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New requirements for loss absorbing capacity: TLAC and MREL

Main features

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1. Why is a loss-absorbing requirement needed?
2. EU loss-absorbing capacity requirement (MREL)
3. MREL & TLAC – “Same dog with different collar”
4. Potential impacts of TLAC/MREL and bail-in

1 Why is a loss-absorbing requirement needed?

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The new resolution framework

Needs to be business model neutral

- The TLAC and MREL features need to be sufficiently flexible to allow different business models. It is necessary to avoid forcing changes against the nature of the entities
- For global banks, both SPE and MPE are legitimate strategies that correspond to different business models

A minimum level of harmonization is necessary

- Not all the jurisdictions need to have exactly the same scheme, but a certain minimum harmonization is necessary
- The need for coordination in the EU and especially in the Eurozone is much higher
- Convergence of TLAC and MREL is crucial for Europe

Banks and investors need clarity

- TLAC and MREL imply huge issuance needs
- A significant phase-in is necessary
- Clarity is crucial. Investors need to know under what conditions they will assume losses
- The real test of the bail-in regime is practical application


ERM... I'M NOT SURE I UNDERSTAND THE WORD LOSS
FIRST LOSS-ABSORBING BOND
HARRY

The new resolution framework challenges

G-20 commitment in 2011

*"The new resolution framework should set out the responsibilities, instruments and powers to enable authorities to resolve failing financial firms in an **orderly manner**, by **protecting critical functions** and **without exposing the taxpayer** to the risk of loss".*

Global banks need to be viable, albeit resoluble

Financial models: enough loss-absorbing liabilities (Loss Absorbing Capacity - LAC)

Legal entity structures: clear and feasible mapping of interdependences

Operating model: operational continuity of shared services

Main ratios

TLAC (G-SIFIs)

+

MREL (all EU banks)

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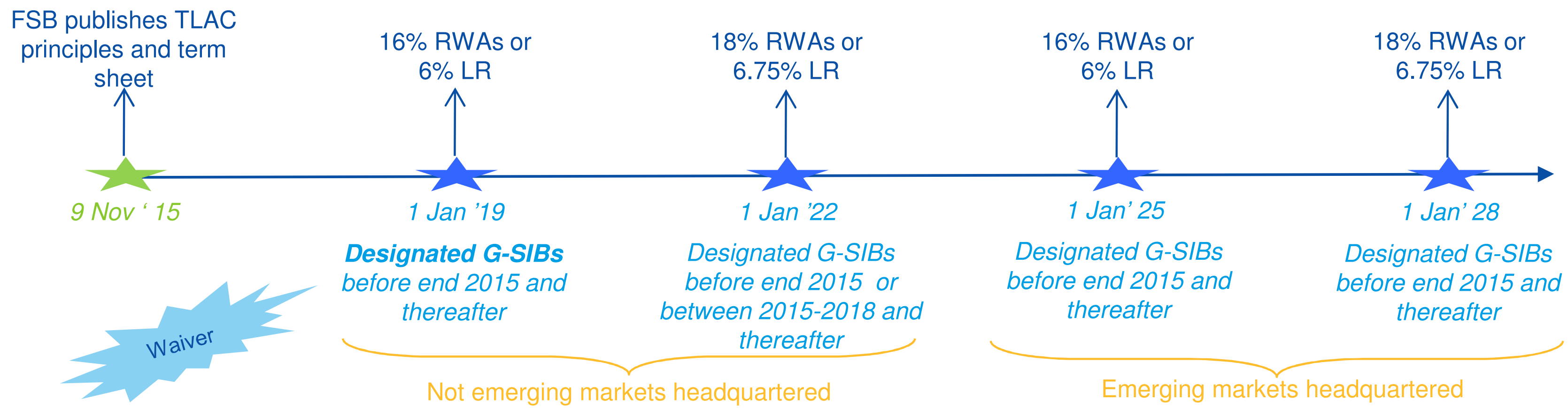
TLAC's calendar and main features



Characteristics

1	Scope	• FSB' G-SIBs
2	Eligible instruments	• CET1, AdT1, T2 and senior subordinated debt
3	Subordination	• 3 types of subordination allowed: contractual – structural – statutory (but clearly benefits structural subordination)
4	Allocation	• External TLAC: MPE & SPE; Internal TLAC: SPE
5	MPE deductions	• Parent companies of MPE GSIBs should deduct from their own TLAC resources the exposures to eligible external TLAC issued from a subsidiary

TLAC includes capital and unsecured debt

TLAC nature principle

The TLAC instruments should be **legally, feasibly and operationally available** to absorb losses when needed

