

# TLAC Implementation in the U.S. and the EU

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# Global Financial Crisis

- During Financial Crisis many failing banks bailed out by public sector funds – considered “too big to fail” e.g. Citigroup, RBS, Lloyds
- Some failing banks allowed to fail e.g. Lehmans, Icelandic banks
- Became apparent that existing insolvency regimes not suited to bank/financial institution failures
- Some jurisdictions, including UK, drew up legislation to implement “resolution” regimes for banks and certain financial institutions

# International Response

- G-20 summit in Seoul, November 2010 agreed that no firm should be too big/complicated to fail and tax payers should not bear costs of bank resolution
- Summit endorsed Financial Stability Board's policy framework designed to reduce moral hazard risks posed by systemically important financial institutions (SIFIs)
- Reaffirmed its commitment to national implementation of Basel Committee's cross-border resolution recommendations and asked FSB to develop key attributes of effective resolution regimes
- November 2011, FSB published its Key Attributes for Effective Resolution Regimes for Financial Institutions (updated in October 2014)

# Putting Banking Regulation into Context...

## Doom-loop between sovereigns and banks



The regulators identified three areas to address in the context of the crisis aftermath

Capital

Strengthen capitalisation, both on risk-sensitive and absolute measures

Liquidity

Regulate Liquidity

Regulatory

Break the Doom-Loop and end Too-Big-to-Fail

# Bank Resolution

- Restructuring of a failing institution by a regulator through use of resolution “tools” and ancillary powers, to:
  - ensure continuity of critical functions
  - preserve financial stability
  - restore viability of all or part of the institution
  - any remaining non-viable parts to be placed into normal insolvency proceedings
- Aim is to be able to effect all resolution actions over a “resolution weekend” to minimise uncertainty and loss of market confidence/financial contagion

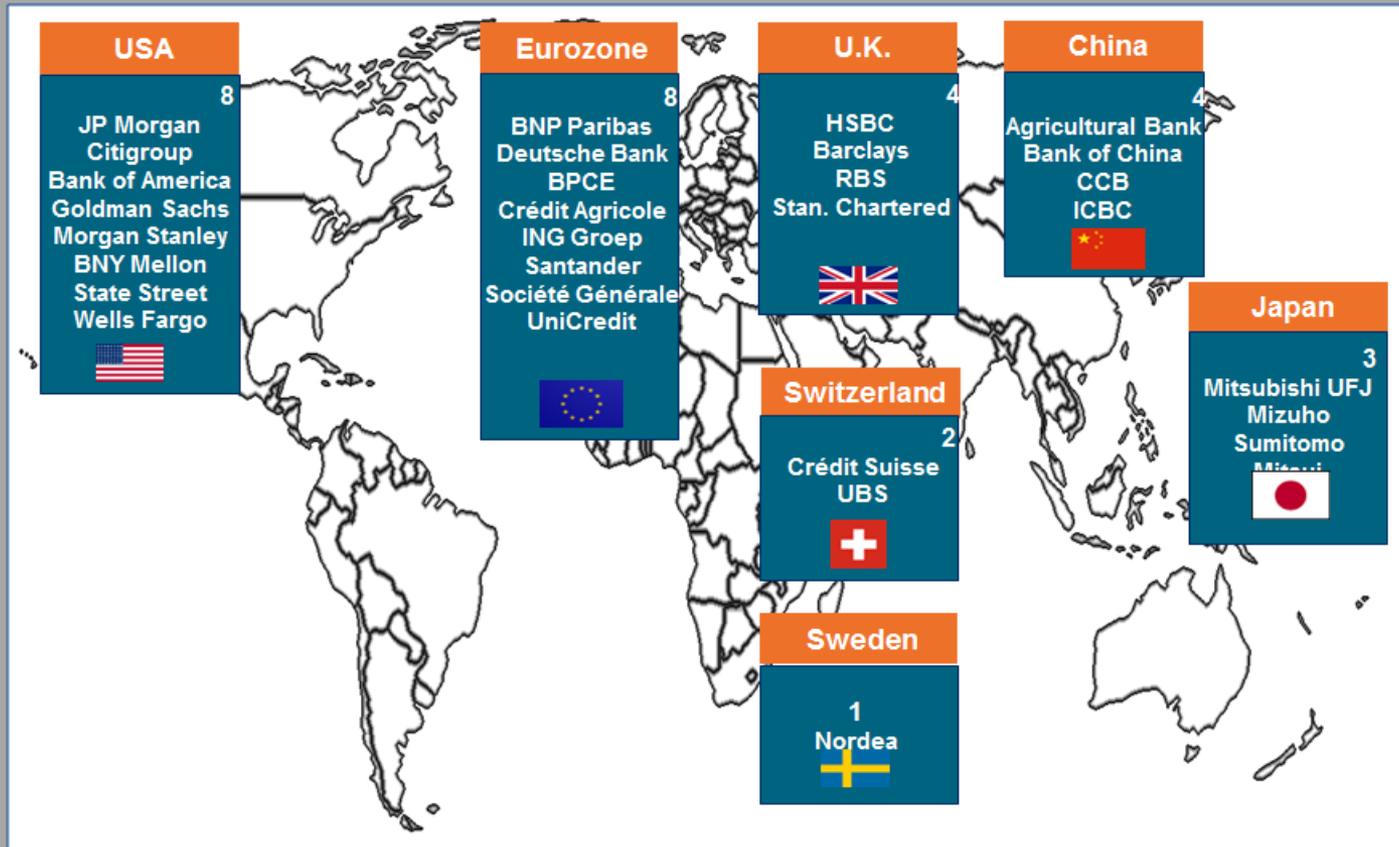
# Resolution Strategies for Cross Border G-SIBs

- Two different approaches identified by Financial Stability Board that could be adopted by a G-SIB's Crisis Management Group (CMG)
- CMG to consist of relevant authorities from G-SIB's home jurisdiction, as well as key host jurisdictions
- SPOE involves application of resolution powers at level of top holding company, by a single resolution authority, for the entire resolution group
- Benefit is that continuity of operation of subsidiaries is ensured and there would be no distinct resolution proceedings at the level of operating subsidiaries
- MPOE involves simultaneous application of resolution powers by two or more resolution authorities in different jurisdictions. Each resolution authority would have control over the resolution of different parts of the G-SIB group, with the "home" resolution authority coordinating

- FDIC and Bank of England in 2012 released a joint paper focused on the application of an SPOE strategy for the resolution of U.S. or UK G-SIB groups
- They acknowledge that whether a SPOE or MPOE strategy is more appropriate depends on a range of factors, including whether liabilities at the top of the G-SIB group are sufficient to absorb the group's losses

- Resolution authorities have many tools and powers to assist them in resolving a failing bank
- However for global systemically important banks (“GSIBs”) and other banks that are large or systemically important on a national basis (O-SII’s), the bail-in tool is likely to be essential in order to ensure a successful resolution
- In turn, a bail-in strategy can only be successful if there are sufficient funds/liabilities available to absorb losses by being written down or converted into equity instruments
- This is due to the principle that the use of public funds to rescue a failing bank should be prohibited or restricted, and where some resolution funds exist, they will still take several years to be funded to the ultimate planned levels
- Therefore the FSB finalised principles as to the building up of Total Loss Absorbing Capacity by GSIBs and these are being closely implemented by jurisdictions such as the U.S. and the EU (among others) into their national laws

# Global Systemically Important Banks



Source: FSB

EME temporary stay of TLAC-application assumed to apply to Chinese banks.

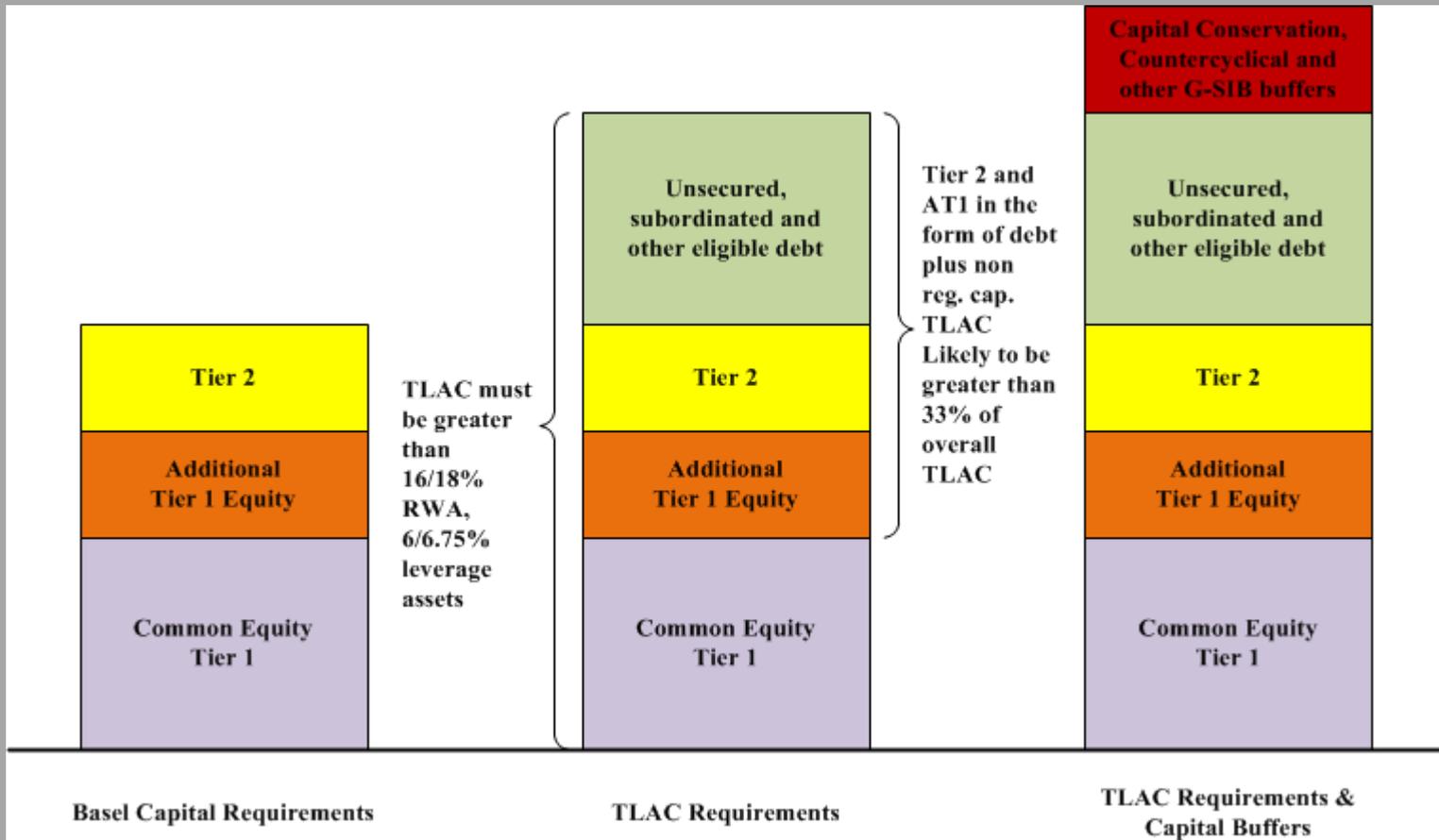
# Total Loss Absorbing Capital (“TLAC”)

