ALERT MEMORANDUM – 24 NOVEMBER 2016

EU Proposes Intermediate Holding Company Requirements for Non-EU Banks and Broker-Dealers

On 23 November 2016, the European Commission published proposals[1] for widespread revisions to the EU prudential regulatory framework for banks and investment banks. The proposal includes (among other global and EU-specific reforms):

- Requirements for certain non-EU financial institutions to establish an EU intermediate holding company (an **EU IHC**) where they have two or more banks or investment firms in the EU;
- Minimum external total loss-absorbing capacity (**TLAC**) requirements for EU global systemically important banks (**G-SIBs**), referred to as global systemically important institutions (**G-SIIs**) under EU law;
- Minimum internal TLAC requirements for EU IHCs with material subsidiaries of non-EU G-SIBs which are not resolution entities, which require the internal TLAC to be issued to a parent outside the EU;
- Implementation of various changes to the EU bank resolution framework, including changes to the minimum requirement for eligible liabilities (**MREL**), to insolvency priority and to the requirement to obtain contractual recognition of bail-in in non-EU law-governed contracts under Article 55 of the BRRD; and
- Implementation of various Basel standards including the leverage ratio, net stable funding ratio and fundamental review of the trading book.

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[1] CRD/CRR materials available here: http://ec.europa.eu/finance/bank/regcapital/crr-crd-review/index_en.htm#161123; BRRD materials available here: http://ec.europa.eu/finance/bank/crisis_management/index_en.htm#161123

These reforms will be implemented through changes to the Bank Recovery and Resolution Directive (**BRRD**) and the Capital Requirements Directive (**CRD**) and Capital Requirements Regulation (**CRR**).[2] The proposals are intended for implementation in 2019. The proposals are the first public drafts of the new legislation and it therefore remains uncertain whether they will be preserved in the same form in the final text of the legislation.

Perhaps the most controversial component of the proposals is the proposed requirement for many non-EU banks and investment banks to establish an EU intermediate holding company (an **EU IHC**). This late addition to the proposal has already prompted commentary highlighting its apparent "retaliatory" nature as a response to regulations issued by the Board of Governors of the Federal Reserve System (the **Federal Reserve**) requiring all non-U.S. banking organizations with U.S. non-branch assets of $50 billion or more to establish a U.S. intermediate holding company (**U.S. IHC**) to hold all of their U.S. subsidiaries (banking and nonbanking). Adopted in 2014, these regulations were strongly opposed by non-U.S. banking organizations and criticized by numerous government officials, including representatives of the European Commission, who expressed concern that the U.S. IHC requirement "could spark a protectionist reaction from other jurisdictions."[3] A U.S. IHC is subject to U.S. capital and liquidity, stress testing and other prudential requirements as if it were a U.S. bank holding company.

This memorandum summarizes the EU IHC proposal and provides an initial view on some of the likely implications for U.S. and other international financial institutions.

Legal context and background to the proposals

To date, the EU regulatory framework has not required either EU or non-EU financial institutions to structure their EU businesses through holding companies. Both the CRD and the BRRD include discretionary powers permitting EU regulatory authorities to require the imposition of holding companies for prudential purposes, but these powers have very seldom been exercised in practice.

Holding companies bear significant attractions to certain regulators, including those in the UK and the U.S., in facilitating resolution of large and complex organizations. They consider resolution of a 'clean' holding company to be more feasible and credible than resolution at operating bank level, as it limits disruption to the balance sheet and legal relationships of the operating bank, avoids operational complexities associated with the transfer or bail-in of creditors and reduces the risk of claims under the 'no creditor worse off' principle.

In the UK, the Bank of England has expressed a strong preference for holding-company based resolution: in its recently finalized statement of policy on setting MREL (The Bank of England's approach to setting MREL, November 2016) it sets an expectation that banks whose resolution strategy involves bail-in (broadly, all banks with balance sheets over £25 billion, and potentially some with balance sheets between £15 billion and £25 billion) should issue bail-in debt which is structurally subordinated (Appendix, paragraph 4.9).

