August 5, 2016

ISSUE 3

Contents

News and calendar 1

The impact of Brexit on the UK's implementation of TLAC/MREL 2

Bankers' bonuses and Brexit 5

For additional commentary on politics and finance in Europe, read **Francesco Guerrera's** Morning Exchange on

POLITICO

August has arrived and, with it, little additional clarity on next steps in the Brexit process. Speculation remains rife about the objectives of the UK Government in the negotiations. Will it seek access to the single market, will it pursue a clean break from the EU, or will a hybrid engagement model emerge? What has become clear in recent weeks, however, is who will be leading the negotiations. David Davis, the Secretary of State for Exiting the EU, will manage the negotiations on the UK's behalf, while Michel Barnier, a former European Commissioner responsible for financial services, will act as the EU's chief negotiator.

In the third edition of Lex et Brexit, we examine the development of the Total Loss Absorbing Capacity ("**TLAC**") and Minimum Requirement for Own Funds and Eligible Liabilities ("**MREL**") standards applicable to financial institutions, the UK's proposed implementation of these standards and how Brexit might affect such implementation. We conclude that the UK's ability to influence the final EU standards is likely to diminish as it negotiates the terms of its withdrawal from the EU. In addition, while there may be some divergence in the way in which the TLAC and MREL standards will be applied in the UK and the EU, an overarching trend towards convergence may attenuate the adverse consequences that could result from parallel regimes.

We then examine the impact of Brexit on the regulation of variable pay in the UK. Although the UK will legally be able to repeal the bonus cap following Brexit (assuming the UK does not retain its membership of the European Economic Area (the "**EEA**")), it may not want to do so. Removing the cap would create discrepancies between the regulatory regimes of the UK and the EU, which could burden the UK's ability to pass the EU's equivalency assessment and, as a result, might impair the rights of UK financial institutions to do business in the EU.

News and Calendar

News

- While there have been many political and financial developments in the last two weeks, more on which can be found in POLITICO's Morning Exchange, these developments have not changed the legal landscape in a way that enables us to provide more definitive guidance.

Calendar

- Theresa May says UK may delay triggering of Article 50 of the Lisbon Treaty until 2017
- UK Government dismisses the threat by House of Lords peers to thwart any legislation triggering Article 50, making the possibility of blocking Brexit increasingly unlikely
- EU summit on Brexit to be held in Slovakia on September 16

The Impact of Brexit on the UK's Implementation of TLAC/MREL

The past several years have been a period of intense focus by the financial community and regulators on how to ensure that shareholders and creditors of failing financial institutions, rather than taxpayers, effectively bear the burden of bank recapitalizations. "Bail-in", the regulatory mechanism that provides for the write-down or conversion of securities and other liabilities issued by a failing institution, has been the main tool devised to achieve this objective. The effective application of bail-in relies on banks holding sufficient capital and liabilities with loss-absorbing capacity which can be bailed-in. In this respect, the Financial Stability Board (the "**FSB**"), mandated by the G-20, developed a global set of standards for TLAC applicable to all globally systemically important banks ("**G-SIBs**") and each resolution entity within each G-SIB's group. In parallel, European regulators and member states (including the UK) have been developing a similar set of rules known as MREL, which is a requirement set out in Article 45 of the EU Bank Recovery and Resolution Directive 2014/59/EU (the "**BRRD**") that applies to all EU credit institutions and some investment firms (including G-SIBs). While the MREL and TLAC standards share a number of conceptual similarities, they currently diverge in several respects, although the current expectation is towards convergence of these standards.

Here, we look at the development of the TLAC and MREL standards, the UK's proposed implementation of these standards and the effect Brexit may have on such implementation. Until the UK Government formally triggers the mechanism for leaving the EU and reaches an agreement on its withdrawal, the MREL framework, as set out in EU legislation, will continue to apply (and be required to be implemented) in the UK. The Bank of England, which has recently closed a consultation on the implementation of the TLAC/MREL standards in the UK, will be required to determine the framework which will apply to UK banks in light of these developments and may ultimately be influenced by broader political discussions relating to the UK's withdrawal from, and future relationship with, the EU.