- Financial Stability Board Proposal for Comment issued in November 2014; comment period closed in February 2015; final TLAC principles released in November 2015
- Intended to be effective by January 2019
- Designed to facilitate orderly resolution of G-SIBs
- 30 banks globally
- includes 8 US banks, 13 EU G-SIB’s (incl. 4 in the UK)

# Objective of TLAC

- Where does TLAC fit in?
  - for Basel purposes, a bank must satisfy the minimum regulatory capital requirements
  - in addition to the minimum regulatory capital requirements, banks are subject to the capital conservation buffer and any applicable counter-cyclical capital buffer
  - in addition to that, G-SIBs must have “buffer” capital or a G-SIB “surcharge”
  - finally, G-SIBs must meet TLAC requirements
    - TLAC would be relied upon to provide additional loss absorbency and facilitate resolution

# Where does TLAC fit in?



# TLAC Principles - overview

- Calibration of minimum TLAC from January 1, 2019 of 16% of risk weighted assets (RWAs) rising to 18% from January 1, 2022 and from January 1, 2019, 6% of the Basel III leverage ratio denominator and from January 1, 2022, rising to 6.75% of the Basel III leverage ratio denominator
  - phased in requirements for GSIBs headquartered in emerging markets
  - Tier 1 and Tier 2 Capital is “eligible”
  - other eligible TLAC that is not regulatory capital
- Additional TLAC may be required for individual G-SIBs based on risk factors
- Two elements: Risk-weighted TLAC ratio and a TLAC leverage ratio

# Regulatory capital instruments

- TLAC and regulatory capital instruments
  - The sum of a G-SIB's resolution entity's (1) Tier 1 and Tier 2 regulatory capital instruments that are in the form of debt, plus (2) other eligible TLAC that is not regulatory capital, is equal to or greater than 33% of the G-SIB's minimum TLAC requirement
  - Regulatory capital instruments may count toward minimum TLAC requirement, subject to certain conditions:
    - CET1 regulatory capital instruments used to satisfy minimum TLAC requirement cannot also be used to satisfy capital buffers
    - non-CET1 regulatory capital instruments must be issued under the laws of a jurisdiction in which resolution tools, statutory write-down or conversion powers are effective
    - non-CET1 regulatory capital instruments issued by subsidiaries of the resolution entity, that are located in a different jurisdiction from the resolution entity, must be capable of being written down or converted to equity at the point of non-viability of the subsidiary without the subsidiary having to enter into a resolution proceeding

- Regulatory capital instruments issued from entities forming part of a material subgroup may count toward minimum TLAC only to the extent that home and host country authorities agree conversion to equity would not result in a change-of-control

# TLAC Term Sheet

- TLAC Eligible Securities:
  - issued and maintained by resolution entities (except in limited circumstances regulatory capital issued by wholly and directly-owned funding entity will be eligible)
  - paid-in, unsecured
  - perpetual or remaining maturity of at least one year
- Excludes
  - insured deposits
  - any liability callable on demand without supervisory approval
  - liabilities funded by the issuer or a related party
  - liabilities arising from derivatives or debt instruments with derivative-linked features—e.g., structured notes
  - non-contractual liabilities, such as tax liabilities
  - preferred liabilities
  - other liabilities that cannot be written down or converted to equity by resolution authorities

- Junior to excluded liabilities on the balance sheet of the resolution entity (whether by way of contractual subordination, statutory subordination or structural subordination)
- No set-off
- No redemption without supervisory approval
- Resolution entity must maintain “External TLAC”
- Material subsidiaries in jurisdictions outside of bank’s home country must have “Internal TLAC”
  - each material sub-group must have 75-90% of the external requirement that would apply to it if it were a resolution group

- For this purpose, a “material sub-group” is a group consisting of one or more direct or 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 incorporated in the same jurisdiction (outside of the resolution entity’s home jurisdiction) and:
  - generates more than 5% of total operating income of the G-SIB group;
  - has more than 5% of consolidated RWAs of the G-SIB group;
  - has total leverage exposures that are more than 5% of the G-SIB group’s total leverage exposure; or
  - has otherwise been identified as material to the firm’s functions

# Non-regulatory Eligible Debt Instruments – Subordination Requirements

- Must be subordinated to Excluded Liabilities
- Subordination can be achieved by one of three alternatives:
  - structural subordination
  - statutory subordination
  - contractual subordination

# US DFA Title II Resolution Tools

- When appointed as OLA, FDIC inherits all rights and powers of the financial company and its shareholders, directors and officers and has the right to take all actions necessary to liquidate the financial company, including:
  - organising a bridge financial company to which assets of financial company can be transferred
  - merging the financial company or transferring its assets and/or liabilities to another company
- Financial company subject to OLA must be liquidated – compare with BRRD in Europe

# US DFA Title II – Resolution Principles

- Shareholders should not receive payment until all other claims and resolution fund are fully paid
- Unsecured creditors bear losses in accordance with liquidation priority of claims
- Management responsible for failure of the financial company to be removed
- FDIC must not take an equity interest in the financial company or its subsidiaries

# U.S. Single Point of Entry

- The ability to apply a SPOE strategy successfully is what has driven the FRB's Proposed TLAC rules
- Under these rules, only the BHC or IHC of the G-SIB would be placed into resolution
- Assets of the failed holding company (including equity in subsidiaries and loans to subsidiaries) would be transferred to a bridge financial company established by FDIC and officers and directors of holding company would be replaced
- Bridge company to prepare business plan designed to maximise recoveries and minimise fire sales. FDIC retains control of important decisions of bridge company, such as securities issuances, asset sales/transfers, mergers, distributions. Bridge company exempt from regulatory capital requirements and tax

- Bridge company intended to have lifespan of no more than two years, but this can be extended to a maximum of five years by FDIC. Might be sold in its entirety, or divided into separate entities, or parts of business sold to different third parties
- Bridge company to be capitalised firstly by bail-in of outstanding long-term debt of failed holding company
- This requires sufficient long-term debt to be outstanding at the holding company level, hence the FRB's TLAC requirements for holding companies
- Capital could also be raised (in theory) from the capital markets, and funding could also be available from the Orderly Liquidation Fund established by DFA Title II – such funding to be secured on assets of bridge company and its subsidiaries
- Creditors of failed holding company generally treated similarly with other creditors of same class and priority of claim, though FDIC has power to prefer creditors, such as providers of critical services

# U.S. FRB TLAC Final Rule

- The FRB released its proposal on October 30, 2015 which would establish for covered BHCs and covered intermediate holding companies (IHCs) an external TLAC requirement in the case of covered BHCs (and an internal TLAC requirement in the case of covered IHCs), a related TLAC buffer, a minimum long-term debt requirement for covered BHCs (and a minimum internal long-term debt requirement for covered IHCs), and a “clean holding company” requirement
- Premised on the view that TLAC alone is not sufficient to facilitate single point of entry (SPOE) resolution
- As a result, the FRB approach differs from the FSB approach
- In addition, to avoid contagion risk, the FRB proposal also would penalise banks generally for holding unsecured debt of a covered BHC

- It proposed that U.S. covered BHCs must maintain:
  - outstanding eligible external long-term debt equal to the greater of: (i) 6% of RWAs, plus the applicable G-SIB buffer, and (ii) 4.5% of total leverage exposure, plus
  - outstanding eligible external TLAC equal to the greater of: (i) 18% of RWAs (when fully phased-in), and (ii) 9.5% of total leverage exposure
  - an external TLAC buffer

# Comments on the FRB proposal

- The proposed rules were the subject of significant comment
- Commenters raised concerns regarding, among other matters, the following:
  - calibration of the requirements and the phase-in period
  - potential competitive disadvantages for U.S. BHCs compared to their European counterparts as a result of more onerous requirements proposed by the FRB (compared to those contained in the FSB Final Principles)
  - Various aspects of “eligibility,” such as:
    - whether covenants contained in existing senior note indentures for most BHC debt would cause such debt not to qualify as eligible long term debt
    - the treatment of structured notes
    - the treatment of long-term debt that is governed by the laws of a foreign (non-U.S.) jurisdiction

- Investor disclosures relating to these instruments
- The “mechanics” for bailing in these instruments
- The possibility of adopting a multiple point of entry resolution (MPOE) approach
- The 5% capped liabilities

**Comments on the FRB  
proposal (cont'd)**

# Final FRB Rules

- On December 15, 2016, the FRB voted unanimously to adopt final rules that impose an external TLAC requirement in the case of covered BHCs (and a TLAC requirement in the case of covered IHCs, which has been modified from the proposal), related TLAC buffers, a minimum LTD requirement for covered BHCs (and a minimum LTD requirement for covered IHCs, which has been modified from the proposal), and a “clean holding company” requirement
- The final rules differ from the proposed rules only in certain modest respects

# Principal Differences

- Effective date of January 1, 2019 (in other words, no “phase in” period from 2019 to 2022)
- Grandfathering of outstanding LTD of covered BHCs issued prior to December 31, 2016 (including otherwise eligible LTD governed by non-U.S. laws and otherwise eligible LTD subject to acceleration clauses)
- FRB is allowed to order a G-SIB to exclude from its outstanding eligible LTD any debt securities with features that would significantly impair such debt securities to take losses (subject to notice and opportunity to respond)
- The final rule permits a MPOE approach for a resolution-covered IHC
- A resolution-covered IHC has the option to issue LTD externally to third parties (like a covered BHC) subject to certain conditions

