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FINANCE WATCH POLICY BRIEF
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TLAC/MREL: Making failure possible?

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This note provides an update on recent developments in the area of bank recovery and resolution. It contains a brief primer of the current European Union (EU) bank resolution regime, in particular the "bail-in" tool, and an introduction to the recently published capital standards, TLAC and MREL.

"Bail-in", previously known as "haircut", and generally associated with smoke-filled rooms on crisis-era weekends, has now finally joined polite society. It forms the backbone of TLAC and MREL, the new capital standards for banks currently being introduced in the European Union. Governments and regulators alike are putting their faith in this as-yet-untested instrument, in spite of its technical complexity and known risks. It does not solve the problems of thin capitalisation and contagion risk that have bedevilled the industry for the last decade. What appealed to the banking industry as a "quick fix" at the lowest cost, and to regulators as the lowest common denominator, may be found wanting in the moment of need. It appears that yet another opportunity to properly recapitalise the banking industry and to initiate profound structural reforms is being wasted. How many more of these opportunities will we get?

"… bail-in securities are not the silver bullet. In practice, they will likely make matters worse. If more gold plating of bank capital is what is required, then this fool's gold will not do."

Avinash D. Persaud

Summary

This note provides an update on **recent developments in the area of bank recovery and resolution**. It contains a brief primer of the current EU bank resolution regime, in particular the "bail-in" tool, an introduction to the recently published capital standards, TLAC and MREL, and Finance Watch's assessment of the potential benefits and shortcomings of these initiatives.

TLAC (Total Loss Absorbing Capacity) and **MREL** (Minimum Requirement for own funds and Eligible Liabilities) are regulatory standards which define a minimum amount of own funds and certain debt obligations that must be held by banks to allow them to be restructured or wound up in an orderly fashion in the event of a crisis.

TLAC is a global standard issued by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) in November 2015[1]. It covers only the 30 largest global banks which have been designated "Global Systemically Important Banks" (G-SIBs) by the FSB[2]. Thirteen of these banks are domiciled in the EU[3].

It is not legally binding by itself but G-20 member states which are home to G SIBs are bound to adopt its rules into domestic legislation. From 2019 onwards, **G-SIBs will be required to hold mandatory minimum TLAC levels** equivalent to 16% of risk-weighted assets (RWA) or 6% of total exposure[4], rising to 18% and 6.75% in 2022. In addition to regulatory capital (min. 8% of RWA), TLAC may include subordinated or unsecured senior debt (8 10% of RWA). Capital buffers, which typically range from 2.5 to 6.0% of RWA, are not included and must be covered by additional equity (CET1) capital. TLAC is a mandatory "Pillar 1" requirement under Basel III and will apply to all G-SIBs globally.

MREL, on the other hand, is based on the EU's Bank Recovery and Resolution Directive (BRRD)[5] and legally binding for all banks domiciled in the EU including, but not limited to, G SIBs. **MREL does not impose any mandatory minimum levels** over and above the minimum regulatory capital requirement of 8% of RWA, which is already enshrined in CRR/CRD IV[6], but delegates to the relevant resolution authorities the power to set MREL individually for each bank on a case-by-case basis ("Pillar 2"). Capital buffers are not additive, i.e. CET1 capital used to cover capital buffers may also be counted towards MREL. As a result, the current rules might well justify MREL levels as high as 16-20% of RWA, notably for larger banks, but the baseline for any such exercise effectively remains at a lowly 8% of RWA.

The BRRD framework contains a so called "burden sharing" clause[7], which requires shareholders and other investors of an EU-based bank to contribute at least 8% of all liabilities, including own funds, to the cost of its resolution before any external funding can be accessed, e.g. from the Single Resolution Fund. There is disagreement between the European Commission and EBA currently whether this threshold should be incorporated into MREL as a formal requirement for large banks[8].

Definitions

Global systemically important bank (G SIB) – a banking group whose distress or disorderly failure, because of its size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity. In the EU, G SIBs are known as G SIIs (Global Systemically Important Institutions).

Domestic systemically important bank (D SIB) – refers to financial institutions that due to their size, complexity and interconnectedness pose a disproportionately large risk to the financial system in a particular geography. In the EU D SIBs are known as O SIIs (Other Systemically Important Institutions).

Risk-Weighted Assets (RWA) – the sum of a bank's balance-sheet assets and off-balance-sheet exposures multiplied by a risk weighting for each asset class. Under the Basel III framework, such risk weightings may be fixed ("standardised" approach) or calculated in accordance with banks' own internal risk models ("internal ratings-based" or "IRB" approach).

Total exposure/Exposure measure – the sum of a bank's balance-sheet assets as reported, plus derivatives and other off-balance-sheet exposures. Total exposure is the basis for calculating the leverage ratio under Basel III.

Regulatory capital / Own funds – the sum of Tier 1 and Tier 2 capital. Under the Basel III accord, banks must have regulatory capital / total own funds of at least 8% of RWAs at all times.

Tier 1 capital – common shares and retained earnings (Common Equity Tier 1 or CET1 capital), preference and convertible preference shares, certain contingent convertible bonds (Additional Tier 1 or AT1 capital). Under the Basel III accord, all banks must have CET1 capital of 4.5% and total Tier 1 capital of 6% of RWAs at least at all times.

Tier 2 capital – certain categories of gone concern capital which qualify as regulatory capital / own funds for the purposes of calculating a bank's Basel III capital requirements. They include, in particular, cumulative preference shares, convertible and other subordinated bonds.

Capital Buffer[9] – an amount of capital, usually CET1, that must be held by a bank in addition to its regulatory capital to counter certain specific risks. Buffers may be imposed for certain categories of banks, e.g. G SIBs (Pillar 1) or on individual banks on a case-by-case basis (Pillar 2).

Hybrid security – a category of financial instruments that combine features of equity and debt, e.g. convertible bonds. Hybrid securities are frequently issued by banks to raise Tier 2 capital.

As a result, the current MREL rules are not sufficient to guarantee that EU-domiciled G SIBs will satisfy the FSB's TLAC benchmarks. **MREL rules for European G-SIBs – and, arguably, other banks which are systemically relevant** at the national level – therefore **need to be amended in 2016** to ensure compliance with the FSB's TLAC requirements.

A recent European Commission proposal[10] suggests that the regulatory capital regime for European banks in CRR/CRD IV should be amended to increase the regulatory capital for EU-domiciled G SIBs to 16-18% of RWAs, in line with the TLAC requirements. This could be achieved by aligning the definition of Tier 2 capital in CRR/CRD IV with the FSB's eligibility criteria to create a single new category of TLAC-compliant Tier 2 debt. The minimum Tier 1 capital level would not be altered, so that European G-SIBs would be in a position to satisfy the new requirements by refinancing a part of their current outstanding debt in the course of the next three to seven years with new issues of TLAC-compliant Tier 2 debt.

Eligible liabilities – bank liabilities, such as certain categories of subordinated and unsecured senior debt which does not form part of regulatory capital but can be converted into gone concern capital in the event of the bank entering into resolution, e.g. as part of a bail-in.

Pillar 1 capital requirement – the minimum capital requirements under the Basel III accord, which are mandatory for all banks.

Pillar 2 (capital) requirement[11] – measures under the Basel III accord, in particular additional capital requirements, which are imposed on individual banks by their regulators on a case-by-case basis.

Pillar 3 requirement – regulatory public disclosure requirements under the Basel III accord regarding banks' capital structure, capital adequacy, and risk-weighted assets.

Content

Finance Watch comment

Finance Watch cautiously welcomes the Commission's inofficial draft on TLAC:

- The proposed approach goes some way towards improving the capitalisation of "too big to fail" financial institutions and placing them on a sounder, more resilient footing. Finance Watch has long supported calls for regulatory capital levels of at least 15% of RWA.
- The introduction of a dedicated, TLAC-compliant Tier 2 instrument could offer a way to sidestep some of the complexities regarding the treatment of senior creditors under national insolvency laws, which may cause significant problems with the application of the current bail-in regime under the (BRRD). We maintain convinced, however, that Tier 2 capital remains a far from perfect substitute for Tier 1 capital, which alone is capable of fully absorbing losses without forcing a bank into resolution.

Irrespective of the technical details of implementation, however, TLAC-compliant capital and debt instruments will need to be issued to investors capable of absorbing losses in order to fulfil their intended purpose. If these securities end up being held mainly by other banks, a bail-in at one institution could force the other banks to write down their holdings, potentially triggering a systemic crisis[12]. This issue highlights **the still unresolved conundrum of contagion among "too-big-to-fail institutions"**, since most of the trading in bank securities is done by investments banks – on their own account and on behalf of other large institutional investors, such as insurers and pension funds, which are among banks' biggest funders.

TLAC, and the BRRD resolution regime in general, should therefore **not be** considered as **a valid replacement for long-overdue structural reforms**. Even at the proposed higher capitalisation levels, "too big to fail" banks continue to pose an unacceptable risk as long as market–facing activities are not properly separated from banking operations and other critical services. It would be highly desirable and beneficial for the stability of the financial system to structurally separate trading-oriented banks from commercial ("lending") banks, whose debt they hold and trade, so that investment banks which suffer trading losses do not immediately destabilise the system[13]. The structural requirements associated with TLAC, notably the requirement for eligible debt to be issued by the parent company, could impart new momentum to the stalled discussions about bank structural reform in the EU.

Finally, macro-prudential regulation is needed to address the so-called "regulator's paradox", namely the fact that banks appear to have enough capital in good times but never enough in bad times. To address that we need to curb the excessive pro cyclicality of our financial system.

Macro prudential policies also need to be further expanded beyond banks. There is an urgent need to consider the **systemic relevance of large pension funds and asset managers** that invest in bank debt. Fund managers[14] count, by default, among the largest investors in G-SIB equity and debt. Even if such institutions may be less vulnerable to short-term systemic shocks they still pose a potentially large systemic risk by virtue of the sheer size of their aggregate exposure to the banking sector. As the last financial crisis has proven, "fire sales" of assets by funds responding to sudden outflows of liquidity due to redemptions can become a major vector of contagion. The FSB's provisional conclusion to exclude asset managers from its universe of systemically important "non-bank, non-insurance institutions" ("NBNIs") should be revisited accordingly.

Although the MREL debate appears to have moved on, at least in respect of implementing TLAC for EU based G-SIBs, it is worth restating some of our **concerns regarding the proposed MREL standard**, which remain valid in our view:

- The BRRD's definition of MREL-eligible liabilities is fairly broad and includes, in particular, senior unsecured debt and deposits that are not covered by a guarantee scheme. The treatment of such obligations in resolution or insolvency is governed by the law of the Member states, which often differs materially. The Commission's proposal to impose the use of Tier 2 capital by G-SIBs for covering their TLAC requirements could, and probably should, be expanded to MREL more generally. This would reduce legal uncertainty and maximise the benefits of a harmonised European market for Tier 2 debt.
- MREL affords ample discretion to resolution authorities in setting loss absorption and recapitalisation amounts. It would appear logically consistent and prudent to formally link the loss absorption amount to the regulatory capital requirement, including capital buffers and Pillar 2 requirements, as it is already outlined in CRR/CRD IV. If liquidation by way of an ordinary insolvency is not considered practicable it would also appear sensible to impose a minimum recapitalisation amount to secure "breathing space" for the implementation of the resolution plan.

Background: Bank resolution and "bail-in"

Ever since the financial crisis of 2008 global regulators have been grappling with one key question: how can a large international bank be allowed to fail without triggering a "systemic" domino effect or forcing a taxpayer-funded bail-out? The crisis has demonstrated conclusively that national insolvency procedures could not be relied upon to provide a satisfactory outcome: the uncoordinated insolvency and liquidation of individual entities or sub-groups at the national level increased the likelihood of systemic contagion by crystallising losses in other financial institutions which were connected to the failing bank. It also ruled out alternative approaches, such as the creation of a "bad bank", which could have produced a more equitable treatment of creditors and reduced aggregate losses for all creditors and taxpayers. Finally, it caused disruption to essential services provided by the failing bank, such as payments, which could have been mitigated or avoided altogether if the relevant operations of the bank had been separated.

The **concept of bank "resolution"**, first outlined in detail by the Financial Stability Board (FSB) in October 2011[15], provides a toolkit for authorities to first stabilise and then restructure, or wind up, a failing bank in order to ward off the potential systemic shock of a sudden collapse, shield taxpayers from the cost of a bail-out and, in general, minimise the aggregate cost to bank investors and the general public. These tools include, in particular, the sale of some or all of a bank's assets and/or operations, the creation of a "bridge institution" or "bad bank" and, perhaps most controversially, the "bailing-in" of certain classes of debtholders and uninsured depositors.

The EU's Bank Recovery and Resolution Directive (BRRD), published in May 2014, sets out the relevant regulatory regime for all EU-domiciled banks. At its core, it requires every bank to have in place a "resolution plan" (also known as a "living will" in the U.S.), which set out in detail how they could be restructured and/or liquidated in an orderly way in the event of a crisis. The resolution plan identifies which entity/ies within a corporate group the resolutions tools would be applied to and describes the choice and proposed implementation of resolution tools (and/or other options, such as liquidation) in respect of these entities. BRRD also enables resolution authorities to impose the write-down and/or conversion into equity of a bank's (AT1 and Tier 2) capital in the event of a crisis, even before the bank is placed into resolution. Responsibility for the preparation and implementation of resolution plans lies with the respective resolution authorities. These are either national resolution authorities (NRAs)[16] or, for the 144 Eurozone banks which are within the scope of the Single Resolution Mechanism, the Single Resolution Board (SRM)[17].

Resolution entity – a legal entity within a banking group which becomes the legal object of the resolution tools applied by the resolution authority.

Single Point of Entry – a resolution strategy whereby only the holding company of a banking group is put into resolution. Losses of operating companies at the subsidiary level are covered by capital that is down-streamed from the holding company so that losses are concentrated and crystallised at the top level of the group. Resolution tools, such as bail-in, are applied at the level of the holding company only.

Multiple Points of Entry – a resolution strategy where multiple entities within a banking group are designated as resolution entities. Resolution tools are applied at different levels within the group.

Single Resolution Mechanism (SRM) – an umbrella term for the legal and institutional framework which governs the resolution of major financial institutions in the Eurozone. It is based mainly on the BRRD and comprises the Single Resolution Board, as its central decision-making body, and the Single Resolution Fund, a dedicated institution funded by contributions from the banking sector, which has been created to provide a financial backstop for the resolution of failing banks.

Bail-in – a resolution mechanism which enables regulators to impose a mandatory write-down or conversion into equity of certain eligible liabilities so that bondholders, (uninsured) depositors and certain other creditors are made to participate in covering the bank's losses. Bail-in may be triggered when a bank is expected to breach its going-concern capital requirements, i.e. becomes insolvent.

Going concern capital – permanent capital of the bank that is subordinated to all other categories of capital, creditors and depositors and first available to absorb the losses incurred by the bank in the ordinary course of business, i.e. while it is solvent and trading, as well as in insolvency and/or resolution. Going concern capital consists of Tier 1 capital, as defined by the Basel III framework.

Gone concern capital – other capital instruments which are not permanent, i.e. they are repayable at maturity, and have an original term of at least 5 years. They are subordinated to other creditors and depositors and are designed to be written down or converted into equity in the event of the bank entering insolvency or resolution. Gone concern capital includes, but is not limited to, Tier 2 capital.

Solvency – the ability of a company or financial institution to meet its long-term financial obligations. Solvency is the key legal criterion for a financial institution to continue operating.

Liquidity – the ability of a company to meet its short-term financial obligation. Liquidity is the de-facto criterion for a financial institution to continue operating: if a bank is faced with a sudden withdrawal of deposits or fails to refinance maturing debt, it may not be capable of honouring such outflows in a timely manner due to a lack of liquid assets and therefore cease operating, even if fundamentally solvent.

Residual maturity requirement – the minimum remaining term to redemption of a bond or loan to qualify for inclusion into TLAC or MREL (one year in both instances). The objective is to exclude liabilities which will fall due in the course of the current year and which may not be refinanced if the financial institution is already in trouble.

There are different approaches towards resolution, depending on the legal and operational structure of the financial institution, its geographical scope, business model and range of activities. Resolution strategies can either concentrate on the parent company of the group as the sole resolution entity ("single point of entry", SPE) or, particularly in the case of large multi-national groups, sub-divide the group into several – geographic and/or functional – resolution entities, which could be resolved individually and separately ("multiple point of entry", MPE). The "single point of entry" approach, with a non-operational holding company at the top of the group, is generally considered the simplest and most practicable approach, a view shared by the FSB, the European Parliament and many academics. It places responsibility for executing the resolution plan with the resolution authority of the parent company's home country. Many European banking groups have, however, developed more complex group structures and are therefore more likely to adopt a "multiple point of entry" approach, which relies to a much larger degree on a seamless co operation of home and host country authorities and is therefore more prone to procedural delays and more vulnerable to conflicts of interest.

The **"bail-in" tool** is the most significant new addition to the portfolio of resolution tools. It enables regulators to impose a **mandatory write-down or conversion into equity of certain eligible liabilities** so that bondholders, (uninsured) depositors and certain other creditors are made to participate in covering the losses of a bank that is close to failure. The primary purpose of this tool is to create a layer of "gone concern capital" that can be mobilised to absorb losses, stabilise and, if needed, recapitalise the bank once its "going concern" (Tier 1) capital has been depleted so that the economic risk is shared between the bank's investors instead of being transferred to taxpayers. The secondary objective of "bail-in" was to achieve this at the lowest possible cost to financial institutions, i.e. not in the way of substantially raising the requirements for regulatory (Tier 1 and 2) capital, which is loss-absorbing by definition and therefore carries a higher cost of capital, but by allocating some of the default risk to other obligations, such as bonds, which would have a claim to full repayment under normal insolvency law.

As a result, "bail-in" involves a **wholesale restructuring of the equity and liabilities side** of a bank's balance sheet, most likely at a moment of intense time pressure and when the bank's financial condition is precarious and in a state of flux. At the same time, the process is subject always to the condition that "bail-in" cannot place any creditor in a position worse than if the bank had been put into liquidation. This becomes especially difficult when certain categories of senior unsecured debt, which may be eligible for "bail-in", rank equal in the hierarchy of creditors' claims with other claims that relate directly to the bank's operating business, e.g. suppliers, which cannot be "bailed in". Since the implementation of the "bail-in" tool in the EU continues to be the domain of national legislation, any decisions to re-shuffle creditors' claims, in particular to decide which creditors may be safely "bailed in", need to be taken individually – and with potentially **different outcomes** – for each Member state[18].