TLAC/MREL at a glance

TLAC is not legally binding by itself, but G-20 member states which are home to G-SIBs have agreed to adopt the TLAC standards into domestic legislation, and a number of jurisdictions are in the process of doing so. Of the total 30 G-SIBs, thirteen are located in the EU, four of which are in the UK: HSBC, Barclays, The Royal Bank of Scotland and Standard Chartered. The standards require G-SIBs to hold minimum levels of loss-absorbing capital consisting of an external fixed minimum (Pillar 1) TLAC requirement (which can largely be comprised of tier 1 and tier 2 regulatory capital instruments and long-term unsecured debt) of 16-20% of risk-weighted assets ("**RWAs**") and at least 6-6.75% of the Basel III leverage ratio denominator (excluding capital held for purposes of meeting Basel III buffer requirements) plus a firm-specific (Pillar 2) requirement. The requirements apply from January 1, 2019 and are subject to phase-in provisions.

MREL applies to all EU credit institutions and some investment firms (including G-SIBs) on either an individual basis for multiple point of entry institutions or on a consolidated basis for single point of entry institutions. Unlike the TLAC standard, the MREL requirement is set on a case-by-case basis for each financial institution and is calculated as a percentage of the financial institution's total liabilities and own funds (essentially the bank's Tier 1 and Tier 2 capital resources) on the basis of three components (which can be adjusted by the regulator): a loss absorption amount based on capital requirements including Pillar 1 requirements, the combined buffer requirements and additional, firm-specific Pillar 2 requirements; a recapitalization amount designed to provide sufficient capital for the failing financial institution to meet its capital requirements post-resolution and maintain market confidence; and additional adjustments determined by the relevant regulator. Within the Banking Union,[1] the Single Resolution Board (the "**SRB**") is responsible for setting MREL requirements for

---

[1] The banking union in the EU (the "**Banking Union**") facilitates centralized supervision and resolution for banks in the euro zone, as well as banks in member states outside the euro zone that have opted to join the Banking Union.

larger banking groups. The SRB has indicated that it would seek to determine MREL requirements during the course of 2016.

The UK's approach to TLAC and MREL

In the UK (which is not part of the Banking Union), the Bank of England is responsible for setting MREL requirements for UK banks and on December 11, 2015 published a consultation paper on its proposed implementation into national law of the MREL framework. As part of its proposed framework, the Bank of England intends to implement the FSB's TLAC standards for UK G-SIBs through the MREL rules. A final policy statement is expected to be published in the coming months.

In its consultation paper, the Bank of England indicated that it would set MREL on a firm-specific basis, according to the resolution strategy for the firm (which, in turn, is based on the firm's size, the scale of its critical economic functions and the complexity of transferring these activities in resolution). There are three categories of resolution strategy: **modified insolvency, partial transfer** and **bail-in**.

The amounts required to be held by UK banks will need to be sufficient for loss absorption purposes prior to and in resolution, and, if applicable, including with respect to certain larger financial institutions, will need to include an amount necessary for recapitalization. The loss absorption amount will be based on at least the minimum capital requirements, including any applicable leverage ratio requirement set by the Prudential Regulation Authority or the Financial Conduct Authority. The recapitalization amount must also be based on existing minimum capital requirements, with some possibility to adjust upwards or downwards to reflect more accurately the post-resolution balance sheet of the firm. Under the Bank of England's approach:

- for a modified insolvency resolution strategy (for small firms which provide limited critical functions), no recapitalization component will be required;
- for a partial transfer resolution strategy (for firms which provide critical functions where a transfer is feasible), firms will be required to hold enough loss absorbing capital to recapitalize the part of the balance sheet to be transferred; and
- for a bail-in resolution strategy (for the most complex firms where a transfer is infeasible, including G-SIBs), firms will be required to hold capital sufficient to recapitalize the whole balance sheet.

