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The Impending Review of the European Resolution Framework

The Commission's Proposals of 23 November 2016

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‘Banking Reform’ package

Background

Review of existing norms based on

- 2015 public consultation on impact of CRD IV/CRR banking prudential regime on the financing of the EU economy
- ‘Call for Evidence’ on all post-crisis legislation on financial services
- Specific Commission analysis on CRD IV rules on remuneration

Need to implement FSB’s TLAC standard in EU

23 Nov 2016: launch of the Banking Reform package

‘Today, we have put forward new risk reduction proposals that build on the agreed global standards while taking into account the specificities of the European banking sector’ – Commission Vice-President Valdis Dombrovskis

Five legislative proposals

Amendment of CRD IV/CRR prudential regime of 2013

Amendment of BRRD & SRM Reg resolution regime of 2014

Key prudential proposals

Completion of the Basel III prudential regime

Binding 3% leverage ratio (LR)

Binding detailed net stable funding ratio (NSFR)

More risk-sensitive own funds requirements for securities & derivatives trading (BCBS's FRTB)

No amendments on topics still under discussion in the BCBS (credit and operational risk, including introduction of 'output floor')

Facilitation of lending to SMEs and for infrastructure projects

(But at the cost of significant divergence from Basel standards)

Making supervisory requirements more proportionate & easing burden for smaller and non-complex banks

More proportional rules on supervisory reporting

CRR disclosure requirements

Amendment of the remuneration rules

Phasing-in of IFRS9

Resolution-related proposals

New standards on TLAC (total loss-absorbing capacity) for G-SIIs

- Minimum (Pillar 1) levels of capital and other instruments (debt) designed to bear losses in resolution (EU implementation of the FSB standard)
- Possibility of discretionary Pillar 2 add-on

Review of the MREL system

- Integration of TLAC standard into existing MREL system, which applies to all institutions
- Technical redesign of the MREL system, to align it with the TLAC standard

Norms on group resolution planning

- Designation of ‘resolution groups’ and ‘resolution entities’
- Intermediate EU parent undertakings for non-EU G-SIIs
- External v internal TLAC/MREL

Amendments to strengthen the legal underpinning of the resolution process

- New creditor hierarchy: new rank of non-preferred senior debt
- Moratorium powers
- Contractual recognition of bail-in in third-country instruments: possibility of waiver

Group structures and resolution planning

EU resolution law envisages –but presently does not provide an effective legal basis for– group-wide approaches to resolution

Resolution may take place in relation, not to individual operating subsidiaries, but to their intermediate or ultimate holding company

- Only the holding company enters into resolution
- Only holding company's direct claimants stand to suffer losses
- Operating subsidiaries survive / may remain part of the same group
- Creditors of operating subsidiaries are insulated from effects of bail-in

Resolution on this basis may affect the whole group or distinct parts (sub-groups)

- Single Point of Entry (SPE): only one 'resolution entity' for the whole group
- Multiple Point of Entry (MPE): several resolution entities, with corresponding resolution groups (which include all their direct and indirect subsidiaries)

Amendments to the existing prudential and resolution framework will allow for effective planning and application of group-wide resolution strategies

Financial holding companies: brought under direct supervisory control

FHCs: undertakings engaging in non-banking financial activities, whose subsidiaries are exclusively or mainly credit institutions, investment firms or financial institutions

Currently caught by the EU regulatory net only indirectly (through operating subsidiaries)

Proposed amendments bring FHC and mixed FHC under direct supervisory control and shift to them the responsibility for compliance with prudential norms on the consolidated level

Changes in the resolution framework (BRRD & SRM Reg) to ensure proper classification of various entities within a banking group

Introduction of new legal concepts of

- 'resolution entities' (the entities to be resolved in accordance to the resolution plan), and
- 'resolution groups' (the subsidiaries belonging to the resolution entities)

Explicit *ex ante* characterization of each entity within a group in the context of group resolution planning

Consideration of the implications of planned resolution actions for group resolution

Simultaneous determination of the level of application of the rules on loss absorbing capacity (MREL/TLAC)

Corralling of the EU part of large non-EU banks

New CRD structural requirement for large third-country banking groups

Applicable to

- non-EU G-SIIs and
- other non-EU groups with extensive activities in the EU (total EU assets of at least €30 billion; assets in branches of non-EU entities are also included in the calculation!)