Full recognition in the TLAC

Common Equity Tier 1

Additional Tier 1 instruments

Tier 2 instruments

Senior subordinated debt

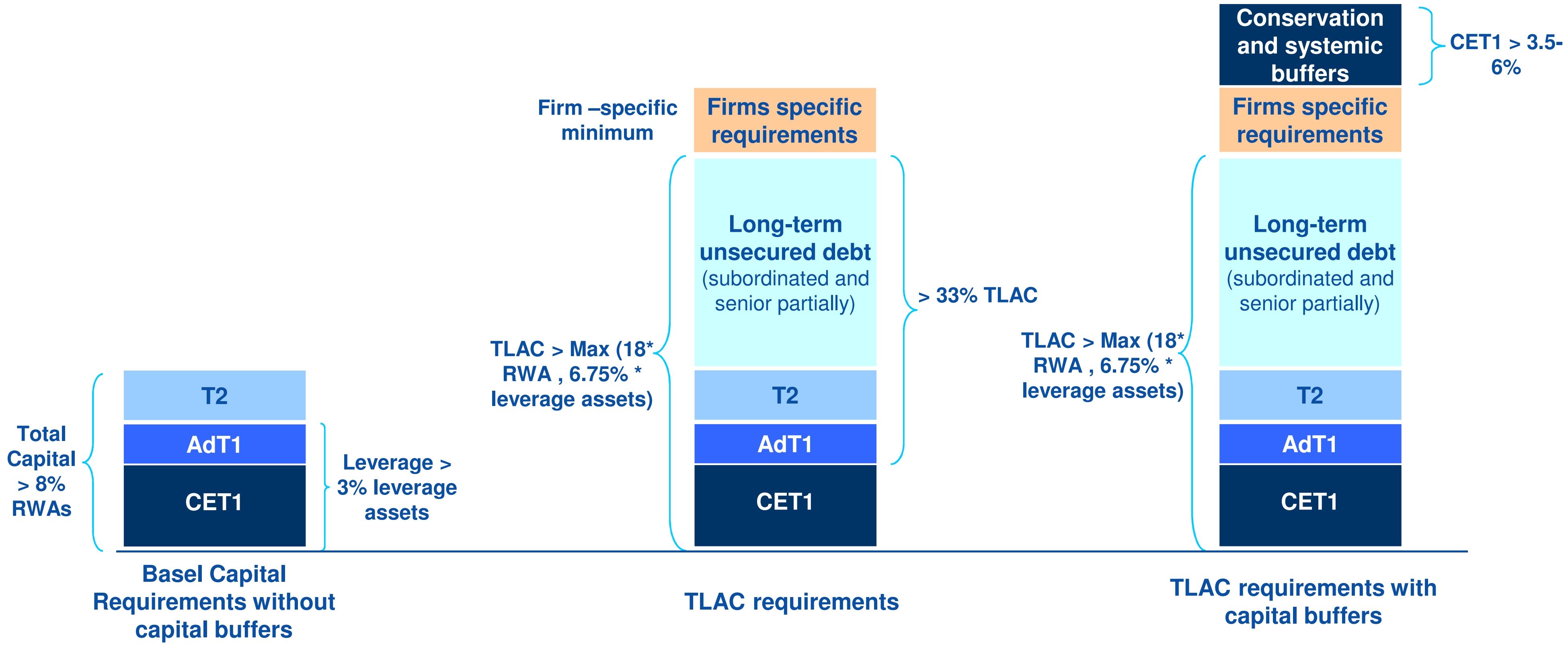
Full recognition if excluded liabilities <5% TLAC.
If not, partial recognition (up to 2.5% RWA in 2019 & 3.5% in 2022)

Senior debt (pari-passu with derivatives, corp. depo, etc.)

TLAC calibration

TLAC size principle → After the bail-in, the TLAC must ensure the **recapitalization**, **market confidence** and regulatory **capital requirements**

Min. TLAC without capital buffers $_{2019}$ = Max (16% * RWA, 6% * leverage ratio denominator)
Min. TLAC without capital buffers $_{2022}$ = Max (18% * RWA, 6.75% * leverage ratio denominator)

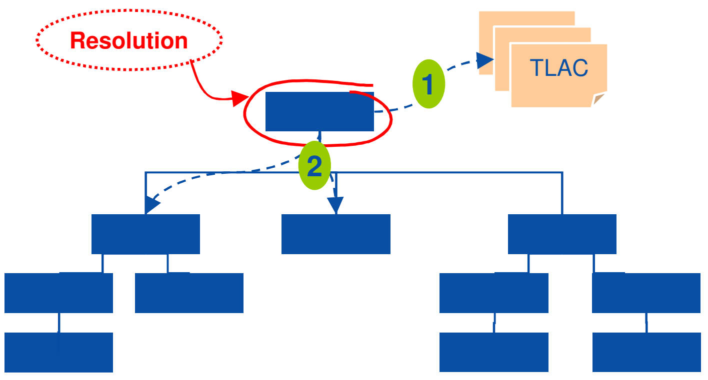


The TLAC should be issued from each point of entry

TLAC placement principle

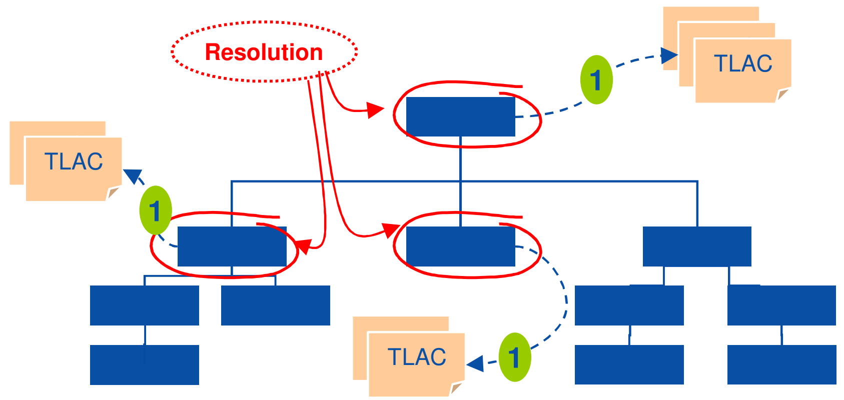
The appropriate allocation of TLAC will be determined by the **preferred resolution strategy**: at parent level under an SPE scheme and at subsidiary level under an MPE scheme.