Likewise, in the U.S, where nearly all banking groups are headed by non-operating holding companies, the Federal Deposit Insurance Corporation (**FDIC**) has described its primary resolution strategy under the Orderly Liquidation Authority, the U.S. special resolution regime, as focusing on resolution at the holding company level.[4] This approach was further reinforced by the TLAC rules proposed earlier this year by the Federal Reserve,[5] which focus on ensuring that the bank holding companies of U.S. G-SIBs issue sufficient structurally subordinated bail-inable debt to support the resolution of the group as a whole. Controversially, the Federal Reserve's TLAC

[2] Directive 2014/59/EU, Directive 2013/36/EU and Regulation 2013/575/EU, respectively.

[3] Letter from Michel Barnier, European Commissioner for Internal Market and Services, to Chairman Bernanke, dated Apr. 18, 2013 (the **Barnier Letter**), available at http://www.federalreserve.gov/SECRS/2013/April/20130422/R-1438/R-1438_041913_111076_515131431183_1.pdf

[4] https://www.fdic.gov/news/board/2013/2013-12-10_notice_dis-b_fr.pdf

[5] https://www.clearygottlieb.com/news-and-insights/publication-listing/the-federal-reserve-proposes-tlac-and-related-requirements-for-us-g-sibs-and-us-ihcs-of-foreign-g-sibs34

proposal also focused on ensuring the separate resolvability of the U.S. IHCs that certain non-US G-SIBs were required to establish, notwithstanding that most such non-GSIBs pursue single-point-of-entry resolution strategies aimed at avoiding the separate resolution of subsidiaries. Notably, to ensure the separate resolvability of U.S. IHCs, the Federal Reserve's TLAC proposal would require them to issue to foreign parent entities significant amounts of long term debt with contractual write-down or conversion features to support the resolution of the U.S. operations.

By contrast, in a number of jurisdictions, such as France, Germany, Italy and Spain, regulators have instead (consistent with the direction of recent EU reforms) focused their efforts on altering the priorities of long term debt issued by operating banks to ensure that the debt could be bailed in without impairing other liabilities of the banks, such as deposits and derivatives liabilities. To date (in contrast with the proposed EU IHC requirement for non-EU banking groups), there has been no indication by EU authorities that they will seek to prescribe holding companies for EU banking groups.

In its "Frequently Asked Questions" memo published to accompany the proposals[6], the Commission has justified the EU IHC requirements imposed on foreign banking groups by reference to the TLAC standards (which do not in themselves prescribe an IHC structure), as well as "more broadly, to simplify and strengthen the resolution process of third country groups with significant activities in the EU".

Application

The draft requirement is set out in new Article 21b of the revised CRD. It applies where a third country group (any group whose ultimate parent is incorporated outside the EU):

(a) has two or more EU institutions (banks or investment firms incorporated in the EU); and

(b) is a non-EU G-SII or has total European assets of EUR 30 billion or more.

For this purpose, total assets are to be assessed based on the sum of the total assets of (i) the consolidated balance sheet of each institution in the EU and (ii) any branch of the third country group authorized in the EU. (Assuming the proposals come into effect prior to Brexit, the assets of UK branches and institutions will count towards this test until Brexit takes effect.)

The proposed threshold for the formation of an EU IHC is significantly lower than the threshold in U.S. regulation for formation of a U.S. IHC. By contrast, non-U.S. banking organizations only become subject to the U.S. IHC requirement when their total U.S. assets, excluding any assets held through a U.S. branch or agency, reach $50 billion.[7]

Key obligations

The following are key requirements applicable to the EU IHC under the proposal:

Single EU IHC

There must be a single EU IHC for all EU institutions (i.e., banks and broker-dealers) within the third country group.