For this last category of financial institutions, the Bank of England has indicated that it would generally set the MREL requirement to two times the current minimum capital requirements and MREL resources issued by such institutions must be structurally subordinated to operational liabilities (whereas the TLAC standard allows for contractual, structural and statutory subordination). The consultation paper also sets out the Bank of England's proposed approach to setting MREL requirements for subsidiaries of international groups incorporated in the UK.

Moving toward convergence of standards?

Although they share a common objective and a number of conceptual similarities, the TLAC and MREL standards currently differ in a number of ways, including with respect to their scope (G-SIBs only versus all institutions within the EU), their approach (minimum standard plus add-on versus bank specific), recognition of resolution strategies (single point of entry or multiple point of entry versus bank specific), calculation methodology (higher of 16%/18% of RWAs or 6%/6.75% of the leverage exposure, excluding capital instruments used to comply with regulatory buffers versus the sum of a loss absorption amount and a recapitalization amount subject to various adjustments, determined as percentage of total liabilities and own funds, where capital can be used to meet both MREL and regulatory buffers), recognition of eligible instruments (including subordination requirements, maturity and excluded liabilities), approach to deductions of cross holdings (i.e., loss-absorbing eligible instruments issued by other G-SIBs), consequences of breach and timeline for implementation (January 1, 2019 subject to transitional provisions versus end of 2016 subject to transitional provisions).

Under Article 45 of the BRRD, the European Banking Authority (the "**EBA**") is required to submit by October 31, 2016 a report on the implementation of the MREL rules, so that the European Commission can submit a legislative proposal on the harmonized application of the MREL rules. The

Commission has indicated that it would publish a proposal for further amendments to the MREL framework (which may include Level 1 amendments to the BRRD as well as the Capital Requirements Regulation ("**CRR**") and Capital Requirements Directive IV ("**CRD IV**")) which also address the TLAC standards by the end of 2016 prior to its entry into force in 2019. The European Commission is therefore exploring alternatives for further amending the MREL rules to implement the TLAC standards although based on recent discussion papers a preference appears to be emerging for adopting an integrated approach consisting in merging TLAC and MREL requirements for G-SIBs. In addition to the work undertaken by the European Commission, the interim report published by the EBA in July 2016 suggests a number of areas of possible convergence. In particular, the EBA has expressed a view that:

- RWAs (complemented by a leverage ratio) may be a more appropriate reference base rather than total liabilities and own funds;
- CET1 capital used to meet MREL should not be double counted towards meeting capital buffers (i.e. buffers should "sit on top");
- calibration of MREL should be closely linked to an institution's resolution strategy; and
- mandatory subordination of MREL eligible liabilities should be introduced.

Notwithstanding the above, there remains considerable uncertainty as to the final MREL framework and it is unlikely that clarity will be achieved prior to the end of 2016. In addition, a number of related topics remain subject to further debate and rulemaking, including debt subordination, the interaction of MREL requirements with buffers and in particular distribution restrictions, disclosure requirements, treatment of cross-holdings and deductions.

Implications of Brexit

The implications of Brexit on the current implementation of the TLAC/MREL requirements remain uncertain and will depend on the approach the EU and the UK take to exit negotiations and the ultimate terms of the UK's withdrawal from the EU.