- The final rule contains some modifications to the clean holding company requirement
  - Under the final rule, covered BHCs and covered IHCs are permitted to guarantee certain QFCs of their subsidiaries to the extent guarantees are permitted by regulations governing stays
  - The final rule imposes a 5% cap on external liabilities (other than those related to TLAC) unless the covered BHCs and covered IHCs issue eligible LTD as contractually subordinated debt
- The capital deduction for investments in the unsecured debt of covered BHCs and covered IHCs that was in the proposed rule is not included in the final rule; however, this issue is expected to be addressed jointly with the OCC and the FDIC

Principal differences (cont'd)

# External long-term debt

- The final rule includes both a minimum LTD requirement and a minimum TLAC requirement
- **Why a long-term debt requirement?**
  - In principle, the objective of the external LTD requirement is to ensure that each covered BHC has a minimum amount of eligible external LTD such that, if the covered BHC's going-concern capital is depleted and the covered BHC fails and enters resolution, the eligible external LTD will be sufficient to absorb losses and recapitalize the covered BHC by replenishing its going-concern capital (referred to in the preamble as a “capital refill” approach)
- **What is eligible external long-term debt?**
- Debt securities issued directly by the covered BHC that:
  - are unsecured
  - are “plain vanilla”

- are governed by U.S. law (*commenters had requested that the FRB consider debt securities governed by the laws of at least certain foreign jurisdictions*)
- only 50% of the amount of eligible external LTD that is due to be paid between one and two years can be used for purposes of the eligible external LTD requirement (although all of it would count in full for purposes of the external TLAC requirement)
- *The amount of eligible external LTD due to be paid in less than one year will not count toward the external TLAC or the external LTD requirement*
- **What is “plain vanilla” debt?**
  - The debt cannot contain an embedded derivative, have a credit sensitive feature (such as an interest rate that resets periodically based in whole or in part on the G-SIB’s credit quality), contain any contractual conversion or exchange features, or include acceleration rights, other than a right that is exercisable in the event of the covered BHC’s insolvency or a payment failure that continues for 30 days or more; no structured notes

External long-term debt  
(cont’d)

- **What is the external LTD requirement under the final rule?**
  - A covered BHC must maintain outstanding eligible external LTD in amount not less than the greater of: 6% of total RWA plus the G-SIB surcharge, and 4.5% of total leverage exposure
- **Can a covered BHC redeem or repurchase outstanding external LTD?**
  - A covered BHC must seek FRB approval to repurchase or redeem where the repurchase or redemption would result in noncompliance with the requirement
- **Other relevant provisions**
  - The final rule includes a new provision that the FRB may, after notice and an opportunity to respond, order a G-SIB to exclude from its outstanding eligible LTD amount any debt securities with features that would hinder a resolution
  - No grace period during which a covered BHC that breaches the external LTD requirement can take voluntary actions to come into compliance without being subject to other regulatory consequences

**External long-term debt  
(cont'd)**

- **Grandfather provision**
  - Certain outstanding LTD of covered BHCs issued prior to December 31, 2016 counts toward the external LTD and external TLAC requirements
- **Acceleration provisions and incentives to redeem**
  - Eligible external LTD cannot have a contractual right to acceleration of payment of principal or interest, other than on the occurrence of either an insolvency event or a payment default event that continues for 30 days or more, except that eligible external LTD instruments are permitted to give a holder a put right as of a future date certain, subject to certain conditions

# External TLAC

- **What is eligible external TLAC?**
  - The sum of (1) common equity Tier 1 capital and AT1 capital issued directly by the covered BHC (excluding minority interests), plus (2) the covered BHC's eligible external LTD that is due to be paid after one year or more
    - **The proposal had been based on the “remaining maturity” of the debt, rather than the unpaid principal amount “due to be paid”**
- **What is the required amount of eligible external TLAC?**
  - An amount not less than the greater of 18% of the covered BHC's total RWAs and 7.5% of the covered BHC's total leverage exposure
  - In addition, there are two separate external TLAC buffers
    - **Same as the proposal, except the leverage component of the external TLAC requirement is reduced from 9.5% to 7.5%, and the FRB has adopted a 2% buffer on top of the leverage component**

- **TLAC Buffers for covered BHCs**

- ***TLAC Leverage Buffer***: the final rule reduced the minimum amount of the leverage component of the external TLAC requirement (from 9.5% to 7.5%) and a 2% buffer has been added over the leverage component of the external TLAC requirement. This buffer must be filled solely with T1 capital and breach of this buffer subjects the BHC to limits on capital distributions and discretionary bonus payments
- ***TLAC RWA Buffer***: the TLAC buffer for the RWA component of the external TLAC requirement is equal to 2.5% plus the GSIB surcharge applicable to the covered BHC under method 1 of the GSIB surcharge rule plus any applicable countercyclical capital buffer. This buffer must be filled solely with CET1. Breach of this buffer subjects the BHC to limits on capital distributions and discretionary bonus payments
- Limitations on distribution and discretionary bonus payments will be based on the more restrictive of these two buffers

External TLAC (cont'd)

# Eligibility of Specific Securities

- Eligible LTD cannot include contractual provisions for conversion into or exchange for equity
  - A convertible debt instrument is viewed as a debt instrument with an embedded stock call option
- Debt with a “survivor put”: the date on which debt is due to be paid is the date that the holder first has a contractual right to request or require payment of principal—as a result, debt with a survivor put would be treated as having matured on the first day it became subject to a put right, or the date of issuance, and it would not qualify as eligible LTD

# IHCs of Non-U.S. G-SIBs

- A covered IHC is any US IHC (FBOs with consolidated global assets of \$50 billion or more and consolidated U.S. assets of \$10 billion or more must establish an IHC) that is controlled by a FBO that is a G-SIB
- A covered IHC's eligible TLAC equals the sum of the Tier 1 regulatory capital issued from the covered IHC to the foreign parent that controls the covered IHC, and the covered IHC's eligible LTD
- Significant changes were made from the NPR to the final rules in relation to covered IHCs—for example, the final rules include a number of provisions that facilitate the resolution of a FBO under a MPOE approach

# SPOE or MPOE

- **Is the covered IHC expected to enter resolution?**
  - If so, it is referred to as a resolution covered IHC in a MPOE resolution strategy, or operate outside of resolution proceedings (a non-resolution covered IHC) while its non-U.S. parent entity is resolved under a SPOE approach
  - A resolution covered IHC (adopting a MPOE approach) has the option either to: issue capital and LTD to third parties, as will covered BHCs, or to issue LTD internally
  - A non-resolution covered IHC will be required to issue LTD either to a non-U.S. parent or to a directly or indirectly wholly owned non-U.S. subsidiary of the top-tier non-U.S. parent (internal TLAC and LTD)
  - The IHC must certify to the FRB on the later of June 30, 2017, or one year prior to the date on which the covered IHC is required to comply with the covered IHC TLAC and LTD requirements as to its planned approach

# Calibration of IHC Requirements

- **What is the TLAC requirement?**
  - For SPOE, a non-resolution covered IHC would be required to keep outstanding eligible internal TLAC at least equal to the greater of: (i) 16% of the IHC's total RWAs, (ii) 6% of total leverage exposure (for those IHCs subject to the supplementary leverage ratio (SLR)), and (iii) 8% of average total consolidated assets as computed for purposes of the US Tier 1 leverage ratio
  - For MPOE, resolution covered IHC would be required to keep outstanding eligible TLAC at least equal to the greater of: (i) 18% of the covered IHC's total RWAs, (ii) for covered IHCs subject to the SLR, 6.75% of total leverage exposure, and (iii) 9% of average total consolidated assets as computed for purposes of the US Tier 1 leverage ratio
    - a buffer applies only in respect of the RWA component of the TLAC requirement

- **What is the minimum eligible LTD requirement?**
  - Eligible LTD will at least equal the greater of (i) 6% of total RWAs, (ii) for covered IHCs subject to the SLR, 2.5% of total leverage exposure, and (iii) 3.5% of average total consolidated assets
    - **The RWA component has been reduced from the proposal (7%) to 6%; the SLR component has been reduced from 3% to 2.5%, and the TCAs component from 4% to 3.5%**

Calibration (cont'd)

# Eligible LTD for IHCs

- **What are the requirements for eligible LTD for IHCs?**
  - Same general requirements as those applicable to eligible external LTD for covered BHCs
  - Same grandfather provision as available to covered BHCs
  - Covered IHCs may adopt either contractual subordination or structural subordination for their eligible LTD
  - Eligible internal LTD must include a contractual trigger pursuant to which the FRB could require the covered IHC to convert or exchange the LTD into CET1 without the covered IHC's entry into a resolution proceeding if:
    - FRB determines that the covered IHC is in default or in danger of default, and
    - any of the following apply: the top tier FBO or any subsidiary outside the United States is put into resolution, the home country supervisory authority consents to the conversion or does not object following 24 hours' notice, or the FRB provides a written recommendation to the UST that the FDIC should be appointed as receiver

- There are a number of differences from the proposal:
  - the final rule removes FRB's ability to require cancellation of debt and requires only ability of the FRB to require conversion or exchange;
  - the final rule permits eligible internal debt securities to have the same acceleration clauses as eligible external LTD;
  - eligible external debt securities are not required to be contractually subordinated; and
  - final rule allows for possibility of partial conversion or exchange of less than all of the eligible internal debt securities of the IHC.

