overall outstanding stock of a particular liability layer, which is seen generally as too low
  - Here the EBA indicated a potential increase in the limit, for as long as the immediate deduction principle is kept to preserve prudence
- Firstly, the RTS will be published — timing Q4 2020/Q1

2021, then the relevant Q&As may need to be revised
- Questions were raised on the notion of "sufficient certainty" — the criterion which, when fulfilled, requires immediate deduction from OF/EL of the impacted instrument:
  - Such notion has not always been clear and some competent authorities have not always implemented immediate deduction, e.g. upon a replacement of an instrument
  - This is not something the EBA will not oppose as it avoids a cliff effect in the Own Funds of the bank, in particular if there is replacement intention

AT1 instruments
- The EBA stated that in international regulatory fora the debate on AT1 instruments and their very existence has returned again in the context of the Covid-19 crisis, with some stakeholders voicing concerns that AT1 effectively prohibits buffer usage
  - In this context it is noted that the Basel Committee has launched an evaluation exercise of the capital framework, especially relevant given the crisis context
- As part of discussions, the (old) debate on AT1 trigger levels has resumed
  - According to the EBA, a review of the level of the AT1 trigger (maybe too low, but what is the right level?) would require a re-design of the entire capital framework, including the interaction with MDA and buffer requirements
- The EBA sees as the best defence for existence of AT1 instruments the maintenance of their strict criteria in the EU and hence the EBA has defended in the recent past these strict criteria (e.g. continued exclusion of dividend stoppers in the EU, no pecking order between AT1 coupons and equity dividends)
- Finally, the EBA noted that there must be some stability in the regulatory framework for a while, rather than creating new rules and new classes of grandfathered instruments circa every 10 years

Regulatory updates from CACIB

EBA: First MREL/TLAC Instruments Monitoring Report

On 29 October, the European Banking Authority published its first MREL/TLAC Instruments Monitoring Report (under CRR).

HIGH LEVEL OBSERVATIONS AND KEY POINTS

- Unsurprisingly, most issuers have anticipated well the EBA's findings and recommendations. For the largest part, existing (SNP) documentation should comply fully with the EBA recommendations
- Nevertheless, there are a few specific areas which banks/credit investors may want to follow closely

ESG/Green bonds aimed at Own Funds/MREL qualification

- *The basic principle is Loss Absorbing Instrument first, then ESG instrument …* Potential legal loopholes to this principle must be avoided
  - Here the risk is not that investors do not understand this risk, it is that the relevant documentation must ensure that Loss Absorbency is valid and enforceable, meaning that investors must acknowledge the principle above and accept being bound by it, in a similar way to accepting bail-in powers. Otherwise, in a bail-in situation certain (investing) parties may wish to exploit legal arbitrages and hide behind ESG characteristics to avoid application of bail-in
  - It appears that the EBA is thinking about addressing this risk through the wording of Risk Factors in the documentation, rather than a Bail-In Recognition Condition (BIRC), although a BIRC would clearly be helpful in this context, irrespective of whether EU or third country governing law applies
  - Potential Guidance/Opinion on the matter to be issued by the EBA in Q1' 2021

Set-Off Waivers — validity/enforceability limitation by national law

- In the EBA's own words: "*The EBA will investigate further the interaction between such [set-off waiver] clauses and relevant national laws to better understand the effectiveness of such a clause in practice*"
- The key question is what happens if the EBA finds that set-off/netting applies under certain national laws and thus overrides CRR eligibility criteria → if there is no fix for such a situation and upon narrow interpretation, it would mean *in extremis* that AT1-T2-SNP-SP layers are disqualified as Own Funds/MREL, or, as set-off application may also be limited by asset-liability ranking correspondence (i.e. both are of similar rank), there may be at least an issue with SP debt qualifying as MREL (an issue apart from the perennial NCWO ranking issue)

- Having said this, the set-off issue is not new, it has been widely debated during the Banking Package legislative process (e.g. debate on *set-off rights vs. arrangements*), so the probability of a radical outcome such as the above is rather nil, but on the other hand the probability of the set-off issue having gone away for banks is also no longer 100%

(i) Tax Principal Gross-Ups and (ii) No Regulatory Approval Language for Early Redemption in Bond documentation → post-grandfathering treatment implications