For "bail-in" to fulfil its intended purpose, banks will need to issue appropriate equity, debt and hybrid capital instruments to investors who are capable of absorbing losses. Most of the trading in bank securities is, however, done by investment banks – on their own account and on behalf of other large institutional investors, such as insurers and pension funds. If securities that are eligible to be "bailed in" end up being held mainly by other financial institutions, a bail-in at one of them could force the other institutions to write down their holdings, once again triggering a systemic crisis[19]. It is uncertain, therefore, whether "bail-in" is an effective way of solving the **problem of contagion among "too-big-to-fail institutions"**. It is equally questionable, whether "bail-in" would be more successful in achieving its other objective, to protect ordinary citizens, savers and taxpayers, from being saddled with the cost of "bailing out" failing banks. If bonds susceptible to bail-in are sold to retail investors, the general public would once again end up underwriting the losses of too-big-to-fail institutions – only that this time it would be with their personal savings rather than taxpayers' money[20]. It is true, of course, that this risk may be mitigated, e.g. by properly supervising the placement of such instruments with retail customers and by prominently disclosing potential "bail-in" risks. New issues of securities eligible for bail-in need to be accompanied by adequate, and prominent, disclosure of risk factors[21]. Precedents so far, e.g. in the case of the rescue of four regional savings banks in Italy in November 2015[22], do not augur well that ordinary citizens and savers can be shielded effectively from the fall-out of a "bail-in".

Whether even a thoroughly prepared resolution plan can be executed successfully and in an orderly manner under these circumstances still remains to be seen. In our view, **"bail-in" is a poor substitute for a bold and decisive increase in banks' regulatory capital requirements**. It seeks to replace genuine "gone concern" capital – which already exists in the Basel III framework in the shape of Tier 2 capital – with a cumbersome, risky and uncertain process of balance sheet restructuring. The alleged benefit of this, lower funding costs for the banking sector, remains to be proven – if anything it is likely to be temporary at best.

Background TLAC

After extensive consultation the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) published, on 9 November 2015, their principles and term sheet for Total Loss Absorbing Capacity (TLAC) of global systemically important banks (G SIBs). TLAC sets a minimum level of capital and liabilities – 16% of RWA or 6% of total exposure initially, rising to 18% and 6.75% in 2022 – which must be available for resolving and recapitalising a bank in a crisis. It will come into force in 2019 and apply to **13 European banking groups currently designated as G SIBs** by the FSB[23].

As with other FSB/BCBS standards, TLAC is not legally binding by itself but has to be **transposed into legislation at the national – or European – level**. In order to ensure compliant implementation of the TLAC framework for EU-domiciled G SIBs, current EU Level 1 legislation (CRR/CRD IV and BRRD) and the Level 2 Regulatory Technical Standard (RTS) will therefore need to be amended in 2016.

The principal impact of TLAC for European banks will be on two levels:

- EU regulators are obliged within the FSB framework to implement TLAC for European G SIBs into mandatory EU/national legislation;
- overseas subsidiaries of European G SIBs, in particular in the U.S., will be subject to TLAC requirements in their host countries (e.g. regarding internal TLAC levels and pre-positioning) and be required to conform with the respective national interpretations of the framework.

The FSB's TLAC standard favours a **"single point of entry"** approach to resolution. In order to balance the interests of the home country resolution authority, which will be in charge of the resolution entity in the event of crisis, and host country authorities in other countries where the group has significant operations, the standard provides for specific mechanisms, which should ensure that eligible liabilities held by these foreign subsidiaries may be bailed-in by the resolution authority of the relevant parent company/resolution authority.

To ensure that capital can be made available at the parent company level in the event of resolution, TLAC includes a requirement for significant sub-groups, e.g. foreign subsidiaries, to maintain **"internal TLAC"**, i.e. TLAC-eligible capital and liabilities, which amount to at least 75-90% of what that sub-group would have to provide if it were itself a resolution entity. The internal TLAC **must be "pre-positioned"** on the balance sheet, i.e. rank above other creditors of that sub-group, so that it is available to absorb losses when resolution measures, such as a bail-in, are taken at the parent company level.

To prevent contagion, the FSB standard requires G-SIBs to **deduct any holdings of TLAC-eligible securities issued by other G-SIBs** from their own TLAC requirement. The FSB has tasked the BCBS to further specify this provision and to consider extending its applicability to other banks which are not G-SIBs.

TLAC also sets out a number of supporting measures, which EU domiciled G-SIBs would need to comply with. To facilitate bail-in, G SIBs would have to have issued at least 33% of their TLAC in the form of long-term subordinated or senior unsecured debt. In addition, debt securities would be TLAC-eligible from 2022 onwards **only if issued by a resolution entity** (i.e. parent or sub-group holding company).

As a result, European banks will need to issue significant amounts of fresh TLAC/MREL-compliant debt. Estimates of the potential MREL shortfall vary widely depending primarily on the treatment of senior unsecured debt for MREL purposes, which depends largely on national legislation[24]. The Basel Committee on Banking Supervision (BCBS) is expected to introduce new "Pillar 3" disclosure rules requiring banks to provide key information on their resolution plans so as to enable investors to correctly price these newly issued debt instruments.

TLAC: Finance Watch comment

In our view, TLAC represents a major step towards improving the capitalisation of "systemically important" banks. There are nevertheless some shortcomings:

- The method of **calculating TLAC using both RWA- and leverage-based methods** could create incentives for banks to 'game' these metrics. While the leverage ratio is based primarily on reported numbers and is therefore less flexible, RWA, in particular when calculated under the Advanced Internal Ratings-Based (A-IRB) approach, is more susceptible to subjectivity. In order to reduce their TLAC, banks that currently have a lower risk profile (RWA density below 37.5%) may be encouraged to "optimise" their RWA profile and/or make adjustments to their business model that expose them more to higher-risk activities[25].

- The TLAC standard recognises and aims to contain the macro-prudential risk of triggering contagion if the debt of a systemically important institution is bailed in. So far, however, only G-SIBs are asked to deduct **cross-holdings of TLAC-eligible capital and liabilities** from their own TLAC requirement. This rule should arguably be **extended to all banks** by way of an amendment to the Basel III capital adequacy regime introducing a specific, higher risk weight to exposures to TLAC eligible securities issued by G-SIBs.

- **Investment banks**, which handle most of the trading of TLAC-eligible securities, are often members of a G SIB group themselves and therefore a potential **vector of contagion**. In order to maintain their capacity to place and make markets in TLAC-eligible instruments for themselves and other G SIBs they should be organised as a **separately capitalised entity,** apart from the commercial banking operations and other critical services of their group.

- In addition to own funds and subordinated debt, TLAC-eligible liabilities include **senior unsecured debt**, provided it is subordinated to the claims of other senior creditors that are explicitly excluded from bail-in (e.g. guaranteed deposits, tax obligations and similar privileged creditors). The **method of subordination** (statutory, structural, contractual) is **left to national legislators' discretion**. As mentioned above this approach has the potential to cause a significant amount of **fragmentation and legal uncertainty**. Given that the Basel III framework already has clearly-defined categories for "gone-concern capital" – in the shape of Tier 2 capital – it would appear the logical instrument of choice for banks to fund TLAC.

Advanced Internal Ratings-Based (A-IRB) approach – a method of assessing credit risk defined by the Basel III accord which permits banks, with the approval of their local regulators, to develop and apply their own empirical models to analyse credit quality and exposures and quantify capital requirements accordingly.

RWA density – a measure of the average risk of the credit exposure of a bank. It is calculated by dividing RWA by total exposure (see above). If TLAC is defined as the higher of 16% (18%) of RWA or 6% (6.75%) of total exposure, TLAC for banks with RWA density below 37.5% is determined by the leverage ratio criterion, whereas the RWA criterion becomes the main determinant when RWA density exceeds that level.

Background: MREL

An essential precondition for resolution plans to be meaningful is that the bank has sufficient equity and debt capital at all times for the proposed plan to be implemented. In the EU, **Art. 45** of the **Bank Recovery and Resolution Directive (BRRD)**[26] calls on Member States to impose on their banks minimum requirements for own funds and eligible liabilities (MREL), which are to be specified by the European Banking Authority (EBA) by way of a **draft Regulatory Technical Standard (RTS)** and adopted by the Commission as a Delegated Act under Art. 10 EBA Regulation[27]. The MREL framework is legally binding for all banks domiciled in the EU including, but not limited to, G-SIBs. In addition to setting a minimum threshold, MREL is meant to ensure that a bank's external funding, in particular its debt instruments, are structured in such a way that its resolution plan, and "bail-in" arrangements can be implemented.

The draft RTS (MREL RTS) was published by the EBA in July 2015[28], following extensive consultation[29] and submitted to the Commission for approval. It emerged subsequently that the Commission had put forward a number of amendments to the draft RTS, which were opposed by the EBA. A revised EBA draft[30] is now under review by the Commission, which is due to comment by the end of March 2016.

Loss absorption amount – the amount of a bank's own funds and eligible liabilities available to absorb unexpected losses. In general, this would be commensurate with the institution's minimum regulatory capital (Pillar 1 and 2), as defined by applicable law and the competent supervisory authority.

Recapitalisation amount – an additional amount of own funds and eligible liabilities, specified by the competent resolution authority, which is deemed sufficient to a) stabilise the failing institution while the resolution plan is being executed and b) ensure, if appropriate, that it meets the minimum capital requirements for having its licence restored when emerging from resolution.

National competent authority (NCA) – the regulatory body charged with, and responsible for, licensing and supervising financial services, e.g. banking, in a particular jurisdiction.

"Clean holding company" – the parent company of a group, e.g. a bank holding company, funded by own capital and other TLAC-eligible liabilities but prohibited, in particular, from issuing short-term external debt or derivatives. A clean holding company does not conduct banking business

MREL consists of **two components**, a **loss absorption amount**, which should be sufficient to cover all of the bank's losses up to and during resolution, and a **recapitalisation amount**, which should allow the bank to re-enter the market post-resolution, if appropriate.

The RTS does **not itself specify a universally binding minimum level** of loss-absorbing capital. Instead it restates the regulatory capital, as defined by the CRR (8% of RWA)[31], as a lower boundary[32] and effectively defers to the respective resolution authorities[33] to set any incremental requirements based on the resolution plan, granting them significant discretionary power in the process.

For the recapitalisation amount, the RTS again does not specify a binding minimum but indicates, as a starting position, that it should be equal at least to the regulatory capital, i.e. an additional 8% of RWA, so that the bank satisfies the criteria for having its licence restored post-resolution. It does, however, accord ample discretion to the relevant resolution authorities to adjust these requirements on a case-by-case basis, upwards as well as down – including all the way to zero if the authorities are confident, based on the resolution plan, that the bank may be liquidated safely. Equally, the authorities may waive CRD IV buffer requirements if the resolution plan foresees a restructuring of the group that would result in its surviving entities no longer being "systemically relevant". If deposit guarantee schemes are expected to contribute to the financing of the proposed resolution strategy, the potential amount of such contribution may also be deducted from MREL.

Overall, the RTS does not impose a universal mandatory minimum level for the total MREL requirement but delegates to the relevant resolution authorities the power to set MREL individually for each bank. In sum, total MREL under the current rules is subject only to the minimum regulatory capital requirement of 8% of RWA, which is already enshrined in CRR/CRD IV[34] and therefore, by default, also the minimum loss absorption amount.

For **systemically relevant institutions (G-SIBs and D-SIBs)** the draft RTS requires the resolution authority to confirm, as part of its assessment of MREL, that the bank's resolution plan is compatible with the **"burden sharing" clause of Art. 44/5 BRRD**. This provision requires that investors (shareholders and bondholders) of a failing bank be obliged to contribute no less than 8% of total liabilities and own funds to the cost of resolution before any external funds, e.g. the Single Resolution Fund, can be accessed. This test was removed by the Commission on the grounds that it may be seen as introducing a general minimum MREL, at the level of 8% of total liabilities and own funds, for G SIBs and D-SIBs. The EBA argues, in our view correctly, that this is not the case because the resolution authority is still free to set a lower MREL at its discretion. It is also correct that the resolution authority is mandated specifically by the BRRD to ensure that the "burden sharing" conditions are met whenever a bank's resolution plan involves access to external resolution funding.

MREL levels for individual EU banks could potentially be as high as 20% of RWAs (e.g. for a G-SIB) or as low as 8% (if the bank in question is not seen to be posing any systemic risk and may credibly be liquidated). Given this amount of discretionary latitude, the **current MREL rules are not sufficient** to guarantee that EU-domiciled G SIBs will satisfy the FSB's TLAC benchmarks. MREL rules for European G-SIBs – and, arguably, other banks which are systemically relevant at the national level ("Domestic Systemically Important Banks" or D SIBs) – therefore **need to be amended** in the course of 2016 to ensure compliance with the FSB's TLAC requirements.

MREL: Finance Watch comment

As discussed in previous Finance Watch publications[35], the EU's current MREL rules contain shortcomings, which have the potential to significantly detract from the effectiveness of the instrument:

- The **wide margin for discretion** accorded to the resolution authorities does not guarantee the consistent application of the rules across Members States and offers few safeguards against the acknowledged risks of home bias and regulatory capture, two issues that have long bedevilled financial regulation in Europe. The approach runs very much counter to the stated objective of achieving an appropriate degree of convergence across Member States[36].

- Although ultimately denominated as a percentage of total capital and liabilities, the **calculation of MREL still relies on RWA** as its base, despite the known flaws of that method as a measure of G-SIB resilience[37]. A measure based on the leverage ratio[38] has been introduced as a supplementary benchmark. This is welcome, in principle, as it uses a simpler metric that is less susceptible to subjectivity. Since the leverage ratio is not yet a binding ("Pillar 1") capital requirement for European banks under CRR/

CRD IV it does not, however, set a mandatory floor. In addition, as mentioned previously[39], the co-existence of RWA- and leverage-based methods could create additional incentives for banks to 'game' these metrics by 'optimising' their RWA profile and/or making adjustments to their business model which expose them more to higher-risk activities.

- The BRRD's **definition of MREL-eligible liabilities[40] is fairly broad** and not limited to own funds and subordinated debt. The possible inclusion of senior unsecured bondholders, in particular, may create issues: since their legal claims rank equal to other senior unsecured claims in the event of a liquidation, they would, if bailed in, suffer a different and less favourable treatment than other creditors in the same category. This would violate the underlying principle of the bail-in instrument that creditors shall be left no worse off following the application of the bail-in tool than they would have been in insolvency[41]. Because of different legal frameworks across Member States there are **divergent approaches towards dealing with senior unsecured creditors** in an insolvency[42], which complicates the creation and implementation of resolution plans and could, in the event, materially reduce the effectiveness of the bail-in instrument.

- NRAs are not obliged to assess whether the proposed level of MREL for a G-SIB or other systemically important institution (D-SIB) would be sufficient for the institution to qualify for resolution funding[43] as long as the resolvability assessment returns a positive conclusion[44]. This represents a significant shortcoming, in our view, as it breaks the direct link between the calibration of MREL and the objective of insulating third parties from the effects of bank failure. It would be the resolution authority's responsibility, arguably, to ensure that the conditions for accessing the 'safety net' of a resolution fund are respected at all times so that these tools can be reliably applied in a crisis, as intended. This applies, particularly, in the case of G-SIBs or D-SIBs. We do not share the Commission's view that the EBA's draft RTS implicitly imposes a harmonised MREL of 8%, merely by mandating resolution authorities to apply the "burden sharing" test. Whereas we accept that a harmonised minimum level of MREL, although desirable in principle[45], may not be introduced in the RTS[46] we nevertheless support the EBA's opinion that **compliance with the "burden sharing" requirement** should be at least reviewed ex-ante as part of the MREL assessment process.

- Whereas both BRRD and the MREL RTS recognise, in principle, the macro-prudential risk of triggering contagion if the debt of a systemically important institution is bailed in[47], there still appears to be a reluctance to accept, and act upon, the **need for structural measures** to contain precisely these risks. Finance Watch has long argued that investment banks, which hold and trade large volumes of bank debt, should be capitalised separately and separated structurally from deposit-taking banks and bank entities which provide essential services.

- MREL does not explicitly require banks to adopt structural measures that would make resolution more straightforward and protect critical functions. Whereas BRRD contains a statutory mandate for the authorities to enforce the writing-down or conversion of liabilities[48] and thus allows for pushing up losses to the respective parent company, it does not contain any provisions that require banks **to shift critical functions into structurally separate units** or to create "clean holding companies"[49], which would facilitate swift and transparent resolution at the holding/parent company level in a "Single Point of Entry" (SPE) scenario.

Background – The U.S. Approach to TLAC

On 31 October 2015, the Federal Reserve published draft TLAC standards for domestic U.S. bank holding companies and the U.S. operations of foreign-owned banks (Intermediate Holding Companies, IHCs). Perhaps significantly for EU-domiciled banks, the proposal would allow the Federal Reserve to **treat the U.S. operations of overseas banks as G-SIBs** for purposes of TLAC if they are deemed 'systemically relevant'. In this case the IHC of a foreign bank which has not been designated as a G-SIB itself by the FSB could still be subject to TLAC requirements in the U.S.

On 30 October 2015, the U.S. Federal Reserve issued a consultation draft of its own implementation of the FSB's TLAC rules for eight U.S.-domiciled G-SIBs[50]. The proposed standards are **more stringent than the FSB's benchmark** in several respects:

- For U.S. G-SIBs, the proposed minimum TLAC requirement would be the higher of 18% of RWA (vs. 16%) or 9.5% of total exposure (assets) (vs. 6.0-6.75%);

- For foreign-owned IHCs, the minimum TLAC requirement would be 16% and 6.0% if the IHC is part of an SPE group and would not itself enter resolution, otherwise 18% and 6.75% (for MPE groups where the IHC would itself be a resolution entity).

- U.S. G-SIBs (and foreign-owned banks operating in the U.S. deemed as 'systemically relevant' by the Fed) would be required to implement a (U.S.) corporate structure with a "clean holding company" at its top to facilitate the implementation of an SPE approach in resolution.

- Eligible debt instruments would be:
  - ➔ issued directly by the respective parent company under U.S. law;
  - ➔ unsecured and 'plain vanilla' (e.g. no embedded derivatives);
  - ➔ subject to 50% haircut if their residual maturity falls below 2 years.

- U.S. G-SIBs would be required to have a minimum of TLAC-eligible, external long term debt equivalent to 4.5% of total assets in issue at all times (3% for foreign-owned IHCs).

Consultation on this draft has now closed and a revised/final draft is expected in due course. U.S.-domiciled G-SIBs would have to comply by 2019.

The U.S. TLAC approach – Finance Watch comment

The proposed U.S. TLAC regime is a draft and subject to consultation. Any comments at this stage should therefore be suitably caveated.

The proposed standard are more stringent than the FSB's benchmark in several respects:

- For U.S. G-SIBs, the proposed minimum TLAC requirement would be the higher of 18% of RWA or 9.5% of total exposure (assets), i.e. the second, leverage-based criterion sets a higher TLAC baseline for institutions with lower RWA density (below 52.8%)[51]. The decision to shorten the transition period for domestic G-SIBs, who now have to meet the 18% level by 2019, instead of 2022, should be welcomed and would be testimony of U.S. regulators' confidence in the capitalisation of their domestic G-SIBs. The **higher leverage based requirement** raises the bar overall and may decrease the incentive for banks with a lower-risk profile to "optimise" RWA, and thus TLAC, by shifting towards higher-risk activities.

- The requirement for **both U.S. and foreign G-SIBs** to implement a (U.S.) corporate structure with a "clean holding company" at its top, which would also be the issuer of external TLAC-eligible debt, is in line with U.S. authorities' established practice to seek to "ring fence" the **U.S. operations of foreign G-SIBs** so that a U.S. authority would be in control of eventual resolution proceedings.

- The **"clean holding company" requirement** could be seen as a (limited) step towards structural segregation of banking activities. Its primary objective is, of course, to facilitate an SPE approach to resolution. As a corollary, however, and in conjunction with the requirement of external TLAC being issued by the resolution entity/ies, it has the potential to encourage the kind of structural separation of market-facing activities from banking and other critical services that Finance Watch has been advocating for some time.

Recent developments and next steps

At the beginning of February 2016 a working document drafted by the European Commission set out a **proposal for harmonising the TLAC and MREL frameworks**[52], which is currently under review by the Member States. The proposal presents, as its preferred option, an integrated approach which would incorporate the TLAC requirements for G-SIBs into the regulatory capital rules set out in CRR/CRD IV and the MREL regime as a separate (Pillar 2) framework which governs, in particular, the resolution of smaller financial institutions.

The Commission draft proposes, in particular:

- **CRR would be amended** to increase the minimum level of regulatory capital/own funds for EU-domiciled G-SIBs from 8% of RWA today to 16% by 2019 and 18% by 2022, in line with TLAC requirements.

- There would be no change to the minimum level of Tier 1 "going concern" capital (6% of RWA), i.e. the proposed increase (8-10% of RWA) could be covered entirely by Tier 2 or by any combination of **Tier 1 and Tier 2 capital**.

- The criteria for Tier 2 capital in CRR would be modified and **aligned with TLAC requirements** so as to create a single category of TLAC-compliant Tier 2 capital instruments. This change would not be limited to G-SIBs but apply to all EU banks.

- The proposed regime could be extended to other systemically important financial institutions, such as D-SIBs, possibly with a lower target level than that for G SIBs.

MREL would remain as a "Pillar 2" measure and serve mainly as a flexible framework for evaluating and regulating the capital needs of smaller banks, which are not deemed systemically relevant, on a case-by-case basis.

Recent developments – Finance Watch comment

Finance Watch cautiously welcomes the Commission's proposal, which has the potential of remedying some of the main shortcomings of the current MREL framework:

- By limiting TLAC-eligibility to regulatory capital, i.e. Tier 1 and 2 instruments, this proposal would go a long way towards putting "too big to fail" G SIBs on a sounder, more resilient footing. Finance Watch has long supported calls for regulatory capital levels of at least 15% of RWA[53].

- By concentrating the burden of loss absorption and recapitalisation on holders of Tier 1 and 2 capital instruments this approach would oblige banks to create a large pool of subordinated liabilities to be bailed-in in the event of a crisis. This, in turn, would reduce the risk to senior creditors and alleviate some of Member States' concerns about the need to redesign insolvency procedures and creditor hierarchies to allow for the bailing-in of unsecured senior debt.

- The introduction of a TLAC-compatible category of Tier 2 capital would also pave the way towards the creation a large, liquid market segments of transparent, easy for investors to benchmark and price.

The forthcoming review could also be viewed as an opportunity not only to reconsider and tighten the relevant Level 1 and 2 provisions for G-SIBs but also to strengthen regulatory co-operation and convergence between two important jurisdictions and improve the stability and resilience of the banking sector at the global level without compromising the competitive position of EU-domiciled G-SIBs vis à vis their U.S. counterparts.

TLAC, and the BRRD resolution regime in general, should, however, not be considered as a **valid replacement for long-overdue structural reforms**. Even at the proposed higher capitalisation levels, "too big to fail" banks continue to pose an unacceptable risk as long as market–facing activities are not properly separated from banking and other critical services.

MREL and TLAC – Factsheet

MREL has been introduced ahead of the publication of final TLAC guidelines by the FSB. The two frameworks differ in a number of aspects, as explained below. These differences can be explained largely by the underlying assumption that G-SIBs will, in most conceivable instances, need to be stabilised by way of a bail-in to maintain stability at the systemic level until they can be resolved in an orderly way. They will therefore need to be equipped with an adequate level of capital and debt eligible for bail-in. Smaller banks, by contrast, may be restructured or liquidated immediately and thus not require to maintain funding reserves for a restructuring or recapitalisation.

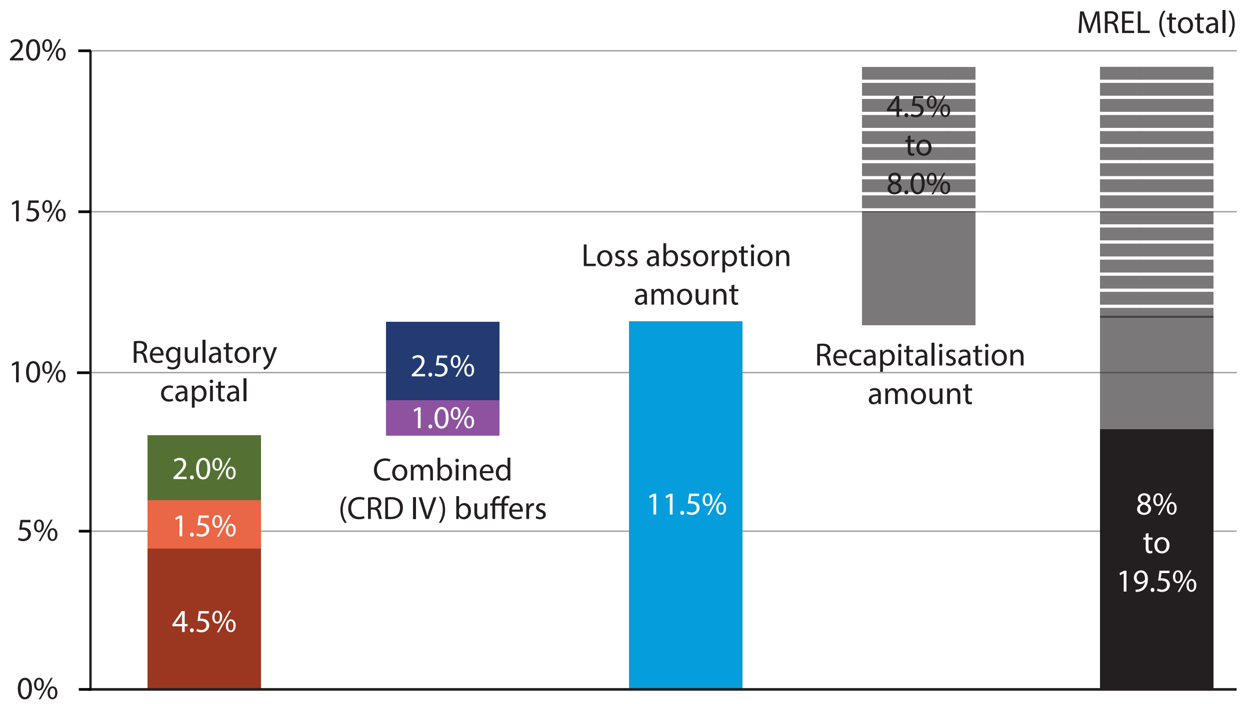
	TLAC	MREL
Legal quality	• TLAC is not legally binding but has to be transposed into EU/national law. As a "Pillar 1" measure under the Basel III regime it is, however, designed to be implemented in all participating states as a compulsory general rule, albeit limited to G-SIBs. • TLAC specifies binding minimum levels, which effectively impose a floor on the SRB/NRAs when assessing MREL for EU domiciled G-SIBs.	• As an EU Regulation, the MREL RTS, once formally adopted, will be legally binding and directly applicable for all EU-domiciled banks.
Timing	• TLAC is to be phased in by 2019, with a step-up in 2022	• MREL will be applicable as of 2016.
Scope of application	• TLAC applies to the designated "global systemically important banks" (G-SIBs) only. There are currently 30 G-SIBs, of which 13 are domiciled in the EU.	• MREL applies to all EU-domiciled banks[54], regardless of size, including, but not limited to, G-SIBs. • All Eurozone G-SIBs are under the direct supervision of the ECB (Single Supervisory Mechanism, SSM) and therefore resort to the Single Resolution Board (SRB) for resolution purposes.

	TLAC	MREL
Principal features	Minimum loss absorption amount, defined as a percentage of RWA: • 16% of RWA (by 2019), rising to 18% of RWA (by 2022) and subject to a minimum of • 6.0% of total exposure[55] (by 2019), rising to 6.75% (by 2022); consisting of: • regulatory capital (Tier 1 and 2) – min. 8% of RWA; • other TLAC-eligible instruments, such as subordinated and senior unsecured debt (min. 33% of total TLAC). Applicable Basel III buffers, in particular the "capital conservation buffer"[56] and the "G-SIB buffer"[57] are excluded, i.e. must be met in addition to the TLAC amount. TLAC-eligible instruments: • must be issued directly by the resolution entity/ -ies (from 2022 onwards); • must be unsecured and formally subordinated to excluded liabilities; • must be non-redeemable prior to maturity, except with supervisory approval; • explicitly exclude certain instruments, e.g. secured creditors and structured notes. Internal TLAC: • represents a portion of the resolution group's total TLAC which is allocated to subsidiaries which are not themselves resolution entities; • must be held for each 'material sub-group' of the resolution entity; • must amount to 75-90% of the theoretical external TLAC that would be required if that sub-group were itself a resolution group; • must be 'pre-positioned' on-balance sheet at the respective sub-groups, i.e. TLAC-eligible liabilities must be available to execute the proposed cross-border resolution strategy. TLAC represents a "Pillar 1" minimum requirement for all G-SIBs.	Minimum loss absorption amount determined by the SRB/NRAs individually for each institution, based on its resolution plan and a general set of criteria set out in Art. 44/6 BRRD. MREL comprises: • a loss absorption amount, equivalent to ➔ regulatory capital (Tier 1 and 2) – min. 8% of RWA; ➔ combined CRD IV buffer requirements[58], typically between 2.5% and 6.0%; ➔ 'Pillar 2' capital requirements (imposed by the competent supervisory authority on individual institutions on a case-by-case basis); and subject to ➔ the leverage ratio-based capital requirement (once enacted); and/or ➔ the (transitional) Basel I 'floor' (until 2018); • a recapitalisation amount (up to 8.0%), to be set in line with the resolution plan, that would be sufficient for the re-authorisation of the surviving entity, equivalent to ➔ regulatory capital (min. 8% of RWA) plus 'Pillar 2' requirements; and ➔ any additional amount necessary to 'maintain sufficient market confidence after resolution' (as a starting point, this would equate to the combined CRD IV buffers). The appropriate level should be assessed by the resolution authority based on a comparison with 'peer institutions'. The combined buffer requirement is not additive, i.e. capital covering the buffers may be double-counted towards the overall MREL amount. The resolution authority may reduce (or even completely waive) the recapitalisation amount at its own discretion, in particular if the institution could be liquidated under normal insolvency proceedings. In addition, G-SIBs should meet the requirements for access to resolution funding (i.e. 'floor' of 8% of total assets / 20% of RWA as required by Art. 44/5 and 44/8 BRRD) (Art. 5/1 MREL RTS). This requirement, too, may be waived by the NRAs under certain conditions (Art. 5/2 MREL RTS)[59]. Art. 45/13 BRRD provides the SRB/NRAs with an option to impose a mandatory minimum level of contractual bail-in instruments on a case-by-case basis. These instruments would have to be formally subordinated and eligible for write-down/ conversion. MREL is currently construed as a "Pillar 2" measure: it sets individual requirements for each bank, based on its resolution plan.

	TLAC	MREL
Technical discrepancies	• The calibration of TLAC is based firstly on RWA, with the leverage ratio as a secondary metric. • TLAC does not include buffers and Pillar 2 requirements; CET1 buffers for G-SIBs (1.0-3.5%), set by the FSB, will apply on top of TLAC requirements. • TLAC specifically requires eligible instruments to be formally subordinated to excluded liabilities, such as guaranteed deposits or secured creditors. • TLAC explicitly disqualifies certain instruments (structured notes, non-equity issued by subsidiaries) which might be eligible under MREL. • TLAC requires G-SIBs to have a specific minimum amount of eligible long-term debt in issue (33% of min. TLAC) for bail-in. • TLAC-eligible instruments must be issued directly by the resolution entity (from 2022 onwards).	• The calculation of MREL is also benchmarked on these two metrics, although the specific MREL requirement is denominated as a percentage of total equity and liabilities, not RWA. • MREL includes both buffers and Pillar 2 requirements, at least in principle, but provides significant discretionary latitude for the SRB/NRAs to make adjustments. • MREL rules[60] exclude guaranteed deposits and secured creditors but are less prescriptive as to the eligibility of specific instruments (structured notes, non-equity issued by subsidiaries). • Instruments eligible for bail-in/MREL- (Art. 45/4 BRRD) do not explicitly have to be subordinated. • BRRD sets formal requirements for the contractual subordination of liabilities[61] only; the hierarchy of claims in liquidation is governed by Member States.[62] • As a mitigant, ESMA has recently issued guidance requiring EU banks to include additional disclosure items (risk factors) in prospectuses for capital markets instruments which may be subject to bail-in.[63]
Structural discrepancies	• TLAC is designed for complex G-SIBs and a Single Point of Entry (SPE) approach to resolution[64]. • TLAC imposes structural requirements on G-SIBs, including specific arrangements for the allocation of capital and eligible liabilities at the parent, subsidiary and sub-holding levels (internal TLAC, prepositioning).	• MREL aims at accommodating banks of all sizes and allows for a case-by-case assessment of each group based on its proposed resolution plan (which may envisage either an SPE or MPE approach). Accordingly, the MREL RTS confers a significant degree of discretionary latitude upon the SRB/NRAs and competent supervisory authorities (NCAs) to account for differences in business model, balance sheet structure and risk profile. • MREL does not explicitly impose specific structural requirements but relies on the general bail-in (write-down and/or conversion) powers conferred upon resolution authorities by Art. 43 ff. BRRD. In addition, Art. 55 BRRD and the respective RTS[65] provide for the recognition of these bail-in powers into banks' non-EU contractual liabilities, e.g. MREL-eligible financial instruments issued in overseas markets.

ANNEX 1

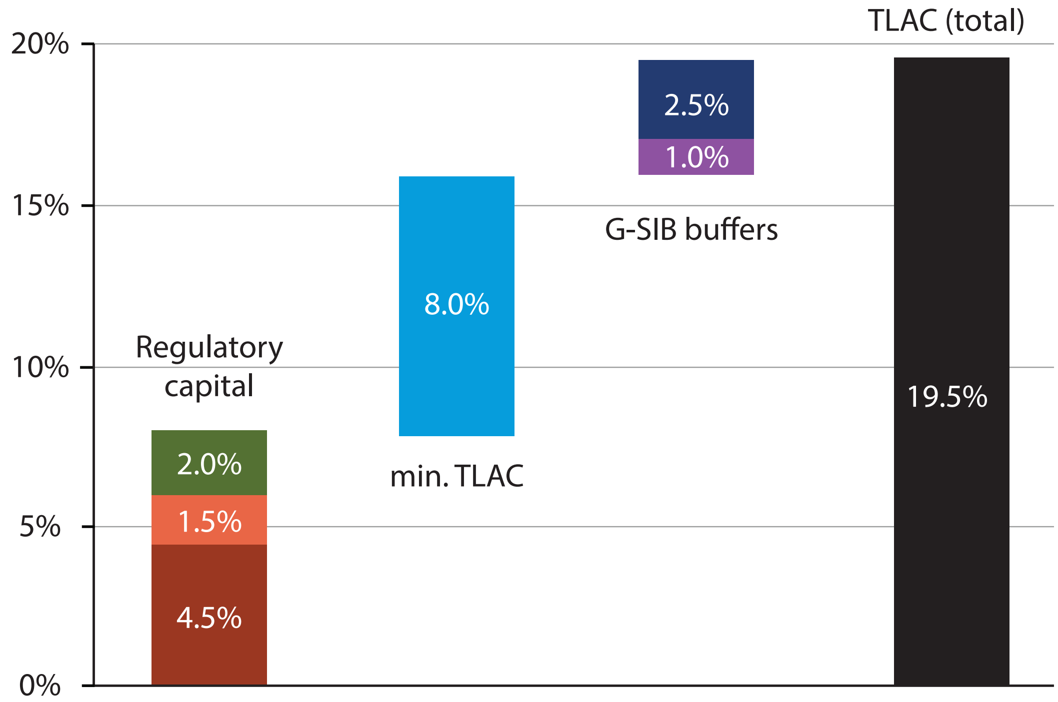
MREL (RWA method)



- Illustrative example for a European G-SIB (FSB 'Bucket 1')
- Regulatory capital: **4.5% CET1**, **1.5% additional Tier 1**, **2.0% additional Tier 2** (CRD IV)
- CRD IV combined buffers: **2.5% capital conservation buffer** (Art. 129 CRD IV), **1.0% G SII buffer** (Art. 131/4 CRD IV) in the form of CET1 capital
- **MREL loss absorption amount**: regulatory capital plus combined buffers
- **MREL recapitalisation amount:** regulatory capital (as required for re-authorisation)
- Depending on the institution's specific resolution plan the resolution authority may calibrate the recapitalisation amount in a variety of ways:
  - by default, the institution would be required to restore its capital position as set out in its resolution plan, including the combined CRD IV buffers (Art. 2/8 MREL RTS)
  - capital held to satisfy the combined buffer requirement may be counted against the overall MREL requirement, i.e. the recapitalisation amount could be reduced accordingly
  - if the institution is deemed not to be systemically relevant post-resolution, it will no longer need to comply with the respective CRD IV buffers, i.e. the recapitalisation amount would be limited to the regulatory capital required for re-authorisation.
  - If the institution can plausibly be liquidated, the recapitalisation amount may be waived altogether (i.e. set to zero)

➔ **In our example, the two methodologies deliver consistent results as long as the combined (CRD IV) capital buffers are maintained in full and the SRB/NRAs do not make use of their discretionary powers (under MREL).**

TLAC (RWA method)

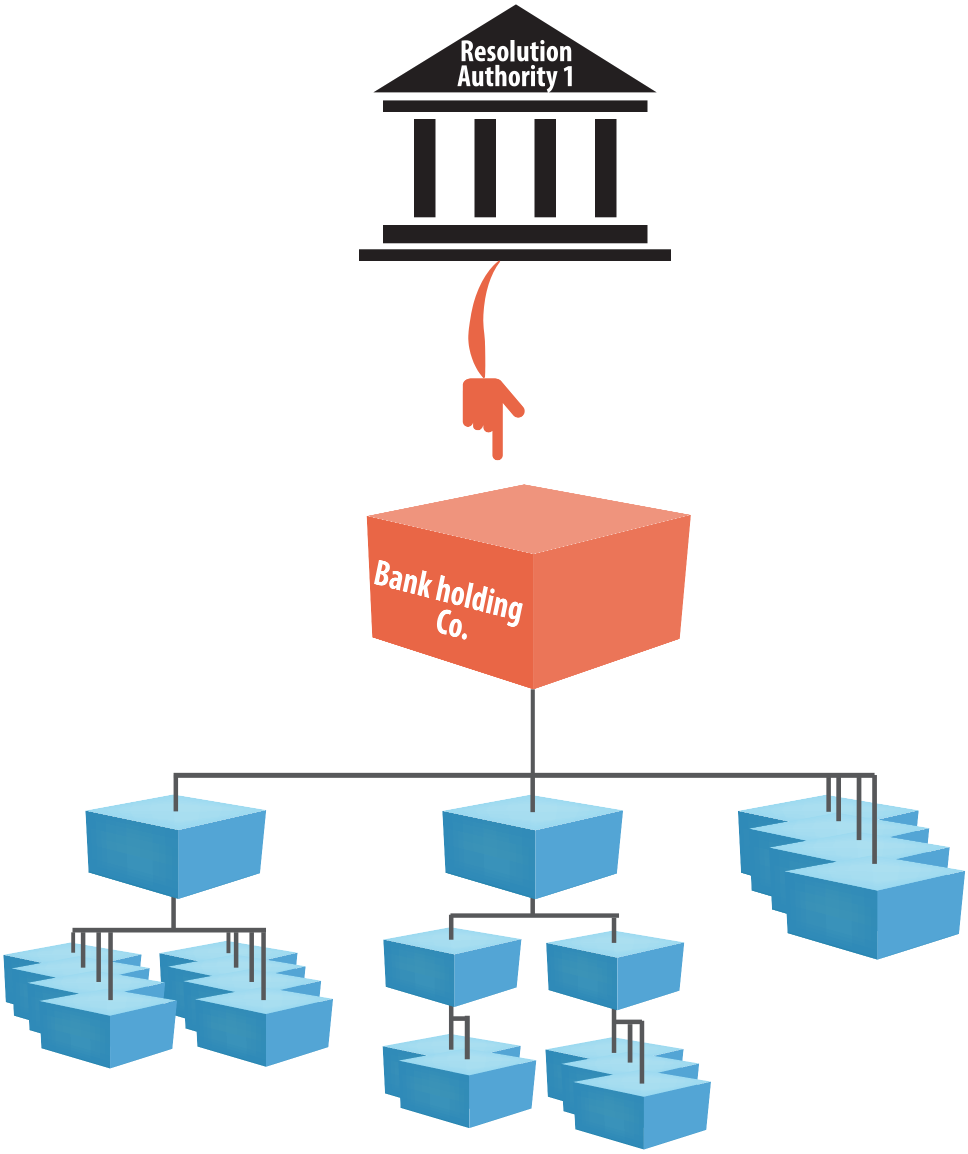


- Illustration for the same institution under FSB TLAC
- Regulatory capital: **4.5% CET1**, **1.5% additional Tier 1**, **2.0% additional Tier 1** (min. requirement under Basel III)
- **TLAC min. requirement of 16%**, (min. 33% thereof in the form of subordinated or senior unsecured debt)
- G-SIB buffers: **2.5% capital conservation buffer**, **1.0% G-SII buffer** (FSB 'Bucket 1') in the form of CET1 capital
- **Total TLAC requirement** (min.) of 19.5% (16% TLAC plus buffers)

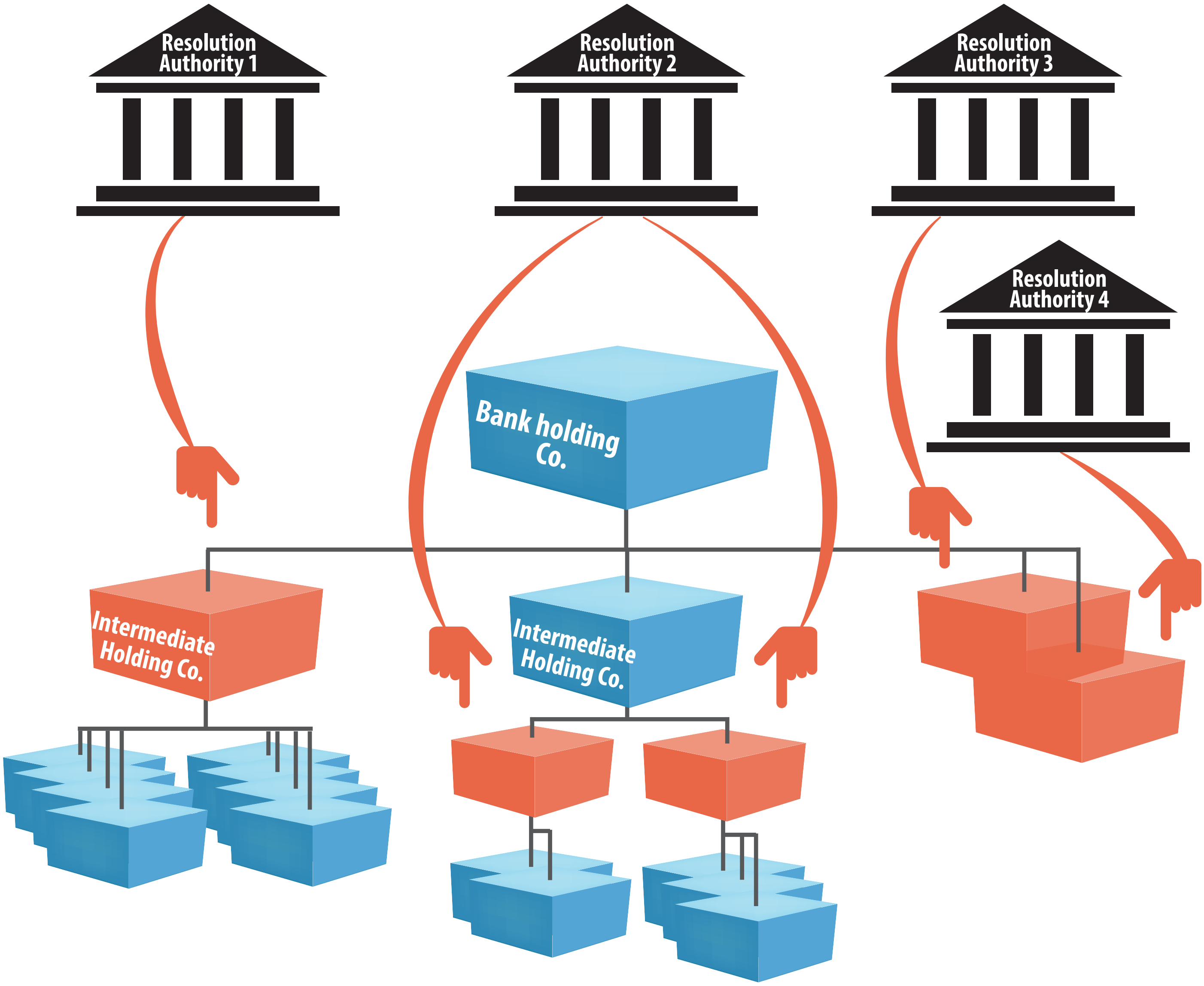
➔ **In our example, the two methodologies deliver consistent results as long as the combined (CRD IV) capital buffers are maintained in full and the SRB/NRAs do not make use of their discretionary powers (under MREL).**

ANNEX 2

Single Point of Entry (SPE)



Multiple Point of Entry (MPE)



FOOTNOTES

1. Financial Stability Board, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIB in Resolution. Total Loss-absorbing Capacity (TLAC) Term Sheet, 09 November 2015 (http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf).
2. Financial Stability Board, 2015 update of list of global systemically important banks (G-SIBs), 3 November 2015 (http://www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf).
3. HSBC, Barclays, BNP Paribas, Deutsche Bank, Group BPCE, Crédit Agricole, ING Bank, Nordea, Royal Bank of Scotland, Santander, Société Générale, Standard Chartered and UniCredit.
4. Also known as the "leverage ratio denominator" or the "exposure measure" it broadly corresponds to total consolidated equity and liabilities, as reported, subject to adjustments for derivatives, securities financing and certain other off-balance sheet exposures. Basel Committee on Banking Supervision, Basel III leverage ratio framework and disclosure requirements, January 2014 (http://www.bis.org/publ/bcbs270.pdf).
5. Directive 2014/59/EU, OJ L173/2014, pg. 190 (Bank Recovery and Resolution Directive, BRRD).
6. Regulation (EU) 2013/575, OJ L176/2013, pg. 1(CRR) and Directive (EU) 2013/36, OJ L 176/2013, pg. 338 (Fourth Capital Requirements Directive, CRD IV).
7. Art. 44/5 BRRD.
8. EBA, Opinion on the Commission's Intention to Amend the Draft Regulatory Technical Standard Specifying Criteria Relating to the Methodology for Setting Minimum Requirement for Own Funds and Eligible Liabilities According to Article 45(2) of Directive 2014/59/EU (EBA/Op/2016/02), 09 February 2016; (http://www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-02+Opinion+on+RTS+on+MREL.pdf).
9. Capital buffers for EU-domiciled banks are defined in Art. 128/6 of Chapter 4 CRD IV and comprise, in particular, the capital conservation buffer (Art. 129), counter-cyclical buffer (Art. 130), G-SIB/O-SIB buffer (Art. 131) and systemic risk buffer (Art. 133).
10. Reuters, EC shocks market with TLAC harmonisation push, 27 January 2016 (http://www.reuters.com/article/banks-bonds-idUSL8N15B2IR).
11. Additional capital requirements imposed by regulators upon individual institutions on a case-by-case basis (Art. 104/1 /CRD IV).
12. TLAC requires G-SIBs to deduct any holdings they may have in TLAC-eligible instruments of other G-SIBs from their own TLAC requirement. Equally, Art. 44/2 BRRD authorises resolution authorities to impose limits upon banks holding other banks' obligations which are eligible for bail-in. Art. 3 MREL RTS enables resolution authorities to exclude such liabilities from counting towards MREL. This safeguard is limited effectively to covering cross-holdings within the banking sector, however, it is subject to regulators' discretion and does not cover other systemically important financial institutions, such as insurance groups and, arguably, fund managers.
13. Finance Watch, Policy Brief: Separating Universal from Too-Big-To-Fail-Banks, March 2015 (http://www.finance-watch.org/our-work/publications/1055) and Finance Watch: Too Big to Fail in the EU, September 2014 (http://www.finance-watch.org/our-work/publications/912-tbtf-note-fw).
14. Financial Times, Fund Managers to Escape 'Systemic' Label, 14 July 2015.
15. Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions, October 2011 (last updated in October 2014); (http://www.fsb.org/wp-content/uploads/r_141015.pdf).
16. e.g. the Bank of England for the UK, the Bundesanstalt für Finanzstabilisierung (FMSA) in Germany or the Autorité de contrôle prudentiel et de résolution (ACPR), a unit of the Banque de France.

17. The Single Resolution Board is responsible for all banks under the direct supervision of the European Central Bank (ECB) – currently 129 – plus another 15 designated cross-border groups (https://srb.europa.eu/sites/srbsite/files/20160108_srb_list_of_cross-border_groups.pdf).
18. Reuters, Mismatching insolvency laws spell trouble for resolution, 16 July 2015 (http://www.reuters.com/article/banks-regulations-idUSL8N0ZQ16120150716).
19. Art. 44/2 BRRD authorises resolution authorities to impose limits upon banks holding other banks' obligations which are eligible for bail-in. Art. 3 RTS enables resolution authorities to exclude such liabilities from counting towards MREL. This safeguard is limited effectively to covering cross-holdings within the banking sector, however, it is subject to regulators' discretion and does not cover other systemically important financial institutions, such as insurance groups and, arguably, fund managers; cf. Footnote 12 above.
20. In the case of a recent bank rescue the Italian authorities encountered fierce criticism for bailing in holders of subordinate bonds, which included pensioners to whom these securities were apparently mis sold as "safe" investments for their retirement savings; Financial Times, Rome government forced into defence of regulators, 15 December 2015; see also Financial Times, Italy bank rescues spark bail-in debate as anger at Renzi grows, 22 December 2015.
21. ESMA, Questions & Answers: Prospectuses, 23rd ed., December 2015, pg. 69 (Q. 96) (https://www.esma.europa.eu/sites/default/files/library/esma-2015-1874_23rd_version_qa_document_prospectus_related_issues_0.pdf).
22. see Footnote 20 above
23. see Footnote 3 above
24. see Footnote 62 below
25. cf. Finance Watch, Response to the FSB's consultation on Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in resolution, 30 January 2015 (http://www.finance-watch.org/our-work/publications/1018-fw-response-to-fsb-consultation-on-tlac).
26. Directive (EU) 2014/59,OJ L173/2014, pg. 190.
27. Regulation (EU) 2010/1093, OJ L331/2010, pg. 12.
28. EBA/RTS/2015/05.
29. cf. Finance Watch, Response to the EBA's consultation on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014//59/EU, 27 February 2015 (http://www.finance-watch.org/our-work/publications/1043-fw-response-to-eba-consultation-on-mrel).
30. EBA, Opinion of the European Banking Authority on the Commission's Intention to Amend the Draft Regulatory Technical Standards Specifying Criteria Relating to the Methodology for Setting Minimum Requirement for Own Funds and Eligible Liabilities According to Art. 45(2) of Directive 2014/59/EU (EBA/Op/2016/02) (http://www.eba.europa.eu/-/eba-expresses-dissent-over-eu-commission-proposed-amendments-to-the-mrel-technical-standards).
31. Art. 92/1 of Regulation (EU) 2013/575, OJ L176/2013, pg. 1 (CRR).
32. Plus any buffers applicable under CRD IV (see Footnote 9 above), which could add up to another 10% of RWA in aggregate, and any additional "Pillar 2" capital requirements impose by regulators on individual institutions on a case-by-case basis (Art. 104/1 /CRD IV).
33. see Footnote 17 above
34. Regulation (EU) 2013/575, OJ L176/2013, pg. 1(CRR) and Directive (EU) 2013/36, OJ L 176/2013, pg. 338 (CRD IV).
35. see Footnote 29 above
36. EBA/RTS/2015/05, pg. 6.
37. Finance Watch, To end all crises? Implementing Basel III in the European Union, 02 February 2012 (http://www.finance-watch.org/our-work/publications/330).

38. Art. 429 CRR.
39. see pg. 7 above
40. Art. 45/4 BRRD.
41. Art. 73 BRRD.
42. see Footnote 62 below
43. Art. 5/1 RTS in connection with Art. 44/5 and 44/8 BRRD.
44. According to Art. 5/2 RTS, the resolution authority must be confident in its resolvability assessment that (1) there are' no impediments to a feasible and credible resolution' without a contribution from the resolution fund; (2) shareholders and creditors would not incur losses greater than in a regular insolvency and counterparties' rights from collateralised financing arrangements would be protected (the 'safeguard clauses' in Title IV, Chapter VII BRRD) without recourse to the the resolution fund; and (3) the proposed MREL is considered sufficient to absorb all losses that would be incurred in the implementation of the resolution plan. There is currently an ongoing discussion between the Commission and the EBA regarding this provision; cf. EBA, Opinion on the Commission's Intention to Amend the Draft Regulatory Technical Standard Specifying Criteria Relating to the Methodology for Setting Minimum Requirement for Own Funds and Eligible Liabilities According to Article 45(2) of Directive 2014/59/EU (EBA/Op/2016/02), 09 February 2016; (http://www.eba.europa.eu/documents/10180/1359456/EBA-Op-2016-02+Opinion+on+RTS+on+MREL.pdf).
45. We note that the chairperson of the European Single Resolution Board (SRB), Elke König, recently stated her view that she would expect MREL for "major European banks" regulated by the SRB to be "not less than 8%"; see: Single Resolution Board, Press Breakfast – Elke König, 21 January 2016; (https://srb.europa.eu/sites/srbsite/files/21012016_srb_opening_ek_final.pdf).
46. According to their inherent legal limitations, regulatory technical standards ("delegated acts" under Art. 290 TFEU) can only amend or supplement non-essential elements of the legislation they refer to – in this case the BRRD.
47. Art. 3 RTS in connection with Art. 44/2 BRRD.
48. Art. 43 ff. BRRD.
49. see pg. 11 below
50. JP Morgan Chase, Citigroup, Bank of America, Goldman Sachs, Morgan Stanley, Bank of New York Mellon, State Street and Wells Fargo.
51. Finance Watch, Response to the FSB's Consultation on Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution, 30 January 2015, pg. 2 (http://www.finance-watch.org/our-work/publications/1018-fw-response-to-fsb-consultation-on-tlac).
52. Reuters, EC shocks market with TLAC harmonisation push, 27 January 2016 (http://www.reuters.com/article/banks-bonds-idUSL8N15B2IR).
53. Finance Watch, To End All Crises, pg. 8.
54. At present there are ca. 5,500 credit institutions registered in the EU (Source: ECB Statistics, November 2015 (https://www.ecb.europa.eu/stats/money/mfi/general/html/mfis_list_2015-11.en.html).
55. see Footnote 9 above
56. 2.5% of RWA, consisting of common equity only; see Basel Committee on Banking Supervision, Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010/rev. June 2011, pg. 54 (http://www.bis.org/publ/bcbs189.pdf).
57. see pg. 2 above
58. 1.0-3.5% , consisting of common equity only; see Financial Stability Board, 2015 update of list of global systemically important banks, 03 November 2015 (http://www.financialstabilityboard.org/2015/11/2015-update-of-list-of-global-systemically-important-banks-g-sibs).

59. See Footnote 44 above
60. Art. 44/2 BRRD.
61. Art. 45/14 BRRD and Art. 55 BRRD.
62. Member States are currently pursuing different approaches, ranging from 'statutory subordination", whereby senior unsecured bondholders' claims are subordinated by law in the event of an insolvency, to "contractual subordination", where new debt instruments (Tier 3) are issued which can be "bailed in" in the event of resolution. The FSB and U.S. approaches favour "structural subordination", which relies on concentrating external TLAC-eligible obligations in a parent/holding company, which is also the principal resolution entity but which does not itself conduct banking business; see also Financial Times, "Holders of Senior Debt Face Rising Risks", 30 July 2015.
63. ESMA, Questions and Answers: Prospectuses, 23rd ed. (December 2015), pg. 69 (https://www.esma.europa.eu/sites/default/files/library/esma-2015-1874_23rd_version_qa_document_prospectus_related_issues_0.pdf).
64. see pg. 7 above
65. EBA/RTS/2015/06.

Further reading:

Finance Watch – "**Separating Universal from Too-Big-To-Fail-Banks**," March 2015
http://www.finance-watch.org/our-work/publications/1055

Finance Watch – **"Response to the EBA's consultation on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014//59/EU"**, February 2015
http://www.finance-watch.org/our-work/publications/1043

Finance Watch – **"Response to the FSB's consultation on Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in resolution"**, January 2015
http://www.finance-watch.org/our-work/publications/1018

Finance Watch – "**Should precautionary recapitalisations make taxpayers nervous?"**, October 2014
http://www.finance-watch.org/our-work/publications/942

Finance Watch – "**Too Big to Fail in the EU"**, September 2014
http://www.finance-watch.org/our-work/publications/912

Finance Watch – "**Report on the Bank Resolution and Recovery Proposal of the EC"**, March 2013
http://www.finance-watch.org/our-work/publications/537

Finance Watch – **"To end all crises? Implementing Basel III in the European Union"**, February 2012
http://www.finance-watch.org/our-work/publications/330

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Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org

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