# Clean Holding Company

- What is the clean holding company requirement?
  - the proposal sets out a “clean holding company” requirement, which has two parts:
    - first, a covered BHC would be prohibited from
      - engaging in short-term borrowings (less than one year)
      - entering into qualifying financial contracts (securities and commodities contracts, swaps, forwards, repos etc)
      - having liabilities that are subject to a subsidiary upstream guarantee or that could create cross-default, set-off or netting rights for creditors of the subsidiary
    - issuing guarantees of subsidiary liabilities that would result in its insolvency or resolution being an event of default on the part of the subsidiary
    - second, a covered BHC’s third-party non-contingent liabilities (other than those related to eligible external TLAC) that are pari passu with or junior to its eligible external LTD are subject to a cap of 5% of the value of its eligible external TLAC

# Clean Holding Company

- The final rule modifies the treatment of the 5% cap
  - Covered BHCs and covered IHCs have the option to contractually subordinate their eligible LTD to other third party liabilities without the need for the 5% cap
  - A BHC can satisfy the external LTD requirement with either senior or subordinated debt instruments
  - A covered BHC that chooses to issue all of its external LTD with a contractual subordination provision would not be subject to the 5% cap
- The preamble also makes it clear that the cap does not limit a covered BHC's ability to issue structured notes out of subsidiaries

# Regulatory capital deduction

- Banks, savings and loans, and similar entities with total assets of more than \$1 billion would suffer from a regulatory capital deduction for any investments in unsecured debt issued by covered BHCs (including eligible external LTD) in excess of certain thresholds

# Timing

- Covered BHCs required to comply with the external LTD and TLAC requirements, the clean holding company requirement and the regulatory capital deduction requirement, by January 1, 2019
- Grandfathering of outstanding LTD of covered BHCs issued prior to December 31, 2016 (including otherwise eligible LTD governed by non-U.S. laws and otherwise eligible LTD subject to acceleration clauses)

# EU Response

- European Commission Proposal for a Bank Recovery and Resolution Directive published in June 2012
- BRRD finally entered into force on 2 July 2014
- Most complex and controversial provisions for legislators to agree on were bail-in provisions
- Member States required to have implemented BRRD into national laws by 1 January 2015, except for bail-in provisions which were to be implemented by 1 January 2016
- UK has applied bail-in provisions from 1 January 2015

# BRRD – Key Features

- Appointment of national resolution authority for each EU member state – Bank of England for UK
- Single Resolution Board replaces national resolution authorities for banks subject to supervision by ECB under Single Supervision Mechanism – broadly banks in member states that are participating in Eurozone and some others
- Main objectives of bank resolution (Article 31):
  - continuity of critical functions
  - avoid significant adverse effect on financial system by preventing contagion and maintaining market discipline
  - protect public funds by minimising reliance on extraordinary public support
  - protect depositors and investors covered by a guarantee scheme
  - protect client funds and client assets

# BRRD – Resolution general principles

- Resolution authorities must ensure resolution action taken in accordance with following principles:
  - the shareholders of the institution must bear first losses
  - creditors of the institution bear losses after the shareholders in accordance with the priority of their claims under normal insolvency proceedings, except as expressly provided otherwise
  - the management body and senior management of the institution are replaced except where their retention is considered necessary to achieve the resolution objectives
  - except where otherwise provided, creditors of the same class are treated in an equitable manner
  - no creditor shall incur greater losses than they would have incurred under normal insolvency proceedings
  - covered deposits are fully protected

# BRRD – Resolution tools

- Sale of business tool – power to transfer to a purchaser (on commercial terms) shares, or all or any assets, rights or liabilities of institution
- Bridge institution tool – similar power to transfer to a publicly-owned bridge institution shares or all or any assets, rights or liabilities of the institution
- Asset separation tool – power to transfer assets, rights or liabilities of an institution under resolution or of a bridge institution to one or more publicly-owned asset management vehicles
- Bail-in tool
- Tools can be applied individually or in combination

# BRRD – Bail-in

- “Bail-in” is the imposition of losses on liabilities owed by a financial institution where such liabilities would not, by their terms, be required to absorb such losses
- Loss absorption can be by:
  - conversion of the liability into a common equity instrument – the most loss-absorbent instrument
  - writing down/off the principal amount of the liability
- Bail-in tool can be used either to:
  - recapitalise the institution under resolution to the extent necessary to restore its ability to comply with the conditions for its authorisation and so continue performing its authorised activities, and to sustain market confidence in the institution; or
  - convert to equity, or reduce the principal amount of, claims or debt instruments that are transferred to a bridge institution (in order to provide capital for that bridge institution) or under the sale of business tool or asset separation tool

# BRRD – Scope of Bail-In Tool

- What is bail-inable?
- All liabilities that are not expressly excluded from the scope of bail-in

## Express Exclusions

- covered deposits – deposits up to the amount covered by a deposit guarantee scheme
- liabilities in respect of holding client assets or client money, where the client is protected under applicable insolvency law
- liabilities resulting from a fiduciary relationship, where the beneficiary is protected under applicable law
- liabilities to other financial institutions (outside its group) with an original maturity of less than seven days
- liabilities with a remaining maturity of less than seven days, owed to payment or securities settlement systems or their participants
- employee remuneration or benefits (other than variable remuneration)
- liabilities to commercial/trade creditors relating to provision of critical goods/services

- liabilities to tax and social security authorities that are preferred by law
- liabilities for contributions owed to deposit guarantee schemes
- secured liabilities – expressly including covered bonds and hedging instrument liabilities of the covered bond issuer

## Additional exclusions

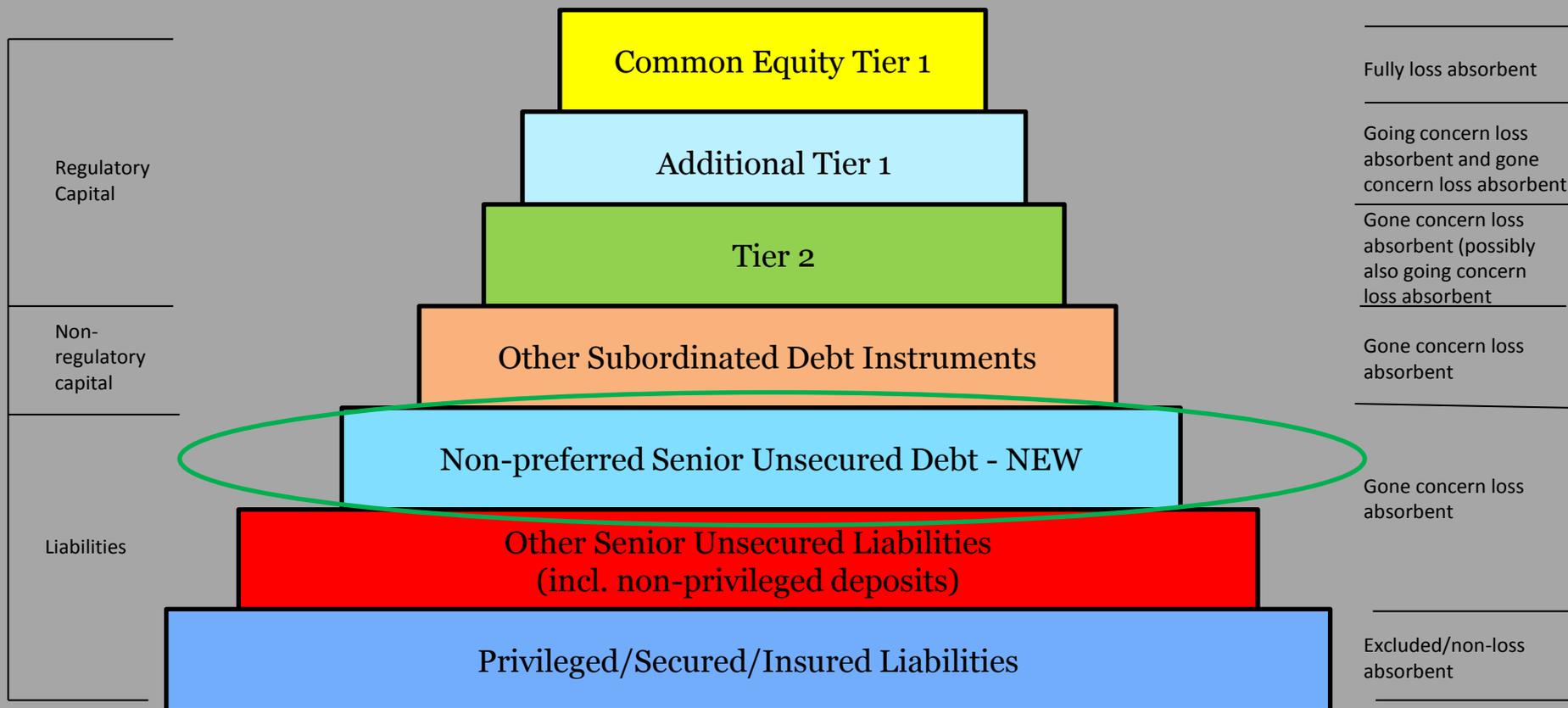
- Resolution authority can wholly or partially exclude liabilities from the scope of bail-in in limited circumstances including:
  - where it is not possible to bail-in the liability in a reasonable timeframe
  - where the exclusion is necessary and proportionate to achieve continuity of critical functions/core business lines
  - where the exclusion is necessary and proportionate to avoid widespread contagion that would disrupt functioning of financial markets
  - where bailing-in the liability would cause higher losses to other creditors than not bailing it in
- Where an exclusion is made, resolution authority may increase levels of write-down/conversion for other liabilities, subject to the NCWOL principle

- Where resolution authority is not able to pass on fully to other creditors the bail-in “shortfall” resulting from such exclusion, the resolution financing arrangement established for the relevant jurisdiction may make a contribution
- Such contribution from the resolution financing arrangement may not exceed 5% of total liabilities of the institution
- A contribution may be made, in extraordinary circumstances, from alternative financing sources after the 5% contribution from the resolution financing arrangement has been made and all unsecured, unpreferred liabilities (excluding deposits eligible for a deposit guarantee) have been fully written down or converted
- Question whether “senior senior” debt will in future be considered “unpreferred” by virtue of changes to Article 108 BRRD in relation to insolvency ranking of liabilities
- However, the resolution financing arrangement can only contribute where there has already been a contribution to loss absorption/recapitalisation, from shareholders, holders of capital instruments and other eligible liabilities (whether through bail-in or otherwise) of not less than 8% of total liabilities of the institution

- Note the view of the European Commission that any common equity tier 1 instruments or additional tier 1 instruments that, at the time of resolution, have or should have been written down already prior to resolution action will not count towards such 8% figure. These instruments will count towards the 8% figure only when they are written down within resolution proceedings
- For smaller institutions (assets below EUR900 billion) the 8% requirement may be waived where the required contribution from shareholder/holders of capital liabilities and eligible liabilities is at least equal to 20% of institution's risk weighted assets and the relevant resolution financing arrangement has ex ante funds (excluding contributions to deposit guarantee schemes) at least equal to 3% of all covered deposits of institutions in the relevant member state

# Bail-in sequence under BRRD

(Proposed amendments by European Commission – November 2016)



# EU Resolution Strategies

- All the key elements of U.S. SPOE resolution strategy are provided for in BRRD, in relation to EU banks
- However, BRRD allows for greater diversity in resolution strategies for individual G-SIBs by providing for additional resolution tools/powers (other than transfers to financial bridge company) and by being non-prescriptive as to which tools/powers to apply and when
- Approach partly driven by diversity of banking structures in EU – some existing group banking structures not conducive to SPOE strategy e.g. groups consisting of multiple well-capitalised operating subsidiaries in different jurisdictions with significant third party liabilities and with little inter-dependence between different group entities. For such groups, MPOE strategy likely to be more appropriate

- Similarly, MREL (EU equivalent of TLAC) to be determined by each individual member state and on an institution-by-institution basis
- How will this diversity of approaches in EU affect demand and pricing for EU bank capital and debt, compared to prescriptive, homogenous approach of U.S.?

