Resolution Regimes: FSB's Key Attributes, TLAC & EU's MREL

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Agenda

- Why the need for Loss-absorbing and Recapitalisation Capacity?
- Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution
- Total Loss-absorbing Capacity (TLAC) - Term sheet
- EU: Minimum Requirement for own funds and Eligible Liabilities (MREL)
- Annex: TLAC & MREL – a comparison

Treatment of problem banks before financial crisis

Traditional Insolvency Proceedings

- Terminate bank's economic functions (eg, deposits, lending business)
- Contagion risk

⇩

Potential risk to financial stability & real economy

Bail-out

- Moral hazard
- Market distortion
- Socialisation of losses and privatization of gains

⇩

Misguided incentives

Treatment of problem banks after financial crisis

Bail-in

- Liability and control aligned by exposing shareholders & creditors to loss and recapitalization
- Minimisation of cost to taxpayers

⇩

Ensuring sufficient bail-inable loss-absorbing capacity

G-SIBs TLAC

EU: MREL for all banks

Bundesbank Monthly Report July 2016

Do you agree?

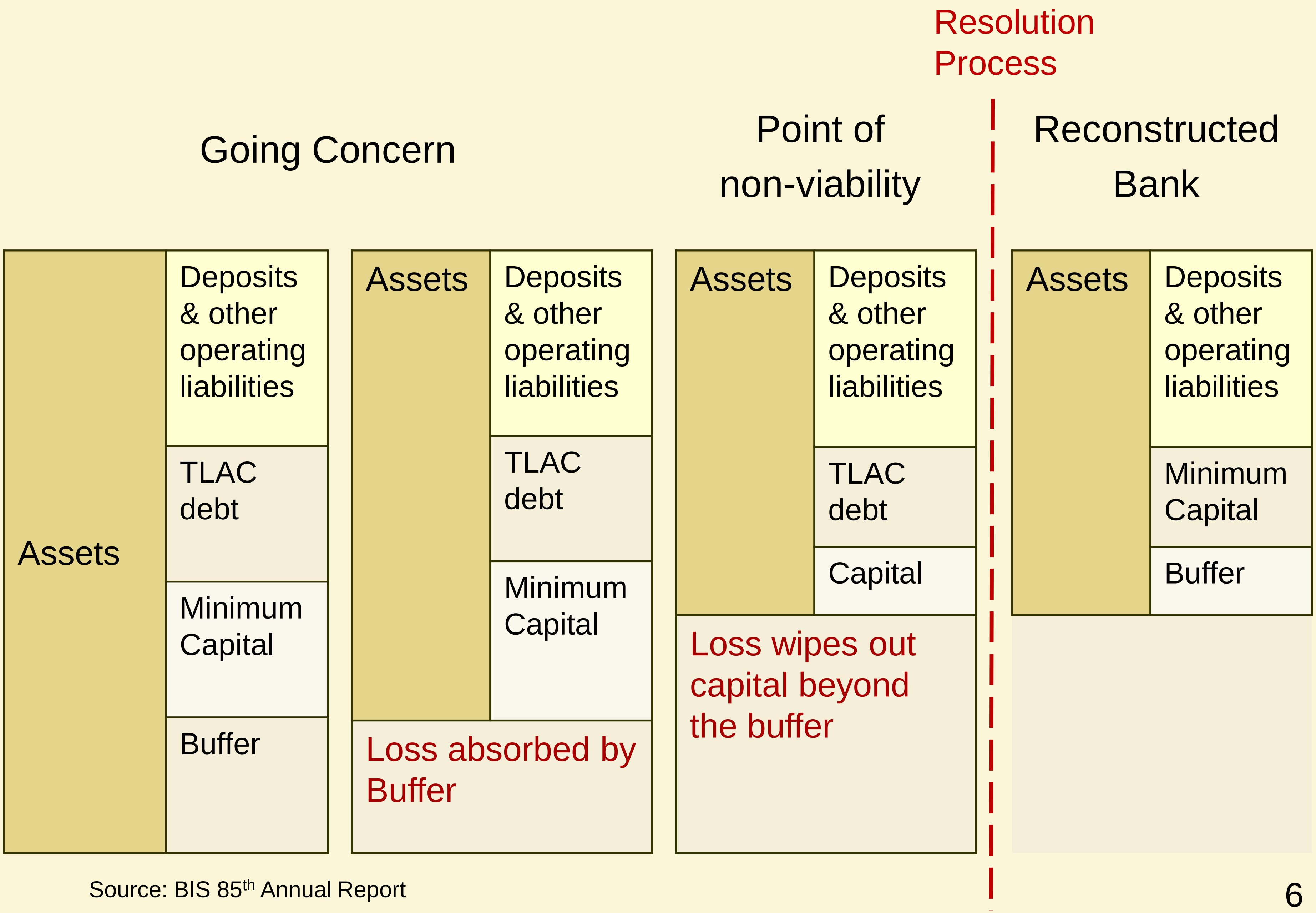
- “TLAC standard implies that the Basel reforms are inadequate –that it would be more straightforward to increase the Basel capital requirements than to design a new framework”.
- “A second criticism is that TLAC concentrates risk and that banks will simply hold each other’s TLAC eligible liabilities”
- “The prospect of bail-in will lead to a ‘buyers’ strike’.”

Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution

The main guiding principle:

(i) There must be sufficient *loss-absorbing and recapitalisation capacity* available in resolution to implement an *orderly resolution* that minimises any impact on *financial stability*, ensures the *continuity of critical functions*, and *avoids exposing taxpayers* (that is, public funds) *to loss* with a high degree of confidence.

How does TLAC work in resolution?



Source: BIS 85th Annual Report

Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution

- Firm-specific Minimum Total Loss-absorbing Capacity (TLAC) requirement for each G-SIB:
  - at least equal to common minimum agreed by FSB
  - prudent assumptions about losses incurred prior to resolution, as well as losses realised in prudent valuation necessary to inform resolution actions
    - Early intervention should moderate losses
    - But, resolution may be followed by additional losses
  - To ensure continuity of critical functions, the entity/ entities emerging from resolution must meet the conditions for authorisation (capital, etc.)
    - *Resolution is not resurrection. But nor is it insolvency*

Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution

- Host authorities - confidence (legal certainty) about sufficient loss-absorbing/ recapitalisation capacity for subs. at the point of entry into resolution
  - Ring fencing, ex-ante or ex-post resolution – fragmentation
- Exposing TLAC instruments to loss should be legally enforceable (NCWOL)

  No systemic risk or disruption of critical functions
  - TLAC not to include operational liabilities on which performance of critical functions depends
  - TLAC – to be subordinated to those operational liabilities
  - Not eligible as TLAC - Any instrument/ liability that cannot be written down/ converted into equity without risk of NCWOL claims

Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution

- TLAC eligible instruments - stable, long-term claims, not repayable on demand/ short notice
  - To avoid breach of TLAC by sudden/unexpected withdrawal of funds
- Capital buffers must be usable without entry into resolution
- Breach of TLAC - as severe as a breach of min. capital req.
- Disclosure of information on creditor hierarchy
  - Investors, creditors, counterparties, customers & depositors to have clarity about order of loss absorption in resolution
- Prudential restrictions on G-SIBs’ & other internationally active banks’ holdings of TLAC instruments issued by G-SIBs
- FSB Resolvability Assessment Process (RAP) to review calibration and composition of **firm-specific TLAC req**.

