

Bank Resolution and Total Loss Absorbing Capacity



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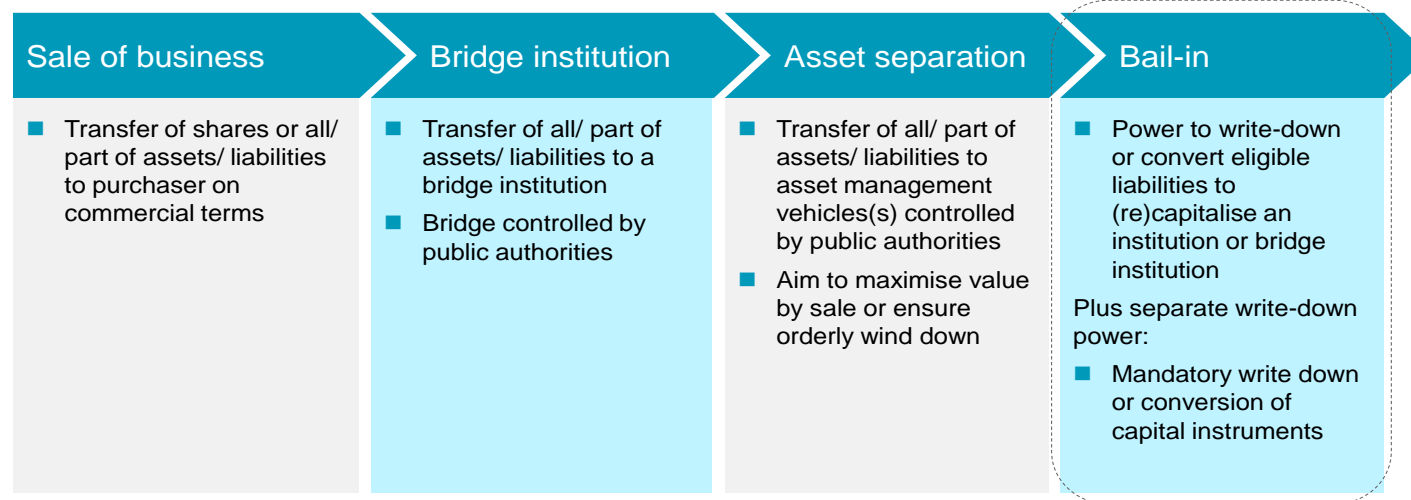
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Introduction

- Overview of the BRRD resolution regime – Habib Motani
- FSB Proposal for Total Loss Absorbing Capacity of Global Systemically Important Banks – Daisuke Tanimoto
- Differences between TLAC and MREL – Habib Motani

Overview of the BRRD resolution regime

Resolution tools



Overview of the BRRD resolution regime cont.

Bail-in under BRRD

Objectives

- To recapitalise an institution or group to enable it to continue to function
- To capitalise a bridge institution or commercial purchaser of the business

Bail-in applied to all liabilities (except excluded liabilities) but other liabilities can be excluded if:

- Bail-in not possible in reasonable time
- Necessary and proportionate to achieve continuity of critical functions
- Necessary and proportionate to avoid contagion
- Bail-in would destroy value causing higher losses for other creditors

Bail-in carried out in accordance with insolvency hierarchy

Bail-in only applied to derivatives after closing out the derivatives

Must be combined with reorganisation plan

Other Member States must give effect to write down/bail-in under their law and shall not give rise to event of default, etc. under terms of instrument

Safeguards:

- No creditor or shareholder shall be worse off as a result of bail-in
- Supported by preliminary and after-the-event valuations to test
- Compensation paid out of resolution fund

FSB Proposal for TLAC

- On 10 November 2014, the Financial Stability Board (“FSB”) proposed an international standard on total loss absorbing capacity (“TLAC”) of global systemically important banks (“G-SIBs”).
- The proposals respond to the call by G20 Leaders at the 2013 St. Petersburg Summit and were developed in consultation with the BCBS.

FSB Term Sheet for TLAC

- FSB's proposal includes the term sheet for TLAC, a concrete proposal for implementing an internationally-agreed standard on TLAC.
- TLAC: External TLAC (Pillar 1 and Pillar 2) and Internal TLAC.