# BRRD – MREL

- Each Member State must set, for each institution in its jurisdiction, a minimum required level of eligible (loss-absorbing) liabilities (“MREL”) (consisting of own funds (regulatory capital) and bail-inable liabilities) expressed as percentage of the aggregate of an institution’s own funds and total liabilities – not of risk-weighted assets
- Minimum own funds requirements are already established by Capital Requirements Regulation by reference to risk-weighted assets
- Applies to all domestic banks, not just G-SIBs
- In November 2016, European Commission released legislative proposals to amend both BRRD and Capital Requirements Regulation to provide detailed rules on setting MREL for both GSIBs/GSIIIs and non-GSIBs/non-GSIIIs in the EU
- Following slides summarise those legislative proposals

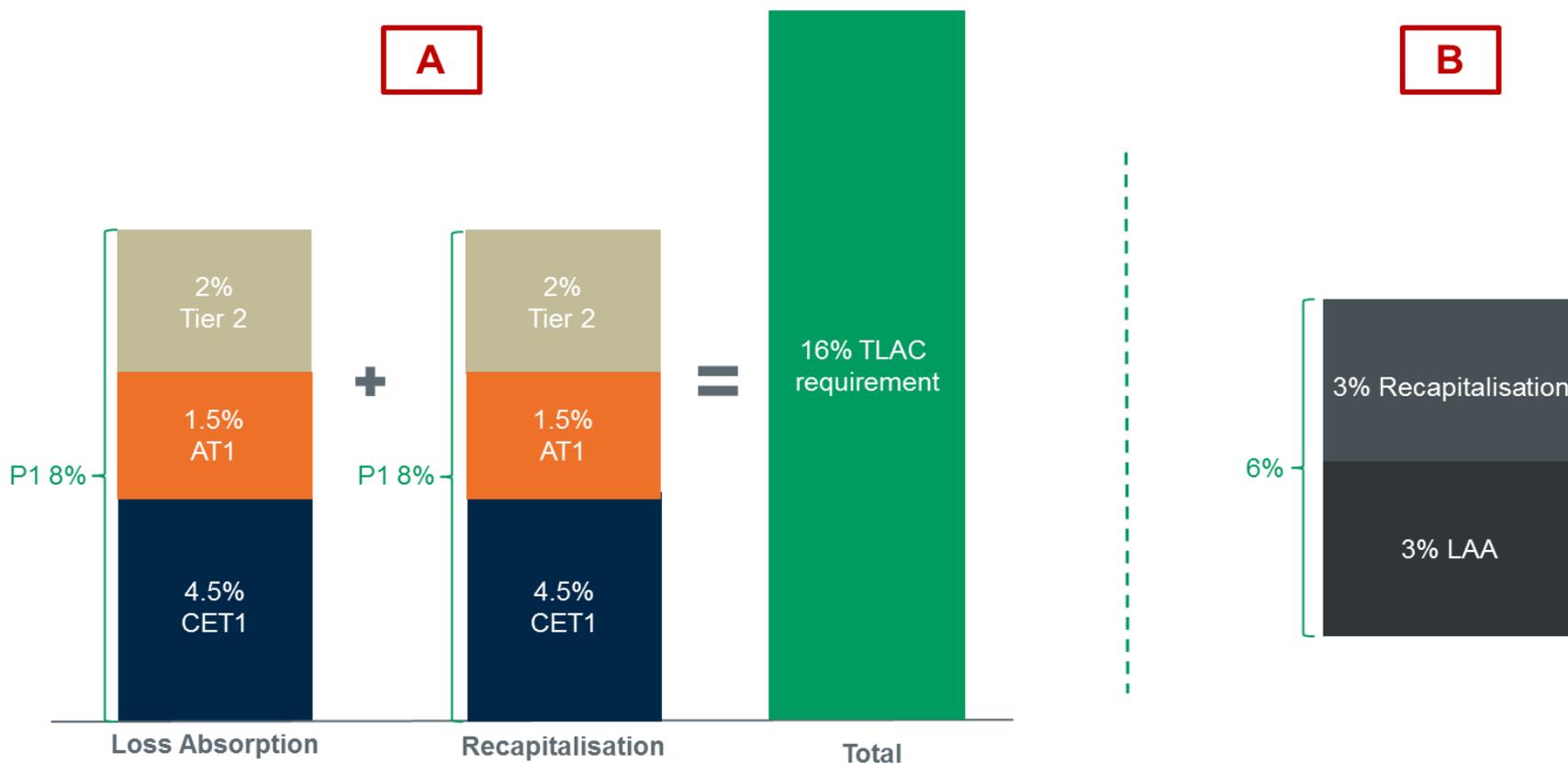
# BRRD Amendment Proposal - MREL - Quantity

- MREL to be set for each bank and expressed as percentage of (i) total risk weighted exposures and (ii) the leverage ratio exposure
- MREL level to be equal to amount determined as necessary to (i) absorb losses and (ii) restore total capital ratio and leverage ratio to level necessary to enable bank to comply with its conditions for authorisation and continue its authorised activities.
- For non-GSIIs, no set minimum level (however, may be likely). However, they cannot be required to be greater than the larger of:
  - an amount equal to twice the bank's Pillar 1 and Pillar 2 capital requirements (once for loss absorption and once for recapitalisation); and
  - an amount equal to twice the bank's leverage ratio requirement (once for loss absorption and once for recapitalisation)
- Resolution authorities also to have power to issue non-binding “guidance” as to additional MREL levels to be maintained, up to the amounts of its combined capital buffers. Although non-binding, repeated failure to follow would result in the “guidance” being converted into binding rules

# BRRD Amendment Proposal - MREL - Quantity

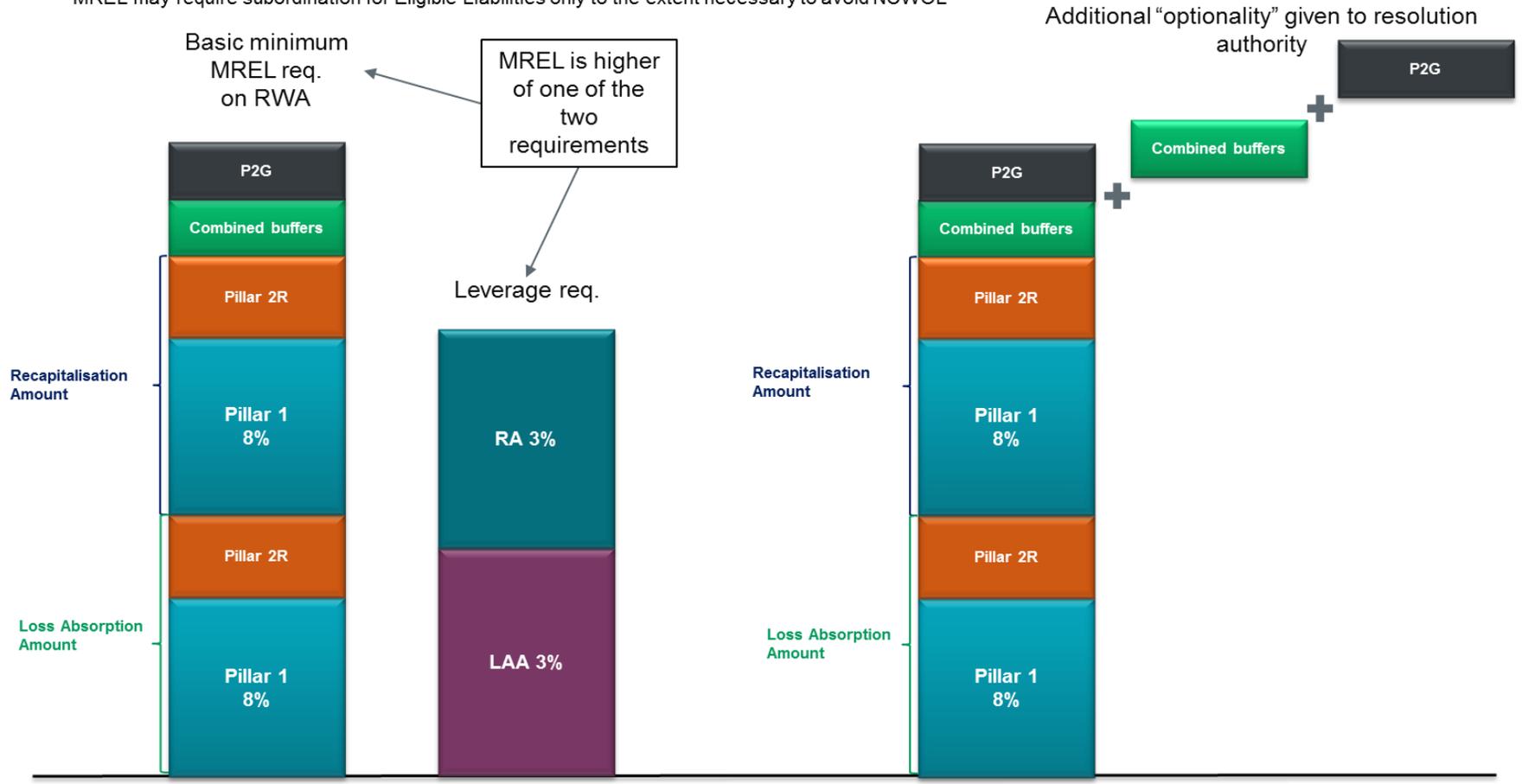
- Applicable only to EU G-SIBs. Applied on consolidated RWA. Represents a “floor”