As further described in the first issue of Lex et Brexit, in the event the UK does not retain EEA membership and becomes a "third country", it will no longer be bound by the BRRD and other EU legislation. However, the BRRD (including Article 45 which sets forth the MREL requirement) has already been implemented into UK law through amendments to the UK Banking Act 2009. Consequently, the UK Government would need to adopt further legislation if the MREL rules are no longer to apply in the UK. If it were to adopt this course of action, it may focus instead on the implementation of the TLAC standards as a result of which non-G-SIBs in the UK would no longer be subject to MREL requirements, unlike their EU counterparts. Any decision to disapply the MREL requirements for non-G-SIBs would constitute a significant departure from the work undertaken by the Bank of England to date at a time of ever increasing focus on the resilience and resolution of all UK banks. Even if it did maintain the existing MREL framework as currently transposed in the UK, the Bank of England, as a third country resolution authority, would no longer be required to comply with, or implement, further rules adopted at the EU level in this respect (including those discussed above) which may lead to divergences in the way in which such requirements are implemented in the UK and in the EU for non-G-SIBs. Such divergences would potentially give rise to level playing field considerations and could conceivably impact any assessment of the equivalence of the UK regulatory regime for passporting purposes, as any such determination might take into account the prudential requirements and resolution regimes to which UK financial institutions are subject.

In addition, any divergences may generate structuring considerations for banking groups with operations in the UK and the EU. Financial institutions with operations in the UK and the EU (including UK banking groups which may decide to relocate certain operations to Europe in order to maintain single market access) would be required to comply with multiple sets of standards.

Bankers' Bonuses and Brexit

In the aftermath of the financial crisis of 2008-09, the EU took various steps aimed at restoring financial stability and rebuilding public faith in the financial system. One such step was to introduce a cap on variable pay for banks and other financial institutions, the so-called cap on bankers' bonuses. The cap proved particularly contentious in the UK, where the government went as far as initiating a case in the Court of Justice of the European Union (the "**CJEU**") to challenge its legality. Certain commentators have argued that, now that the UK has voted to leave the EU, it will have more scope to amend the regulation of variable pay in the UK. Here, we consider whether the UK will, in fact, be able or want to do so following Brexit.

CRD IV and the cap on variable pay

CRR and CRD IV set out requirements in relation to the remuneration policies and practices of certain financial institutions, including a cap on variable pay. The European Parliament was the driving force behind the introduction of the cap during the legislative process for CRD IV, as many of its members believed the cap was required to restrain excessive risk-taking and reduce the focus on short-term gains.

The remuneration requirements contained in CRR and CRD IV apply to credit institutions and some investment firms established in the EU, as well as their non-EU subsidiaries and branches, and EU subsidiaries and branches of financial institutions headquartered outside the EU. The bonus cap specifically applies to material risk takers ("**MRTs**"), i.e., those employees whose professional activities have a material impact on the risk profile of the relevant institution. MRTs include, *inter alia*, members of the management body, senior management and heads of material business units. In addition, employees are presumed to be MRTs if they meet certain quantitative criteria.

Under CRD IV, variable pay is capped at 100% of total fixed pay or, with shareholder approval,[2] 200% of total fixed pay. Member states have the discretion to adopt stricter standards. For example, in the Netherlands, variable pay is capped at 20% of total fixed pay, subject to certain exemptions. Critical to the application of the cap are the definitions of "fixed" and "variable" pay. In general terms, fixed pay is unconditional and determined in advance of an employee's performance, whereas variable pay changes depending on performance.

CRR sets out disclosure requirements relating to remuneration policies and practices. Financial institutions must, for instance, disclose the ratios between fixed and variable pay.

EU member states were required to implement CRR and CRD IV into national law with effect from January 1, 2014 and apply the cap on variable pay to remuneration for "services provided or performance from the year 2014 onwards, whether due on the basis of contracts concluded before or after 31 December 2013."[3]

The UK's opposition to the cap on variable pay

The UK government vehemently opposed the introduction of the bonus cap. It was argued that the cap would be circumvented by raising fixed pay, which, according to George Osborne, then Chancellor of the Exchequer, would endanger, rather than enhance, financial stability. In fact, in 2014, certain financial institutions responded to the cap's introduction by granting role-based allowances to key individuals and treating these as fixed pay. Michel Barnier, then a European Commissioner with responsibility for financial services (and now the EU's chief negotiator with the UK over its withdrawal from the EU), wrote to the EBA to share the Commission's concerns that these institutions were attempting to circumvent the legal framework for variable pay. The EBA published an opinion on the

---

[2] Approval by either 66% of shareholders provided that at least half of the shares are represented or, failing that quorum requirement, 75% of the shares represented.