SPE banking groups



1. TLAC debt issue to third investors at parent
2. Internal TLAC debt issued to the parent

MPE banking groups



1. TLAC debt issue to third investors

Hybrid schemes are possible

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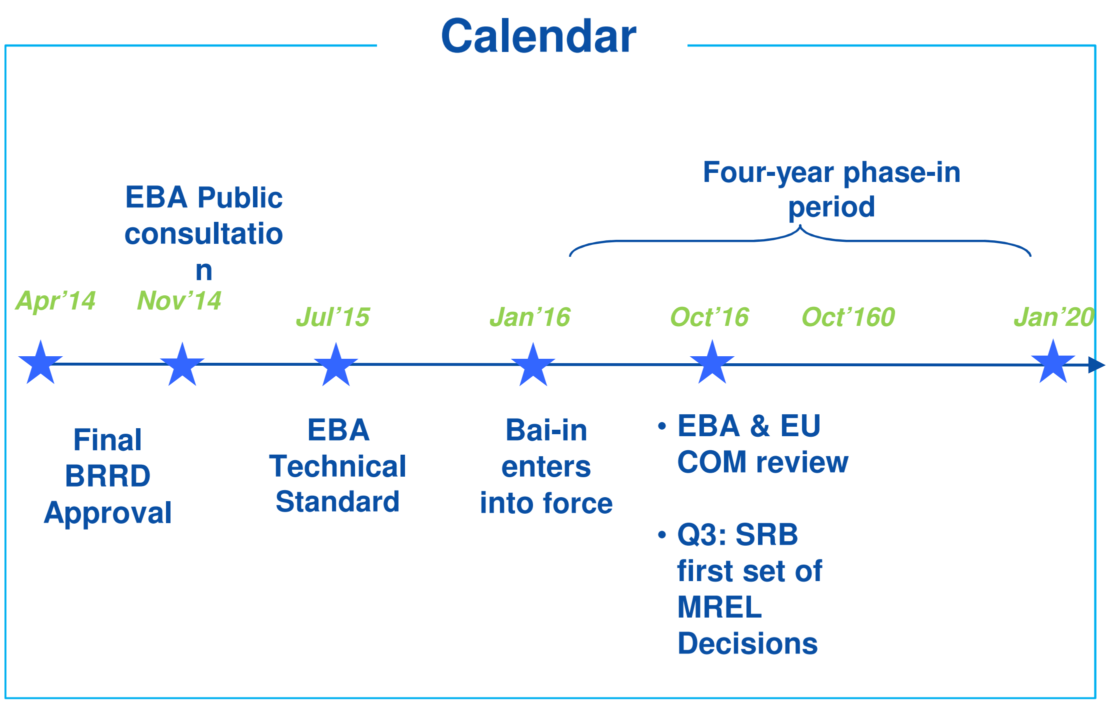
2 EU loss-absorbing capacity requirement (MREL)

The BRRD transposes the loss-absorbing concept

Content of the BRRD

- Scope and institutional framework
- Recovery and resolution plans
- Trigger for resolution
- Resolution tools
  - Sale of business
  - Bridge institution
  - Asset separation
  - Bail-in-MREL
- Government stabilization tools
- Resolution Fund
- Cross Border Agreements



Note: BRRD- Bank Recovery and Resolution Directive

The EBA RTS defines the criteria for determining the MREL on a case-by-case basis

The EBA specifies the **minimum criteria** in order to achieve a **convergence** in how resolution authorities apply them, and ensure that the MREL is set considering the **risk profiles, resolvability, and other characteristics** as BRRD states.

MREL = 1) Default loss-absorption amount + 2) Recapitalization amount - 3) DGS adjustment (only for small banks)

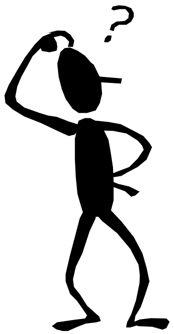
Constraint A: Consider the conditions for use of Single Resolution Fund (8% of total liabilities)

Constraint B: NCWO adjustment in eligible liabilities

MREL premises

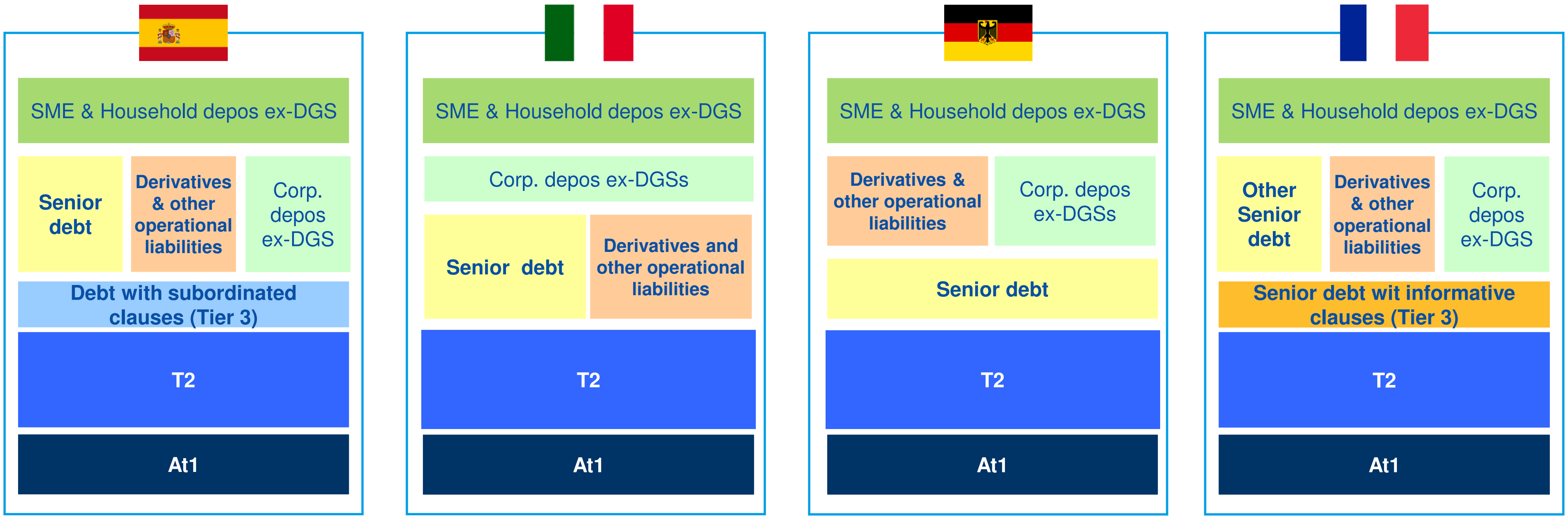
1. There is not a common minimum standard
2. The resolution authority will annually communicate to the bank the MREL
3. The MREL will be assessed based on a few criteria but expressed as a % of total liabilities

Debt subordination is a challenge



Subordination structure

- Whether or not other European countries will implement a contractual or statutory approach is not clear yet. A harmonized subordination scheme across Europe is highly desirable.