TLAC Term Sheet

- **Objective**: G-SIBs- loss-absorbing/recapitalisation capacity:
  - critical functions continue without taxpayers' funds (public funds) or financial stability being put at risk
- **Min. External TLAC Req:** in addition to Basel III minimum
  - applied to each resolution entity within each G-SIB
  - **Resolution entity-** to which resolution tools applied in accordance with the G-SIB resolution strategy
    - may be a parent company
    - an intermediate or ultimate holding company
    - an operating subsidiary
    - G-SIB may have one or more resolution entities
  - **Resolution Group =**
    - Each resolution entity + its Direct Subsidiary + Indirect Subsidiary (owned or controlled directly/ indirectly)

TLAC: Minimum Requirements

TLAC RWA Minimum:

$$\frac{\text{TLAC}}{\text{RWA}} = 16\%,\ 18\%\ (2019,\ 2022)$$ (China – additional 6 years)

- RWA of the resolution group
- Does not include Basel III buffers (to be met in addition to the TLAC RWA Minimum)

TLAC LRE Minimum (Leverage Ratio Exposure):

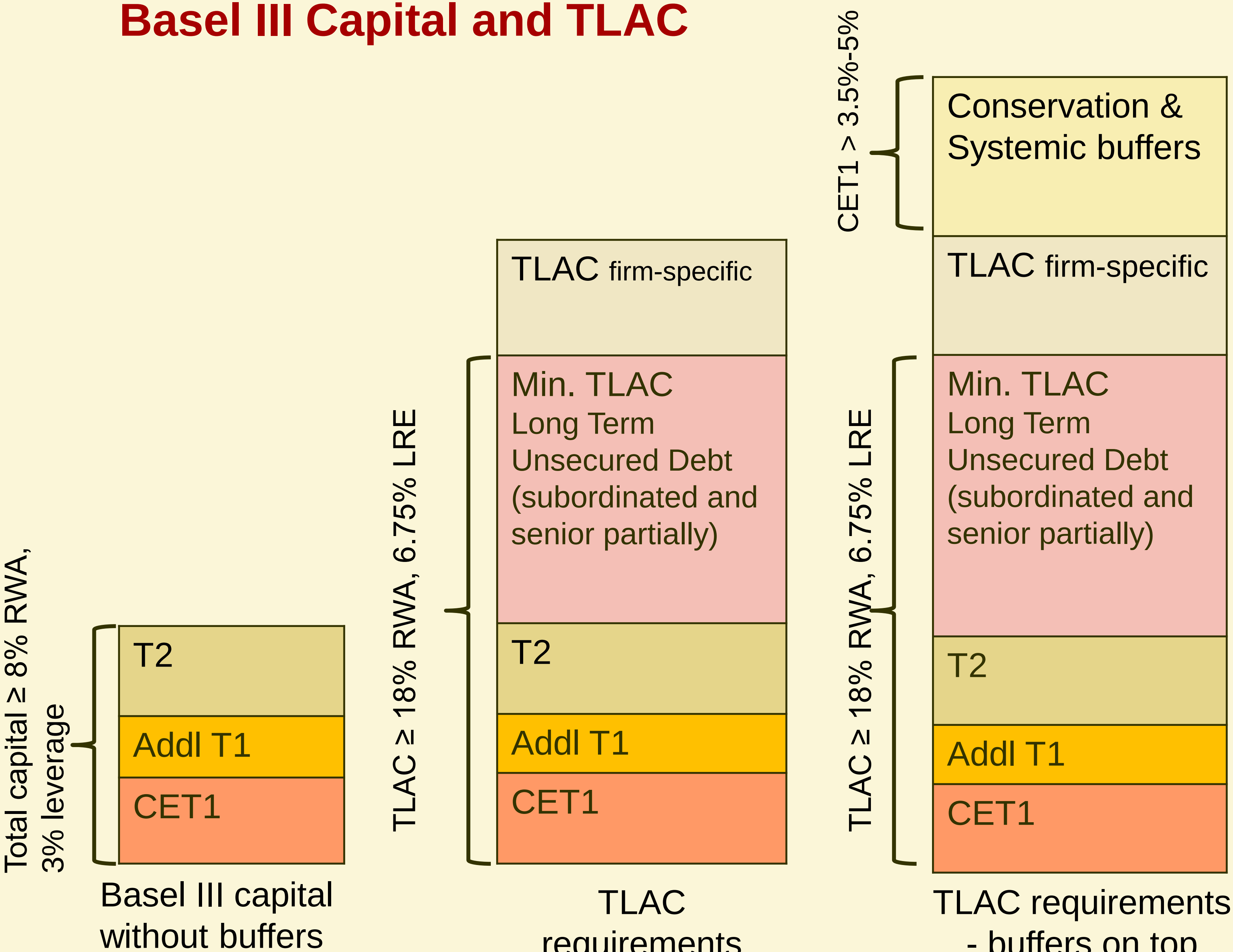
$$\frac{\text{TLAC}}{\text{LRE}} = 6\%,\ 6.75\%\ (2019,\ 2022)$$

- a requirement above the common minimum can be prescribed
- put in place buffers in addition to the TLAC LRE Minimum

Addl. Firm-Specific External TLAC requirement-

- Additional firm-specific TLAC requirements can be applied if necessary for orderly resolution
  - By - Home authorities of resolution entities, in consultation with CMG, subject to review in Resolvability Assessment Process (RAP)

