FINANCIAL MARKETS LAW COMMITTEE

Loss-Absorbing Capacity and Bank Capital

TLAC, MREL and Other Acronyms I Have Known …

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7 July 2016

Slide 3: Going Concern Capital and Loss-Absorbing Capital – A Comparison

In the wake of the financial crisis, in 2010, and as part of an international programme of regulatory reform, the Basel Committee on Banking Supervision published revised standards on capital for internationally active banks as a third iteration of the Basel framework. These standards were stricter than any that had gone before and reflected efforts to increase the resilience of the global banking system.

In Europe, Basel III is implemented in the Capital Requirements Regulation (or "CRR") and in a series of Regulatory Technical Standards produced by the European Banking Authority.

These standards are illustrated by the left column on the slide.

Core capital or "own funds" requirements are represented by the lowest three coloured categories, including core equity, Additional Tier 1 capital and Tier 2 capital. Unless a bank meets these capital requirements, it does not qualify for authorisation. And you will see that they must amount to at least 8% of the value of the bank's risk weighted assets (or "RWA").

Although it may be an oversimplification, one can understand these three categories roughly as:

1. share capital (CET1),
2. instruments known as CoCos or Contingent Convertible Bonds which can be automatically written down when the bank's core equity is eroded (Additional Tier 1 capital); and
3. In the case of Tier 2 capital, either CoCos which have a discretionary trigger exercisable by the regulator OR debt which can be discounted when the bank is placed in resolution.

On top of core capital, sit various capital buffers. The first three of these—including the Countercyclical Buffer, which has been in the news recently—are known as the combined buffer under the CRR. Their job is primarily to absorb losses while avoiding breaching minimum requirements. Once buffers are breached, the Bank is no longer obliged or able to pay certain liabilities in full, including dividend payments.

If we turn now to the column on the right of the slide, we can see a swathe of capital coloured in purple. This represents the additional capital which banks are required to hold as part of regulators' strategies for resolution and which must comprise the same kinds of financial instruments as the first three categories.

In 2009, the G20 acknowledged that the current capital requirements do not deal adequately with the ideal of returning a bank to lending after resolution because they do not provide for a means by which Banks can quickly rebuild their Basel III capital and so meet the requirements for authorisation. In consequence regulators developed standards on so-called "loss-absorbing capacity" which are designed to ensure not only

that banks have enough capital to absorb losses but also that they have enough to recapitalise themselves once the flow of losses has been stemmed.

In this regard, the title "loss-absorbing capacity" is a misnomer, it is actually the Basel III capital that absorbs the losses when a bank fails and it is the new "TLAC" that then recapitalises the bank.

Loss-absorption and recapitalisation occur when a resolution authority writes down, discounts or bails-in claims against the bank. This process is much more complicated than it sounds. Some claims against banks can be written down under their contractual terms, some only by operation of statute. Some can be written down as an act of discretion, others automatically. Some can be written down outside resolution; others can only be bailed-in once the bank has been placed in resolution.

Amid all this complexity, one point that I know my fellow panellists would wish me to emphasise at the outset is that the widely-discussed statutory resolution tool known as "bail in" has the effect of reducing not only those claims against banks which qualify as loss-absorbing capital instruments but most other classes of claim too, including (in Europe, at least) uninsured deposits.

Slide 4: What Does a Resolvable Bank Look Like?

Making sure that by intervening in a failing bank, authorities can not only

- absorb the initial losses, but also
- rebuild capital,

was one of the lynchpins of prudential policy after the financial crisis. But it was not the only one – ending Too Big To Fail also required regulators to figure out

- how banking groups would be resolved across borders;
- how markets themselves could best be prepared for stressful banking events; and
- how to solve the problem of illiquidity, which had manifested so clearly during the sub-prime crisis.

Therefore, the key elements of ending too big to fail are:

1. raising bank capital standards,
2. Introducing loss-absorbing capital requirements,
3. Planning effectively for the resolution of groups,
4. Improving contractual certainty and
5. Addressing any shortage of liquidity.