Resolution Entities

➤ TLAC requirement applies to resolution entities within each G-SIB.

➤ Depending on the resolution strategy, resolution entities may be the top-tier parent or holding company, intermediate holding companies or subsidiary operating companies.

*G-SIBs that are headquartered in emerging markets will not, initially, be subject to the minimum TLAC requirement (Pillar 1).

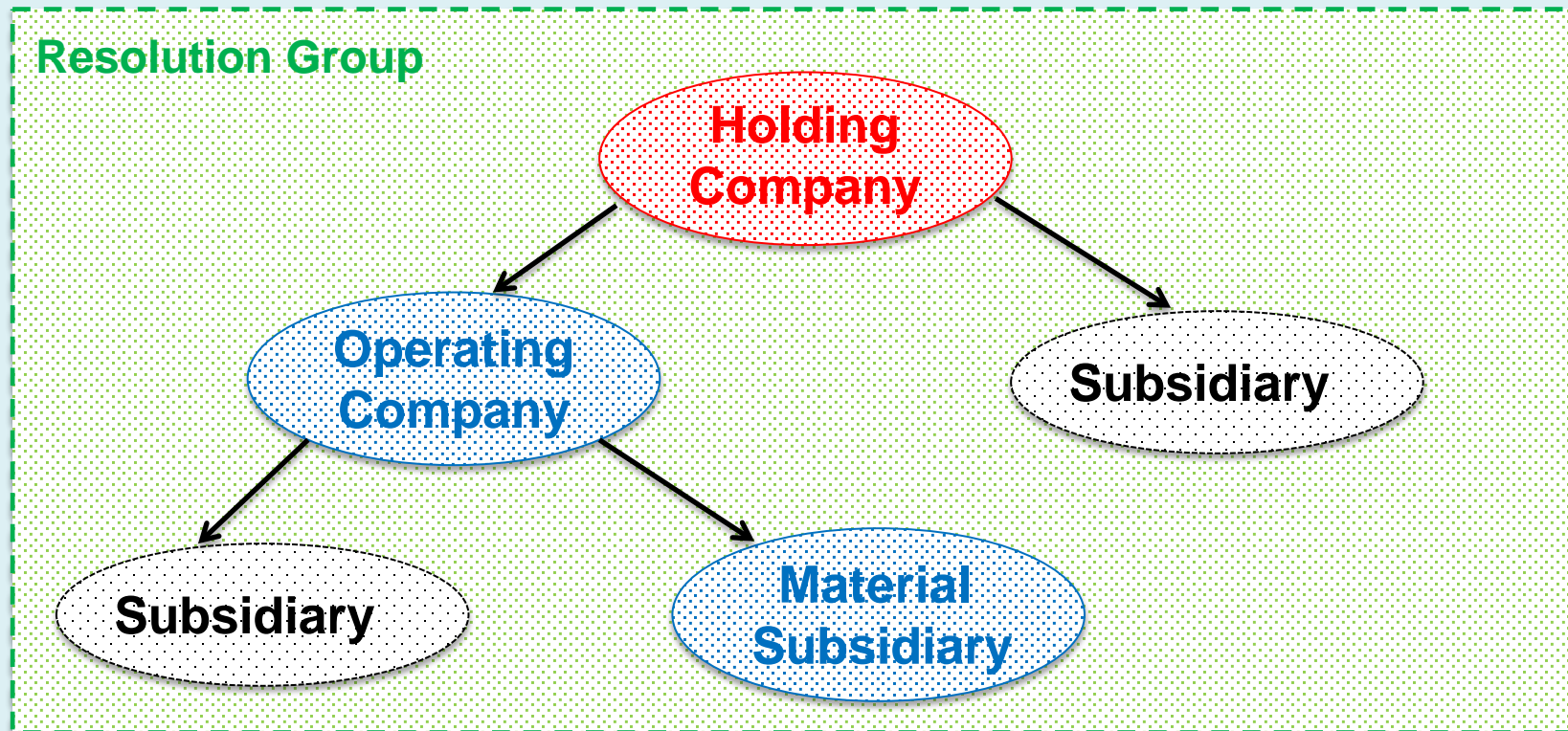
Resolution Group

- Required level of TLAC is determined with reference to the consolidated balance sheet of “resolution group”.

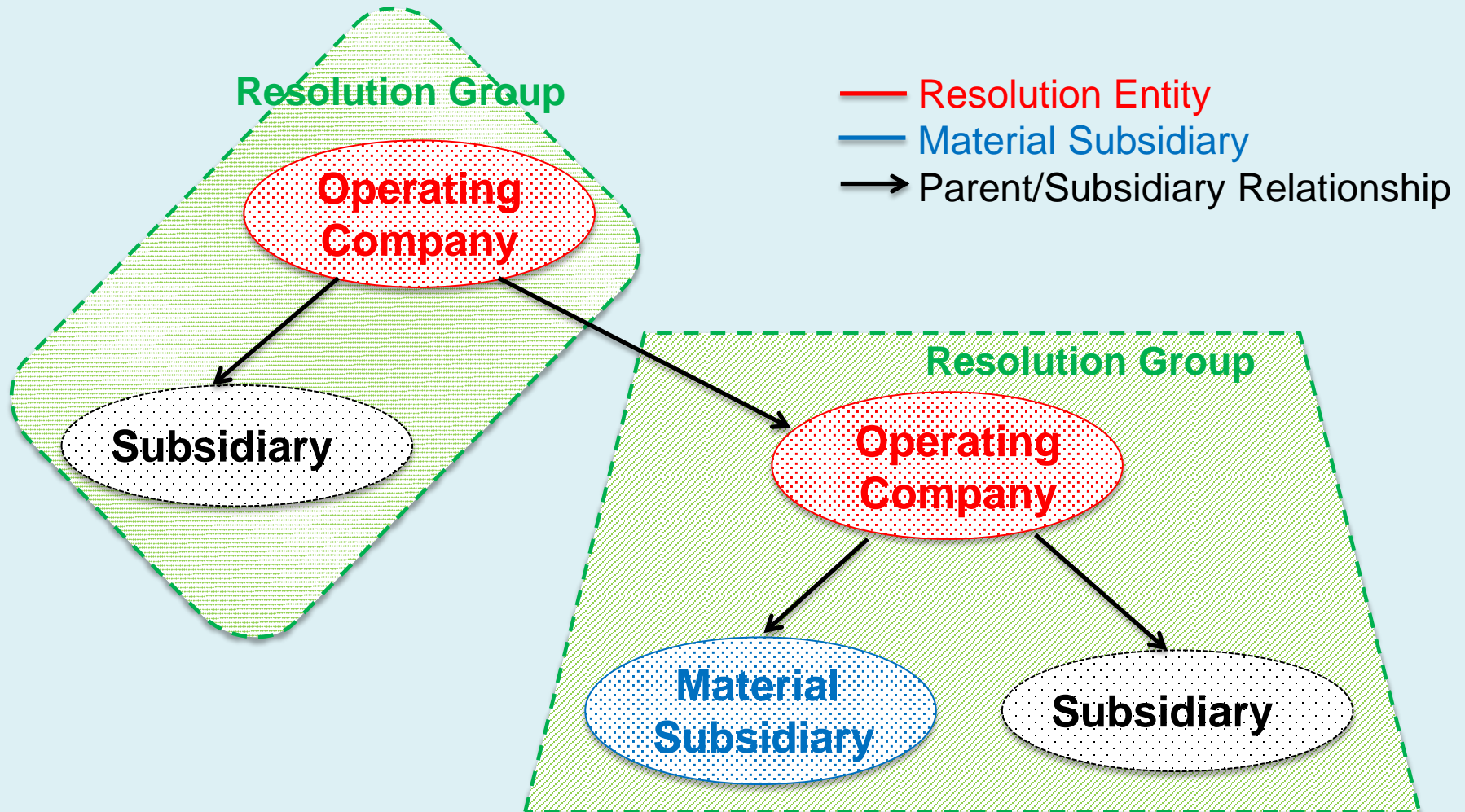
- The resolution group is:
 - a. the group of entities including a single resolution entity; and
 - b. any direct or indirect subsidiaries of the resolution entity which are not resolution entities or subsidiaries of other resolution entities.

G-SIB's Group Structure - Example (1)

- Resolution Entity
- Material Subsidiary
- Parent/Subsidiary Relationship



G-SIB's Group Structure - Example (2)



External TLAC – Pillar 1

- The Pillar 1 Minimum TLAC requirement would be:
 - a. set within the range of 16% to 20% of risk-weighted assets (RWAs) of the resolution group (excluding any regulatory capital buffers); and
 - b. at least twice the Basel 3 Tier 1 leverage ratio requirement.

External TLAC – Pillar 2

- The additional Pillar 2 TLAC requirement would:
 - a. apply over and above the Pillar 1 TLAC requirement; and
 - b. be determined by the relevant home authority for each resolution entity, in discussion with Crisis Management Groups and validated through the Resolvability Assessment Process.

Eligible Instruments

- Among others, External TLAC must:
 - a. not be subject to set off or netting rights that would undermine their loss-absorbing capacity;
 - b. have a remaining maturity of at least one year; and
 - c. absorb losses prior to “excluded liabilities” without giving rise to material risk of successful legal challenge or compensation claims.

Excluded Liabilities

- External TLAC must not include, among others:
 - a. insured deposits;
 - b. liabilities arising from derivatives or debt instruments with derivative-linked features;
 - c. tax liabilities; and
 - d. liabilities which are preferred to normal senior unsecured creditors.

Legal Uncertainty Considered by FMLC (1)

- Material risk of legal challenge or valid compensation claims

Once the TLAC-eligible instruments are used to absorb losses during resolution, the authorities cannot rule out the possibility that the original holder will seek to challenge the legality of the resolution action.

The perception of the level of litigation risk will likely differ from country to country, which could result in the TLAC requirements being applied inconsistently across the globe.

Legal Uncertainty Considered by FMLC (2)

- Instruments subject to set-off or netting rights

Since parties may not contract out of the operation of insolvency set-off rules, it is unclear whether TLAC-eligible liabilities will be free from mandatory set-off.

- Liabilities embedding features of derivatives

Delineating between instruments that have derivative-like features and those that do not have such features has given rise to extensive legal debate in the past.

The issue of uncertainty inherent in the phrase “with derivative-linked features”.

Internal TLAC

- Each material subsidiary within a G-SIB group that is not a resolution entity must maintain a minimum amount of eligible internal TLAC.
- A minimum amount of internal TLAC is 75% to 90% of Pillar 1 Minimum TLAC requirement.
- The core features of eligible internal TLAC are mostly the same as eligible External.

Long-term Debt Requirements

- Term sheet indicates an expectation that the sum of the following instruments is at least 33% of their Minimum TLAC requirements:
 - a. Basel 3 Tier 1 and Tier 2 capital instruments of a G-SIB's resolution entity in the form of debt; and
 - b. other eligible TLAC that is not regulatory capital.

Disclosure Regime for TLAC

- G-SIBs must disclose the amount, maturity, and composition of TLAC maintained by each resolution entity and at each material subsidiary.
- Material subsidiaries that are not themselves resolution entities need to disclose any liabilities which rank *pari-passu* with or junior to internal TLAC.

Development after the FSB Proposal

- The FSB consultation closed on 2 February 2015.
- FSB Chair's Letter to G20 (9 April 2015):
While there are a number of issues to be addressed, work is on track for the FSB to finalise the international standard by the Antalya Summit.
- The conformance period for TLAC will not be before 1 January 2019.

Differences between TLAC and MREL

	Scope	Application	Minimum	Form	Issuer	Excluded liabilities
FSB DRAFT TERM SHEET: EXTERNAL TLAC	G-SIBs (except emerging market G-SIBs)	Each resolution entity in group	16-20% of RWAs and 2x leverage ratio requirement (plus Pillar 2 and buffers)	Re. capital instruments plus unsecured liabilities ≥ 1 year remaining maturity with contractual/statutory write down mechanism (at least 33% debt instruments)	Resolution entity or external reg. capital instruments issued by subsidiaries (if can be written down without using resolution tools and no change of control risk)	Insured deposits, demand debt, derivatives, tax liability, preferred claims, etc.
BRRD MREL	All EU banks and investment firms (exc. certain mortgage credit banks)	Solo and consolidated requirement (solo may be waived in limited circumstances) Resolution authority may also apply to holding company and other subsidiaries	Pillar 2 approach set as % of total liabilities + own funds	Own funds plus unsecured liabilities ≥ 1 year remaining maturity (not derived or preferred deposit)	EU bank or investment firm (or group member for consolidated test)	Liabilities excluded from bail-in under BRRD

Differences between TLAC and MREL cont.