Authorization

The proposal introduces an authorization requirement for holding companies for the first time (Article 21a). The consolidating supervisor of the EU sub-group (the consolidated sub-group headed by the EU IHC) will have powers to compel information from the EU IHC. The CRD already provides for requirements as to fitness and properness of the board of a financial holding company, and as to the ability to compel information from a holding company in limited circumstances. The proposal is silent on other aspects of authorization, including enforcement powers and other responsibilities of the EU IHC and its staff.

Consolidated supervision

The EU FHC will be subject to the prudential regime provided for by the CRD and CRR on a consolidated basis, which (in broad terms) implements the Basel standards on capital, liquidity and funding and imposes related systems and controls requirements.

Resolution; internal TLAC/MREL

EU IHCs will be subject to the EU resolution regime under the BRRD. Consolidated recovery and resolution planning requirements will apply. Further,

[6] http://europa.eu/rapid/press-release_MEMO-16-3840_en.htm?locale=en

[7] 12 CFR 252.153

an EU IHC of a G-SII which has a material subsidiary in the EU will be subject to the proposed rules in the CRR implementing the internal TLAC (or, where it is a resolution entity under a multiple-point-of-entry structure, external TLAC) requirements under the Financial Stability Board's TLAC Term Sheet[8] together with a discretionary 'Pillar 2' MREL requirement. Other EU IHCs will be subject to EU MREL rules only, which provide a similar regime requiring the maintenance of sufficient 'bail-in' debt to enable resolution.

Other observations

Scope

There is no requirement that other EU holdings of the third country group must be held by the EU IHC: accordingly, other EU holdings (including fund managers, some asset managers, payment services providers, insurance companies and unregulated entities) may sit outside the EU IHC structure. Similarly, there is no restriction on non-EU entities being owned by the EU IHC.

Location

The draft legislation does not impose any requirements as to where in the EU the IHC is established.

Implications

Conflict with third country structural regulation

The requirement for a single EU IHC is likely to conflict with requirements imposed by some third countries.

In the UK, the forthcoming ring-fencing regime obliges banks within its scope to run separate ring-fenced and non-ring-fenced banking operations, with an expectation that the ring-fenced banking operations be within a separate sub-group from the wider non-ring-fenced operations. A requirement for a single EU IHC appears to be irreconcilable with ring-fencing for a bank which owns EU subsidiaries on either side of the ring-fence.

For U.S. banking organizations, restructuring their U.S. subsidiaries under a single EU IHC could present complications under U.S. banking laws, especially for banks that own a European bank subsidiary directly under the U.S. bank.

Additional capital and liquidity costs

The Federal Reserve's U.S. IHC requirement proved expensive to implement for foreign banks. The EU IHC requirement appears less draconian, not least because only certain EU entities must be held under the EU IHC, and those entities are already subject to solo and (where part of an EU sub-group) consolidated prudential requirements today. The flexibility to keep entities other than institutions outside the EU sub-group appears welcome in this respect as it should enable firms to minimize any additional incremental capital costs associated with compliance. There will nonetheless be costs associated with additional reporting burdens for groups which do not currently organize their EU holdings through a single EU IHC today.

TLAC/MREL requirements

Whilst the proposal that an EU IHC be subject to local TLAC and/or MREL requirements will not be welcomed by the banking community, it is broadly consistent with the direction of travel of the U.S. and other regulatory authorities.

Brexit

The proposals are intended to come into effect at the beginning of 2019 – before Brexit takes effect (likely to be no earlier than March 2019). Third country groups will be assessed against the EUR 30 billion threshold before Brexit, including their UK holdings. Some groups may find that they are within the scope of the requirement pre-Brexit but outside it thereafter. The proposal does not include any transitional period to permit groups to exceed the EUR 30 billion threshold for a short period. For groups only within scope of the proposal by reason of their UK business, this risks substantial costs associated with reorganizing the corporate structure for the (potentially brief) window between the proposal coming into effect and Brexit.

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[8] http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf