Lost in TLAC

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The regulatory “translation” problem

(Banking) policy objectives not easily transformed into operable regulation (law)

- legislative process (need for political compromise among many constituents)
- technical difficulties in avoiding undesirable (latent) consequences

Two guiding questions for analysis of TLAC and its European close relative MREL

- How much of the basic concept of bail-in gets lost in the regulatory prescriptions that are supposed to support its effective implementation?
- How much can be recovered through the normatively informed interpretation of the pertinent standards?

Roadmap

1. Reminder: Interconnection between bail-in objectives, TLAC, and MREL

2. Closer look at key TLAC and MREL prescriptions

    2.1 Calculation

    2.2 Eligible liabilities

    2.3 Treatment of banking groups

    2.4 Restrictions on holdings

3. Conclusion

1. Interconnection between bail-in, TLAC, and MREL

Objectives of FSB TLAC standard (term sheet item 1)

> "The objective of this standard is to ensure that G-SIBs have the loss-absorbing and recapitalisation capacity necessary to help ensure that … critical functions can be continued without taxpayers' funds (public funds) or financial stability being put at risk."

Means to achieve objective is prescription of sufficient capital available for bail-in (cf. FSB TLAC press release)

> "The TLAC standard defines a minimum requirement for the instruments and liabilities that should be readily available for bail-in within resolution at G-SIBs…"

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1. Interconnection between bail-in, TLAC, and MREL

Identical function of MREL in BRRD (recital 79)

"To avoid institutions structuring their liabilities in a manner that impedes the effectiveness of the bail-in tool it is appropriate to establish that the institutions meet at all times a minimum requirement for own funds and eligible liabilities…"

Bail-in rationale: guiding principle of banking policy post 2007/2008

preserve public finances *ex post* and bolster market discipline *ex ante* (private sector loss participation)

resolution of failing banks without financial stability implications (paramount)

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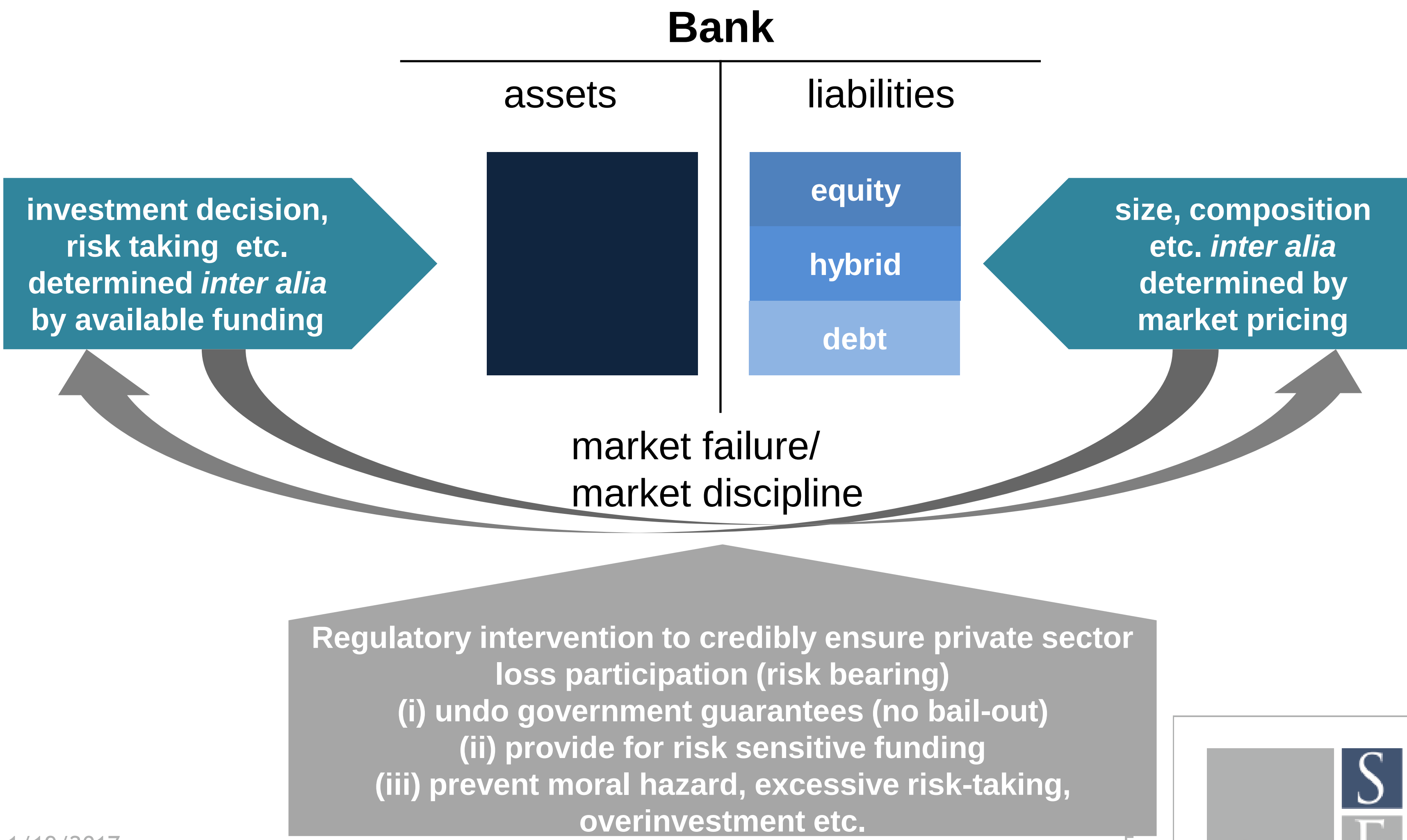
1. Regulatory intervention to instill market discipline (bail-in)