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3 MREL & TLAC – "Same dog with different collar"

TLAC/MREL: Same purpose but different features

FSB proposal → **European transposition (EBA)**

TLAC
Total Loss-Absorbing Capacity

Enter into force: 2019

MREL
Minimum Requirement of Eligible Liabilities

Enter into force: 2016-20 (48 months phase-in)

Both ratios seek to ensure that banks have **enough liabilities with loss- absorbing capacity** to deal with banking crises, protecting financial stability, and minimising taxpayer cost.

Despite having the same purpose, both ratios are different

Scope

The **MREL applies to all European institutions**, whereas the TLAC only applies to G-SIBs.

Sizing

The **MREL is determined on a case-by-case basis**, whereas TLAC is a common minimum standard.

Main differences between MREL & TLAC

	MREL	TLAC	Comparability
Scope of covered firms	• All credit Institutions and investment firms	• Global systemically important banks (G-SIBS)	X
Objective	• To ensure i)- an appropriate level of loss-absorbing and recapitalisation capacity for the relevant group to be resolvable, ii)- critical functions can be continued without taxpayer (public) funding and avoiding adverse effects on the financial system.		✓
Eligible Instruments	• Equity, junior debt, senior debt, and other unsecured liabilities residual maturity over one year. • Senior unsubordinated debt may be excluded if it accounts for less than 90% of the total liabilities in the same rank.	• Equity, junior debt, senior subordinated debt and part of the senior unsubordinated debt which is pari passu with excluded liabilities. The latest may account for an amount equivalent to 2.5% RWA.	≈
Pillar 1 vs. Pillar 2 approach	• Case-by-case approach (Pillar 2) based on each bank's characteristics: resolvability assessment, complexity, risk profile, etc.	• All banks should have the same **Pillar 1** minimum TLAC requirement plus a Pillar 2 firm-specific requirement.	X
Sizing	• Calculation based on the minimum capital including capital buffers and leverage requirements and the recapitalisation needs after resolution. • Additionally, some adjustments may be applied based on risk profile, resolution strategy, etc.	• Pillar 1 standard minimum: (16-20% of RWA or 6% of leverage assets) plus Pillar 2 case-by-case requirements. • TLAC minimum requirements do not include capital buffers.	X
Denominator	• % total liabilities and own funds of each institution • MREL's quantum will be determined in monetary terms based on several factors where the capital and leverage ratios play a central role.	• TLAC is determined by the capital or leverage ratio	✓
Come into force	• 2016 with 48-month phase-in period (four years)	• No earlier than 1 January 2019	✓

Eligibility of instruments is crucial

Unsecured or not collateralised liabilities	Bail-inable liabilities	MREL eligible liabilities	TLAC eligible liabilities	Hierarchy of claims
Capital				
CET1	✓	✓	✓	1
AT1	✓	✓	✓	2
T2	✓	✓	✓	3
Wholesale funding				
Subordinated debt & T3	✓	✓	✓	4
Senior debt	✓	≈	≈	
Unsubordinated Senior debt > 1 year	✓	≈ *	≈ **	5
Subordinated Senior Debt > 1 year	✓	✓	✓	4
Covered Bonds	X	X	X	X
Mortgage bonds	X	X	X	X
Securitizations	X	X	X	X
Structured notes	✓	✓	X	5
Promissory notes	✓	X if < 1 year	X if < 1 year	5
Commercial paper	✓	X if < 1 year	X if < 1 year	5
Certificate of deposit	✓	X if < 1 year	X if < 1 year	5
Deposits by credit institutions				
Maturity < 7 days	X	X	X	X
7 days < maturity < 1 year	✓	X	X	5
Maturity > 1 year	✓	✓	✓	5
Deposits by central banks	✓	✓	✓	5
Deposits by other organizations	✓	✓	✓	5
Deposits by the public administration	✓	✓	✓	5
Customer deposits				
Non covered deposits				
Retail deposits / SME - sight	✓	X	X	6
Retail deposits / SME - fixed term	✓	X	X	6
Corporate deposits - sight	✓	X if < 1 year	X if < 1 year	5
Corporate deposits -fixed term	✓	✓	✓	5
DGS covered deposits	X	X	X	7
Collateral financing (REPOs)	X	X	X	X
Derivatives				
CCP derivatives	✓	X	X	5
OTC derivatives	✓	X	X	5
Secured liabilities (collateralized), Employees' - clients - fiduciary- tax & SS - critical services liabilities	X	X	X	X

* If excluded liabilities ranking pari passu are 10% or less
* * Up to 2.5% (until 2022) or 3.5% (thereafter) of RWAs if excluded liabilities ranking pari passu are less than 5% of total external TLAC