TLAC requirement is higher of {A,B}



# BRRD Amendment Proposal - MREL - Quantity

- Worst case scenario for a EU G-SIB: TLAC is a “floor” with all requirements doubled with MREL
- MREL can be adjusted up/downwards to adopt for impediments to resolution / reflect resolution strategy
- MREL may require subordination for Eligible Liabilities only to the extent necessary to avoid NCWOL



- For GSII's, there is proposed to be an “MREL Floor”
- Equal to FSB’s min. TLAC requirements (so-called MREL Pillar 1):
  - from 1 January 2019, 16% of risk weighted assets and 6% of the leverage ratio denomination
  - from 1 January 2022 (subject to extensions in some cases), 18% of risk weighted assets and 6.75% of the leverage ratio denominator
- EU banks that are material subsidiaries of non-EU GSII's, but are not themselves “resolution entities” (i.e. an entity identified in the group resolution plan as being potentially subject to resolution action), will have to maintain “internal MREL” equal to 90% of the above levels. Additional Tier 1 instruments, Tier 2 instruments and other eligible liabilities will only count towards the required level where they are held by the non-EU parent
- To limit financial contagion, a GSII holding an MREL-eligible instrument issued by another GSII must deduct the amount of that instrument from its own MREL instruments. This is less stringent than the Basel Committee proposals that it should be deducted from its Tier 2 capital.
- No deduction required for non-G-SII's

- Any shortfall in MREL levels will be treated as a shortfall in the common equity tier 1 capital to be held as part of the combined buffer requirements
- This would therefore trigger restrictions on the amounts of discretionary payments to employees and distributions to holders of stock and other regulatory capital instruments
- However, a six-month grace period on such restrictions has been proposed by the European Commission, where such breach of the combined buffer requirements is due to a temporary inability to issue new MREL-eligible debt
- Where discretionary payments are made by a bank during a combined capital buffer shortfall, no CET1 distributions, variable remuneration or discretionary pension benefits payments can be made until all payments due on AT1 instruments have been made, partly counteracts the “no dividend stopper” rule for AT1 instruments under CRR

- Subject to agreement by resolution authorities of the subsidiary and the resolution entity, internal MREL requirement may be met with a guarantee from the resolution entity to the subsidiary, so long as the guarantee;
  - covers the amount of internal MREL that would otherwise be required
  - is triggered when the subsidiary is unable to pay its debts as they fall due or a decision has been made to write down or convert its capital instruments into equity
  - is at least 50% collateralised through a qualifying financial collateral arrangement by collateral eligible under Article 197 of CRR
  - is governed by the laws of the subsidiary's member state
  - is collateralised by collateral that is unencumbered and has an effective maturity of at least one year, and in respect of which there are no legal, regulatory or operational barriers to the transfer of the collateral from resolution entity to subsidiary

# MREL - Exclusions

- Items counting towards eligible liabilities cannot also count towards CET1, AT1 or T2 items
  - However, AT1 and Tier 2 should count towards MREL and TLAC
  - CET1 inclusion under discussion (CET1 in excess of all CRR/CRD requirements, including Buffers)
- The following are excluded from eligibility for MREL:
  - covered deposits
  - sight/short term deposits with original maturity <1 year
  - deposits otherwise eligible for a deposit guarantee, but in excess of the guarantee coverage level, from natural persons, micro, small and medium sized enterprises (NMSMEs)
  - deposits from NMSMEs that would be eligible for a deposit guarantee if they were not made through non-EU branches of EU institutions
  - secured liabilities, including covered bonds and cover pool assets
  - liabilities in respect of client assets/money protected under applicable insolvency law
  - liabilities in respect of fiduciary relationship between resolution entity (or its subsidiaries) and a beneficiary who is protected under applicable insolvency/civil law
  - liabilities to banks/investment firms with an original maturity <7 days
  - liabilities with remaining maturity <7 days owed to payment/settlement systems
  - certain liabilities to employees, commercial/trade creditors for critical goods/services, tax and social security authorities and to deposit guarantee schemes
  - liabilities arising from derivatives and from debt instruments with “embedded derivatives”

# MREL - Eligibility

- Liabilities will qualify as eligible liabilities if they meet all of the following conditions:
  - directly issued/raised by the institution and fully paid-up
  - not purchased by an entity in the same resolution group or by an undertaking in which the institution has ownership interest of 20% or more
  - purchase not funded directly/indirectly by institution
  - (for GSIIIs) subordinated to all MREL-excluded liabilities in normal insolvency proceedings, whether contractually, by the law governing the liability, or structurally (by being issued by a resolution entity which does not have on its balance sheet any MREL-excluded liabilities that rank *pari passu* or junior to eligible liabilities)
  - not secured or subject to any guarantee/seniority-enhancing arrangement by the institution, its subsidiaries, a parent undertaking or an undertaking with close links to any of those entities

- not subject to set-off/netting rights
- no step-up or other incentive to call
- if it contains a holder redemption option, exercisable pre-maturity, maturity of the liability is deemed to be the earliest possible date on which redemption option would be exercised – compare to the U.S. approach
- any call option must be exercisable at sole discretion of competent authority and replaced with equally loss absorbing instrument unless not required for compliance with regulatory requirements
- no indication in the terms of the liabilities that they might be called/redeemed early by the resolution entity, except in case of insolvency/liquidation of the entity
- terms of the liability do not give the holder the right to accelerate payments, except in case of insolvency/liquidation of resolution entity
- interest/dividends must have no credit-sensitive features
- the terms of the liability must provide for permanent principal write-down/conversion to equity upon exercise of bail-in powers by resolution authority
- no equivalent of the U.S. “phased ineligibility” of instruments between 2 years and 1 year from maturity

- Above subordination requirements can be waived for eligible liabilities up to 3.5% of risk-weighted assets, so long as such liabilities rank *pari passu* with the lowest ranking MREL-excluded liabilities and resolution authority considers their inclusion in MREL does not have a material adverse effect on resolvability
- As an alternative to the above, institution can include unsubordinated liabilities that rank *pari passu* or senior to the lowest ranking MREL-excluded liabilities, so long as the MREL-excluded liabilities on the institution's balance sheet that rank *pari passu* or below such subordinated liabilities does not exceed 5% of the institution's MREL, and the resolution authority considers their inclusion in MREL does not have a material adverse effect on resolvability
- Restrictions on acceleration rights is more stringent than FSB's TLAC principles, which permit acceleration rights following non-payments for 30 days or more

# Subordination

- FSB's TLAC rules prescribe that, in order to be TLAC-eligible, liabilities must be subordinated to liabilities that are excluded from TLAC (sometimes referred to as operational liabilities)
- This is prescribed in order to try and avoid breaching the NCWOL principle (no creditor should be worse off in resolution than it would be in an insolvency proceeding)
- FRB's TLAC rules also prescribe such subordination
- European Commission's draft MREL legislation prescribes such subordination for GSII/GSIBs
- However, for non-GSII/GSIBs, such subordination is not prescribed, but can be required by a resolution authority, based on:
  - the fact that the relevant liability has the same priority ranking in insolvency as liabilities that are automatically excluded from bail-in or would be excluded at the discretion of the resolution authority
  - the risk that holders of the relevant liability would incur greater losses than in normal insolvency proceedings
  - the degree of required subordination not exceeding the amount necessary to negate the above risk

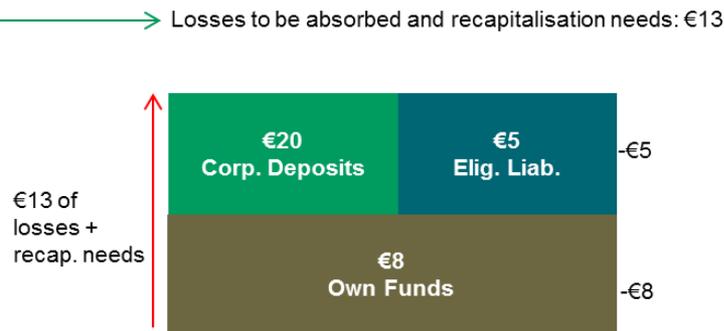
# Will Subordination be Required for MREL Eligible Liabilities for non G-SII's?

- For G-SII's, the usual TLAC termsheet exemptions apply, in that "traditional" senior unsecured debt up to 2.5%/3.5% of RWA's counts towards the TLAC minimum without requiring subordination (the *de minimis* exemption can also be applied by G-SII's, but not simultaneously with the RWA exemption)
- For MREL purposes Art. 45b (1) BRRD2 does not require subordination of Eligible Liabilities to Excluded Liabilities, except to the extent that losses in resolution would be greater than in a hypothetical insolvency scenario (Art. 45b (3) (c) BRRD2)
- What does this mean in practice? We consider the following hypothetical scenario:
  - A Bank with €100 B/S ; RWA density of 50% ; CET1 of 12.5% ; AT1 of 1.5% ; Tier 2 of 2% and P2R of 2% => Own Funds of €8 ; MREL requirement of 26% (2\*P1 of 8% + 2\*P2R of 2% + 2\*CBR of 3%), i.e. €13 ; ex Own Funds net Requirement for Eligible Liabilities of €5
  - Further, we assume €67 of preferred deposits and €20 of large corporate deposits, no derivative liabilities and structured notes