Basel III Capital and TLAC

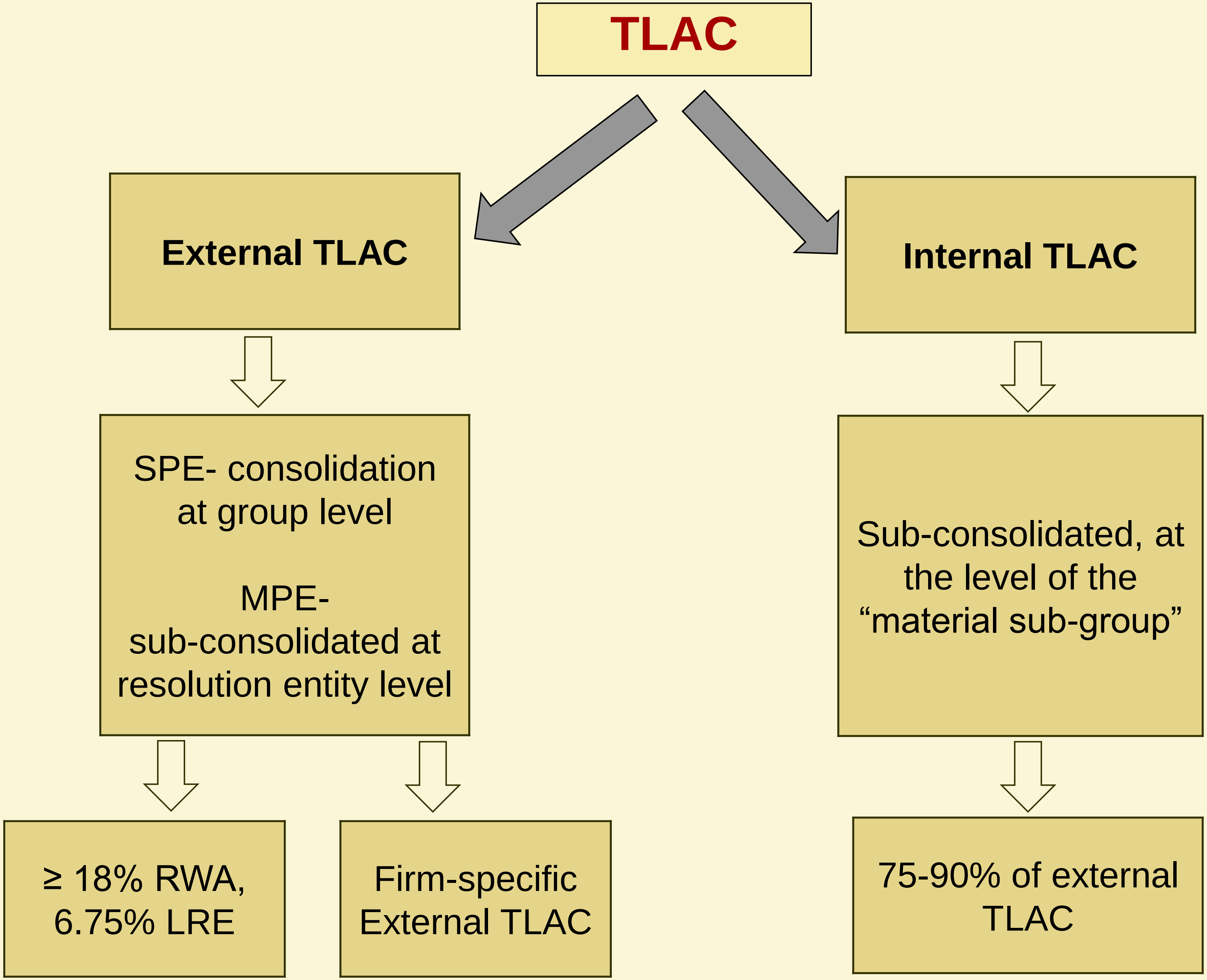


Short quiz- TLAC and buffers

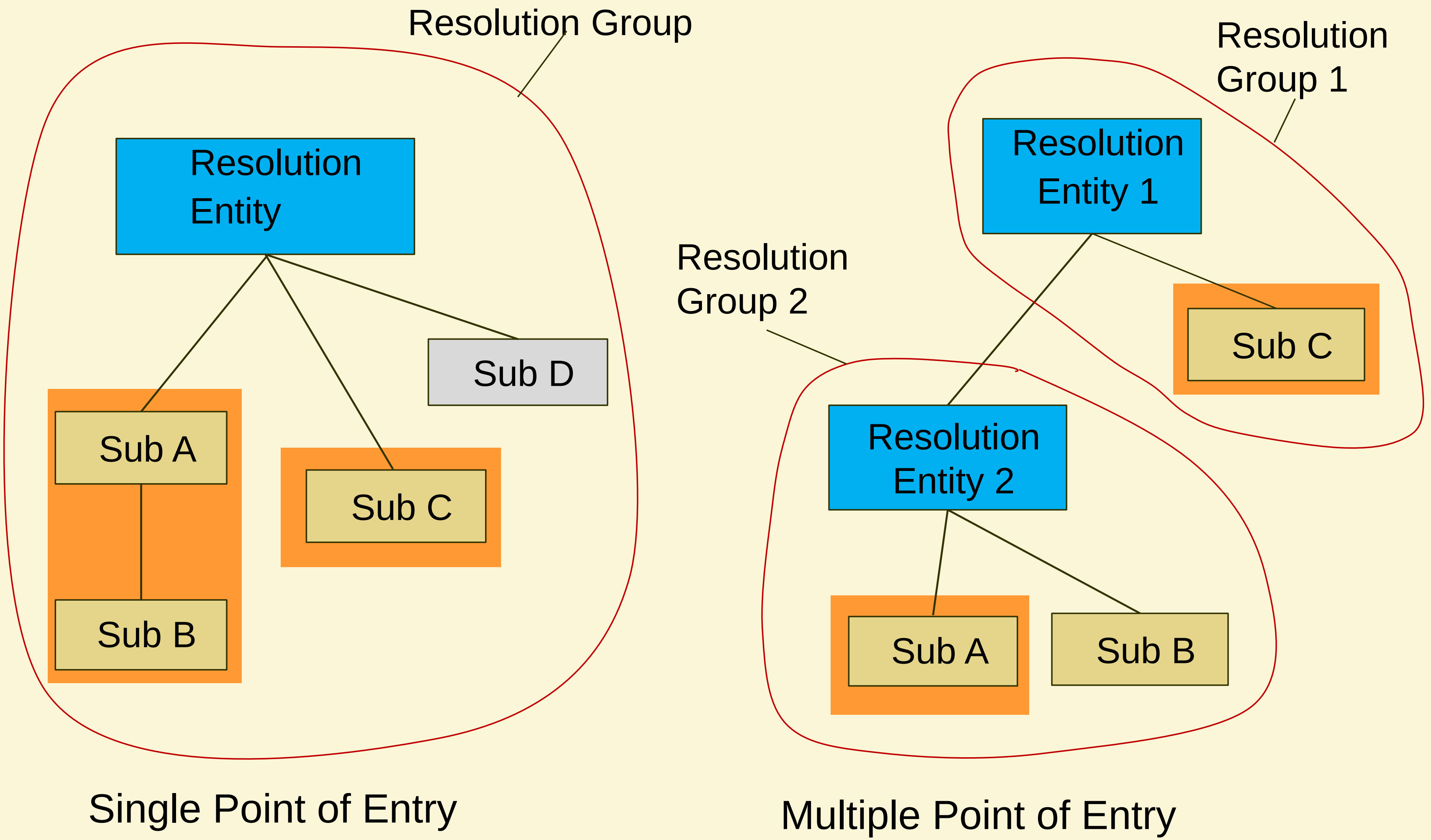
- Why should TLAC RWA minimum be 18% or
  TLAC LRE minimum be 6.75% ?