Observations

Bail-in eligibility wider than MREL / TLAC

MREL and TLAC eligibility is very similar …

…with a few differences: the main one the subordination exceptions…

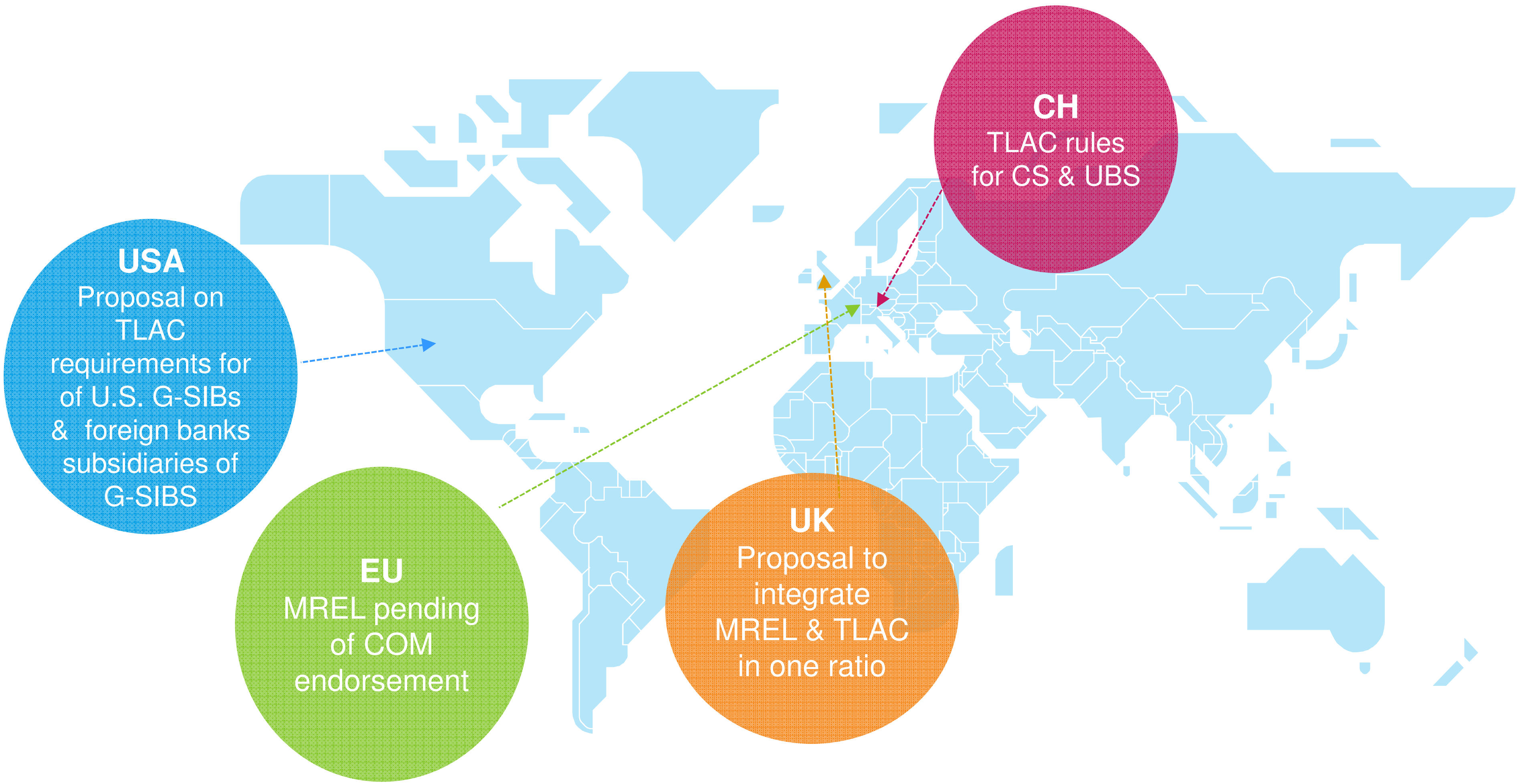
….but not a definitive framework yet.

High level of uncertainty still

1	TLAC	How to implement it in the European legislation ?
2	MREL	Commission Endorsement of EBA's RTS?
3	MREL	EBA's review in October
4	TLAC/ MREL	Commission proposal to modify MREL, align it to TLAC?
5	TLAC /MREL	Local implementation in other jurisdictions (USA, UK, CH)?

- ✓ **There are many doubts regarding the final MREL design**
- ✓ **The uncertainty will prevail until 2017 …..**
- ✓ **…which is impacting financial markets further complicating banks financing strategies**

Divergences in national implementation….



….further complicates a homogeneous regime

UK MREL: introduce TLAC

- **First attempt to introduce both MREL and TLAC at national level in one ratio**
- **Consultation closes on 11 March 2016**

Scope	• All UK Banks
Neutral	• MPE and SPE models are respected
Calibration	• Close to EBA's: Loss Absorption Amount (LAA) + Recapitalization Amount (RA) • BUT RA depends on bank's size and resolution strategy: 3 different types • AND No 8% floor
TLAC features	• Similar calibration for UK G-SIBs but still high level of discretionality • Similar eligibility for liabilities • Requires structural subordination • External/Internal MREL similar to External/Internal TLAC
Timing	• Enters into force in 2019 for G-SIBs and 2020 for the rest, but extended calendar compared to SRB's • Equal to minimum capital requirements until then (No additional requirement)

UK Calibration: Three types of entities, three sizes of MREL

Insolvency

Size

< 40,000 transactional accounts

MREL

Min. Capital requirements only

Subordination

☒

Partial Transfer

Size

< £15bn – £25bn in TA (> 40,000 transactional accounts)

MREL

Min. Capital requirements + additional requirements in proportion to transfered balance sheet

Subordination

☒

Bail-in

Size

> £15bn – £25bn in TA

MREL

2 x Min. Capital requirements only – changes to post-resolution capital requirements

Subordination

☑

- TA = Total Assets
- Transactional accounts = current or payment accounts
- Minimum Capital requirements = Pillar 1 + Pillar 2A

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4 Potential impacts of TLAC/MREL and bail-in

The MREL/ TLAC bail-in will have similar impacts to Basel 3

A. Tax payers

- Reduction of contingent sovereign liabilities (*)

B. Banks

- Higher funding costs (*)
- Share cost with clients (*)
- Impacts on capital distributions (*)
- Shift activity to non-GSIBs (*)

C. Investors

- Uncertain investors appetite (*)
- Demand higher spreads
- More focus on banks' fundamentals
- Increasing market discipline

D. Rating Agencies

- Remove (partially) the sovereign support
- Change credit rating methodologies (e.g., Moodys and S&P)

E. Financial stability

- Financing to real economy (*)
- Emerging markets (*)
- Deposit-funded banking systems

(*) Impacts highlighted by the FSB in the Consultation paper

FSB Impact Assessment Studies on TLAC

According to the FSB, low impact and manageable requirements

Shortfall	Spread	Funding costs	Benefits
€42 – 1,130 bn	+ 30 bps	€195 – 500 mn per year	+ 15 – 20 bps anual GDP
Depending on which instruments ("near eligible") are considered, which minimum TLAC requirement applies and if EMEs G-SIBs are included or not	In comparison to other types of debt…		Increases bank's resilience, reduces the probability of failure of individual G-SIBs and reduces the likelihood of a system-wide financial crisis

- TLAC rules penalize firms that rely mostly on deposits for their funding, such as retail and commercial banks.
- Systemic risk is transferred from banks to other market players

The new resolution framework

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Thanks!