## Stylised B/S

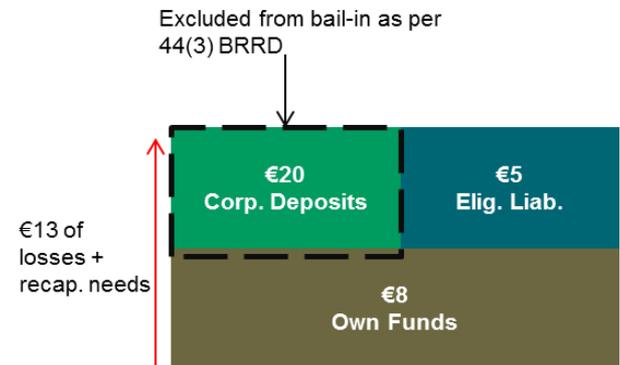


## What happens in a hypothetical liquidation scenario?



€5 ranking pari passu with €20 => 25% Write-Off / Conversion

## What happens in Resolution



Effective losses of 100% => 100% of Write-Off / Conversion

Losses in resolution surpass those in hypothetical liquidation by 75% of nominal => hence 75% of €5 MREL requirement must be met with subordinated liabilities (€3.75)

Source: CA-CIB ; EU Commission

Subordination (cont'd)

- Is the difference in treatment under the European Commission draft proposals driven by the systemic nature of the institutions? Or by the likelihood of a bail-in strategy being applied?
- Competitive advantage for non-GSIIs/GSIBs
- Subordination can be contractual, statutory or structural
- Will these variations themselves give rise to pricing differentials for different TLAC/MREL-eligible instruments
- Will jurisdictional subordination differences affect pricing? UK and U.S. banks likely to apply structural subordination. EU banks without a “clean holding company” structure likely to employ contractual/statutory subordination? Single Resolution Board has not so far released a detailed policy on subordination for non-GSIIs but has stated that it considers subordination essential in limiting breaches of the NCWOL principle

## Subordination (cont'd)

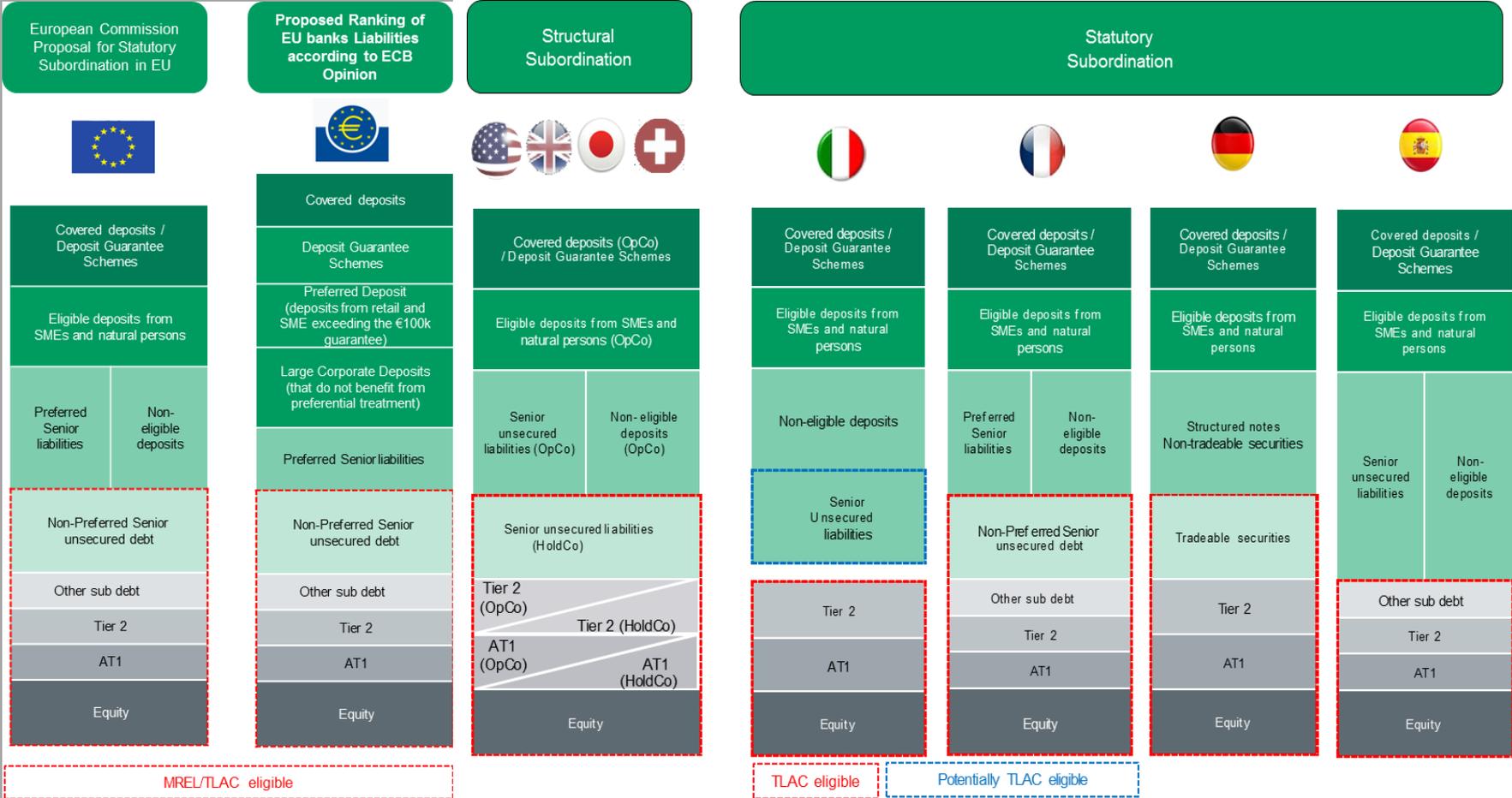
- European Commission’s legislative proposals prescribe the creation, in each member state’s insolvency hierarchy, of a new level of ranking for debt instruments, issued after the relevant directive becomes applicable (originally suggested for July 2017):
  - whose initial maturity is at least one year
  - that have no derivative features
  - whose contractual documentation refers to the insolvency ranking of those debt instruments
- Such debt instruments (“non-preferred senior debt”) will be required to rank in insolvency below ordinary, unsecured debt instruments, but above CETI, Tier 1, Tier 2 and other subordinated debt
- If these proposals become law, they will mirror changes already applied by France to its insolvency ranking. However, they may require some changes to earlier German laws providing for subordination of certain existing and future “plain vanilla” debt securities
- ECB issued an opinion dated 8 March on these proposals

## Subordination (cont’d)

- It generally supports the proposals, but makes a number of points:
  - it considers that the “one year maturity” feature should not be compulsory – even though it is required for MREL eligibility, liabilities of less than one year maturity can still be bailed-in, and therefore protection of the NCWOL principles is still valuable
  - recommends clarifying what is a “derivative feature” for this purpose
  - recommends the legislation clarifying that the new non-preferred senior unsecured liabilities rank pari passu with senior unsecured debt instruments already subject to statutory subordination under national laws, but that “new” issuances of subordinated unsecured debt instruments should be aligned with the current legislative proposals (one of the key points of the ECB Opinion)
  - recommends clarifying that the new asset class referred to in the legislative proposals is in addition to debt instruments subject to other statutory subordination or structural subordination, and is not the only method of achieving subordination for MREL purposes
  - recommends establishing a general depositor preference, rather than the current “tiered depositor preference”, in support of the NCWOL principle
  - recommends requiring further harmonisation of national insolvency hierarchies such that Tier 2 instruments should always rank below other non-Tier 2 subordinated instruments
  - notes, and reiterates, that subordinated instruments are not eligible as collateral for borrowings made under the Eurosystem credit operations

## Subordination (cont'd)

# European Commission, ECB Opinion and EU Nat. Approaches – Stacking of Liability Structures



## Subordination (cont'd)

- Importance of disclosure of MREL/insolvency ranking both to competent authorities and public/investors
- Draft legislative proposals for institutions to publicly disclose their MREL levels, the composition of their MREL and their maturity profile and ranking in insolvency proceedings
- Allows investors a clearer idea of where their investments would rank in insolvency and therefore the likely ranking in a resolution, given the NCWOL principle

**Subordination (cont'd)**

# Structured Products

- Derivatives liabilities (such as over-the-counter derivatives contracts) are able to be bailed-in under BRRD and Title II of Dodd Frank Act
- However, they are ineligible for FSB's TLAC principles, for MREL and for the FRB's Final TLAC Rules, due to the perceived difficulty in valuing such liabilities accurately in a short period of time, such as a resolution weekend
- FSB's TLAC Principles also provide that debt instruments "with derivative-linked features, such as structured notes" are ineligible for TLAC, presumably also due to a perceived difficulty in valuation
- FRB's Final TLAC Rules provide that structured notes will not count towards TLAC for U.S. GSIBs. A "Structured note" is defined as debt instruments that (i) has a principal/redemption amount or stated maturity that is subject to reduction based on performance of an underlying asset, entity index or embedded derivative or similar embedded feature, or (ii) has an embedded derivative or similar embedded feature linked to one or more equity securities, commodities, assets or entities or (iii) does not specify a minimum principal amount that becomes due on acceleration or early termination, or (iv) is not classified as debt under U.S. GAAP. This appears to be due to concerns about their complexity/valuation difficulties.