- The EBA prohibits tax principal gross-ups for MREL Instruments as it sees them as creating too much of a (contingent) incentive to redeem (tax interest gross-up allowed)
- The EBA affirms that terms and conditions of Own Funds/MREL instruments must contain an explicit reference to prior regulatory approval for early redemption (to make them eligible)
- Taking a narrow read, all instruments containing a tax principal gross-up and not having referenced prior regulatory approval for early redemption should therefore be disqualified when considering the fully-loaded eligibility articles of the CRR (52 for AT1, 63 for Tier 2, 72b for MREL instruments)
- Taking a wider view:
  - Legacy instruments without T&C reference for prior regulatory approval for early redemption qualify in their grandfathered bucket until 31/12/2021; most issuers likely to take into account the EBA legacy instruments Opinion, Q&A 2013 544 and paragraphs 123-124 of this report when considering post-grandfathering treatment and likely to find that such instruments are disqualified
  - Instruments with tax principal gross-ups: most likely prolongation of current treatment, that is (i) issued instruments with such a feature are neither disqualified nor grandfathered and (ii) future instruments cannot have such a feature

USD bond issuance and MREL eligibility

- The EBA confirmed the eligibility of 144a issues for MREL
- 3a2 issues guaranteed by a US branch of an issuer are not eligible for MREL, but 3a2 issues guaranteed by a US subsidiary (separate legal entity) are. Final treatment still under consideration, with either all or none of 3a2 issues eligible for MREL (digital outcome)

Context and structure of the report

- The EBA, as part of its mandate to ensure high quality loss absorbency characteristics of Own Funds (CET1, AT1, T2) and MREL Instruments (SNP/Senior HoldCo and equivalent instruments, plus MREL eligible Senior Preferred debt) published the report containing 15 recommendations on various bond documentation conditions (what the EBA would like to see and what it would like to see avoided)
- The report focused on the SNP/Senior HoldCo layer of MREL instruments, so observations/recommendations on the ranking of MREL Instruments must be interpreted as specific to the SNP (or Senior HoldCo) layer only, whereas EBA points in other areas are valid for both SNP and SP layers of MREL instruments
- EBA Opinions and Monitoring Reports are part of the EBA's non-binding powers, whereas EBA Q&As, recommendations and guidelines may also not be binding, but where non-compliance is subject to a Comply or Explain procedure by the competent supervisor (Explain in the event the supervisor does not apply EBA recommendations, guidelines; the supervisor's job is to make sure that banks under its remit comply with EBA non-binding guidance). **Interestingly, the report also contains 15 explicit recommendations, so resolution authorities/supervisors and their banks are bound to respect these recommendations**
- The report also identifies areas of EBA Work in Progress on Own Funds and MREL Instruments → here the EBA lists Substitution and Variation conditions and ESG bonds aimed at MREL/Own Funds eligibility

EBA Observations on Availability

- Definition of Availability: Direct issuance; fully paid-up; ownership restrictions; no direct/indirect funding by institution or subsidiaries; no security or guarantee that enhances the seniority of the claim
- The EBA makes no official recommendation in the area of Availability for the time being
- The EBA notes *"complementary analysis may be warranted to establish that the issuing entity is a resolution entity or that the holders are not themselves resolution group entities or funded by the resolution group"*
- The EBA reminds that the only exception to the ownership restrictions is for a non-resolution entity to issue MREL instruments to an existing shareholder of the resolution entity, provided upon bail-in the resolution entity does not lose control of the non-resolution entity (no change of ownership)
- **3a2 USD onshore issuance and MREL eligibility**
  - Currently, 3a2 issues guaranteed by a US branch of an issuer are not eligible for MREL, whereas 3a2 issues

guaranteed by a US subsidiary (separate legal entity) are (Q&A 2016 2966)
  - The EBA retains for the time being this treatment, but it still keeps this matter under consideration and exchanges with stakeholders (key question is whether under the new regulation the guarantee can be seen as *security-enhancing*, whereas under the previous regulation the only question was if there was any guarantee by the bank (as issuing entity) to itself)
    - The eventual outcome will be digital: Either 3a2 guaranteed issues will be disallowed in all forms (i.e. including US subsidiary guaranteed 3a2 issues); or they will be allowed in all forms
- At the same time, the EBA confirms MREL eligibility of 144a USD onshore issues

EBA Observations on Subordination

The EBA makes four official recommendations on Subordination/Ranking conditions. CACIB reproduces them in full below and adds further observations of interest

