European Parliament

BRIEFING

Loss absorbing capacity in the Banking Union: TLAC implementation and MREL review

This note explains the objectives of and main differences between the Minimum Requirement for own funds and Eligible Liabilities (MREL) under the BRRD framework and the Total Loss Absorbing Capacity (TLAC) standard developed globally by the Financial Stability Board (FSB). It also summarizes the issues arising from the need to implement the TLAC standard under EU law.

MREL: A key requirement for the credibility of the bail-in tool

The new European legal framework for bank resolution

The Bank Recovery and Resolution Directive (BRRD) provides a comprehensive framework for the orderly resolution of failing banks within the European Union. It aims at safeguarding financial stability, in particular through an enhanced regime of early intervention powers conferred upon competent authorities, and stricter obligations in good times regarding resolution planning. In bad times, resolution authorities enjoy new powers to preserve critical functions and clients assets (including deposits), while restructuring the activities of the failing banks in order to make it -or part of it- viable again and allowing for the orderly winding-down of the non-viable parts.

One overarching objective of this new framework is to shift the burden of bank rescues from taxpayers to bank creditors. To that end, resolution authorities were given the power to allocate losses to shareholders and creditors (the "bail in" tool, as per Article 43 BRRD), in line with the valuation of the failing business and according to the sequence provided in Article 48 BRRD. Shareholders and creditors must therefore absorb losses for an amount of at least 8% of total liabilities including own funds before any use of the resolution fund.

As bailing-in some liabilities may be legally difficult (for example for those issued in foreign jurisdictions) or potentially disruptive for the real economy (such as deposits from households and SMEs), the BRRD provides for a list of liabilities which must not be bailed-in, in particular covered deposits and secured liabilities (Article 44.2 of BRRD). It appears that, upon resolution, a failing institution may not hold a sufficient amount of bail-inable liabilities. To tackle this issue, Article 45 BRRD provides that institutions shall meet at **all times a minimum requirement for own funds and eligible liabilities** (MREL), to be determined by the resolution authority. The MREL therefore constitutes an anchor point for the new resolution framework, as it determines the credibility of the bail-in regime.

The BRRD provides that the MREL shall be set on a case-by-case basis, for **all institutions** in the European Union. It will be calculated **for each legal entity** based on a number of criteria to be further developed in level 2 legislation.

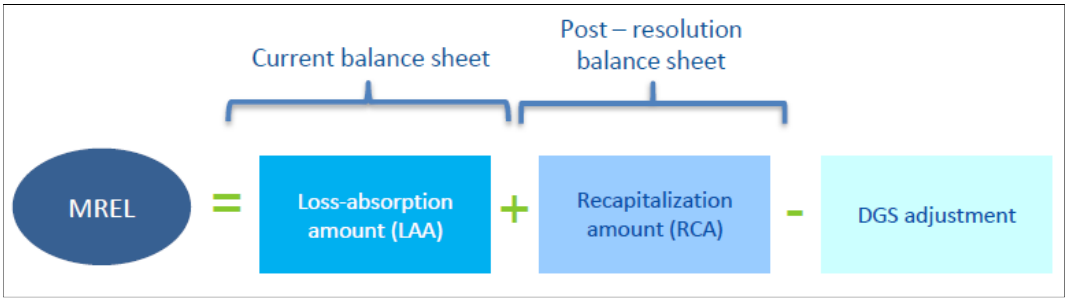
On 3 July 2015, the EBA published its draft regulatory technical standards (RTS) on the criteria for determining MREL, which have not yet been endorsed by the Commission. On 18 December 2015, the Commission informed the EBA that it intended to amend the final draft RTS submitted by the EBA. In particular, the Commission assesses that the reference to the minimum 8% bail-in contribution in Article 5.1 of the draft RTS and the specification for a 48 month limit for the transitional period go beyond the scope of EBA's empowerment set out in the BRRD. On 9 February 2016, the EBA published its opinion on the Commission's proposed amendments, rejecting the substantial amendments proposed by the Commission.

On 23 May 2016, the Commission adopted the delegated regulation on the criteria for determining MREL. On the two issues referred to above, the delegated regulation provides that (i) for systemic institutions *the resolution authority shall take into account the requirements set out in Article 44 of Directive 2014/59/EU* (Article 5.1) and (ii) *resolution authorities shall determine an appropriate transitional period which is as short as possible* (Article 8.2), thereby dropping any explicit reference to the 8% minimum bail-in requirement and the 48 month limit for the transitional period. The Parliament and the Council can object to the delegated regulation within three months.

Implementing MREL within the Banking Union

Within the Banking Union, the Single Resolution Board, as an EU resolution authority, is responsible for setting the MREL for institutions under its direct remits. On 12 January 2016, the SRB held its second industry dialogue where it presented its methodology to determine the MREL, based on the draft RTS published by the EBA.

Figure 1: Determination of MREL requirements



Source: SRB

The MREL is to be calculated on the basis of three components:

- the **loss absorption amount** (LAA), based on the capital requirements of the current balance sheet, including regulatory capital requirements (8% of RWA), the combined buffer requirements[1], and additional pillar 2 requirements (bank specific) set by the supervisor;

- the **recapitalisation amount** (RCA), which aims at covering the capital requirements of the failing institution post-resolution, taking into account potential divestments and other resolution actions under the preferred resolution strategy (the RCA may be set to 0 if the SRB considers it can be put into liquidation), as well as the need to maintain sufficient market confidence;

- the **DGS adjustment**, linked to any potential involvement of a DGS to protect insured depositors.

For each of those three components, the SRB may consider upward or downward adjustments, on the basis of a thorough case-by-case analysis of financial information at granular level, supervisory data and resolution strategies. While the calculation of the MREL is mainly based on risk weighted assets (RWA), the MREL will eventually be denominated as a percentage of total liabilities and own funds.

[1] *The combined buffer requirement consists of the sum of the countercyclical buffer, the capital conservation buffer and the higher of the systematically important institution buffer (G-SII/O-SII) and the systemic risk buffer.*

One key issue is the definition of the liabilities which can be used to comply with the MREL. Article 45.4 BRRD lists a number of conditions, including regular limitations as to the maturity (remaining maturity of at least one year), the holder (instrument issued and fully paid up, not owned, secured nor guaranteed by the institution, and purchase of the instrument not funded directly or indirectly by the institution) and the nature (the liability does not arise from a derivative or from a preferred deposit) of the instruments. In addition, the resolution authority may exclude liabilities governed by the law of a third country, if the resolution authority is not convinced that its decision would be effective under that law. While instruments don't need to be subordinated to count towards MREL, the resolution authority may require that part of the MREL be met with contractual bail-in instruments, that is to say instruments subject to subordination and containing contractual terms providing for their conversion or write down upon resolution.

It is also important to keep in mind that instruments which are not eligible for MREL are not necessarily excluded from bail-in. A number of instruments therefore will therefore absorb losses in line with their ranking in the hierarchy of creditors albeit they do not count toward the MREL. A detailed table on the eligibility of various classes of instruments under both the MREL framework and the TLAC standard is presented in Annex A. It also indicates which instruments are bail-inable and which instruments are excluded from bail-in.

The SRB and resolution colleges will foresee a transition period for the implementation of the MREL by the banks concerned. The SRB included the need to implement a harmonised framework for MREL in its priorities for 2016, and indicated that it would "*strive to obtain MREL decisions for the major banking groups with the Banking Union during 2016*". The outcome of this analysis will substantively impact the funding plan of banks under its remits since they could have to raise significant amounts of MREL-compliant liabilities.

TLAC: A global standard for GSIBs

The Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) published on 9 November 2015 a new standard on **Total Loss Absorbing Capacity** (TLAC). That standard - which has been adopted after the BRRD - shares the same objective as the MREL (i.e. to reduce the impact of banking failures on public funds) but covers a different scope, since it applies to all **Global Systematically Important Banks** (GSIBs) worldwide. Therefore it only applies to 13 banking groups within the EU (See EGOV briefing PE 574.406 *GSIBs in Europe*). In addition, the standard is not a binding act, and has to be implemented into national or European legislation.

As to the approach taken by the FSB, it differs also in its form, since the TLAC standard sets a **minimum level** of loss absorbing capacity to be held by all GSIBs ("pillar 1" requirement), when the BRRD grants full discretion to resolution authorities for setting the appropriate level of individual requirements on a case-by-case basis ("pillar 2" requirements). As from 1 January 2019, GSIBs will have to comply with a minimum TLAC requirement equal to the higher of 16% of RWA or 6% of leverage ratio exposure (LRE)[2]. As from 2022, the minimum thresholds will be set at 18% and 6.75% respectively. Home authorities will nevertheless have the power to apply additional requirement on a case-by-case basis, if deemed necessary and appropriate. Contrary to the BRRD, the TLAC standard provides that instruments used to comply with capital buffer requirements shall not count towards TLAC requirements. In addition, GSIBs are requested to deduct any holdings of TLAC eligible instruments issued by other GSIBs.