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1. Bearing of TLAC/MREL prescriptions on bail-in tool

Desiderata (e.g. Liikanen)

Sophisticated investors must be capable to price risk adequately (*ex ante* designation)

- clear cut trigger event (e.g. CET1 ratio)
- bail-inable instruments identifiable
- specific consequences predictable (automatic haircut/conversion)

Bail-in must not destabilize markets (knock-on effects)

- credible loss bearing capacity
- non-financials as holders (insurers, penion funds, HNIs, hedge-funds)

TLAC/MREL

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2.1 Calculation of TLAC and MREL

Overarching Objective: Supervisor/resolution authority must ensure that banks retain sufficient liabilites (*quantitatively* and *qualitatively)* earmarked for bail-in

FSB: TLAC ***G-SIBs***	**EU: MREL** ***credit institutions and investment firms***
FSB TLAC Principles and Term Sheet	**BRRD, arts. 45, 17; SRMR, art. 12; Reg EU 2016/1450**

RWA Minimum

$$\frac{own\ funds + eligible\ liabilities}{RWA} = 0,16\ (0,18)$$

LRE Minimum

$$\frac{own\ funds + eligible\ liabilities}{LRE} = 0,06\ (0,065)$$

$$\frac{own\ funds + eligible\ liablities}{own\ funds + total\ liabilites}$$

Inclusion of Tier 1 and Tier 2 instruments

(i) coordination with Basel III/CRR capital requirements (cf. TLAC term sheet item 6)
(ii) BRRD/SRMR: supervisory and resolution authorities

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2.2 Eligible Liabilities

FSB: TLAC *G-SIBs*	EU: MREL *credit institutions and investment firms*
Eligible instruments (item 9) • Fully paid in • Unsecured • Not subject to set off or netting rights • Minimum remaining maturity of one year • Non redeemable by holder prior to maturity • Not funded by resolution entity or related party (subject to waiver) **Excluded liabilities (item 10)** • Insured deposits • Sight and short term deposits • Liabilities arising from derivatives • Debt instruments linked to derivatives • Non-contractual liabilities (e.g. tax liabilities) • Liabilities preferred to senior unsecured debt under insolvency law • Liabilities excluded from bail-in or subject to bail-in only with material litigation risk	**Eligible liabilities (BRRD, art. 45(4))** • Issued and fully paid-up • Not owed to, secured or guaranteed by institution • Not funded directly of indirectly by institution • Remaining maturity of at least one year with maturity set at first date of early redemption right) • Not arising from a derivative • Not arising from preferred deposits **Excluded liabilities (BRRD, art. 2(1)(71))** • Liabilities not subject to bail-in, BRRD, art. 44(2), e.g. covered deposits, secured liabilities • BRRD, art 44(3) (SRMR, art. 27(5)) ad hoc-exemptions only if predetermined in resolution plan, BRRD, art. 45(6)(c)

2.2 Subordination problem

TLAC instruments must be subordinated to any financial instruments that are ineligible (item 11) → absorb losses prior to ineligible instruments

Contractual subordination	Statutory subordination	Structural subordination
• Contract clause under which excluded liabilities rank higher than TLAC instruments in insolvency/resolution • Requires recognition of contract clause	• TLAC instruments rank junior to excluded liabilities under statutory creditor hierarchy • Requires recognition of insolvency laws	• TLAC instruments are issued by an entity (eg holding) that has no pari-passu or junior ranking excluded liabilities on its balance sheet that • Requires recognition of corporate structure

2.3 TLAC and MREL in (cross-border) groups

- **loss sharing/capital (liquidity) support among group members**
- **preferences of RA differ according to costs and benefits that respective economy incurs in resolution**

FSB: TLAC ***G-SIBs***	**EU: MREL** ***credit institutions and investment firms***

External TLAC

- **RWA Minimum & LRE Minimum for *resolution entities* calculated on the basis of consolidated balance sheet of *resolution group***
- **No TLAC prescriptions for subs that are not themselves *resolution entities***

Internal TLAC (item 16)

- **75-90% of external Minimum TLAC for *material sub-group* calculated on stand-alone basis**
- **Pre-positioning of bail-in capital to support significant foreign operations of banking group**

MREL prescriptions applied to

- **Individual institution, parent and sub, BRRD art. 45(7) and (10)**
- **EU parent undertaking on a consolidated basis, BRRD art. 45(8)**

Exemptions

- **discretionary waiver for subsidiaries that belong to a sub-consolidated group within one Member State, BRRD art. 45(12)**

EBA Interim Report on MREL

- **Resolution entity issues external MREL**
- **Pre-positioned at subs (internal MREL)**

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2.4 Restrictions on Holdings

Time inconsistend behavior of political decision makers looms if investors in TLAC/MREL instruments don't have loss bearing capacity

FSB: TLAC ***G-SIBs***	**EU: MREL** ***credit institutions and investment firms***
Banks (item 15 and TLAC Holdings Standard) • TLAC-instruments of other G-SIBs have to be deducted from own TLAC (cf. capital requirements) **Retail investors** • no treatment	**Banks** • RA can prohibit investments in MREL instruments of other banks if they pose a threat to the institutions resolvability, BRRD arts. 44(2) subpara 5, 17(5) • large exposure limits, CRR art. 395 **Retail investors** • No treatment

3. Conclusion

„Bail-in under the BRRD is complicated“ (Gleeson, 2016) – and will remain so

- Achieving policy objectives imperiled by complex and detailed implementation
- TLAC/MREL provide some relief as they earmark high-quality instruments available for bail-in (predictability of PSI)
- Requires stringent and impartial implementation based on firm principles derived from policy objectives
- Be as transparent and as time-consistent as possible!

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