

Loss-Absorbing Capacity and Bank Capital

TLAC, MREL and other acronyms I have known...



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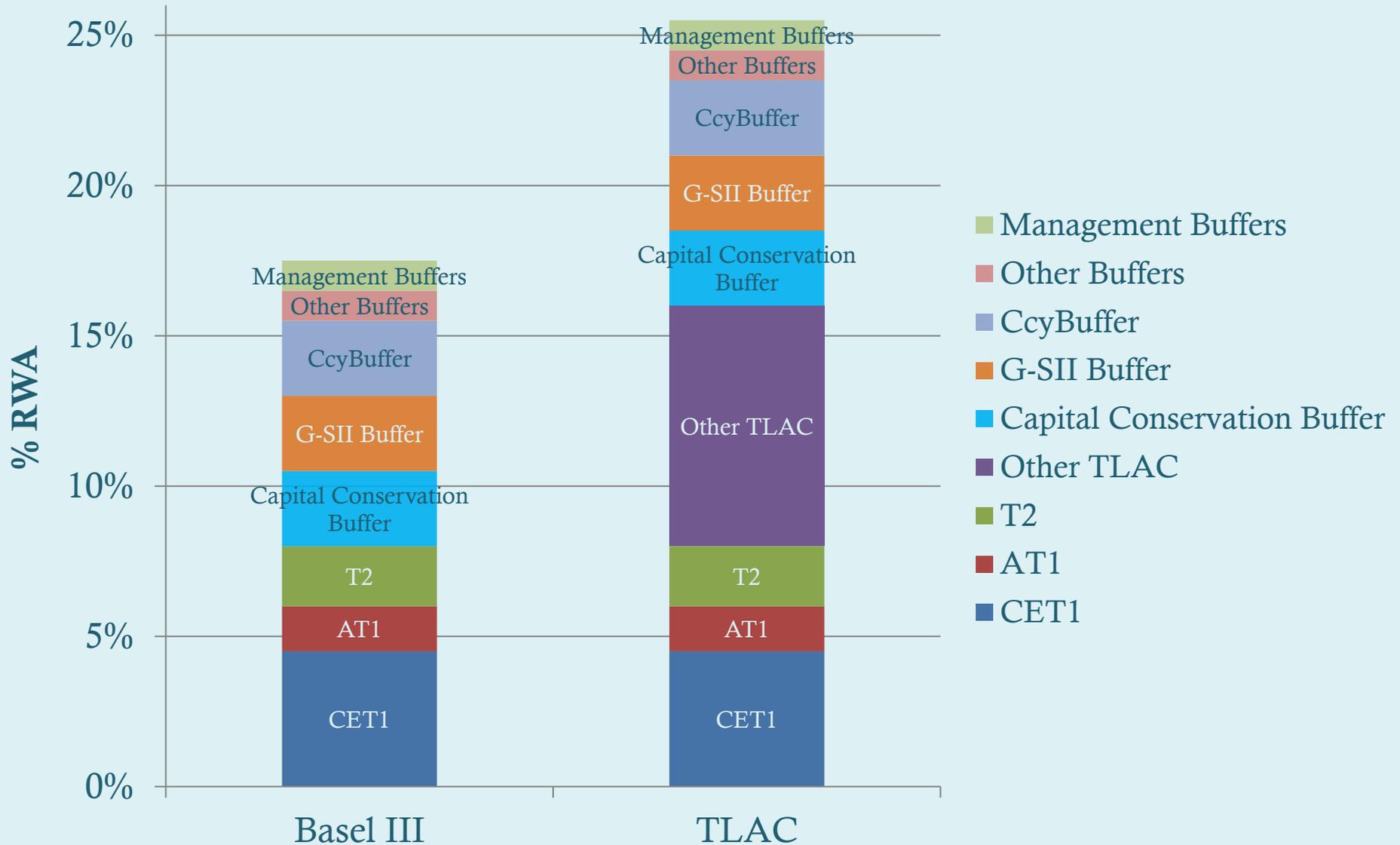
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A glossary

- AT1 Additional Tier 1 Capital
- BRRD Bank Recovery and Resolution Directive
- CET1 Common Equity Tier 1 Capital
- CCyB Counter-cyclical buffer
- FSB Financial Stability Board
- EBA European Banking Authority
- GLAC Gone Concern Loss Absorbing Capital
- CoCos Contingent Convertible Capital Instruments
- G-SIB or G-SII Global Systemically Important Bank/Institution
- LR Leverage Ratio
- LRE Leverage Ratio Exposure
- LTD Long Term Debt
- MREL Minimum Requirement for Eligible Liabilities
- PONV Point of Non-Viability
- RTS Regulatory Technical Standards
- RWA Risk Weighted Assets
- SPOE Single Point of Entry (a resolution strategy applied to Holdco)
- SRB Single Resolution Board
- TLAC Total Loss Absorbing Capacity
- T2 Tier 2 Capital

Going concern capital and loss absorbing capital – a comparison



A resolvable bank...

What does it look like?