The TLAC standard also provides that instruments must be **subordinated** to any excluded liabilities[3]. Subordination reduces the legal risks associated with the bail-in of senior securities ranking pari passu with other senior liabilities which are not bailed-in such as covered bonds and derivatives. Three kinds of subordination are foreseen in the TLAC standard:

- *statutory* subordination, whereby the instrument is by law (statutory creditor hierarchy) junior to excluded liabilities on the balance sheet of the resolution entity;

- *contractual* subordination, whereby a contractual clause makes the instrument junior to excluded liabilities on the balance sheet of the resolution entity;

- *structural* subordination, whereby the instruments is issued by a resolution entity which doesn't have any excluded liability ranking pari-passu or junior to TLAC-eligible instruments.

The TLAC standard also elaborates on internal loss absorbing capacities within banking groups. First, the TLAC standard applies at the level of the resolution entity, whether there are one (resolution strategy based on a single point of entry, **SPE strategy**) or several such entities within a banking group (resolution strategy multiple points of entry, **MPE strategy**). Then a minimum amount of loss absorbing capacity (75-90% of the external TLAC) must be prepositioned at subsidiary level for each material subgroup within a resolution group, so that losses at sub-group level be up-streamed to the resolution entity in accordance with the resolution strategy.

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[2] The Leverage Ratio Exposure (LRE) is the denominator of the leverage ratio as per the Basel III standard.

[3] Excluded liabilities include insured deposits, short term deposits, liabilities arising from derivatives or other than through a contract, debt instruments with derivative-linked features, liabilities which are preferred to senior unsecured liabilities under the relevant insolvency law, and any liability which cannot be bailed-in without giving rise to material risk of successful legal challenge or valid compensation claims.

Table 1: Main differences between MREL and TLAC

	MREL	TLAC
Entry into force	2016 with phase-in period	1 January 2019 (16% RWA/6% LRE) 1 January 2022 (18% RWA/6.75% LRE)
Scope	All institutions within the EU	GSIBs
Approach	Bank-specific (Pillar 2)	Minimum standard (Pillar 1) and individual add-on
Calculation	Sum of the Loss Absorption Amount (current capital requirements) and Recapitalisation Amount (capital requirement post-resolution), subject to various adjustments by the resolution authority, including potential use of DGS Denominated as % of total liabilities and own funds Capital can be used to meet both MREL and regulatory buffers	The higher of 16%/18% of RWA (2019/2022) or 6%/6.75% of the leverage exposure, excluding capital instruments used to comply with regulatory buffers Bank-specific add-on above the minimum requirement to be applied by competent authorities, if necessary and appropriate
Deductions	No deduction of cross-holdings	Deduction of TLAC eligible instruments issued by other GSIBs
Eligible instruments	Eligible instruments are not necessarily subordinated, but the resolution authority may require that part of the MREL be met with contractual bail-in instruments which must be subordinated to other eligible instruments A number of further specifications apply (unsecured, fully paid up, residual maturity of at least one year...), and some instruments are excluded (derivatives, covered deposits...)	Eligible instruments must be unsecured and formally subordinated to excluded liabilities, with few exceptions (in particular option to allow non-subordinated instruments to count toward TLAC for an amount up to 2.5%/3.5% of RWA) A number of further specifications apply (in particular, a residual maturity of at least one year, instrument fully paid up) and some instruments are excluded (including structured notes, derivatives, insured deposits...)
Jurisdiction	If the instrument is governed by the law of a Third country, the institution must demonstrate it can be legally and effectively bailed-in upon resolution	As from 2022, eligible instruments must be issued directly by the resolution entity

Impact of implementing the TLAC standard at global level

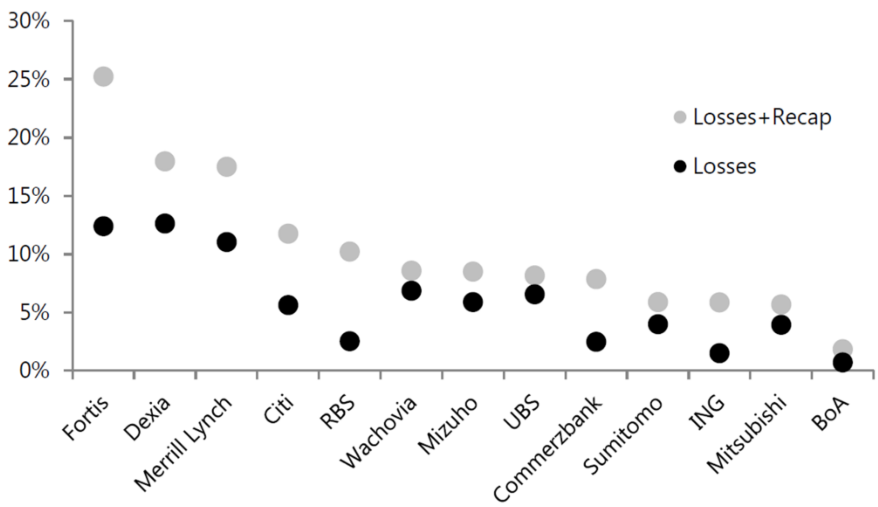
On 9 November 2015 the FSB published the [Summary of Findings from the TLAC Impact Assessment Studies](). The overall conclusion is that even under the most conservative assumptions macroeconomic benefits (+15/20 bps of annual GDP) exceed costs (-15 bps). In particular, the median lending rates would increase by 8 bps.

The impact assessment indicates that the 29 GSIBs had an average TLAC ratio of 13.1% of RWA and 7.2% of LRE at the end of 2014. This translates into a TLAC shortfall of EUR 307 billion to EUR 790 billion against the 2019 requirement of 16% of RWA and 6% of LRE, depending on which instruments are considered. The shortfall ranges from EUR 457 billion to EUR 1130 billion when calculated against the 2022 requirement of 18% of RWA and 6.75% of LRE.

This represents less than 2% of the global debt securities market (EUR 80 trillion, of which EUR 4.5 trillion are unsecured bonds issued by GSIBs). The FSB impact assessment notes that market participants estimated that the impact on bond spreads would be about +30 bps, with an increase of funding costs by EUR 195 to 511 million for GSIBs depending on the scenario.

Lastly, the impact assessment looks at the historical losses and recapitalisation needs for a number of global banks (not necessarily GSIBs) during the latest financial crisis and the Japanese banking crisis in the 1990s. Figure 2 shows losses (in terms of total comprehensive income) and recapitalisation amounts for those cases, as % of RWA.

Figure 2: Losses and recapitalisation needs as % of RWA



Source: FSB

In all cases but one a total (Fortis) a loss absorbing capacity of about 18% would have been sufficient to cover losses and recapitalisation needs.

Towards an integrated standard in Europe?

In its communication of November 2015 "*Towards the completion of the Banking Union*" the Commission announced that it would bring forward, by the end of 2016, a proposal for the implementation of the TLAC standard within the agreed deadline (1 January 2019). In addition, according to article 45 of the BRRD, the EBA shall submit by 31 October 2016 a report on the implementation of the MREL, so that the Commission, if appropriate, submit a legislative proposal on the harmonised application of the MREL. Therefore the Commission started designing different options for implementing TLAC and harmonising MREL.

It was reported in the press that on 27 January 2016 the Commission presented to the Commission Expert group on Banking, Payments and Insurance a working document listing three options for implementing the TLAC standard into EU law. According to those reports, the preferred option described in the document was the implementation of TLAC through its integration into level 1 legislation on capital adequacy (Capital Requirement Regulation "CRR", Capital Requirement Directive "CRDIV") and resolution (BRRD, Single Resolution Mechanism Regulation "SRMR"). This "integrated approach" would consist in merging the TLAC requirement and MREL requirement into a single framework, while allowing for a differentiated treatment of bank according to their size and significance:

- the minimum capital ratio would be increased from 8% of RWA to 16% in 2019 and 18% in 2022 for GSIBs; since the Tier 1 requirement would remain at 6% of RWA, this increase could be covered by any combination of Tier 1 and Tier 2 capital;

- the eligibility criteria of Tier 2 capital instruments in the CRR (applicable to all banks, not only GSIBs) would be amended to be compatible with the TLAC standard;

- a similar regime was foreseen for other systematically important institutions, albeit with lower minimum requirements, and smaller banks would only be applied a pillar 2 requirements, with minimum capital requirements unmoved at 8% of RWA.

However it was also reported that the initial proposal did not receive much support, in particular since it ignored the possibility to meet the TLAC requirements with senior debt. The Commission confirmed it was exploring "*appropriate ways to transpose the FSB's TLAC standard into EU law in a manner that articulates well with existing MREL and capital requirements*".

The Commission services circulated another working document in late April 2016 further exploring the preferred option for implementing TLAC. It is reported that the paper "*intended to initiate debate*" and "*does not prejudge the position*" of the Commission.

The main issues regarding the implementation of the TLAC standard are presented below.

Scope of application

MREL requirements could be split into minimum pillar 1 requirements and firm-specific pillar 2 requirements, with pillar 1 MREL requirements set in accordance with the TLAC standard for GSIBs. On top of Pillar 1 requirements, additional firm-specific requirements could be required.

One key issue is whether this regime should be extended to other institutions (for example those institutions which are domestically significant), since European banks are currently only subject to a pillar 2 requirement. Related questions are which minimum thresholds should apply for non-GSIBs, and according to which criteria (significance, size, business model, governance, ...).

Level of application

Since external TLAC requirements apply at the level of a resolution entity (there may be several resolution entities if a group opts for an MPE strategy), while MREL are set on an individual basis, the level 1 legislation could be amended to introduce the concepts of resolution entity/resolution group, so that the same framework apply to all institutions within the EU.

One other related issue is whether the EU should be considered as one jurisdiction, or several ones. The TLAC standard foresees that a minimum amount of internal TLAC[4] should be prepositioned in each material subgroup located in foreign jurisdictions. If the EU is considered as one jurisdiction, existing home-host rules enshrined in the BRRD would govern the cooperation among resolution authorities. In any event, the respective powers of home/host authorities need to be clarified as the regards the prepositioning of internal/external loss absorbing capacity at subsidiary level.

Calibration of the requirements

The calibration needs to be in line with the TLAC as regards GSIBs. If pillar 1 requirements apply to other institutions, the calibration of such requirements would need to be discussed. In addition, an integrated approach could entail the change of the denominator, that is to say that MREL requirements could be denominated as a percentage of RWA or LRE, in line with the TLAC standard.

As to pillar 2 requirements, any proposal would need to clarify the level of discretion enjoyed by the competent authority: according to Bloomberg the Commission services propose that, to set additional pillar 2 requirements, the resolution authority would need to demonstrate that pillar 1 requirements are not sufficient. The report underlines that it raises concerns since it could limit the flexibility of resolution authorities to require higher requirements.

Eligibility of instruments

MREL eligible instruments need to be subordinated to any excluded liabilities, as per the TLAC standard. One important issue is whether, and to which extent, the eligibility criteria of MREL, TLAC and Tier 2 instruments should be aligned in the legislation. One further issue is whether eligibility criteria could differ for those instruments used to comply with pillar 2 MREL requirements: could pillar 2 requirements be met with instruments which are *not* subordinated, since currently the BRRD does not require subordination for MREL?

Supervisory regime

Another field of discussion is the supervisory response to breaches of the requirements. Should a breach in the pillar 2 MREL requirement trigger restrictions on dividends, coupons and bonuses? The pillar 2 MREL requirement may be split between a hard requirement (disclosed to investors, and sitting below capital buffers, which means capital buffers would be breached first and trigger automatic restrictions) and a soft one (confidential guidance).

Deduction of cross-holdings

This is one shortcoming of the MREL framework: if all loss-absorbing instruments were held by other banks then bailing-in those instruments could trigger contagion of financial instability, and the overall loss-absorbing capacity of the sector would not be enhanced. The question is whether holdings of MREL eligible instruments should be deducted from T2 capital or from MREL liabilities, and according to which rules when it comes to the limited exemptions foreseen in the TLAC standard regarding instruments which are not subordinated to excluded liabilities.

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[4] *Internal TLAC refers to loss-absorbing capacity that resolution entities commit to material sub-groups. Those instruments are issued by the subsidiary and held by the resolution entity, and allow for the up streaming of losses to the resolution entity upon resolution.*

Annex A: Eligibility of various classes of financial instruments under MREL and TLAC

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

* If excluded liabilities ranking pari passu are 10% or less

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

Source: BBVA, 2016, page 20.