- Why is there a need for firm-specific TLAC requirement?

- TLAC Does not include Basel III buffers (to be met in addition to the TLAC RWA Minimum). Why?


TLAC
External TLAC
Internal TLAC
SPE- consolidation at group level
MPE- sub-consolidated at resolution entity level
Sub-consolidated, at the level of the “material sub-group”
≥ 18% RWA, 6.75% LRE
Firm-specific External TLAC
75-90% of external TLAC

Resolution Group, Resolution Entity and Subsidiaries: An Illustration



Material Sub-Groups

TLAC: Relationship with Basel III capital

- Minimum TLAC is in addition to minimum Basel III capital
- Basel III Capital may also count towards TLAC subject to certain conditions:
  - Common Equity Tier 1 (CET1) used to meet TLAC req. must not be used to also meet regulatory capital buffers
- Breach of TLAC req. as serious as breach of min. capital req.
- **Expectation-** the sum of a G-SIB's resolution entity/ entities' debt liabilities in the form of :

  (i) Tier 1 +

  (ii) Tier 2 +

  (ii) Other TLAC-eligible instruments that are not also eligible as regulatory capital (eg, senior debt)

  should be ≥ 33% of min. TLAC req.

  - to ensure sufficient o/s long-term debt for absorbing losses and/or effecting a recapitalisation in resolution

TLAC- eligibility criteria

- External TLAC must be issued and maintained directly by resolution entities
- TLAC-eligible instruments must:
  - be paid in
  - be unsecured
  - not be subject to set off or netting rights that would undermine their loss absorbing capacity in resolution
  - have a min. remaining contractual maturity of at least 1 yr. or be perpetual (no maturity date)
  - not be redeemable by the holder (i.e., not contain an exercisable put) prior to maturity
  - not be funded directly or indirectly by the resolution entity or a related party of the resolution entity (except where relevant home & host authorities in the CMG allow TLAC-eligible instruments/ liabilities issued to a parent of a resolution entity to count towards external TLAC of the resolution entity)

Short Quiz: Regulatory Capital and bail-in liabilities

	Addl T1	Tier 2	Bail-in Liabilities
Paid-up			
Unsecured			
Maturity			
Redeemable			
Subordinated			
Funded by the bank			

Liabilities excluded from TLAC

TLAC-eligible instruments must not include:

- insured deposits
- sight deposits & short term deposits (original maturity < 1yr)
- liabilities arising from derivatives
- debt instruments with derivative-linked features, eg, structured notes
- liabilities arising other than through a contract (tax liabilities)
- liabilities which are preferred to senior unsecured creditors under the relevant insolvency law
- any liabilities legally excluded from bail-in or cannot be written down/ converted into equity without risk of NCWOL claims

TLAC: Subordination, redeeming, triggers

- Eligible TLAC generally must absorb losses
  - prior to liabilities excluded from TLAC in insolvency/ resolution
  - without giving rise to risk of successful NCWOL claims
- TLAC eligible instruments must be subordinated through either:
  a. "contractual subordination" or
  b. "statutory subordination" or
  c. "structural subordination"
- **Redeeming** TLAC prior to maturity without supervisory approval is **Prohibited**, *if redeeming results in breach of TLAC req.*
- Eligible external TLAC should contain a contractual **trigger**/ statutory mechanism to effectively:
  - write it down or
  - convert it to equity in resolution

Liability cascade in a bail-in event

CET 1 → Write-down or, if net value is positive, dilution through conversion of debt

If insufficient

Addl. T 1 → Write-down or conversion

If insufficient

Tier 2 → Write-down or conversion

If insufficient

Subordinated liabilities → Write-down or conversion

If insufficient

Other eligible liabilities[1] → Write-down or conversion

If insufficient

Deposits held by natural persons or SMEs not covered by Guarantee schemes → Write-down or conversion

If insufficient

Contribution from deposit guarantee scheme → Cash contribution from deposit guarantee scheme

[1] includes all categories of the class “non-subordinated liabilities,” eg, the German subordinated senior instruments

Bundesbank Monthly Report July 2016

TLAC: Subordination and Priority of claims

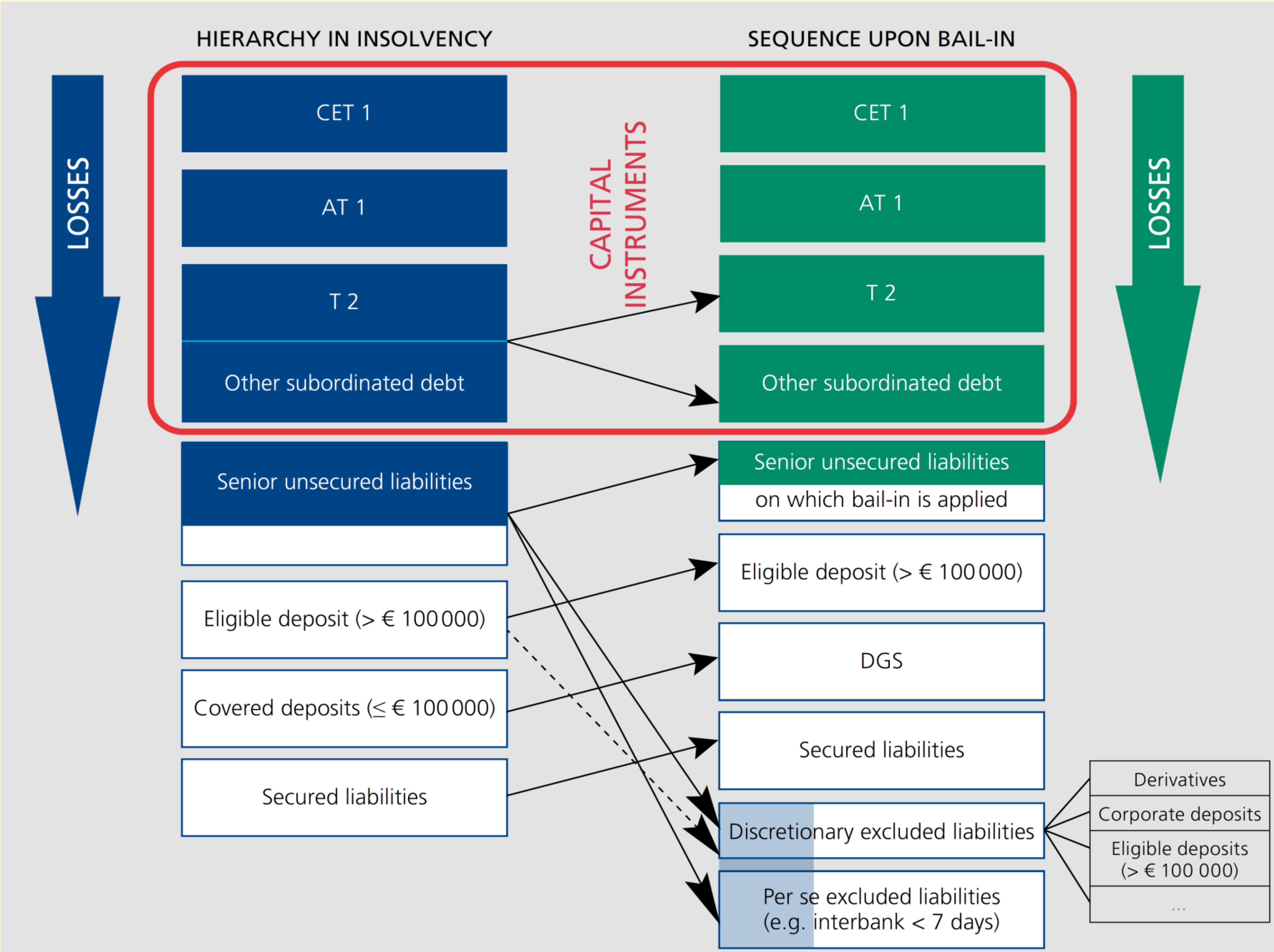
Subordination of eligible external TLAC to excluded liabilities is not required if:

- Resolution entity's Excluded Liabilities that rank pari passu/ junior to TLAC do not exceed 5% of its eligible external TLAC
- Resolution authority of the G-SIB has the authority to differentiate among pari passu creditors in resolution
- Differentiation in resolution in favour of such excluded liabilities would not give rise to material risk of NCWOL (successful legal challenge or valid compensation claims)
- No material adverse impact on resolvability

Types of subordination

Structural subordination	Contractual subordination	Statutory subordination
- based on role of issuer in the corporate structure - Issuer – Holding Co. transfers capital to operating subsidiaries - generates revenue by dividend from Subs. - Holding Co. Creditors subordinated in structural terms because all debt of Subs. must be serviced first - Costly and complex to establish a new/ clean Holding Co.	- Based on contract - Creditor & Issuer contractually agree that, in the case of insolvency, interest/ principal payments can only be made on these liabilities once other, more senior liabilities have been serviced in full	- Based on statute - statutory provision in national insolvency regimes. - By law- in case of insolvency, interest & principal payments may only be paid on certain liabilities once other, more senior liabilities have been serviced in full

EU: Bail-in & NCWO principle (Earlier)



Adjustments to national solvency regimes

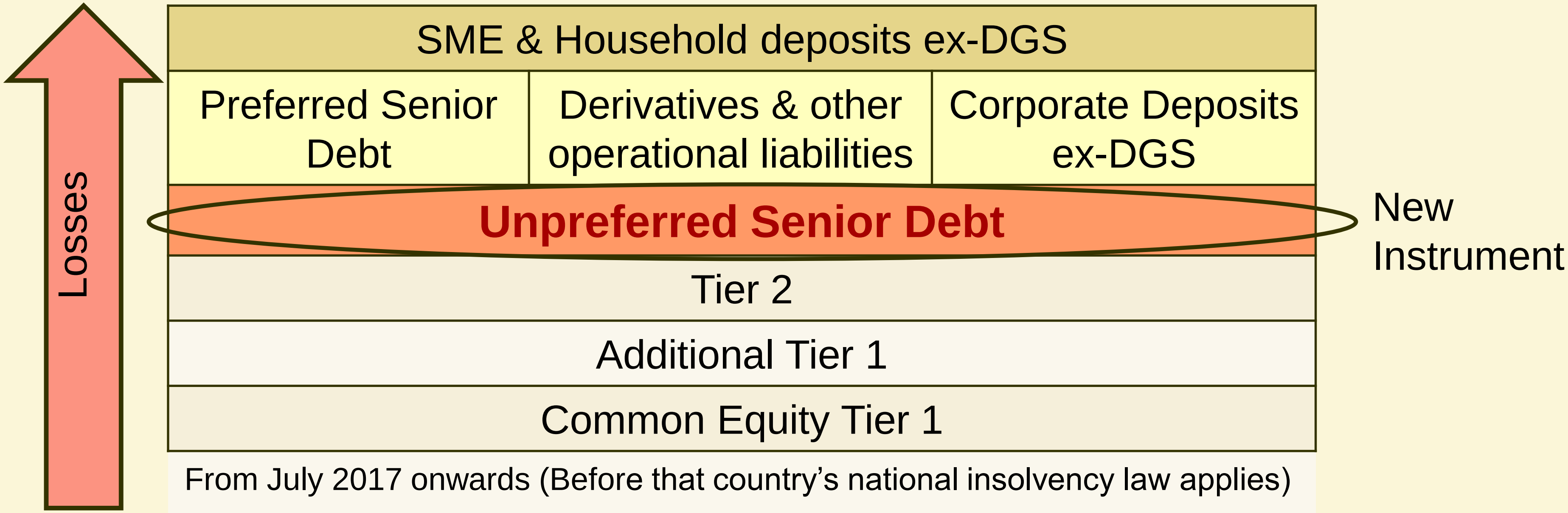
Germany		
CET1		
AT1		
Tier 2		
Subordinated debt		
“Subordinated” senior instruments **(statutory subordination)**		
Other senior debt	Deriv-atives	Corp. Dep.> 100000
Retail/SME Deposits >100,000 Euros		
Covered deposits <100,000 Euros		

France		
CET1		
AT1		
Tier 2		
Subordinated debt		
“Non-preferred” senior **(contractual subordination)**		
Preff-ered senior	Deriv-atives	Corp. Dep.> 100000
Retail/SME Deposits >100,000 Euros		
Covered deposits <100,000 Euros		

Italy	
CET1	
AT1	
Tier 2	
Subordinated debt	
Other senior debt	Deriv-atives
Corp. Dep.> 100000	
Retail/SME Deposits >100,000 Euros	
Covered deposits <100,000 Euros	

Spain		
CET1		
AT1		
Tier 2		
Subordinated debt		
“Subordinated” Tier 3 **(contractual subordination)**		
Other senior debt	Deriv-atives	Corp. Dep.> 100000
Retail/SME Deposits >100,000 Euros		
Covered deposits <100,000 Euros		

EU: Harmonised Creditor Hierarchy – Nov 2016



From July 2017 onwards (Before that country's national insolvency law applies)

Europe – to harmonize creditor hierarchies in senior debt, will amend insolvency laws to include a new "non-preferred senior debt" category by July 2017 (French approach). This will count towards MREL if

1. Remaining maturity > 1 year
2. No derivative components
3. Include contractual clause specifying ranking of instruments in creditor hierarchy.