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5 Annex

MREL: The starting point:"Loss Absorption Amount (LAA)"

Objective

The starting point is the **minimum prudential requirement, including capital buffers,** that supervisors are requiring in a going-concern basis.

The maximum of…

A)
- Total capital
- \+
- The combined buffer (Conservation, countercyclical & systemic)
- \+
- Any Pillar 2 requirement

B) Basel I capital floor

C) Leverage ratio requirement

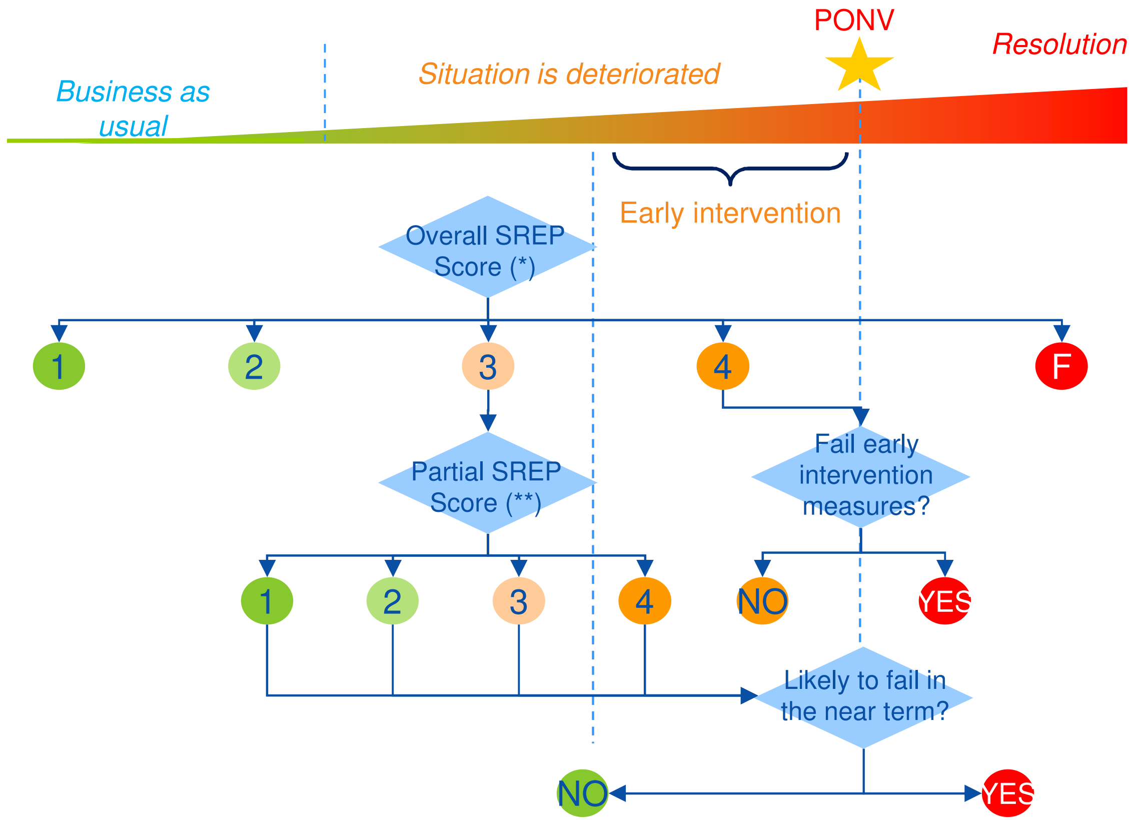
The resolution authority adjustments

+	-
• *SREP Adjustment (*):* Idiosyncratic characteristic (business model, funding model & risk profile). • To reduce or remove an impediment to resolvability or absorb losses on holdings of MREL instruments issued by other group entities. Deduction or higher RWA requirement ?	• Additional pillar 2 requirements derived from stress test or macroprudential risks are not relevant to ensure losses can be absorbed in resolution. • Part of the combined buffer requirement is assessed not to be relevant to ensure that losses can be absorbed in resolution.

(*) See next slide

LAA: SREP will also play a key role

The BRRD requires authorities to determine the **MREL taking into account the idiosyncratic characteristics of each institution** (i.e. business model, risk profile, governance, etc.).

