FINANCIAL REGULATION

Europe: TLAC implementation and MREL review

Maria Abascal / Javier Garcia

The European Commission has published its long awaited legislative proposal to amend both the prudential and the resolution frameworks in Europe. Regarding the latter, the proposal seeks to introduce TLAC for EU G-SIIs and amend MREL for other financial institutions. From now on, the EU Council and the Parliament will discuss whether to amend or approve the Commission's proposal. Once approved and published in the Official Journal of the EU, Member States will have 18 months to apply the measures.

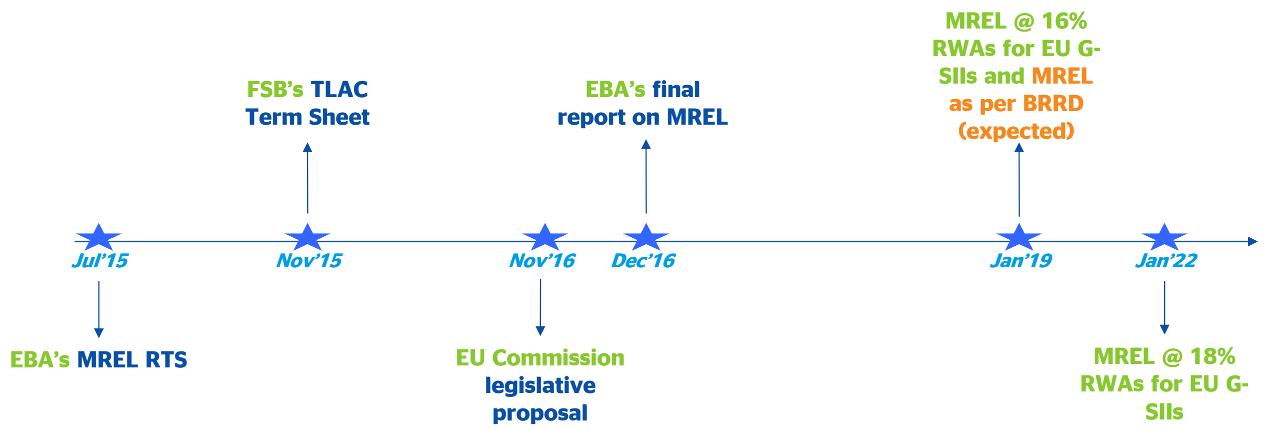
The new legislative package represents a positive step forward to reduce regulatory uncertainty and facilitates capital planning for banks. Nevertheless there is still a lot of work to do in order to finalize the framework through the adoption of rules and the development of level 2 legislation.

The main features are:

- The Commission has released its legislative proposal to **introduce TLAC in the EU** (through the CRR) by adapting the MREL of EU G-SIIs so its features coincide with those of the FSB's Term Sheet (with very few exceptions) in terms of calibration, eligibility, mandatory debt subordination, calendar, etc.
- For banks other than **EU G-SIIs, MREL will continue to be set on a case-by-case basis** although its features have been amended and clarified (in the BRRD).
- MREL will be calculated as **twice the sum of Pillar 1 and the new Pillar 2R**, or twice the leverage ratio, whichever is higher.
- A **breach of MREL** in the case of an entity not able to rollover eligible debt will trigger MDA restrictions after a 6 month period.
- The **eligibility of instruments** is the same as per the TLAC Term Sheet, for those banks who are required to subordinate their senior debt.
- In parallel, there is a proposal for **a clear and harmonized creditor hierarchy in Europe for senior debt**. The Commission has opted to mirror the French approach by forcing Member States to create a "non-preferred" senior debt class that banks can use in order to issue TLAC/MREL compliant debt.
- The proposal introduces the **concepts of resolution entities and groups** which clarifies the scope of application of MREL and is consistent with both MPE and SPE resolution strategies.
- Finally, **the Commission has reduced the burden of complying with art. 55** by adopting a proportionate approach allowing for certain waivers. The Commission seems to have taken EBA's recommendations into account except the one related to reducing the scope of affected liabilities in art. 55 of the BRRD.
- EBA's final report on MREL is not yet published but is expected to come out very soon.