Internal TLAC

- Internal TLAC ensures appropriate distribution of loss-absorbing/ recap. capacity within resolution groups
  - facilitates co-operation between home & host
  - Implement effective cross-border resolution strategies
- Internal TLAC is the Loss-absorbing capacity that resolution entities have committed to material sub-groups
- A material sub-group consists of direct/ indirect subsidiaries of a resolution entity that:
  - are not themselves resolution entities
  - do not form part of another material sub-group of the G-SIB
  - are generally incorporated in the same host country
  - either on a solo or a sub-consolidated basis meet the criteria for "material sub-group"
- G-SIB can have more than 1 material sub-group in a country

Internal TLAC

- Host to determine the composition of material sub-group and distribution of internal TLAC
  - support effective implementation of agreed resolution strategy
  - achieves objectives of internal TLAC
  - in consultation with Home authority of the resolution entity of the resolution group to which the material sub-group belongs and the CMG
- Material sub-groups to meet “Minimum Internal TLAC” req.
  - Host can specify additional firm-specific external or internal TLAC req. for a GSIB subsidiary
- Branches are not subject to any separate internal TLAC req.

Material Sub-Group

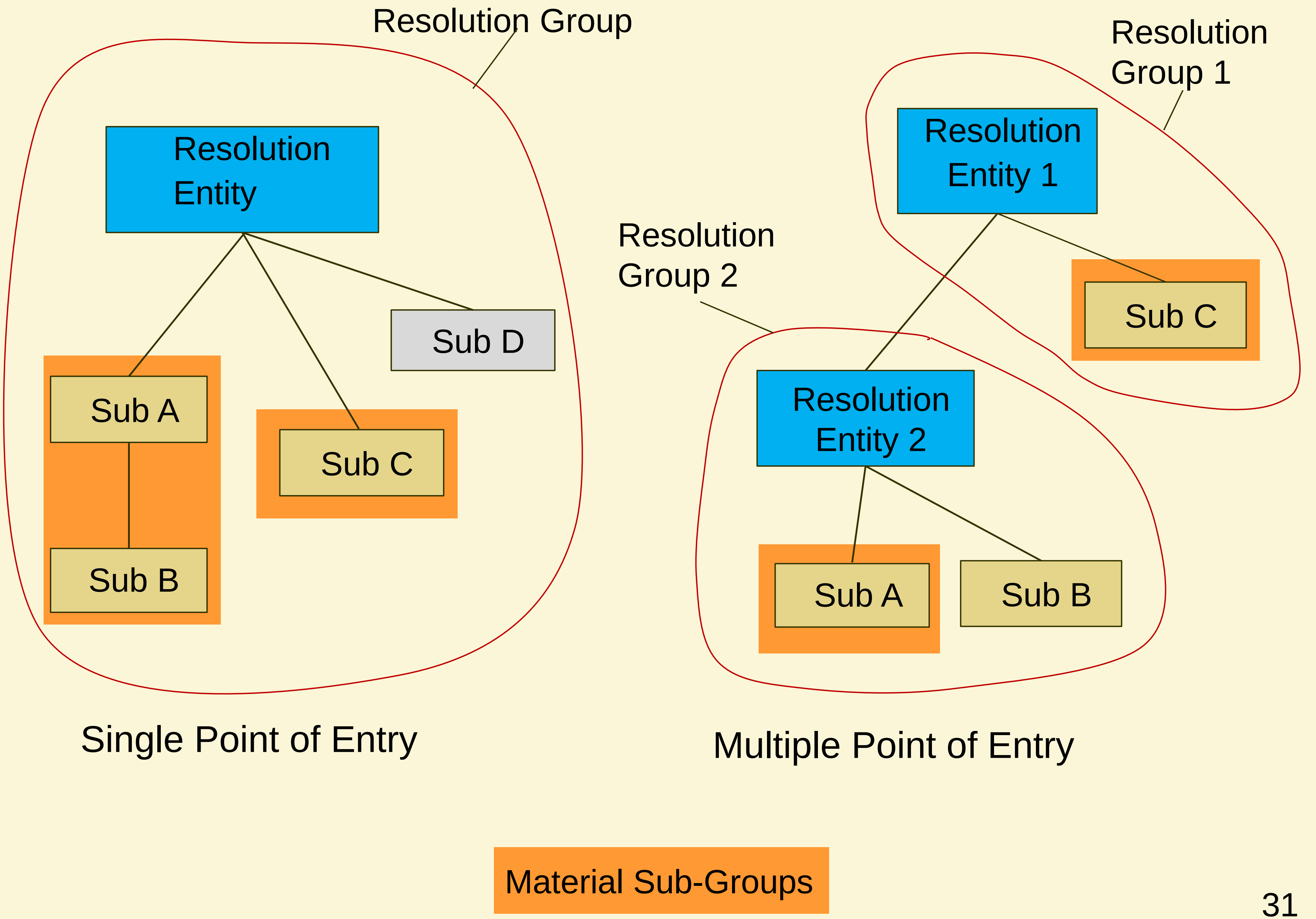
- "Material" sub-group for Internal TLAC purposes if ***at least one*** of the following criteria met:
  - RWA > 5% of consolidated RWA of the G-SIB group
  - Operating income > 5% of total operating income of G-SIB
  - Total leverage exposure measure > 5% of G-SIB's consolidated leverage exposure measure
  - Identified by firm's CMG as material to the exercise of the firm's critical functions (irrespective of any other criteria)

- Annual review of the list of material sub-groups and their composition by home & host authorities within the CMG

Internal TLAC – Size

- TLAC - distributed within resolution groups in proportion to size and risk of exposures of its material sub-groups
- Each *material sub-group* must maintain **75%-90% of the Min. External TLAC req. as Internal TLAC** (as if it were a *resolution group)*
  - Actual Internal TLAC req within 75%-90% range to be determined by host in consultation with home authority
- Internal TLAC must be pre-positioned on-b/s at the material sub-groups to facilitate effective cross-border resolution
  - TLAC not pre-positioned, should be readily available for recapitalisation without any legal or operational barriers
- *Resolution entity's external TLAC* = Internal TLAC+ TLAC for resolution entity's own material risks
- Why 75-90% Internal TLAC (why not 100%) req. for material sub-group?

Quiz: Which entities need External TLAC and Internal TLAC?