[3] Article 162(3), CRD IV.

use of these allowances in October 2014 and found that most of the allowances it had investigated did not possess the characteristics necessary to be classified as fixed pay.

In 2013, the UK government's opposition to the cap culminated in a legal challenge that sought to annul the relevant CRR and CRD IV provisions. The CJEU heard the case in September 2014. Following the hearing, the Advocate General issued his opinion in November 2014, which, though non-binding, would be considered by the CJEU during their deliberations. In his opinion, the Advocate General found that all of the UK government's arguments should be rejected and that the action should be dismissed. Not wanting to waste taxpayers' money on a legal challenge that would now be unlikely to succeed, the UK government withdrew its challenge.

Brexit's implications for the regulation of variable pay in the UK

Loss of ability to pursue a removal of the cap on variable pay at the EU level

On July 28, 2016, the European Commission released a report on the remuneration rules under CRR and CRD IV. The European Commission found that it was not yet possible to draw any final conclusions on the impact of the bonus cap, as this measure had only recently been introduced and was yet to reveal its full effects. The European Commission stated "that conclusive findings can only be reached once more implementation experience is gained."[4]

Since the review remains ongoing, member states continue to be able to pursue a removal of, or amendment to, the bonus cap. In the wake of the Brexit referendum, however, the UK has likely lost much of its ability to do so. Prior to the referendum, Jonathan Hill – at that time, the UK's European Commissioner responsible for financial services – told the UK Parliament's Treasury Committee that, had he been in his position when the bonus cap was introduced, he would have argued for there not to be a cap. Hill resigned in the referendum's aftermath and, thus, will no longer be able to push for the cap's removal or amendment. Following Brexit, the UK will likely lose its remaining influence on whether or not the bonus cap should be repealed.

Can the UK repeal the cap?

Once the UK withdraws from the EU (and assuming the UK does not retain its membership of the EEA), the UK will no longer be bound by CRR or CRD IV. As a regulation, CRR has direct applicability in the UK. The disclosure requirements under CRR will, therefore, fall away following Brexit, unless they are transposed into UK law. On the other hand, as a directive, CRD IV has been implemented into UK law, which means that the UK government will need to take some active step for the provisions of CRD IV (as implemented into UK law) to stop applying. There are a number of reasons why it may be difficult for the UK to do so in respect of the bonus cap.

First, there are differing opinions on the bonus cap within the UK itself. Members of the Conservative Party have traditionally viewed the cap as a danger to financial stability, while certain members of the Labour Party have stated that the cap is an important part of ensuring such stability and preventing an increase in economic inequality. It is by no means clear, therefore, that the UK Parliament would pass legislation repealing the bonus cap following Brexit.

Second, without access to the single market, the UK would become a third country for the purposes of the Markets in Financial Instruments Directive ("**MiFID**"), which means that UK financial institutions would lose their passporting rights. When they become applicable on January 3, 2018, the Markets in Financial Instruments Regulation and the Markets in Financial Instruments Directive II (together, "**MiFID II**") will introduce third country passports, and UK financial institutions could seek to rely on these instead (please see the first issue of Lex et Brexit for more detail). To do so, however, the UK's regulatory regime would need to be deemed "equivalent" to that of the EU.