- ***Clear Ranking language:*** *Recommendation 1: Issuers should set out unambiguous terms on the ranking of notes in national insolvency, and in particular there should be no doubt that the notes are subordinated to excluded liabilities within the meaning of Article 72a(2) of the CRR. A description of instruments ranking junior and senior to a note under consideration constitutes good practice, particularly if the note is not statutorily subordinated as a result of the application of the national measures implementing Article 108 of the BRRD, as amended by the Creditor Hierarchy Directive.*
- ***Clarity on ranking of interest:*** *Recommendation 2: Having interest subordinated to excluded liabilities is not a CRR eligibility criterion. However, there should always be clarity in the terms and conditions of the bonds of the ranking of interest in the insolvency hierarchy. Furthermore, interest subordination can be seen as a best practice when this is compatible with the creditor's hierarchy according to national insolvency law. The EBA will continue to monitor this aspect.*
  - Other point of note: Only accrued interest with a residual maturity of at least one year and subordinated to excluded liabilities in the sense of 72(a)2 CRR can explicitly count in MREL/TLAC
- ***Statutory subordination — Ranking description:*** *Recommendation 3: in addition to referring to the applicable statute transposing the Creditor Hierarchy Directive, a clear description of where the notes sit in the national hierarchy, in particular in relation to excluded liabilities within the meaning of Article 72a(2) of the CRR, is conducive to additional clarity.*
  - This means to refer to the SNP rank as per the applicable article/paragraph/law of national legislation and, in addition, describing liabilities which are senior/junior to the MREL instrument, whilst highlighting in particular the excluded liabilities and how they rank senior to the MREL instrument
  - Interestingly, the EBA also makes the soft observation that marketing instruments explicitly subordinated to achieve MREL eligibility with a name that is associated with more senior liability classes may not be ideal from a bank and regulatory point of view
- ***Subordination via HoldCo-OpCo structure — clear description of the structural subordination:*** *Recommendation 4: If notes are structurally subordinated, good practice consists of clarifying, for investor awareness purposes, the structural subordination mechanism and risks. This may, for example, be described in the risk factors and does not imply that the notes should be contractually subordinated (they remain unsubordinated vis-à-vis other creditors of the resolution entity).*
  - Where the MREL notes are subordinated via a structural subordination mechanism (i.e. issued from the HoldCo in a HoldCo-OpCo structure), then a *Good Practice* consists in a clear description of the structural subordination mechanism, where the investor sits within this mechanism and attached risks (e.g. via Risk Factors)
  - Nevertheless, the EBA observes that compliance with the Clean Balance Sheet requirement for HoldCos (i.e. excluded liabilities are less than 5% of the own funds and eligible liabilities of the bank) is first a responsibility for the banks, under the surveillance of resolution authorities in cooperation with competent authorities, facilitated by granular reporting

EBA Observations on Loss Absorption Capacity

The EBA makes seven official recommendations on Loss Absorption-related conditions

The EBA aggregates under the area of Loss Absorption Capacity the following regulatory requirements applicable to MREL instruments (in bold the areas where the EBA makes recommendations):

- **No set-off/netting arrangements; no acceleration by investor of scheduled interest/principal payments**; level of interest not amended based on credit standing; **write-down — conversion (bail-in recognition) conditions; negative pledges**
- **Set-Off Waivers:**
  - *Recommendation 5: Although this is not a legal requirement and the absence of such a clause does not mean that the instrument concerned needs to be grandfathered and ultimately disqualified, an explicit waiver of set-off and netting rights is conducive to legal certainty, and, in the light of market practice, is seen as good practice. The EBA will investigate further the interaction between such clauses and relevant national laws to better understand the effectiveness of such a clause in practice.*

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- Interaction with national laws and actual effectiveness of Set-Off Waivers:
  - N.B: Set-Off Waiver may be de facto rendered void by applicable national law provisions and, hence, be ineffective → loss absorbency capacity could be undermined by the applicable set-off/netting rights
  - Hence, the EBA is not very comfortable with wording along the lines of "waived, however, to the extent possible under national law"
- **This is an area that deserves perhaps some of the greatest attention from bank issuers in respect of this report, as the potential negative impact is large and likely to impact certain jurisdictions more than others**

- *Recommendation 6: Some issuances not only explicitly preclude set-off and netting but also provide for a compensatory payment from the holder in case an amount due to the issuer is nevertheless unduly discharged as a result of netting or set-off. This is seen as best practice, where this is compatible with national law. The EBA will continue to monitor such mechanisms regarding their application and effectiveness.*
  - The EBA further sees as a *Best Practice* the inclusion in Set-Off Waivers of a requirement for a compensation payment from an investor to the issuing bank, in the event that set-off or netting rights have been *unduly* exercised. I.e. the investor reduces exposure to the bank under set-off/netting mechanisms. Questions arise here as to the definitions of "unduly" and "compatibility with national law"
  - **As the EBA sees the inclusion of the "compensation backstop" as a *Best Practice*, banks must be prepared to include such language upon their next EMTN Programme updates (if compatible with national law) and/or be prepared for an Explain procedure with their resolution authority in the event that such compensation backstop cannot be included**