Table 1

MREL/TLAC Calendar



Source: BBVA Research

Summary of the new features

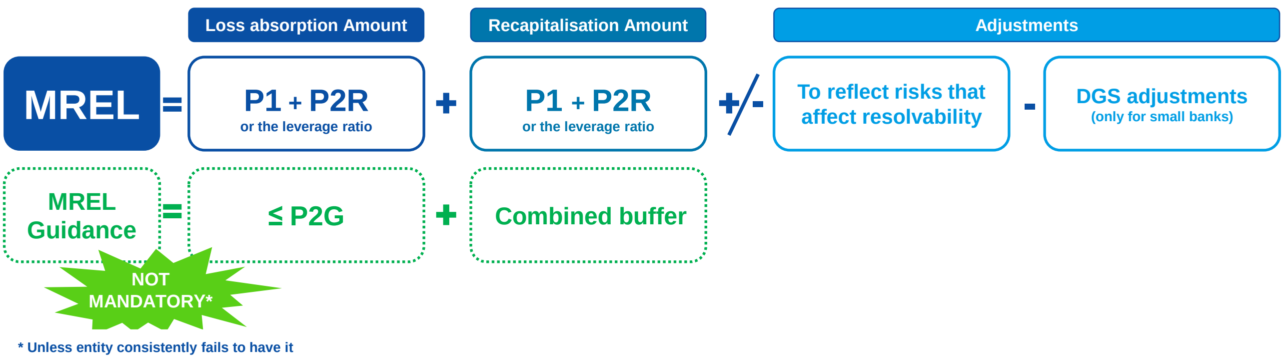
1. Objective
    - To introduce TLAC in Europe and to amend the current definition of MREL. For that, the prudential (CRR, CRDIV) and the resolution (BRRD and SRMR) frameworks are amended.
2. MREL denominator
    - In order to bring its definition closer to TLAC, the denominator of MREL is changed from total liabilities and own funds to either Risk Weighted Assets (RWAs) or the Leverage Ratio Exposure (LRE), whichever is higher.
3. Calibration: MREL will be different for EU G-SIIs and others:
    - **New formula for all entities.** The amendments clarify that MREL is calculated at resolution entity level which is consistent with both MPE and SPE resolution strategies. As per the initial EBA's RTS, MREL will still be the result of the sum of two components: loss absorption and recapitalisation amounts. However, buffers are excluded from its calculation:
        - MREL = Loss Absorption amount + Recapitalisation amount = Max {**2 * (Pillar 1**[1] **+ Pillar 2 required**[2]**)**; 2 * Leverage ratio}
        - Furthermore, the resolution authority "***may adjust the recapitalisation amount*** *to adequately reflect risks that affect resolvability arising from the resolution group's business model, funding profile and overall risk profile".*
    - **Timeline**: It is not clear when institutions would have to comply with MREL. The amendments to the BRRD establish that Member States shall transpose them by a date which is 12 months after their entry into force (unclear as of today, it depends on how long it takes for the Parliament and the Council to approve the legislative package). Furthermore Member States will have an additional 6 months period before applying the measures.

[1] Total capital ratio of 8% (CET1 4.5%, AT1 1.5% and T2 2%)
[2] As per new article 104ª of CRDIV

- **Minimum level for EU G-SIIs.** Mirroring the TLAC Term Sheet, the 13 EU G-SIIs will have to comply with at least a minimum MREL which is the highest of:
    - 16% of RWAs or 6% of the LRE as of 1 January 2019
    - 18% of RWAs or 6.75% of LRE as of 1 January 2022
- On top of the minimum MREL, EU G-SIIs may have to comply with a specific add-on as required by the resolution authority on a case-by-case basis (provided it is duly justified by the authority) as established in the TLAC Term Sheet.
- Buffers will be excluded from MREL and only the required part of the new Pillar 2 Required (P2R) will count in the calculation.
- There are no back-stops in terms of total balance sheet such as the 8% of total liabilities plus own funds (or 20% of RWAs) requirement.
- **MREL guidance.** This is a new non-binding requirement (its breach does not trigger MDA restrictions) according to which all banks must have additional MREL on top of the required level. It is also calculated as the sum of two components: a first one which shall not exceed the P2G and a second one that replaces the previous concept of “market confidence buffer” and which should not exceed the combined buffer requirement. Although not mandatory, MREL guidance may become binding if the entity consistently fails to have it.

Table 2

MREL Calibration



Source: BBVA Research

4. Subordination

- **For EU G-SIIs**: mandatory subordination of their minimum MREL level; for their entity specific add-on: case-by-case according to what the resolution authority decides.
- As per the TLAC Term Sheet, subordination may be achieved through contractual, statutory or structural means. Also, the exceptions to subordination of the TLAC Term Sheet are included such as the **2.5%/3.5%** of RWAs of non-subordinated senior debt and the **5% “de minimis”** threshold.
- **For other entities**: subordination is decided case-by-case according to what the resolution authority decides
- Furthermore the Commission has released a proposal (through a separate set of amendments to the BRRD) to **harmonize the creditor hierarchies in senior debt in Europe. Based on the French approach**, most EU Member States will have to amend their insolvency laws to include a new “non-

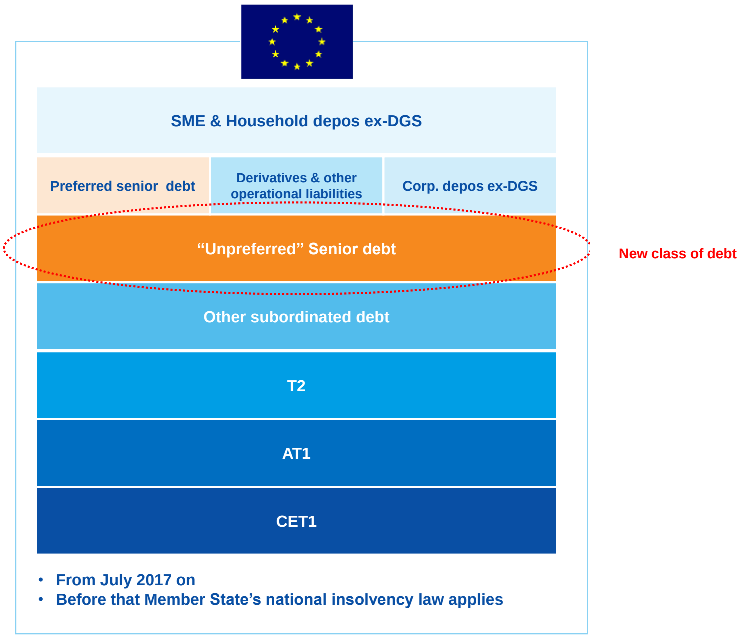
preferred senior debt" category **by July 2017**. The instruments issued under that class will count towards MREL if