There is a question as to whether the UK's regulatory regime would be deemed equivalent if the UK government amended or repealed the bonus cap. The EU may not, for instance, wish to allow a UK

---

[4] **http://ec.europa.eu/justice/civil/files/company-law/com_2016_510_f1_report_from_commission_en.pdf**

financial institution to provide services into an EU country if the bonuses that that UK institution awards to its executives are not subject to a similar cap. Any divergence may also give rise to level playing field considerations. If an EU financial institution is subject to the bonus cap, but a UK financial institution is not, then how will the EU be able to conclude that the UK financial institution is subject to a regulatory regime that is equivalent to the regime to which the EU institution is subject? In addition, where bonuses granted to the executives of EU financial institutions are subject to a cap, but those granted to the executives of UK financial institutions are not, this may make it difficult for EU firms to compete for talent with UK firms. The EU could conceivably take this into account when determining the UK's equivalence, given the level of discretion available to the Commission in the equivalence assessment process.

During its assessment of the UK's equivalence, the EU may also look to the remuneration provisions contained in MiFID II itself. Like MiFID, MiFID II will require investment firms to apply certain remuneration standards in addition to those set out in CRR and CRD IV. MiFID II introduces a new, explicit requirement on the management of financial institutions to "define, approve and oversee…a remuneration policy of persons involved in the provision of services to clients aimed at encouraging responsible business conduct, fair treatment of clients as well as avoiding conflicts of interest in the relationships with clients."[5] The regulatory technical standards provide that remuneration policies and practices should "be designed in such a way so as not to create a conflict of interest or incentive that may lead relevant persons to favour their own interests or the firm's interests to the potential detriment of any client."[6] The EU may take the view that repealing the bonus cap would be in direct conflict with these provisions (even though the cap is located in a different legislative measure, CRD IV), and that, as a result, UK financial institutions would no longer be subject to an equivalent regulatory regime.

Some commentators have aspired for the UK to set its own terms in trade negotiations following Brexit as if she was still the mercantilist power of the eighteenth century. However, the simple question of bankers' compensation shows that, inside or outside the EU, the world is just too interconnected, and those connections are just too important for the UK, for there to be the economic independence post-Brexit that may have been touted by some politicians.

---

[5] Article 9(3)(c), Markets in Financial Instruments Directive II.

[6] Article 27(1), Commission Delegated Regulation (EU) …/… of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (C(2016) 2398 final).

Davis Polk

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Thomas J. Reid	**+1 212 450 4233**	tom.reid@davispolk.com
John D. Amorosi	**+1 212 450 4010**	john.amorosi@davispolk.com
John Banes	**+44 20 7418 1317**	john.banes@davispolk.com
Leo Borchardt	**+44 20 7418 1334**	leo.borchardt@davispolk.com
Randall D. Guynn	**+1 212 450 4239**	randall.guynn@davispolk.com
Kirtee Kapoor	**+1 650 752 2025**	kirtee.kapoor@davispolk.com
Will Pearce	**+44 20 7418 1448**	will.pearce@davispolk.com
Margaret E. Tahyar	**+1 212 450 4379**	margaret.tahyar@davispolk.com
Simon Witty	**+44 20 7418 1015**	simon.witty@davispolk.com
Connie I. Milonakis	**+44 20 7418 1327**	connie.milonakis@davispolk.com
Michael Sholem	**+44 20 7418 1027**	michael.sholem@davispolk.com
Joanna A. Valentine	**+44 20 7418 1323**	joanna.valentine@davispolk.com
Elisabeth Milan	**+44 20 7418 1382**	elisabeth.milan@davispolk.com

About Lex et Brexit — The Law and Brexit

Lex et Brexit is our fortnightly publication on Brexit developments. In each issue, we select and discuss emerging legal issues from the maze of Brexit-related debates and developments.

Read previous issues at **www.davispolk.com/brexit >**

Sign up to receive Lex et Brexit >

© 2016 Davis Polk & Wardwell London LLP | 5 Aldermanbury Square | London EC2V 7HR

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's **privacy policy** for further details.

Davis Polk & Wardwell London LLP is a limited liability partnership formed under the laws of the State of New York, USA and is authorised and regulated by the Solicitors Regulation Authority with registration number 566321.