Obligation to establish a single intermediate EU parent undertaking for all their subsidiaries in the EU

The intermediate EU parent undertaking may be either a FHC or an EU authorized institution

Rationale of the new requirement – and remaining difficulties

The corralling of the foreign groups’ EU subsidiaries under a single roof facilitates the application of TLAC standards ,as well as the application of the resolution tools

However, it is unclear how the new system will operate in situations where the group applies a global (SPE) resolution strategy

Special difficulties in the case of US groups, which are also subject to the Volcker rule: what happens , e.g., if some of the EU subsidiaries are credit institutions, while others carry on a proprietary securities trading business?

Bail-in-able liabilities as a prerequisite for bail-in

To enable bail-in, it is necessary that banks have a sufficient stock of non-excluded (bail-in-able) liabilities

To ensure ex ante the availability of sufficient bail-in-able liabilities (and to prevent shift to excluded liabilities): need to regulate banks' funding structure, over and above the maintenance of capital ratios

Additional consideration of European law: bail-in of at least 8% of total liabilities (including own funds) is a legal condition to the activation of 'public' funding resources in support of resolution

- Assistance by the resolution fund
- Activation of 'government financial stabilization tools': recapitalization with taxpayers' funds / nationalization

Accordingly: special requirements on banks' liability structure

EU: MREL (currently, BRRD, Art 45)

FSB: TLAC

FSB’s TLAC standard for G-SIBs

Complements the bail-in provisions in the ‘Key Attributes’ standard

Original mandate: G20 St Petersburg summit, 2013

Draft standard, FSB, Nov 2014

Final FSB standard, Nov 2015

Comprises a set of Principles and a more technical Termsheet

Establishes minimum requirement for total loss-absorbing capacity for G-SIBs

While resolution-related, its practical effect is to greatly enhance the prudential/ex ante control of banks’ financial structure, over and above the Basel III capital & liquidity standards

Seeks to promote

- market discipline
- market confidence (both by setting a floor and by requiring transparency)
- a level-playing field internationally

Supports cross-border coordination by addressing the internal allocation of bail-in-able liabilities in multi-country G-SIBs

TLAC requirement

Common minimum TLAC requirement for all G-SIBs

Rule-based floor

Will eventually rise to the highest of 18% total RWAs or 6.75% of the Leverage Ratio Exposure)

plus

Firm-specific TLAC for each G-SIB set by its resolution authority

Discretionary add-on, over and above the minimum, based on

prudent assumptions about

- losses incurred prior to resolution, and
- ‘losses realised in the prudent valuation necessary to inform resolution actions’,

and

estimated capitalization needs of the surviving entity, which should be able to

- meet minimum capital requirements under Basel III, and
- regain market confidence

Subject to review in FSB Resolvability Assessment Process (RAP)

TLAC calibration & conformance period

		Existing G-SIBs	EME G-SIBs	New G-SIBs (2016–18)	New G-SIBs (after 2019)	After voluntary bail-in (recovery measure)	G-SIB / bridge entity after resolution
TLAC / RWAs	16%	01 Jan 2019	01 Jan 2025	—	—	24 months	24 months
	18%	01 Jan 2022	01 Jan 2028	01 Jan 2022	36 months	24 months	24 months
TLAC / Leverage Ratio Exposure	6%	01 Jan 2019	01 Jan 2025	—	—	24 months	24 months
	6.75%	01 Jan 2022	01 Jan 2028	01 Jan 2022	36 months	24 months	24 months
Allowance for credible commitments to recapitalize in resolution (off-balance-sheet)	Up to 2.5% of RWAs	01 Jan 2019	01 Jan 2025	—	—	24 months	24 months
	Up to 3.5% of RWAs	01 Jan 2022	01 Jan 2028	01 Jan 2022	36 months	24 months	24 months

MREL: Europe’s TLAC?

MREL v TLAC

- MREL preceded TLAC: incorporated from the start in the BRRD, Art 45
- Shares with TLAC the same objectives and general approach; but with
- Significant differences in the technical specifications
- Currently calculated as a percentage of total liabilities and own funds
- Applicable in principle to all European institutions, not only G-SIIs
- MREL: institution-specific (‘Pillar 2’-type) requirement; should it be harmonized for all/some banks?

Review of MREL & EU implementation of TLAC

- Due to lack of consensus: MREL originally left to the discretion of national resolution authorities or, for significant EA banks, the SRB
- Commission enabled to submit by end-2016 proposal for revisions of MREL (possibly including the introduction of common minimum level for various categories of banks); BRRD, Art 45(18)
- Explicit reference in BRRD, Art 45(20) to the need for consistency with international standards
- Attempt by EBA to make the process more rule-bound by way of draft Level 2 legislation (technical standard) apparently rejected by the Commission as *ultra vires*

TLAC v MREL (present state)

	TLAC	MREL
Legal source	Soft-law international standard	Binding European provision
Scope	G-SIBs (including 13 EU banks / 8 EZ banks)	All institutions
Objective	Sufficient bail-in-able liabilities for continuation of critical functions without use of public funds or risk to financial stability	Implicitly, less ambitious: external resolution funding available, following limited use of bail-in (8% of total liabilities)
Placement	Calculated at each point of entry ('resolution entity') for the respective 'resolution group' (direct and indirect subsidiaries of the resolution entity)	Applies at both the individual and consolidated levels; but Solo compliance may be waived
Pre-positioning	Each 'material sub-group' (i.e. significant national sub-group within a resolution group) must maintain internal TLAC at a level of 75–90% of the external TLAC requirement to which it would be subject if it were itself a resolution group	No provision
Nature of requirement	Rule-defined minimum (Pillar 1), and Discretionary bank-specific add-on	Discretionary bank-specific requirement (Pillar 2)

	TLAC	MREL
Basis of calculation	% of RWAs, and % of Leverage Ratio Exposure	% of total liabilities, including own funds
Calibration	Higher of 16% / 18% of RWAs, or 6% / 6,75% of Leverage Ratio Exposure	Loss Absorption Amount (total capital requirements of present bank), plus Recapitalization Amount (minimum capital requirement post-resolution), *minus* adjustments, including estimated contribution of DGS to resolution financing
Composition	Tier 1 and Tier 2 own funds, plus eligible instruments, *minus* CET1 covering the Basel III capital buffers	Tier 1 and Tier 2 own funds, plus eligible liabilities
Minimum share of debt instruments	33%	No provision
Allowances	Up to 2.5 / 3.5% of RWAs in the form of off-balance-sheet credible commitments to recapitalize bank upon resolution	No allowance

	TLAC	MREL
Priority	TLAC-eligible instruments must be junior to excluded liabilities (subject to *de minimis* exceptions) Subordination can be statutory, contractual or 'structural' (i.e. TLAC-eligible instruments issued by resolution entity which does not issue itself excluded liabilities)	No clear stance: certain classes of eligible liabilities are statutorily subordinated, but some can rank *pari passu* with excluded liabilities
Foreign-law instruments	Instruments issued under non-domestic law are admitted only if their availability is guaranteed under local statute or legally enforceable contractual provisions	For instruments issued under third-country law, institution must demonstrate that they can be legally and effectively bailed-in
Issuer	From 2022, direct issuance only by resolution entity (with certain exceptions, esp. CET1 capital issued by subsidiaries)	No specific provision
Basel III capital buffers	Deduction of CET1 covering buffers	No deduction
Cross-holdings	Deduction of holdings of other G-SIBs' eligible instruments	No deduction
Implications of breach	Treatment should be as severe as for breaches of minimum capital requirements	No specific provision
Entry into force	2019 / 2022	Bank-specific requirements set from 2016; discretionary phase-in

The Commission's strategy

List of options

1: No change to BRRD framework; TLAC implementation by resolution authorities as MREL requirement

2: Legislative adoption of TLAC for G-SIIs; no change to the general capital regime or MREL

3: MREL review, leading to integrated regime (alignment with TLAC and prudential regime)

The Banking Reform package is based on Option 3: the Commission's preferred option – on grounds of simplicity, clarity, market confidence

Implementation of TLAC

Mandatory Pillar 1 requirements for G-SIIs, implemented through amendments to CRR