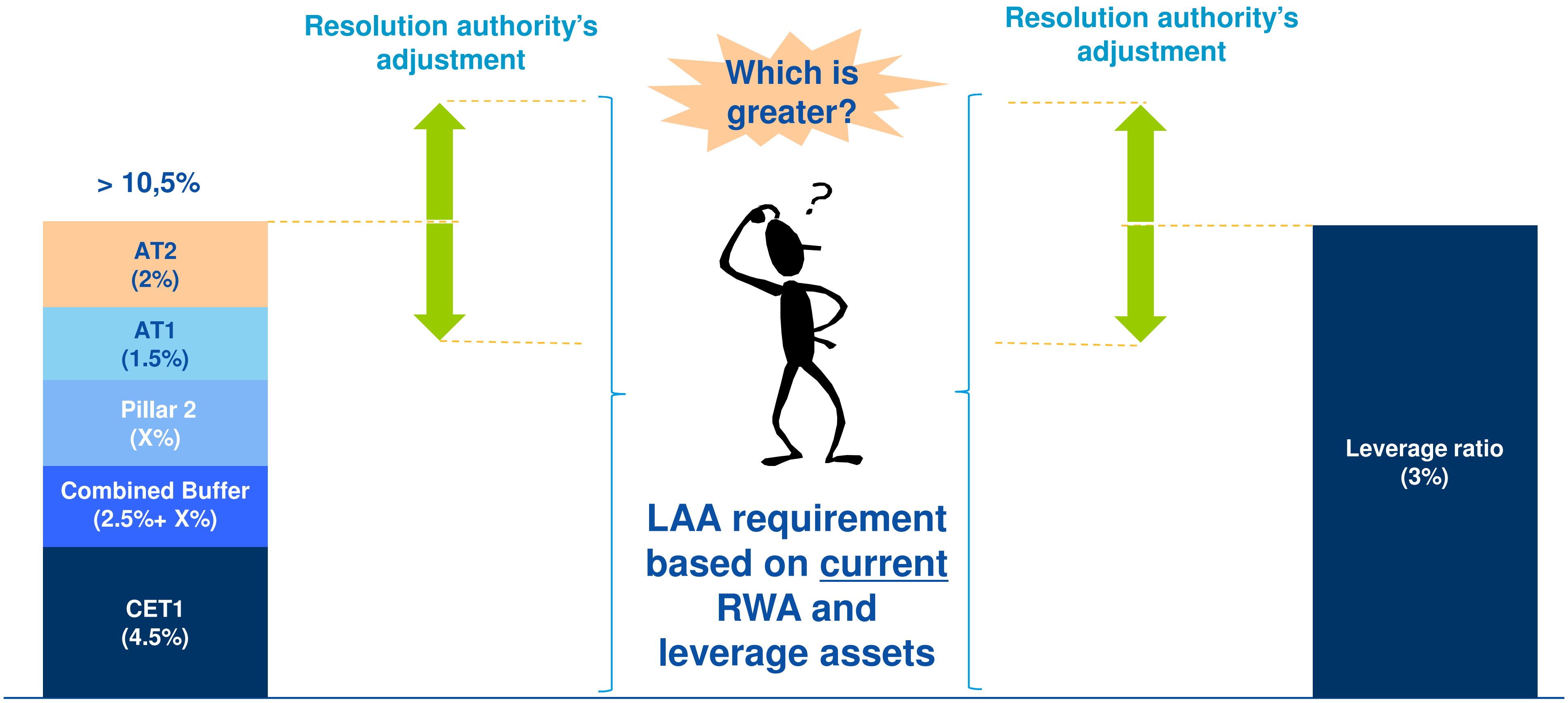


The dialogue, coordination and information sharing between the resolution authority and supervisors are critical.

- Assessment of business model, funding model & risk profile
- Assessment of whether capital and liquidity ensure coverage of the risks
- Additional own fund requirements on the outcomes of SREP
- Other prudential requirements

(*) Overall SREP Score: 1- no risk, 2-low risk, 3,-risk, 4-high risk, F-Fail
(*) Partial SREP Score refers to the following areas: capital, liquidity, internal governance, and business model

An overview of the loss absorption amount



The recapitalization amount anchors on two criteria

MREL = 1) Default loss-absorption amount + 2) Recapitalization amount (RA) - 3) DGS adjustment

A **The RA will take into account the resolution strategy**

The EBA acknowledges that the resolution plan may not imply that the entire group is recapitalized in the same form in which it enters into resolution. **“Resolution is not resurrection”**

B **The RA should maintain sufficient market confidence**

To satisfy **applicable capital requirements** and to comply with the conditions for authorization & ensure **sufficient market confidence** after the resolution strategy has been implemented