1. Meets Basel III Capital Requirements and/or provides early warning of potential breach.
2. Susceptible to recapitalisation at PONV:
 - Reserve capital sufficient to replenish CET1 after write down
 - Additional loss-absorbing capital sufficient to replenish reserve capital after conversion
3. Can be placed in cross-border resolution without fragmentation:
 - Parent company invests in reserve capital of bank subsidiary
 - Individual subsidiaries to meet minimum capital requirements at all times
4. Constructive market certainty about recapitalisation:
 - Capital liabilities contractually subordinate to senior liabilities, operating liabilities and deposits
5. Access to further liquidity
 - Possible bail-in of additional liabilities etc
 - Bridge bank likely to benefit from improved credit conditions
 - Pre-funding commitments

Regulating for loss absorption—a timeline

- **2009**
 - G20 Finance Ministers commit to introducing new regulation on bank capital and bank resolution
- **2013**
 - G20 leaders call on the FSB to develop proposals by end-2014 on the adequacy of global systemically important financial institutions' loss-absorbing capacity
- **2014**
 - EU BRRD establishes rules for MREL
 - FSB publishes proposal for TLAC guidelines
- **2015**
 - FSB publishes final term-sheet for TLAC and Impact Assessment Study
 - EBA publishes Draft RTS on MREL criteria under BRRD
 - Federal Reserve issues rules on TLAC for U.S. G-SIBs and intermediate Holdcos of foreign banks
 - Bank of England and PRA publish proposals for setting MREL and combining MREL with capital requirements—BoE proposes to incorporate TLAC requirements for UK G-SIBs
- **2016**
 - SRB presents MREL methodology
 - EBA publishes opinion rejecting amendments to Draft RTS on MREL criteria
 - EU Commission explores "appropriate ways to transpose the FSB's TLAC standard into EU law in a manner that articulates well with existing MREL and capital requirements".
 - EU Commission adopts Delegated Regulation on RTS for MREL criteria and methodology

Loss-absorbing criteria...

TLAC (for G-SIBs) according to the FSB

- 16% RWA from 2019, rising to 18% by 2022
 - LRE Minimum = 6% LR denominator, rising to 6.75%
 - Possible additional firm-specific requirements
 - No double accounting with CET1 capital buffers
 - Eligible instruments: paid-in, unsecured, not subject to set-off or netting, maturity of 1 yr+, not subject to acceleration or early redemption, not issued intra-group (unless internal TLAC).
 - Does not include excluded instruments, e.g. structured notes
 - Subordinated liabilities only.
 - Write-down/bail-in must be legally enforceable under governing law
 - 75-90% **internal** TLAC requirement for “material” subsidiaries
- N. B. (1) *The FSB takes the view that a breach of TLAC requirements should have the same consequence as a breach of Basel III capital requirements, i.e. the institution has reached the point of non-viability and should be placed into resolution.*
- (2) *The impact study published by the FSB indicates that 29 G-SIBs had average TLAC ratio of 13.1% of RWA in 2014. This indicates a global shortfall of €307 to €790 billion, depending on which instruments are considered (or, if excluding emerging market G-SIBs, of €42bn to €520bn).*

Loss-absorbing criteria...

MREL according to the EU

Article 45 Bank Recovery Resolution Directive:

- MREL applies to all banks, not just G-SIBs
- Calculated as % of total liabilities (not RWA)
- Appropriate level MREL to be tailored to each institution by competent authority
- Eligible instruments: paid-up, not self-referencing (e.g. as guarantor), maturity of 1 yr+, not arising from a derivative or a preferred deposit.
- Write-down must be enforceable under governing law and, for “contractual bail-in instruments”, provided for in the contract
- Subordinated liabilities only

Commission Delegated Regulation on Regulatory Technical Standards (May 2016)

MREL must cover, at least:

- capital requirements and a corresponding recapitalisation amount

Loss-absorbing criteria...

LTD according to the Federal Reserve

- Contingent capital is not currently required to be held by financial institutions or bank holding companies in the United States
 - G-SIBs will, however, be required to hold LTD or $> 6\%$ RWA and $> 4.5\%$ LR denominator.
 - They will also be required to meet strict TLAC requirements:
 - 18% RWA
 - LRE Minimum = 9.5% LR denominator
 - Eligible external LTD instruments prohibited from: (a) Being structured notes; (b) having a credit-sensitive feature; (c) including a contractual provision for conversion into or exchange for equity in the covered BHC; or (d) including a provision that gives the holder a contractual right to accelerate payment (including automatic acceleration).
- N. B. *There are two routes to resolution in the U.S.—by the Orderly Liquidation Authority (i.e. the FDIC) under Title II of Dodd Frank Act and under the Bankruptcy Code (which is preferred). “Living wills” for resolution under the Bankruptcy Code are required under Title I of Dodd Frank and focus on either the “SPOE” or “Bridge Bank” options for G-SIBs. There are differences across all these routes but none contemplates bail-in as a significant resolution strategy and all focus on sale, transfer or restructuring of viable businesses and liquidation of any “rump”. The Hoover Resolution Project has proposed a new “Chapter 14” to the US Bankruptcy Code which would (in their view) facilitate the SPOE approach under the Code.*

Conclusion

- Conclusions