- **Acceleration of scheduled payments on instrument:**
  - *Recommendation 7: It should be clear from the notes that acceleration can occur only on the ground of insolvency or liquidation, and that, in particular, it cannot occur in resolution or a moratorium under the BRRD (Art. 33a)*
  - *Recommendation 8: Whether, as best practice, 'resolution' and 'moratorium' should be mentioned explicitly by the notes as not giving rise to acceleration is subject to further reflection*
- **Bail-In Recognition Condition (BIRC):**
  - *Recommendation 9: The AT1 report recommends standard drafting for bail-in clauses under Article 55 of the BRRD. In the medium term, a similar effort could be envisaged in relation to eligible liabilities, to ensure compliance with Article 55 of the BRRD as well as Article 72b(2)(n) of the CRR, taking into account their specificities.*
  - *Recommendation 10: A clause to the effect that delay or failure by the issuer to notify in advance the noteholders of the write-down or conversion action shall not affect the validity and enforceability of the bail-in or write-down and conversion powers could be considered good practice.*
    - The inclusion of a condition stating that delay or failure to notify noteholders from the bank about the imposition of resolution measures/bail-in does not affect the validity and enforceability of such resolution measures/bail-in is still under consideration as Good Practice recommendation
- ***Explicit exclusion of Negative Pledges:*** *Recommendation 11: Considering the fact that many notes already explicitly exclude negative pledges, it appears appropriate to recommend such exclusion as best practice.*
  - The EBA sees the *explicit* exclusion of Negative Pledges as *Best Practice* (i.e. including a clear condition in the documentation that there is no Negative Pledge rather than achieving the exclusion of Negative Pledges by simply not including them in the documentation (implicit approach, not recommended by the EBA))

EBA Observations on Maturity

The EBA makes three official recommendations on Maturity-related conditions

- The EBA aggregates under the area of Maturity the following regulatory requirements applicable to MREL: (Issuer) Call/(Investor) Put options; Incentives to redeem; supervisory approval for early redemption
- ***(Issuer) Call/(Investor) Put options:*** *Recommendation 12: The EBA will continue to monitor the wording of options carefully, especially for put options that are not exercised on the initiative of the issuer, to ensure in particular that put options cannot be exercised at any time*
  - In the event that put options can be exercised by the investor at any time, the instrument is not eligible for TLAC/MREL purposes
- **Incentives to Redeem:** *Recommendation 13: Guidance (EBA reports and Q&A) to be developed in relation to incentives to redeem in the area of TLAC/MREL-eligible liabilities should be aligned with that developed for own funds*
  - The EBA to develop future guidance on Incentives to Redeem for MREL Instruments via future EBA reports and the Q&A tool. Such guidance to be aligned with the already developed guidance for Own Funds (CET1, AT1, T2)
  - Of note, the EBA outlines very clearly the different consequences of the presence of Incentives to Redeem on eligibility of instruments:
    - *In the case of own funds, incentives to redeem are subject to a strict prohibition and trigger ineligibility [from the outset]*
    - *In the case of eligible liabilities, they instead cause a shortening of the maturity if combined with a call option*
- ***Supervisory Approval for early redemption:*** *Recommendation 14: The terms and conditions of eligible liabilities instruments should contain an explicit reference to the need for prior approval from resolution authorities of reductions in eligible liabilities, as in the case of own funds instruments*
  - The EBA recommends the inclusion of explicit and clear language in the relevant documentation stating that prior regulatory approval is needed for early redemptions / reductions of MREL instruments (as clearly indicated in Q&A 2013 544, referred to in the report)
  - The Policy Observations, paragraphs 123-124, requiring explicit reference of regulatory approval for early redemption of Own Funds instruments in the terms and conditions of such Own Funds instruments are of critical importance
    - In the context of the recent EBA Opinion on the regulatory treatment of legacy capital instruments post the end of the CRR1 grandfathering period on 31 December 2021, these observations address a long-standing question, namely, can a legacy Own Funds security that otherwise fulfils Tier 2 criteria be considered Tier 2, even if it lacks explicit recognition of regulatory approval for early redemption in the documentation? → the EBA answer appears to suggest that such securities will not qualify as fully-eligible CRR Tier 2
  - The EBA notes that "vague terms", such as "relevant regulator/regulations", "to the extent required", etc. should be avoided, as the legislative framework is now in place
  - Clear reference to regulatory approval needed where e.g. the legal party debtor under the MREL instrument can be substituted with another legal party debtor
  - If instrument transferred from one entity with TLAC/MREL requirements to another one with same requirements, instrument must be examined at point in time of debtor substitution to see if it still fulfils all relevant criteria for MREL/TLAC eligibility