Consistency with Basel III and TLAC floors

- 2019 targets: TLAC/RWA > 16 and TLAC/LRE > 6%
- 2022 targets: TLAC/RWA > 18 and TLAC/LRE > 6.75%

Streamlined Tier 2 eligibility criteria, to mirror TLAC standard (subordination, one-year minimum residual maturity)

Exclusion of CET1 meeting capital buffer requirements

Pillar II going-concern add-on to capital requirements, at discretion of competent authorities

Revision of MREL and alignment to TLAC technical approach

MREL requirement continues to apply to all banks

- Set at a bank-specific level by the resolution authorities / SRB
- Consistently with TLAC standard, the resolution authorities enabled to impose supplementary (Pillar 2) MREL requirement also on G-SIIs

Amendments to the BRRD and the SRM Reg (for the BU) to align existing MREL requirements with the TLAC technical specifications

- Abandonment of current basis for MREL calculation (total liabilities) in favour of RWAs and LRE

Bank-specific level of MREL set by resolution authorities when preparing resolution plans

- Takes into account the envisaged resolution approach
- Diversity of business models and funding strategies recognized

MREL ‘guidance’

Regulatory requirements v ‘guidance’

The Banking Reform package distinguishes between Pillar 2 requirements and guidance

- Pillar 2 capital requirements: bank-specific mandatory requirements , imposed by supervisors to address risks not fully covered by Pillar 1 and buffer capital requirements
- Capital guidance: supervisors’ expectations that an institution will hold capital in excess of the various mandatory requirements, as a protection against remote risks

Resolution authorities and MREL guidance

In similar vein, resolution authorities may give MREL guidance

MREL requirements are set at the level necessary to

- absorb losses (in line with the supervisors’ determination of capital requirements) and
- to recapitalise the bank following resolution, up to the point where the surviving operation complies with its continuing authorisation requirements

MREL guidance may be set to

- cover capital guidance that has already been set by the bank's supervisor or
- ensure market confidence in the resolved entity

Internal v external MREL in banking groups

For individual regulated entities within a group, the nature of MREL requirements will depend on their classification

In line with the group-wide approach to resolution outlined above (also reflected in the TLAC standard), the Commission's proposals distinguish between the MREL requirements of resolution entities and other group entities

- Resolution entities will observe external MREL requirements (by issuing eligible liabilities to non-group parties)
- The funds raised may be 'downstreamed' to individual subsidiaries (and, in accordance to TLAC techniques, partially pre-positioned to 'material sub-groups')
- Subsidiaries which are not resolution entities will observe internal MREL requirements (by issuing intra-group eligible liabilities to their resolution entity)

Internal MREL enables the 'upstreaming' of losses to the resolution entity without need for commencement of resolution proceedings at the subsidiary's own level

Possibility of waivers where both entities are established in the same MS

Where the entities are established in different MSs, the relevant resolution authorities may agree to allow the subsidiary to meet its MREL requirement by receiving from its resolution entity guarantees in its favour, instead of issuing intra-group eligible liabilities to the resolution entity

Consequences of breach of MREL requirements

While the current regulatory framework does not specify the consequences for failure to meet MREL requirements, the Commission's proposals does!

- In line with the TLAC standard, where a bank's eligible liabilities do not suffice to cover its MREL, the shortfall is automatically cover with CET1, which is deducted from the amounts allocated to the combined capital buffer requirement
- Since this may cause the bank to breach its combined capital buffer requirement, the breach can indirectly trigger automatic limits on discretionary payments to holders of regulatory capital instruments and employees
- To address the situation where the shortfall of eligible liabilities is due to market conditions (temporary inability to issue new instruments), the proposals provide for a six month grace period prior to the activation of limits on discretionary payments
- However, even during the six-month period, it will be possible for the authorities to take other measures to correct the bank's financial problems
- Due to the nature of MREL guidance, its breach does not lead automatically to sanctions (limits on discretionary payments)

Proportionality of MREL requirements

The specification of the proposed MREL norms reflects the Banking Reform package's more general emphasis on proportionality

MREL remains a Pillar 2 type, whose level must be determined on an individual basis; the Commission did not pursue the option in BRRD, Art 45(18), to set common minimum MREL requirements for particular categories of banks

The resolution authorities' decisions on the level of MREL must be duly justified, also by reference to the chosen resolution strategy