Eligible Internal TLAC – Core Features

- Eligible Internal TLAC core features are same as those for Eligible External TLAC (except for issuing entity & permitted holders)
  - Liabilities excluded are same
  - Statutory or contractual subordination for Internal TLAC instruments for excluded liabilities at subsidiary level
- Internal TLAC must be subject to write-down and/or conversion to equity by the relevant host authority at PONV without entry of the subsidiary into statutory resolution proceedings

Internal TLAC in the form of Collateralised Guarantees

- Home & host authorities in CMGs may jointly agree to substitute on-b/s Internal TLAC with collateralised guarantees (a form of internal TLAC), subject to conditions:
  - guarantee = equivalent amount of substituted internal TLAC
  - collateral (after haircuts)- sufficient to cover amount guaranteed
  - guarantee does not affect the subsidiaries' other capital instruments, eg, minority interests, from absorbing losses
  - collateral is unencumbered, not used as collateral to back any other guarantee
  - collateral's effective maturity same as that of external TLAC
  - no legal, regulatory or operational barriers to transfer of collateral from resolution entity to relevant material sub-group

Disclosure

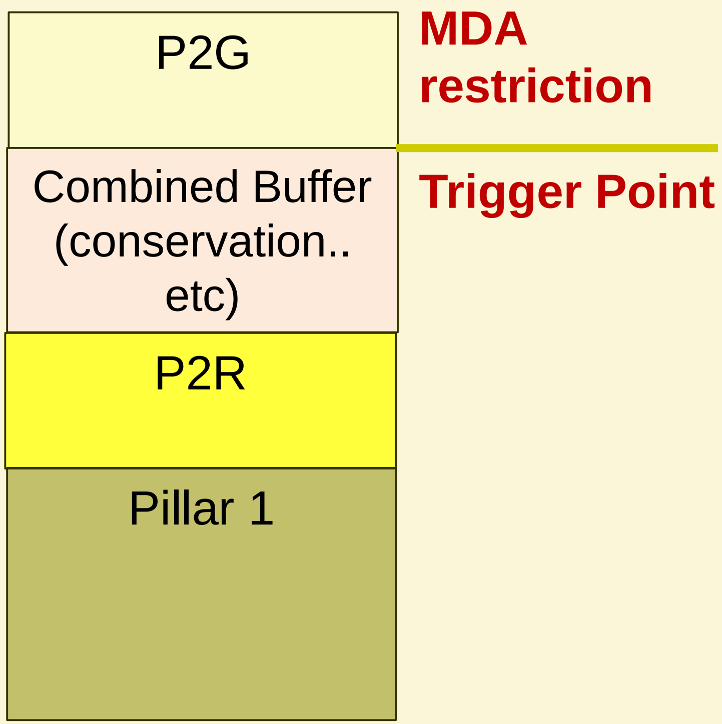
- G-SIBs to disclose amount, maturity, composition of external & internal TLAC that is maintained by each resolution entity

- Resolution entities - amount, nature, and maturity of any liabilities which rank pari passu or junior to liabilities which are eligible as TLAC

- Entities that are part of a material sub-group and issue internal TLAC to a resolution entity must disclose any liabilities which rank pari passu with or junior to internal TLAC issued to a resolution entity.

Pillar 2, Capital Buffers & MREL

Stacking order for Maximum Distributable Amount (MDA)



2015-Capital =P1+P2+combined buffers

2016- Capital=P1+P2 (**P2G+P2R**) + combined buffers

2016 EU Stress Tests – crucial input for SREP

SREP Two parts-

(i) P2G- Pillar 2 guidance – not directly binding, no automatic legal action, but ECB expects compliance

(ii) P2R -Pillar 2 Requirements are binding, breaches can have direct legal consequences

<u>Stacking order for capital components-</u>

- P2G breached- Analyze reasons, appropriate supervisory responses
- Combined Buffers breached- restrictions on distributions (dividends, bonuses, etc.)
- P2R breached– wide set of addl. Supervisory actions
- Pillar 1 breached – serious consequences

Source: ECB FAQs on 2016 EU-wide Stress Test

EU: Minimum Requirement for own funds and Eligible Liabilities (MREL)

- Nov 2016 – European Commission released legislative proposal to introduce TLAC in EU (through CRR)
- MREL denominator changed from total liabilities and own funds to either RWA or LRE, whichever is higher
- MREL to be calculated at resolution entity level which is consistent with both MPE and SPE resolution strategies
- MREL will be different for GSIBs & banks which are not GSIBs
- EU G-SIIs (or 13 EU GSIBs) need to comply with at least a minimum MREL which is the highest of (same as TLAC):
  - 1. 16% RWA or 6% of LRE as of 1 Jan 2019
  - 2. 18% RWA or 6.75% of LRE as of 1 Jan 2022
  - In addition, firm-specific MREL
  - Buffers excluded from MREL, only P2R will count in calculation
- For banks other than GSIBs, MREL will continue to be on a case by case basis (twice the sum of Pillar 1 & Pillar 2R or twice the leverage ratio, whichever is higher)

EU: MREL Calibration

Loss absorption Amount | Recapitalisation Amount | Adjustments

MREL (min req) = P1+ P2R or leverage ratio + P1+ P2R or leverage ratio +/- To reflect risks that affect resolvability (business model, funding model, risk profile) - DGS adjustments (only for small banks)

Max {2*(Pillar 1 + Pillar 2 required);
2*Leverage ratio}
Buffers excluded from the calculation