EBA Observations on Governing Law

- In paragraphs 137-144, the EBA undertakes an analysis to understand whether the circumstances of Art. 55 BRRD are automatically triggered every time when even the slightest part of a bond documentation is governed by third country law
- In the end, the EBA opts for a conservative stance, although it does not elevate its finding to a recommendation at this stage:
  - *As a conclusion, it would seem prudent to apply Article 55 of the BRRD strictly, whereby institutions should include write-down and conversion clauses in all circumstances in which part or all of the contract is governed by third country law to ensure TLAC/MREL eligibility*

EBA Observations on tax and regulatory calls

- Banks should *keep in mind* existing guidance and recommendation for Own Funds' tax and regulatory calls when implementing them for MREL instruments (here the refers to its AT1 monitoring report; regulatory and tax call paragraphs)
- The EBA explicitly states that both for both tax and regulatory calls, redemption can only be in whole and not in part, which is consistent with the EBA AT1 monitoring report
- No recommendation made in this respect, nor is this an area of future concern for the EBA

EBA Observations on tax gross-ups

- *Recommendation 15: Consistent with the own funds framework, tax gross-up should be accepted only under certain conditions, as applicable to eligible liabilities instruments, i.e. gross-up clauses can be considered acceptable if they are activated by a decision of the local tax authority of the issuer, and if they relate to interest and not to principal*

- Gross-ups only accepted for tax-related matters (i.e. imposition of or increase in potentially applicable withholding tax on interest and principal payments to investors), otherwise they are seen as an incentive to redeem
- Consistent with gross-up treatment on Own Funds, the EBA states that:
  - The activation of the tax gross-up can only be triggered by a decision of the local tax authority of the issuer
  - Only gross-up relating to interest allowed, whereas principal tax gross-ups are not allowed (too strong incentive to redeem)

Areas subject to Work in Progress

The EBA is carrying out further work in a number of areas of documentation for MREL instruments, including in the area of Substitution and Variation conditions

- Here the EBA is considering whether for conditions that are present and/or similar in both Own Funds and MREL instruments and where the EBA has previously issued recommendations for the Own Funds part, these existing recommendations should be extended also to MREL instruments

ESG/Green MREL and Own Funds instruments

- The EBA observes that banks have started initially to issue ESG bonds for MREL purposes in 2018 and are now looking to extend ESG bond issuance into the AT1/T2 part of the capital stack, both to *finance* (i.e. Use of Proceeds approach), but also to *capitalise* (i.e. green RWA/LRE capitalisation approach) their ESG portfolios
- In its preliminary analysis the EBA finds that (i) ESG/Green MREL bond issuance is limited to the Use of Proceeds approach and (ii) there is no link between ESG asset performance and the payment of interest and principal on the ESG bonds
- The EBA explicitly lists the following risks, which are first and foremost risks of wrongful investor perception:
  - Risk that investors think that the green assets/capital can be ring-fenced/separated from the rest of the bank;
  - Risk of invoking the NCWO protection if ESG investors are bailed-in whilst the ESG assets are still performing
  - Reinvestment risk for the bank upon insufficient green assets and therefore incentive to redeem OR perceived obligation to reinvest in ESG assets or disqualification of the green assets and impossibility of redeeming the ESG capital simultaneously (reputational/conduct risk)
- The EBA references in this document and in other fora that the message "First Capital/MREL and then Green" must be clearly understood and acknowledged by all investors
- This may require some revised language in the Risk Factors of issuers and it may be the main subject of the potential ESG/Green MREL/capital guidance scheduled for earliest 1Q 2021

(See page five for more EBA insights into green bonds.)

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Software and CET1 RTS

On 14 October, the EBA published its final draft RTS on prudential treatment of software assets. These final draft RTS specify the methodology to be adopted by institutions for the purpose of the prudential treatment of software assets, following the amendments introduced as part of the Risk Reduction Measures (RRM) package adopted by the European legislators.

Article 36(1)(b) of the Capital Requirements Regulation (as amended) (CRR), provides for an exemption from the deduction of intangible assets from Common Equity Tier 1 (CET1) items for "prudently valued software assets the value of which is not negatively affected by resolution, insolvency or liquidation of the institution". The EBA has revised the amortisation period from two years to three years which must be set in relation to circa six years average accounting amortisation (as found by the EBA, applicable to new software). The intention is to have the RTS adopted by the Commission, published in the Official Journal of the EU before year-end, and having it enter into force on the same day as publication, without the usual delay of 20 days between publication and entry into force — in this way banks will be able to book the CET1 benefit for the publication of 2020FY results. The EBA estimates the CET1 benefit for the concerned banks on average of c. 30bp (from ~20bp with two years average amortisation).

Opinion on Regulatory Treatment of Legacy Capital Instruments

On 21 October, the European Banking Authority published its long-anticipated Opinion on the regulatory treatment of legacy capital instruments post the end of the CRR1 grandfathering period on 31 December 2021.

HIGH LEVEL OBSERVATIONS AND KEY POINTS

Infection risk

- Legacy instruments creating infection risk are expected to be taken out via available issuer/regulatory calls or buy-backs, or alternatively the ranking changed via Consent Solicitations, so that the infection risk is remedied
  - There may be no need for a take-out of legacy instruments if the national insolvency ranking for bank liabilities is amended such that the ranking of the legacy instrument follows its regulatory classification
- The EBA and competent authorities will closely follow if banks have undertaken all possible actions to take out problematic liabilities and will grant allowance to keep legacy instruments only where there is documented evidence that the bank has undertaken take-out attempts and failed.
  - **In the event the bank is allowed to retain a legacy instrument, then it will not be allowed to qualify the instrument as capital or MREL/TLAC eligible item**

Flexibility of payments

- The EBA will accept dividend pushers and stoppers on e.g. legacy Tier 1 cascaded into Tier 2 (provided the infection issue is solved). This solution is limited to only legacy instruments.
  - The EBA will not accept "reverse" stoppers (e.g. coupon payments on a Tier 2 instrument deferred/cancelled upon cancellation of AT1 coupons)

Regulatory Treatment

- Provided the infection and flexibility of payments issues above are resolved, the instrument is then tested for compliance with Tier 2 rules as per CRR2
  - If the instrument passes the test, then it is requalified as fully-eligible Tier 2
  - If the instrument passes the test, except for the requirement to have a Bail-In Recognition Condition (BIRC) and Set-Off Waiver, then it is requalified as grandfathered Tier 2 until 28 June 2025
- CACIB assumes that an analogous treatment will be applied when a legacy instrument is aimed at being cascaded into SNP/SP

The EBA frames the issue of legacy instruments by recalling that the generous grandfathering period until the end of 2021 under CRR1 was introduced in order to allow banks sufficient time to build their capital in accordance with the new regulation and to take out legacy instruments. The current Opinion serves as a basis to establish common rules for the treatment of legacy instruments post the end of the CRR1 grandfathering period within the EU.

1 Infection risk

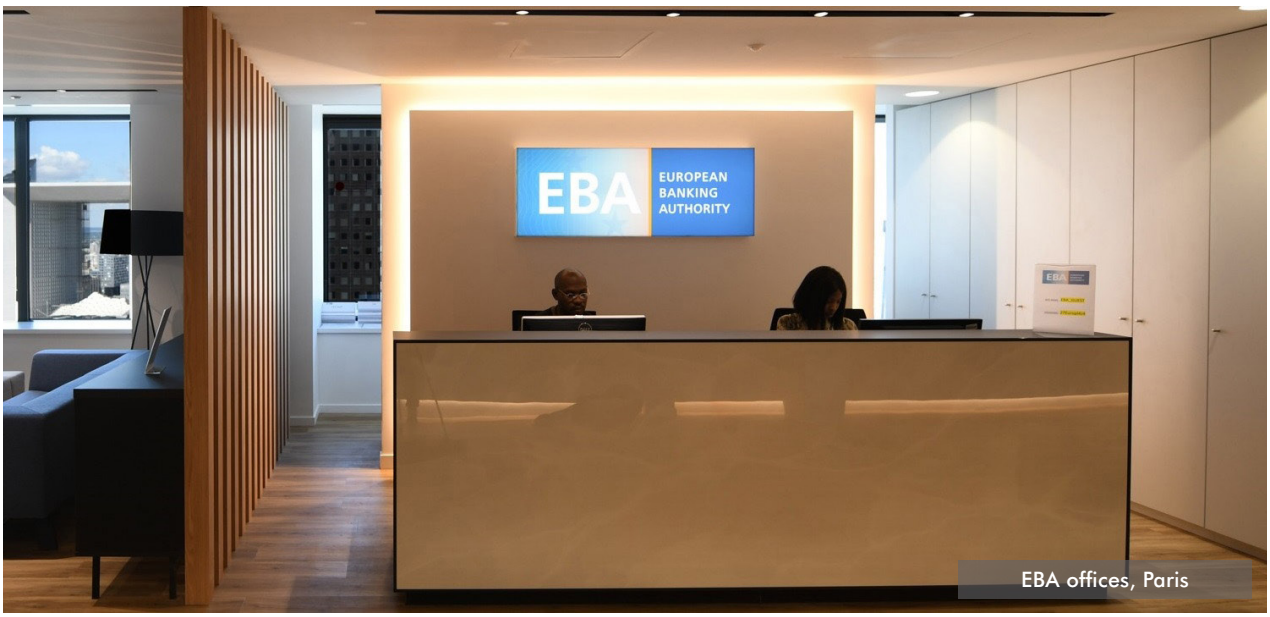
- What is infection risk? A legacy Tier 1 instrument ranking pari passu with fully eligible AT1 bonds and otherwise qualifying as e.g. Tier 2 would lead to disqualification of the entire AT1 stack due to conflict with CRR AT1 ranking provisions, a Tier 2 instrument ranking pari passu with fully eligible Tier 2 and otherwise qualifying as e.g. Eligible Liability would disqualify the Tier 2 stack, and so forth …
  - In §§ 14-15, the EBA reiterates the clear ranking of instruments under CRR: AT1 below all Tier 2 items, Tier 2 items below MREL/TLAC Eligible Liabilities, and Eligible Liabilities below excluded liabilities as per Art. 72a(2) CRR
- **In order to avoid the grave consequences of infection risk, banks must ascertain that legacy instruments do not create infection risk (CACIB NB: post the end of the CRR1 grandfathering period)**

2 Flexibility of payments

- The EBA will accept dividend pushers (if equity dividends/AT1 coupons are paid, then the instrument also pays interest) and stoppers (if the instrument must defer/cancel payments of interest, then equity dividend/AT1 coupon payments have to be eliminated) on e.g. legacy Tier 1 cascaded into Tier 2 (provided the infection issue is solved). This solution is limited to only legacy instruments.
  - The EBA will not accept "reverse" stoppers (e.g. coupon payments on a Tier 2 instrument deferred/cancelled upon cancellation of AT1 coupons)

3 Regulatory Treatment

- Provided the infection and flexibility of payments issues



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above are resolved, the instrument is then tested for compliance with Tier 2 rules as per CRR2

- If the instrument passes the test, then it is requalified as fully eligible Tier 2
- If the instrument passes the test, except for the requirement to have a Bail-In Recognition Condition (BIRC) and Set-Off Waiver, then it is requalified as grandfathered Tier 2 until 28 June 2025 (§ 17)
  - Of interest, the EBA references for the regulatory classification test not only CRR provisions and relevant RTS, but also Q&A and the latest EBA AT1 Monitoring Report
  - In this context, the reference to EBA Q&A 2018 4417 means that a bank should perform the regulatory classification test on the basis of the original issue date of the legacy instrument and not the end of the CRR1 grandfathering period (31 December 2021)
  - Some banks/issuers may ask themselves how (i) a principal gross-up for tax purposes and (ii) lack of regulatory approval for early redemption in the T&Cs of a capital/MREL item will impact post-2021 treatment
  - A possible interpretation of the EBA MREL Monitoring report is that: (i) it does not provide further guidance on tax principal gross-ups, though it may not be a relevant criterion; (ii) it may be more prudent to consider a capital/MREL instrument lacking regulatory approval for early reduction in the T&Cs as disqualified post 2021

- CACIB assumes that an analogous treatment will be applied when a legacy instrument is aimed at being cascaded into SNP/SP
  - Here the grandfathering treatment is more lenient in that the instruments would qualify as grandfathered SNP/SP until the end of their lifetime
  - Also, the scope for grandfathered features goes beyond BIRC and Set-Off Waiver and includes, inter alia, acceleration of payments outside of insolvency upon Event of Default