Slide 5: Regulating for Loss-Absorption – A Timeline

Implementing these improvements has been a 7-year journey. Over the course of those several years, national regulatory authorities have been working in cooperation on the big picture but have been working largely in isolation on the detail. For that reason, significant differences have emerged in the standards that apply in each jurisdiction or region.

Internationally, standards were finalised by the Financial Stability Board for so-called G-SIBS or globally systemically important banks at the end of last year.

Unfortunately, these came too late for Europe, where standards on loss-absorbing capital were baked into the Bank Recovery and Resolution Directive, or BRRD, in 2014. These standards are known as the Minimum Requirement on Own Funds and Eligible Liabilities or "MREL".

To complicate the picture yet further, the FSB's TLAC standard represented a compromise in which the standard preferred by the US, known as Gone Concern Loss Absorbing Capital, was discarded. The US, however, has preserved that approach in part by adding an additional standard on Long Term Debt.

Slide 6: Loss-Absorbing Criteria: TLAC (for G-SIBs) According to the FSB

The first thing to note about the FSB's international TLAC standards is the basic requirement of 16% loss-absorbing capacity. This, like the Basel requirements, is measured against risk-weighted assets. It is twice the Basel III minimum of 8% (excluding buffers) allowing for both loss-absorption and recapitalisation.

The second thing to note at the fifth to eighth bullet points is that the standards are very prescriptive as to the kinds of financial instruments that will qualify. My fellow panelists will say a bit more about this.

The ninth bullet point refers to an internal TLAC requirement. This is part of resolution planning for international groups. The standard requires parent companies in one jurisdiction to pre-fund operating subsidiaries overseas.

Principle X on the FSB's Term Sheet stipulates that a breach of the minimum TLAC requirement should be treated as severely as a breach of minimum capital requirements and it strongly implies that bank resolution should follow such a breach.

Slide 7: Loss-Absorbing Criteria: MREL According to the EU

TLAC can be contrasted with the European standard: MREL.

The first point to note is that MREL applies to all European Banks subject to the resolution regime, and not just to G-SIBs. It is less prescriptive and leaves national regulators with greater scope to impose their own requirements.

The second point is that MREL is calculated as a percentage of total liabilities, not risk-weighted assets. This makes it difficult to measure accurately against the TLAC standard.

In other respects, however, MREL is similar to TLAC. Just like the FSB's standard, it covers both the Basel III requirements and a recapitalisation amount.

It is also worth foreshadowing that, quite apart from any stipulations as to the form of instruments that will qualify as MREL, the BRRD requires banks to insert clauses in virtually all their contracts that recognise the potential for any claim to be bailed-in.

Slide 8: Loss-Absorbing Criteria: LTD According to the Federal Reserve

As usual, the US has gone its own way.

The Federal Reserve has recommended separate long-term debt requirements, which would prohibit G-SIBs from holding all of their TLAC in the form of equity

The purpose of this requirement is to ensure that some claims are available to be written down or, indeed, written off to fund a resolution exercise, even if the bank's equity has been entirely eroded during a crisis.

The Fed's standards represent a trade-off between, on the one hand, reducing the chances that a bank will need resolution (which equity does very well) and, on the other hand, reducing the chances that the resolution will be underfunded (which equity does rather badly).

American finance trade associations believe that banks should have the option to fund TLAC with debt or equity. This change would have the support of a number of prominent economists who, in general, are concerned that the cross-default provisions in debt instruments mean that a prevalence of such instruments will tend to exacerbate a financial crisis.

One reason why the US may have gone in a different direction on TLAC is that US regulators have largely settled upon a Single Point Of Entry resolution strategy for banking groups, which involves placing a holding company into resolution while allowing operating and lending subsidiaries to continue solvent trading. This can be contrasted with a Multi-Point Of Entry strategy, which involves placing all group companies into resolution. In an SPOE scenario, there may be less to fear from cross-default provisions in financial instruments, in particular because the Fed proposes to prohibit holding companies from conferring cross-default rights on its counterparties.

Slide 9: In Conclusion

The need to improve bank resolvability has been on the cards since the last financial crisis and giant steps forward have now been taken. It is to be hoped that the ripples of uncertainty, which the other panellists will explore, don't upset the boat now as it comes home to harbour