The recapitalization amount (RA) will take into account the resolution strategy

Two alternatives based on the resolution assessment

If the bank/subsidiary will be liquidated in case of resolution…

MREL

=

1) Default loss-absorption amount

\+

~~2) Recapitalization amount~~

If the bank/subsidiary will NOT be liquidated, but restructured…

MREL

=

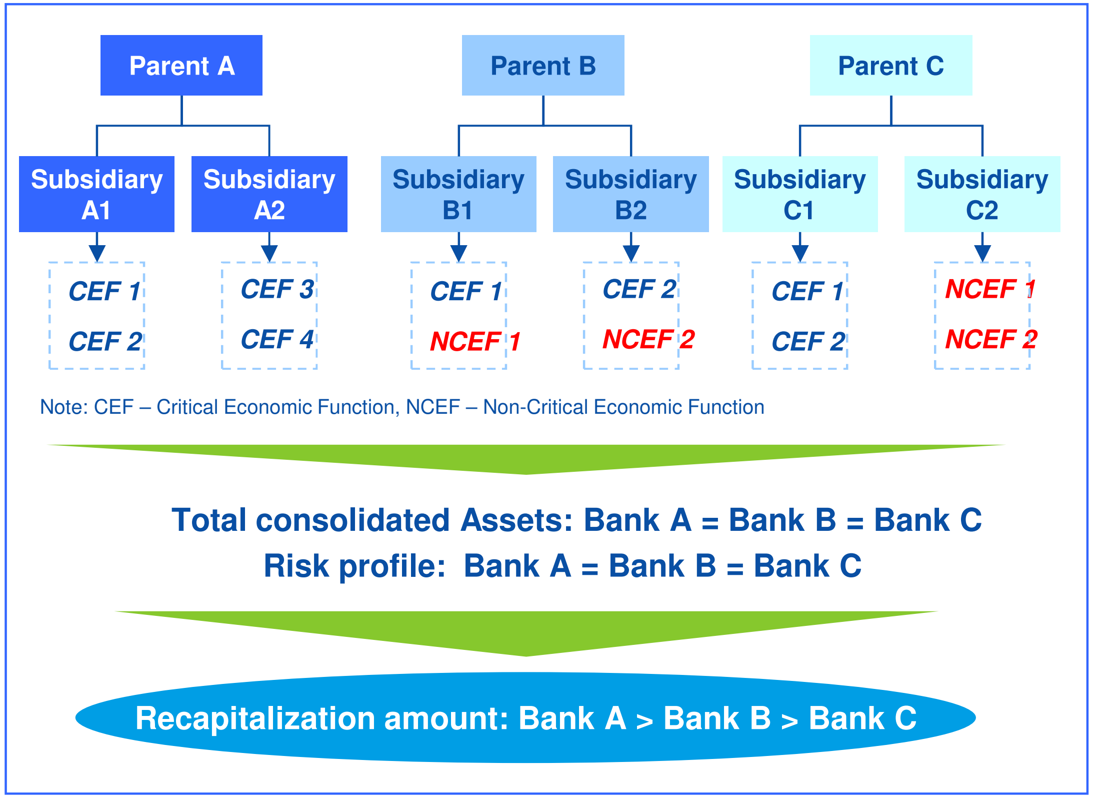
1) Default loss-absorption amount

\+

2) Recapitalization amount

Current RWA?

RWA post resolution?



Only if the resolution strategy is feasible & credible. Future discussions with resolution authorities will be key

The RA should maintain sufficient market confidence

The maximum of…

A)

Total capital

+

~~The combined buffer~~
~~(Conservation, countercyclical & systemic)~~

+

Any Pillar 2 requirement

B) Basel I capital floor

C) Leverage ratio requirement

+

Any additional requirement to maintain market confidence

To continue provision of critical functions

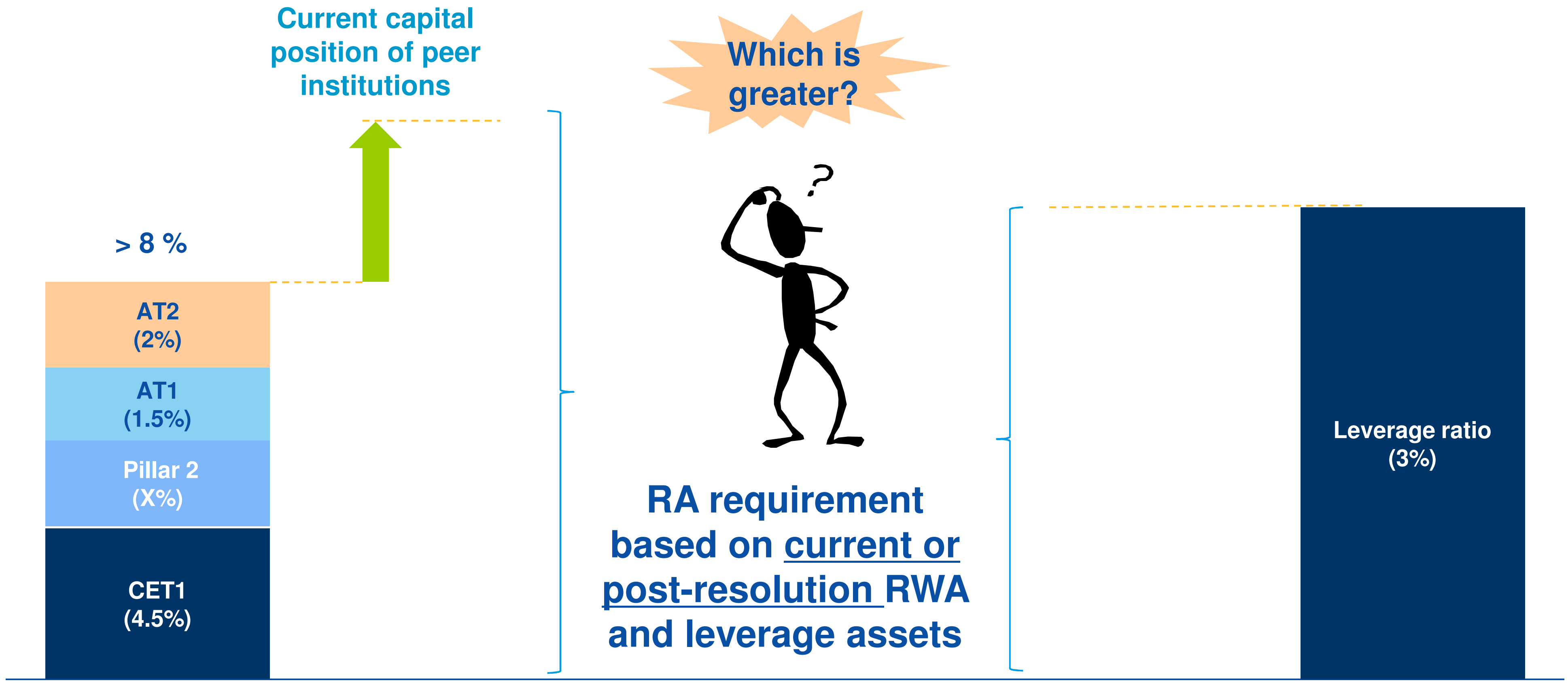
To access to funding

Is it credible?

Whether the capital position of the institution after the resolution is appropriate in comparison with peer institutions. For GSIBs the peers group will be other GSIBs.

The EBA allows resolution authority to adjust the recapitalization amount based on the business model, funding model and risk profile of the restructured institution. However, it is not clear how it will do it (probably through the Pillar 2 adjustments).

An overview of the recapitalization amount



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Senior debt and potential bail-in exclusions: NCWO principle as a backstop

Hierarchy

The resolution authority may exclude or partially exclude certain liabilities from the application of the write-down or conversion powers where:

- Not possible to bail-in a liability within a reasonable time (legal or valuation challenges),
- Continuity of critical functions,
- Avoid widespread contagion,
- Liabilities owed by certain creditors
- and destruction in value

Senior debt and other liabilities may not count towards the MREL, if…

$$\frac{\text{Liabilities extraor. excluded}}{\text{total same rank}} > 10\%$$

Senior debt could not count towards MREL due to "Non Creditor is Worse Off than in liquidation" principle (NCWO)