4 Way Forward

- Legacy instruments creating infection risk or flexibility of payment issues are expected to be taken out via available issuer/regulators calls or buy-backs, or alternatively the ranking changed via Consent Solicitations, so that the infection risk is remedied
  - **There may be no need for a take-out of legacy instruments if the national insolvency ranking for bank liabilities is amended such that the ranking of the legacy instrument follows its regulatory classification** (e.g. the legacy grandfathered Tier 1 becomes Tier 2, and its ranking is changed from pari passu with AT1 to senior to AT1 and pari passu with Tier 2, i.e. the instrument changes its ranking depending on regulatory classification during its lifetime)
- The EBA and competent authorities will closely follow if banks have undertaken all possible actions to take out problematic liabilities and will grant allowance to keep legacy instruments only where there is documented evidence that the bank has undertaken take-out attempts and failed
  - **In the event the bank is allowed to retain a legacy instrument, then it will not be allowed to qualify the instrument as capital or MREL/TLAC-eligible item**, thereby creating a further incentive for the bank to attempt to take out the instrument
  - The EBA also underlines that it is not its intention *to give a general signal that it is desirable for institutions to issue new instruments that might rank pari passu with regulatory instruments while not being part of own funds or TLAC/MREL-eligible instruments*

UK banks: PRA consults on CRD V — MDA modifications

Following the recent swathe of changes to UK bank regulation relating to Brexit, the PRA on 20 October published a consultation paper on further points relating to CRD V implementation.

Capital buffers (O-SII and SyRB)

- Current application in the UK:
  - No O-SII buffer
  - SyRB set only at the ring-fenced level — not at the consolidated level

Proposals:

- Under CRD V, the SyRB can no longer be used to address a firm's individual systemic importance — only the O-SII/G-SII buffers can be used for this purpose
- **The proposal is to replace the current SyRB with an O-SII buffer — which will follow the same principles (i.e. a one-for-one change)**
- The PRA does not intend to set a SyRB at present, but in the future if it were to apply it, it will be cumulative to the O-SII/G-SII buffer at the appropriate level of consolidation in which it is applied

Maximum Distributable Amounts (MDA)

- Distributions that result in the combined buffer being used:
  - CRD IV (and CRD V) do not permit a bank to make distributions that would lead to CET1 falling into the combined buffer, therefore incentivising banks to hold excessive management buffers
  - The PRA seeks to amend the MDA definition to increase the usability of combined buffers in stress, as well as reduce the incentive to hold excessive management buffers
  - **The PRA believes that the above amendment from CRD V does not go far enough, and proposes that banks should be able to make distributions even if this leads to CET1 levels falling into the combined buffer, but that firms should provide notice (but not explicitly request permission) to the PRA of any distribution that will lead to such a scenario**
- Definition of MDA:
  - The current definition of MDA limits the usability of capital buffers as intended (restricting the distributions a firm can make to a percentage of profits made since the last distribution)
  - CRD V modifies the above restriction by permitting firms to distribute interim and year-end profits that are not included in CET1, irrespective of the timing of the last distribution
  - **In order to strike a balance between buffer usability and capital conservation, PRA is proposing (after the transition period) that MDA should include certain profits already included in CET1** (the last four quarters of profits included in CET1, net of distributions)
- **PRA believes that this approach (which deviates from CRD V) will reduce incentives for firms to hold management buffers, and ensure that profits may be distributed reasonably to reflect the recent financial performance of the firm (the PRA's proposed approach is in line with Basel Committee principles)**
- ***As a reminder, under the BRRD2 transposition in the UK, the BoE/PRA also do not intend to apply MDA linked to breach of MREL (M-MDA)***

Pillar 2:

- Article 104a (P2R) and 104b (P2G)
  - CRD V requires firms to meet Pillar 2 requirements with at least 56.25% CET1 (in line with the proportion of CET1 required to meet Pillar 1)
  - **PRA currently requires banks to meet Pillar 2A with 56% capital, and will align with the CRD V requirement (i.e. increasing from 56% to 56.25%)**

Variable risk weights for real estate exposures:

- **PRA is proposing to exercise its discretion, as per CRR II, to set stricter criteria than those specified in CRR that firms need to comply with in order to be able to apply a 50% risk weight to CRE exposures under the SA**
- PRA believes that a 50% risk weight under the SA is inappropriate for CRE exposures and therefore is removing the possibility for firms to use this lower risk weight — therefore **firms will be required to use the 100% risk weight for CRE exposures under the SA**

Note

- *This consultation should be read in conjunction with CP 12/20, which sets out the PRA's approach to implementation of other elements of CRD V*
- *There are a number of points mentioned in in the CP, including the supervision of holding companies and consolidation, that are omitted from this summary* ●

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