MREL Guidance = <= Pillar 2 Guidance + Combined buffer

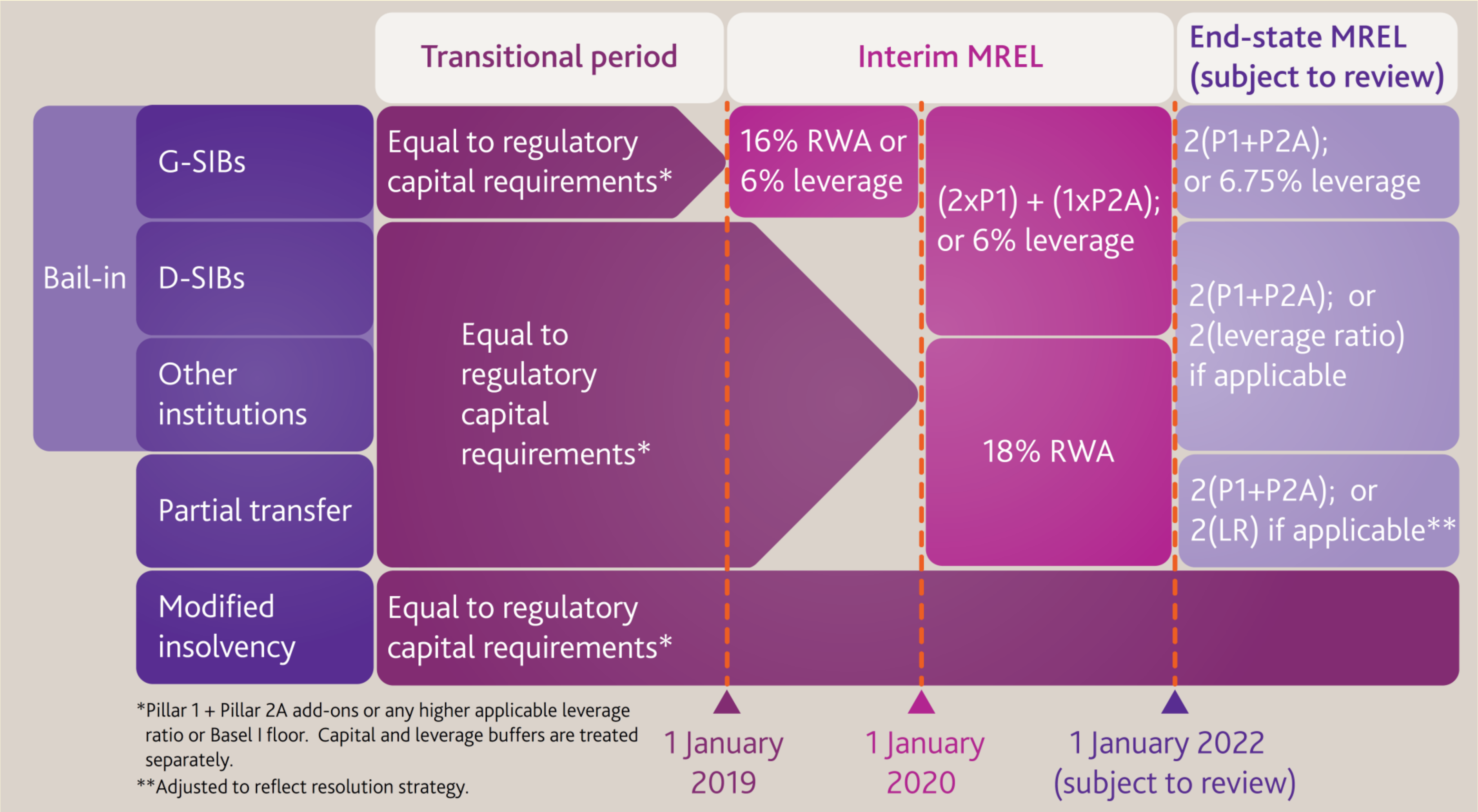
Not mandatory unless consistently non-compliance

Source: BBVA Research, Regulation Economic Watch, 24 Nov 2016

Bank of England's Approach to Resolution and MREL

Modified Insolvency Process	Partial Transfer	Bail-in
Small institutions, no critical services < 40,000 - 80,000 transactional Accounts (usage)	Too large for modified insolvency process < £15bn – £25bn B/S	largest and most complex institutions GSIBs/DISBs/Other Institutions > £15bn – £25bn B/S
Payout of covered deposits by FSCS (Dep Ins) meets resolution objectives	-Simple A/L structure -potential buyers -Critical parts of business– transfer to a purchaser	- Critical eco. functions - Resolution: Stabilise the institution, restructure - Operate without public support
MREL = Regulatory Capital Req.	MREL = Level which permits such transfer to take place **Reg. Capital req. +** additional requirements in proportion to transferred B/S	MREL = 2 (P1+P2A) or 2 (Leverage ratio)

Bank of England's Approach to MREL



Source: The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL), Nov 2016

Final Remarks

- TLAC contributes to building up of sufficient *loss-absorbing and recapitalisation capacity*
  - a minimum requirement on the liabilities side of B/S
  - not a legally binding requirement
  - follows the Resolution Strategy and not the other way round
  - should contribute to a more stable financial system

ANNEX

TLAC & MREL

	TLAC	MREL
Scope	G-SIBs and their material subsidiaries. External TLAC for each resolution entity; internal TLAC for each material subgroup.	Banks (Credit institutions) and investment firms on a consolidated and solo basis
Minimum Req.	18% of RWAs (plus buffers) and > 6.75% of leverage exposure - 2022	- No harmonised minimum requirement; six firm-specific criteria set out in the BRRD relating to resolution strategy (loss absorption; recapitalisation; impact of exclusion of certain liabilities from bail-in; funds available under DGS; size, business model, funding model, risk profile; potential adverse effect on financial stability). - RTS on MREL - resolution authorities to determine an appropriate transitional period which is "as short as possible". - SRB: Generally expect most institutions under SRB remit to have MREL of at least 8% of own funds + total liabilities

Source: EBA, Final report on MREL, Dec 2016

TLAC & MREL

	TLAC	MREL
Firm-specific req.	Additional firm-specific requirements if necessary and appropriate to implement resolution, minimise impact on financial stability, ensure continuity of critical functions, or avoid exposing public funds to loss	MREL - firm-specific requirement, sufficient loss-absorbing capacity- - to implement the preferred resolution strategy, - size and - risks, - DGS contribution, and - impact on financial stability RTS on MREL - Must assess: a) loss absorption amount (starting from own funds requirements) b) recapitalisation amount (starting from own funds requirements) c) adjustments for DGS contributions and excluded liabilities Denominator of MREL is total own funds and liabilities, but MREL requirement set as an **amount**. SRM Regulation: At least=own funds (buffers included) SRB currently expect most SRB institutions to have MREL of at least 8% of own funds + total liabilities (still under discussion)

Source: EBA, Final report on MREL, Dec 2016

TLAC & MREL

	TLAC	MREL
Denominator	RWA/leverage ratio denominator of the resolution group	Total liabilities and own funds at individual and consolidated level
Group requirements Including internal	- External TLAC for the resolution entity set in relation to the consolidated B/S of each resolution group - Internal TLAC set for each material subgroup at 75-90% of the external TLAC requirement that would apply if that material subsidiary were the resolution entity.	- MREL for the group on a consolidated basis. - MREL set for all credit institutions and investment firms within groups on an individual entity basis, set having regard to consolidated MREL and the group resolution strategy. Limited possibility of waivers when institution and parent are in the same Member State. - No req. to issue at least as much external MREL as the sum of internal MREL.

Source: EBA, Final report on MREL, Dec 2016

TLAC & MREL

	TLAC	MREL
Relationship with capital buffer requirements	CET1 capital cannot count simultaneously towards both TLAC RWA minimum and regulatory capital buffers	- Capital instruments count towards MREL - Relationship between MREL and buffers not specified in BRRD. - MREL is a minimum requirement that "must be met at all time".
Penalties for breach	Breach should be treated as seriously as a breach of minimum regulatory capital requirements	Not specified in BRRD. Options available include: - triggering powers to remove impediments to resolvability - triggering early intervention powers - administrative penalties under Article 110 BRRD - general supervisory powers and penalties for any associated breach of capital requirements
Composition	Expectation that one third of TLAC is non-equity	None

Source: EBA, Final report on MREL, Dec 2016

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