- Under European Commission Proposals, debt instruments with “embedded derivatives” are not eligible as MREL for GSIIIs/GSIBs
- However certain such instruments would be considered eligible as MREL for non-GSIIIs/GSIBs
- Eligibility for debt instruments “with derivatives features, such as structured notes” is subject to the conditions that:
  - a given amount of the liability (“principal protected amount”) arising from the debt instruments is known in advance at the time of issuance, is fixed and not affected by a derivative feature
  - neither the debt instrument, nor its derivative feature, is subject to any netting agreement or valued on net basis
- Eligibility will be limited to the principal protected amount of such instrument

- Not clear why this relaxation proposed for non-GSIIs/GSIBs, but not for GSIIs/GSIBs, as systemic nature of the institution does not appear to be relevant
- February 2017 working paper of the EU Council notes:
  - there is no standard definition of a structured note
  - embedded derivatives are not “derivatives” – merely an economic description of the pay-off of the structured note
  - some structured notes have a “floor” or principal protected amount that is not fixed, but increases over time, and it recommends that such notes should also be eligible for MREL, up to the principal protected amount from time to time
- However, the critical question of what are “embedded derivatives” has not been clarified yet, due to differing views of the legislative stakeholders within the EU

# UK Response

- UK Banking Act 2009 introduced Special Resolution Regime for banks and some other financial institutions
- Applies to banks, building societies, certain investment firms, recognised CCPs and bank holding companies
- 4 pre-insolvency stabilisation options for banks: (i) transfer to private sector purchaser, (ii) transfer to bridge bank (iii) transfer to temporary public sector ownership, and (iv) bail-in of liabilities
- PRA responsible for triggering SRR in respect of a bank, if satisfied that:
  - bank is failing, or likely to fail, to satisfy PRA's threshold conditions, and
  - not reasonably likely (having regard to timing and other circumstances) that action will be taken by or for the bank that will enable it to satisfy threshold conditions

# UK Approach to Single Point of Entry

- Although BRRD provides for several bail in tools and powers, Bank of England acknowledges that for a large, complex bank entering resolution a bail-in is likely to be needed
- It envisages that bail-in would be carried out in the holding company of the failed bank group, where the holding company has issued external debt
- BofE envisages four core elements to a bail-in of a UK G-SIB:
  - preparation period for the resolution weekend
  - bail-in period, including resolution weekend
  - announcement of final bail-in terms and compensation arrangement
  - restructuring of the bank after bail-in

- In the preparation period, BofE would create a draft resolution instrument to give effect to the bail-in and would identify those liabilities that could be bailed-in
- During the resolution weekend, BofE would confirm which liabilities would be bailed in. Any listing of shares of the resolution entity would probably be suspended by the FCA
- Bail-in would be executed by transfer of shares to a third party commercial bank, appointed to act as depositary bank. BofE is likely to appoint a resolution administrator to act under its control
- Certificates of entitlement will be issued to creditors holding the liabilities potentially subject to bail-in. These represent a potential right to compensation should the creditor become entitled under the “no creditor worse off than in a winding-up” principle
- At the end of the weekend, BofE would announce:
  - that the bank has entered into resolution
  - the nature of the resolution i.e. a bail-in without immediate changes to the structure and functioning of the bank group
  - that the group’s operations would continue as normal and depositors protected by the UK’s deposit guarantee scheme would continue to be protected
  - the bank would be open for business on Monday morning

- Depository bank holds the shares in trust until they can be distributed to any bailed-in creditors
- Detailed valuation work is carried out, in order to determine and announce the final terms of the bail-in as soon as possible
- Resolution administrator controls all share voting rights
- Announcement of final terms of the bail-in will specify ratio of shares due to each class or certified holder
- Write downs will be applied to the bailed-in liabilities, trading suspension could be lifted and share voting rights transferred to the new owners

- After bail-in, the resolution administrator would prepare a restructuring plan
- Intended that recapitalisation would be sufficient to absorb losses and rebuild minimum capital and buffers, so that the restructured entity could regain access to market funding (over time)
- In the meantime, temporary funding to be made available by various UK authorities to meet liquidity needs, secured (with appropriate haircuts) over the bank's assets

# UK Approach to MREL

- Bank of England to set level of MREL for each UK bank
- Smallest/simplest banks likely to be subject to UK's modified insolvency procedures (not one of the resolution tools) and therefore would not require the capitalisation element of the EBA's RTS. Therefore, for these banks, MREL to be set at a level equal to the bank's existing minimum capital requirements
- For banks providing more than 40,000 transactional accounts, likely that one or more resolution powers would be used. If the bank's only critical function were the provision of current accounts, BoE would transfer all retail /SME deposits to a third party purchaser or bridge bank. Therefore, for such banks, MREL would be set at a level equal to the bank's existing minimum capital requirements (for loss absorption) plus a percentage of the existing minimum capital requirements equal to the percentage of the balance sheet that would be transferred (for recapitalisation)
- For the above banks, BoE will generally not require subordination of MREL to senior operating liabilities

- Where a bank has reached a certain size/complexity, the bail-in tool is likely to be used. BoE would usually expect bail-in strategy to be appropriate for a bank with total assets exceeding £15-25bn
- For these banks, BoE intends to set MREL at a level equal to twice the bank's current minimum capital requirements – once for loss absorption and once for recapitalisation
- In this case, MREL will have to be subordinated to senior operating liabilities, such as uninsured corporate deposits and derivatives liabilities
- In the case of UK subsidiaries of foreign (non-UK) banking groups, where the home resolution authority would pursue a SPOE resolution strategy, the subsidiary would not become subject to BoE's resolution powers, though it would still prescribe a level of MREL that would be necessary to support the overall agreed group resolution strategy.

- In this case, MREL would be expected to consist of capital or subordinated liabilities issued to the foreign parent
- For foreign banking groups with a MPOE strategy, the levels of MREL for UK subsidiaries would be set in the same way as for domestic banking groups
- Where subordination is required, BoE expects it to be by way of structural subordination. In other words, it expects the banking group to raise MREL funds at the holding company level and downstream the funds in the form of capital or other subordinated claim to the material operating subsidiaries
- The above MREL principles to apply from January 2019. In the meantime, all UK banks' MREL levels to be set at level of minimum capital requirements

# EU Single Resolution Board Approach to MREL

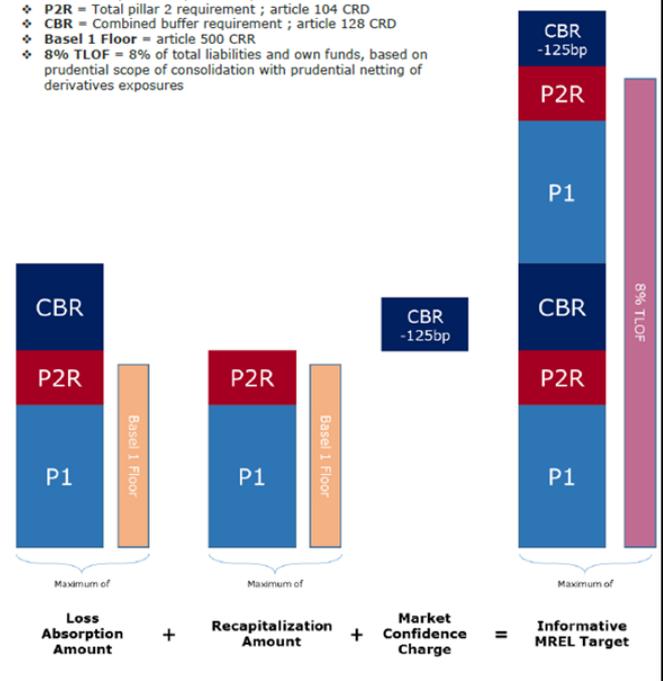
- Single Resolution Board is the resolution authority for all banks in the Eurozone
- Although MREL is to be set out on a bank-by-bank basis, SRB considers that an MREL of not less than 8% of total assets would generally be required for Eurozone banks
- It considers that MREL would consist of:
  - a loss absorption amount equal to the greater of:
    - the bank's minimum capital requirements plus the combined buffers (conservation, countercyclical and systemic) plus any Pillar 2 requirement imposed by the bank supervisor; and
    - the Basel I capital floor; and
    - any applicable leverage ratio requirement, plus
  - a recapitalisation amount equal to the above loss absorption amount minus the combined buffers, plus
  - an additional amount specified by the SRB as necessary to maintain sufficient market confidence, taking into account capital position of peers. This amount is proposed to be equal to the combined buffer requirement, less 125 basis points

- The loss absorption amount above can be:
  - increased by the resolution authority to account for the particular bank's business model, funding model and risk profile, or to reduce/remove an impediment to resolvability or absorb losses on holdings of MREL instruments issued by other group entities; and
  - decreased to the extent that:
    - Pillar 2 requirements, determined on the basis of stress tests or to cover macroprudential risks, are assessed to be not relevant to resolution loss absorption; or
    - part of the combined buffer requirement is assessed to be not relevant to resolution loss absorption
- For 2016, SRB has been using only the default loss absorption amount, similarly to the Bank of England

## SRB MREL approach for 2016

### Legend

- ❖ P1 = Total pillar 1 requirement ; article 92 CRR
- ❖ P2R = Total pillar 2 requirement ; article 104 CRD
- ❖ CBR = Combined buffer requirement ; article 128 CRD
- ❖ Basel 1 Floor = article 500 CRR
- ❖ 8% TLOF = 8% of total liabilities and own funds, based on prudential scope of consolidation with prudential netting of derivatives exposures



Source: SRB

- In terms of eligible liabilities, a subordination requirement mirroring TLAC standards was requested for G-SIIs. For large O-SII's, SRB indicates that the TLAC reference was useful although no detailed methodology has been developed for now to determine the proportion of subordination. That said, the SRB reiterates that "subordinated instruments to be essential in limiting no-creditor-worse-off (NCWO) issues and ensuring the resolvability of banking groups beyond G-SIIs."

MREL Eligible Debt	Not Eligible for MREL
<ul style="list-style-type: none"> <li>• Large Corp Term Deposits</li> <li>• Pari Passu vanilla senior debt</li> <li>• Certain "lightly" structured notes (zero coupons?)</li> <li>• SPV debt where e.g debt guaranteed by CRR institution (subject to Due Diligence)</li> <li>• Retail-held subordinated and senior debt</li> </ul>	<ul style="list-style-type: none"> <li>• Structured Notes</li> <li>• SPV-issued debt</li> <li>• 3<sup>rd</sup> country law liabilities</li> <li>• Debt issued by an institution outside of the EU</li> </ul>

### Next steps for SRB

- Setting binding MREL targets at consolidated level (or appropriate sub-consolidated level according to the resolution strategy) for major banking groups in 2017. Adequate transition periods will be set and will address both the quantity and the quality (e.g. subordination) of MREL instruments
- Assessing significance of retail investors in different Member States and develop potential measures to address the issue. Of note, liabilities held by retail investors were considered MREL eligible in the context of the 2016 exercise but the SRB notes that senior or subordinated holdings by retail customers could prove to be an impediment to resolution.
- Defining its approach to subordination for banks under its remit. This could have potential implications for O-SIIs (e.g. EBA 13.5% subordination requirement recommendation)
- Defining a policy stance with respect to deductions of cross-holdings of MREL-eligible instruments
- Developing an internal MREL framework (on-lending)
- Potential requirement for banks to disclose the composition of their MREL eligible instruments (but the SRB does not intend to publish the individual decisions on MREL targets)