Bank Resolution and Total Loss Absorbing Capacity

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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

<table>
<thead>
<tr>
<th>Sale of business</th>
<th>Bridge institution</th>
<th>Asset separation</th>
<th>Bail-in</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer of shares or all/ part of assets/ liabilities to purchaser on commercial terms</td>
<td>Transfer of all/ part of assets/ liabilities to a bridge institution</td>
<td>Transfer of all/ part of assets/ liabilities to asset management vehicles(s) controlled by public authorities</td>
<td>Power to write-down or convert eligible liabilities to (re)capitalise an institution or bridge institution Plus separate write-down power:</td>
</tr>
<tr>
<td></td>
<td>Bridge controlled by public authorities</td>
<td>Aim to maximise value by sale or ensure orderly wind down</td>
<td>Mandatory write down or conversion of capital instruments</td>
</tr>
</tbody>
</table>

- **Bail-in**
  - Power to write-down or convert eligible liabilities to (re)capitalise an institution or bridge institution
  - Plus separate write-down power:
    - Mandatory write down or conversion of capital instruments
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

### 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)

Resolution Group

Operating Company

Subsidiary

Resolution Group

Operating Company

Material Subsidiary

Subsidiary

Resolution Entity
Material Subsidiary
Parent/Subsidiary Relationship
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.
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.
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.
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

<table>
<thead>
<tr>
<th>Scope</th>
<th>Application</th>
<th>Minimum</th>
<th>Form</th>
<th>Issuer</th>
<th>Excluded liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FSB DRAFT TERM SHEET: EXTERNAL TLAC</strong></td>
<td>G-SIBs (except emerging market G-SIBs)</td>
<td>Each resolution entity in group</td>
<td>16-20% of RWAs and 2x leverage ratio requirement (plus Pillar 2 and buffers)</td>
<td>Re. capital instruments plus unsecured liabilities ≥ 1 year remaining maturity with contractual/statutory write down mechanism (at least 33% debt instruments)</td>
<td>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)</td>
</tr>
<tr>
<td><strong>BRRD MREL</strong></td>
<td>All EU banks and investment firms (exc. certain mortgage credit banks)</td>
<td>Solo and consolidated requirement (solo may be waived in limited circumstances) Resolution authority may also apply to holding company and other subsidiaries</td>
<td>Pillar 2 approach set as % of total liabilities + own funds</td>
<td>Own funds plus unsecured liabilities ≥ 1 year remaining maturity (not derived or preferred deposit)</td>
<td>EU bank or investment firm (or group member for consolidated test)</td>
</tr>
</tbody>
</table>
## Differences between TLAC and MREL cont.

<table>
<thead>
<tr>
<th>Priority</th>
<th>Governing law</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FSB DRAFT TERM SHEET: EXTERNAL TLAC</strong></td>
<td>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)</td>
<td>Not before Jan 2019</td>
</tr>
<tr>
<td><strong>BRRD: MREL</strong></td>
<td>May be required to use “contractual bail-in instruments” (subordinated instrument with contractual write down provision) to meet requirement</td>
<td>Home state law (otherwise, resolution authority may require institution to demonstrate that bail-in or write down would be effective under the foreign law)</td>
</tr>
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<td></td>
<td></td>
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</tbody>
</table>

* 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
### TLAC and MREL compared

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

* EBA draft assessment criteria allow resolution authority to set lower MREL to enable an appropriate transitional period (up to 4 years)
Critical issue: does senior unsecured debt count as MREL?

### Aggregate MREL shortfall

<table>
<thead>
<tr>
<th>Scenario 1</th>
<th>Scenario 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>MREL = 2 x capital requirement (incl. buffers)</td>
<td>MREL = 8% total liabilities and equity</td>
</tr>
<tr>
<td><strong>Amount</strong></td>
<td><strong>Amount</strong></td>
</tr>
<tr>
<td><strong>% of assets</strong></td>
<td><strong>% of assets</strong></td>
</tr>
<tr>
<td><strong>No. of banks</strong></td>
<td><strong>No. of banks</strong></td>
</tr>
<tr>
<td>A. Equity and sub debt only</td>
<td>€332 bn</td>
</tr>
<tr>
<td></td>
<td>0.98</td>
</tr>
<tr>
<td></td>
<td>80</td>
</tr>
<tr>
<td>B. A + senior unsecured &gt; 1 year residual maturity</td>
<td>€36 bn</td>
</tr>
<tr>
<td></td>
<td>0.11</td>
</tr>
<tr>
<td></td>
<td>15</td>
</tr>
</tbody>
</table>

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