For G-SIIs, which are already subject to Pillar 1 MREL/TLAC, the imposition by resolution authorities of an bank-specific add-on must be duly justified, necessary and proportionate

The concern for 'flexibility' and differentiation is also evident in the technical specifications

- Unlike in TLAC/Pillar 1 MREL, for Pillar 2 MREL subordination of debt instruments is not a condition of eligibility, but may be required by resolution authorities if this is deemed appropriate in order to facilitate the application of bail-in tool; however, a requirement of this type will need to be specifically justified
- Banks will be allowed to use debt instruments with certain derivative-linked features (*e.g.*, structured notes), provided that these have a fixed principal amount
- The existing exemption from MREL for mortgage credit institutions will be preserved

New hierarchy of claims

Creditors' hierarchy governed by national insolvency laws, with certain exceptions (partial harmonization of priority of claims in bank insolvency)

- Depositor preference (covered followed by other preferred deposits) already established in BRRD, Art 108
- Significant divergence in national approaches to the ranking of senior unsecured bonds
- Certain MSs (Germany, Spain) have introduced statutory subordination of senior bonds, with retrospective effect, in order to make existing debt instruments eligible for TLAC/MREL
- This creates inconsistency of treatment across MSs, legal uncertainty, competitive distortions; and complicates the application of bail-in

Proposal for harmonized priority ranking for 'non-preferred' senior debt instruments; draft Dir on ranking of unsecured debt, COM(2016) 853 final

- The new category does not include loans
- It does not include debt instruments with derivatives-like features
- The instruments must have an original contractual maturity of more than one year

Compliant instruments rank above capital instruments and contractually subordinated junior debt, but below other senior liabilities

They will be eligible for MREL/TLAC purposes (they meet the mandatory 'subordination' requirement for Pillar 1 TLAC as well as any discretionary Pillar 2 subordination requirement) (in contrast to usual senior debt)

The proposed rule eschews retroactivity

It comes into effect from the date of application of the new Dir (July 2017?)

The ranking of existing stocks of debt instruments will still be governed by national laws adopted before [31 December 2016]

EBA views on ranking; ECB Opinion of 08 Mar 2017 (CON/2017/6)

Introduction of general depositor preference, based on tiered approach

Clarification that non-preferred senior instruments rank *pari passu* with senior debt already subject to statutory subordination in insolvency/resolution

Possibility of bailing in non-preferred senior instruments with shorter maturities

Alignment of national insolvency regimes, to establish that Tier 2 instruments rank below other subordinated liabilities

Waiver of obligation recognize contractually bail-in in instruments issued under third-country law

Change justified on grounds of proportionality

The rule of BRRD, Art 55 currently applies to all contracts not legally excluded from bail-in, whether these are likely to be included in bail-in or not

It is reputed to create significant problems to banks having branches in third countries, thus forcing them either to adopt structural solutions (subsidiarization) or to withdraw

Amendment enabling resolution authorities to waive the requirement

Where they determine that

- it is ‘legally, contractually or economically impracticable’ for banks to include a compliant contractual clause and
- such waiver would not impede the resolvability of the bank

The exercise of the power to waive is fully discretionary

Special treatment of foreign liabilities covered by a waiver

They do not count towards the MREL

Are senior to liabilities that do count (to avoid breaches of the NCWO principle)

New moratorium powers

New harmonized powers to impose moratorium inserted in the BRRD

- Enable the suspension of certain contractual obligations for a short period of time
- Aim to prevent the unravelling of a bank’s liquidity through the withdrawal of creditors’ claims
- Applicable both as an early intervention power and in the resolution phase
- Provide time for the establishment of the true situation and the making of necessary valuations of assets and liabilities

Conditions of application

- A moratorium may be employed in the pre-resolution phase, as an early intervention power, to provide time for determining whether early intervention measures are necessary or whether the institution is failing or likely to fail
- Suspension of payments may also be employed during the resolution process to facilitate the effective application of resolution tools or to provide time for a valuation under BRRD, Art 36
- Covered deposits are excluded from the new moratorium powers in order to ensure consistency with the principles of DGS Dir and to safeguard market confidence
- A moratorium is of limited duration, which may not exceed five working days

Thank you for your attention

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