- their remaining maturity is greater than one year,
- they do not include derivative components (which excludes the structured notes),
- they include a contractual clause specifying the ranking of the instruments in the creditor hierarchy.

- From July 2017 on, EU institutions that are required to subordinate their debt will use that category to issue MREL compliant senior debt. The Commission's proposal is flexible in the sense that it allows all bank senior debt issuances done before July 2017 to be treated as per their Member States' national insolvency laws as they were adopted before the 31 December 2016. Therefore, the German approach is valid until July 2017 as its own national insolvency allows computing outstanding senior issuances in a retroactive form. Issuances done before that date and governed by the law of that country will count towards MREL until their maturity. Furthermore, other Member States may combine the Commission's debt subordination proposal with a preference for certain types of deposits. Consequently, despite a significant step forward to harmonise creditor hierarchies in Europe, we can still envisage different approaches across countries regarding other liabilities different from senior debt.

Table 3

A harmonized creditor hierarchy in the EU



Source: BBVA Research

5. Eligibility

- This is where the amendments bring MREL closer to TLAC. The eligibility criteria for MREL are now the same as per the TLAC Term Sheet, save for those entities where subordination is not required and for structural notes which, under certain conditions, can count towards MREL.

- Unlike the TLAC Term Sheet, the amendments to the eligibility do not force banks to comply with MREL with a certain percentage of debt instruments (the Term Sheet specifies that non capital instruments must represent at least 33% of the TLAC eligible instruments).

6. Breaches of MREL
   - If a breach occurs because a bank cannot rollover part of its eligible liabilities, a six month "grace" period is granted during which time no MDA restrictions would apply. The "grace" period is in fact a temporary waiver to the MDA restrictions provided in the prudential framework that apply once a bank breaches its buffers. The grace period is justified because buffers are now excluded from MREL and placed "on top" of the requirement and because a breach of MREL is automatically covered (when available) with CET1 from the combined buffers.
   - Authorities can now react more quickly to breaches of MREL, by asking entities to remove obstacles to resolvability, changing the maturity profile of their debt and requiring them to draft an MREL restoration plan within 2 weeks.
7. Internal MREL
   - European subsidiaries of non EU G-SIIs which are not resolution entities will have to issue internal MREL to their parents abroad equal at 90%.
   - Guarantees (with a minimum level of collateral of 50%) may be used to comply with internal MREL for both EU and non-EU G-SIIs.
8. Art. 55
   - The scope of liabilities has not been reduced as per the EBA's recommendations in its MREL interim report but the Commission has opted for a proportional approach through waivers granted by resolution authorities so banks can exclude certain liabilities if they are unable to include the bail-in clause for legal, contractual or economic reasons.
9. Deductions
   - Following the recent publication of the final standards of the BCBS concerning deductions of investments in TLAC, the Commission has adopted them into European law with some variations. The main difference is that the deductions will apply to MREL liabilities instead of Tier 2.
10. Disclosure
    - Entities will have to disclose publicly their MREL at least on an annual basis, the maturity profile and the position in the creditor hierarchy of their eligible liabilities.
11. Moratorium Tools
    - These are new tools that both the Competent Authority (during the pre-resolution phase) and the Resolution Authority (during the resolution phase) can use to suspend the payment of principal and interest of certain obligations for a maximum period of 5 days.
    - The suspension does not apply to covered deposits, obligations to CCPs, Central Banks
12. EBA's assignments to develop level 2 legislation
    - EBA will have to complete the package of level 1 legisltation amendment by developping Regulatory Technical Standards and Implementing Technical Standards on several topics:
      - MREL (1 month after the entry into force of the amendments)
      - Disclosure requirements (after 12 months)
      - Communication of MREL between authorities and EBA (after 12 months)

    - Specify the conditions for waivers to art. 55 (no indication of timing)

- Furthermore, the EBA will have to release reports on the implementation of MREL every two years.

13. Other topics

- The CRD (art. 21b) introduces a requirement similar to the obligation that foreign banking organizations have in the US to establish an Intermediate Holding Company (IHC) if the foreign entity:
    - has two or more institutions in the EU which are part of the same third country group
    - has more than EUR 30 bn in assets (in subsidiaries or branches)
    - is part of a non-EU G-SII
- According to the Commission, the purpose of this new requirement is to facilitate the implementation of internal MREL for non-EU G-SIIs and to simplify the resolution process of third-country groups.

.

DISCLAIMER