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Banking: Council agreement on creditor hierarchy, IFRS 9 and large exposures

On 16 June 2017, the Council agreed its stance on part of a package of proposals aimed at reducing risk in the banking industry, namely:

- a draft directive on the **ranking of unsecured debt instruments** in insolvency proceedings (bank creditor hierarchy);

- a draft regulation on transitional arrangements to phase in the **regulatory capital impact** of the IFRS 9 international **accounting standard**.

The draft regulation also contains a phase-out of provisions on the large exposures treatment of **public sector debt** denominated in non-domestic EU currencies.

Ministers asked the presidency to start talks with the European Parliament as soon as the Parliament has approved its own negotiating stance.

"These proposals set out to help make our banks more **resilient to shocks** in the light of **new prudential standards** agreed at international level. We have decided to make these texts a priority and hope the Parliament will be able to start negotiating by the end of this year", said Edward Scicluna, minister for finance of Malta, which currently holds the Council presidency.

Creditor hierarchy in insolvency proceedings

Directive 2014/59/EU on bank recovery and resolution subordinates uncovered deposits (above €100 000) to covered deposits in the event of insolvency proceedings. It establishes a preference for natural persons and SMEs. It does not provide, however, for subordination for **senior unsecured debt securities** versus other forms of unsecured debt claims.

Such a specification is now necessary in view of the Financial Stability Board's November 2015 '**total loss-absorbing capacity**' (TLAC) standard. To be implemented by global systemically important banks in 2019, the TLAC standard requires the holding of subordinated instruments ('subordination requirement').

The draft directive therefore requires member states to create a new class of **'non-preferred' senior debt**, eligible to meet the subordination requirement.

It will thereby facilitate the application of EU bail-in rules in cross-border situations and avoid distortions of the EU single market. A number of member states have amended or are in the process of amending their insolvency laws. The absence of harmonised EU rules creates uncertainty for banks and investors alike.

The draft, which mainly amends article 108 of the bank recovery and resolution directive, has been made a priority amongst other banking proposals presented by the Commission in November 2016. The aim is to provide **legal certainty** for banks and investors.

IFRS 9 and large exposures

The regulation will **mitigate** the potential negative regulatory capital impact on banks of the introduction of International Financial Reporting Standard (IFRS) 9.

IFRS 9 was published by the International Accounting Standards Board in July 2014. Regulation 2016/2067 requires EU banks to use it in their financial statements for financial years starting on or after **1 January 2018**.

IFRS 9 is aimed at improving the loss provisioning of financial instruments by addressing concerns that arose during the financial crisis. It responds to the G20's call for a more forward-looking model for the recognition of expected credit losses on financial assets.

Use of IFRS 9 by banks may however lead to a sudden increase in expected credit loss (ECL) provisions and a consequent sudden fall in their regulatory capital ratios. **Transitional arrangements** are needed from 1 January 2018, consistent with use of the new accounting standard. It was therefore decided to split and fast-track the entry into force of certain provisions from a broader November 2016 Commission proposal amending regulation 575/2013 on bank capital requirements.

The presidency prepared the resulting draft regulation, which would allow banks to **add back** to their 'common equity tier 1' capital a portion of the increased ECL provisions as **extra capital** during a **five-year** transitional period. That added amount will progressively decrease to zero during the course of the transitional period.

The draft regulation also provides for a **three-year phase-out** of an exemption from the large exposure limit for banks' exposures to public sector debt denominated in the currency of any other member state.

The exemption is used by banks in several **non-eurozone member states** for their **euro-denominated holdings** of those member states' public debt. Unless regulation 575/2013 is amended, the exemption will cease to apply after 31 December 2017. The phase-out is intended to **soften the impact** of its termination.

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Agreement was reached at a meeting of the Economic and Financial Affairs Council.

The Council requires a qualified majority to adopt the two legal texts, in agreement with the Parliament. (Legal basis: articles 53(1) and 114 of the Treaty on the Functioning of the European Union).

May 2017 draft regulation on the transitional period for introduction of IFRS 9
May 2017 draft directive on the ranking of unsecured debt instruments

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