	Priority	Governing law	Timing
FSB DRAFT TERM SHEET: EXTERNAL TLAC	Subordinated to excluded liabilities in resolution entity or issued by a resolution entity (e.g. holding company) without excluded liabilities Senior debt counts if excluded liabilities not subject to bail-in or (subject to cap of 2.5% RWAs) may be excluded from bail-in (if no challenge/compensation risk)	Home state law or legally effective clauses/local regime recognising resolution	Not before Jan 2019
BRRD: MREL	May be required to use “contractual bail-in instruments” (subordinated instrument with contractual write down provision) to meet requirement	Home state law (otherwise, resolution authority may require institution to demonstrate that bail-in or write down would be effective under the foreign law)	Applies from Jan 2016.* EBA to report by 31 Oct 2016 and Commission to submit a legislative proposal for harmonisation of MREL by 31 Dec 2016 (if appropriate)

* EBA draft assessment criteria allow resolution authority to set lower MREL to enable an appropriate transitional period (up to 4 years)

Differences between TLAC and MREL cont.

MREL: EBA draft assessment criteria

Resolvability and capital adequacy

- MREL should absorb losses = total capital requirements (incl. buffers)
- Plus enough for recapitalisation to implement resolution strategy (may be zero for banks to be resolved by liquidation)
- No explicit adjustment of solo requirement where part of consolidated group

Impact of exclusions

- Increase MREL(or require subordination) to allow for the exclusion of some liabilities from contributing to loss absorption or recapitalisation
- To avoid risk of NCWO claims by holders of MREL

DGS contribution

- MREL to ensure any resolution contribution by DGS does not exceed avoided losses to insured depositors in insolvency or 50% of DGS target funding level
- But depositor insolvency preference means DGS unlikely to contribute

Risks and systemic risks

- Adjust MREL to reflect size, business model, funding model and risk profile to extent not already addressed by mitigants (in consultation with supervisor)
- At least for G-SIIs/O-SIIs, MREL sufficient to allow access to loss absorption contribution by resolution fund under Art 44 BRRD if may be needed

Differences between TLAC and MREL cont.

TLAC and MREL compared

	TLAC	MREL
Scope	G-SIBs	EU banks and investment firms
Level of application	Resolution entities (external TLAC) Material subsidiaries (internal TLAC)	Solo and consolidated requirements
Minimum level	Pillar 1 plus Pillar 2	Pillar 2 approach (but EBA criteria)
Denominator	RWAs	Own funds + total liabilities
Eligible liabilities	Narrow category	Broader e.g. structured notes?
Subordination	Mandatory (limited exclusions)	Not mandatory (but may be required)
Redemption	Consent requirement	No consent requirement
Minimum debt	Yes (33%)	No
Implementation	Not before 1 Jan 2019	1 Jan 2016* (EBA review by end 2016)
Disclosures	Specified	Not covered
Treatment of investments	Deduction regime	Not covered

* EBA draft assessment criteria allow resolution authority to set lower MREL to enable an appropriate transitional period (up to 4 years)

Differences between TLAC and MREL cont.

Critical issue: does senior unsecured debt count as MREL?

Aggregate MREL shortfall

	Scenario 1 MREL = 2 x capital requirement (incl. buffers)			Scenario 2 MREL = 8% total liabilities and equity		
	Amount	% of assets	No. of banks	Amount	% of assets	No. of banks
A. Equity and sub debt only	€332 bn	0.98	80	€464 bn	1.37	66
B. A + senior unsecured > 1 year residual maturity	€36 bn	0.11	15	€12 bn	0.04	6

Source: EBA. Sample of 128 EU banks. 2013 consolidated data: A. Total equity and sub debt = €2450 bn. B. Total of A plus estimated senior unsecured debt > 1 year residual maturity = €6,325 bn).

“These estimates are illustrative, but indicate the importance of this assessment [viz. whether only equity and subordinated debt could be feasibly and credibly loss absorbing]”

Source: EBA impact assessment