AFME Position Paper

EU implementation of TLAC and review of MREL

October 2016

This paper provides a summary of AFME's views on the implementation of TLAC in the EU and the review of MREL. Further details can be found in our May 2016 position paper on TLAC implementation, here, and on our response to the EBA Interim Report on MREL review, here. For more details please do not hesitate to contact us.

Introduction

AFME strongly supports the development of an effective recovery and resolution framework and the efforts to put in place credible cross-border resolution plans that enable banks to be resolved without systemic disruption or exposing taxpayers to loss. The EU has made very significant progress towards this objective. Establishing an effective and appropriate framework for loss absorbing and recapitalisation capacity is key to progress further on this path and to address "too-big-to-fail". As such, we welcome the forthcoming proposal to implementation of TLAC in the EU and the EBA's review of MREL.

We suggest that the legislative proposal should establish a single framework that implements the TLAC Standard for GSIBs and establishes a common framework for all banks, minimising inconsistencies and distortions. In doing so the following key principles should be followed:

a) The EU should implement the TLAC Standard for GSIBs as agreed with no material deviations. This is essential to provide international consistency, support cross-border cooperation and provide clarity for banks and the market.

b) Clarity regarding loss absorbing capacity requirements and confirmation that the above principle will be met should be provided as a matter of urgency in order to enable banks to plan implementation by the deadlines set in the TLAC Standard. An appropriate transitional period is required in the meantime and this should be aligned with the TLAC Standard. Many banks will need to issue significant amounts of eligible debt and investors require clarity as to the final requirements before investing, particularly in the current challenging market conditions. Clarity should also be provided as to how the existing MREL regime will be applied and when the new framework will come into force.

c) TLAC and MREL implementation should provide for a single framework for loss absorbing and recapitalisation capacity for banks in the EU. Overlapping requirements which apply to the same banks with different criteria seeking to achieve the same purpose would create confusion amongst investors, potentially result in conflicting requirements for banks and add additional complexity for banks and the authorities which would have to monitor and manage multiple requirements.

d) The purpose of MREL and TLAC is to facilitate the group resolution strategy. It is therefore vital that the calibration and location of MREL/TLAC is aligned with the resolution strategy for the group, as agreed in the Crisis Management Group or resolution college.

e) The European legislation should support cross-border cooperation both within the EU and with authorities in third countries. It should take account of the ongoing work at international level on issues such as internal TLAC, disclosure and cross-holdings treatment.

Adequacy and calibration

Calibration of MREL should be closely linked to and justified by the institution's resolution strategy. We broadly support the current MREL calibration framework which is focused on the relevant resolution plan for the group, subject to implementation of the TLAC standard for GSIBs. We recommend that certain aspects of the existing MREL framework should be reviewed, in particular excluding capital buffers in the event that these sit on top of MREL and some adjustments to the determination of the recapitalisation amount to take account of the resolution strategy.

We strongly support the EBA recommendation that firm specific requirements should only be set at levels necessary to implement the resolution strategy. For GSIBs, MREL should be aligned with the TLAC requirement and any further firm-specific requirement should be duly justified by the resolution authority on the basis of being necessary to implement the resolution strategy. Consideration should also be given to the potential impact on MREL calibration arising from potentially very substantial increases in RWAs under the capital standards agreed and proposed at the Basel Committee since the TLAC Standard was finalised.

We believe that requiring MREL to be calibrated at 8% of total liabilities and own funds in order to ensure that it is possible to access resolution funds for solvency support is the wrong starting-point for calibration. The focus should be on resolvability and achieving the resolution objectives without the need to use resolution funds to absorb losses.

Eligibility

We support the implementation of the TLAC Standard including subordination requirements for GSIBs. As part of this, the EU should implement the exemptions to subordination and the transitional arrangements provided for in the TLAC Standard.

With respect to other eligibility criteria, we support the alignment of the MREL eligibility criteria with the TLAC Standard. However, one area that we encourage the authorities to consider further is the treatment of structured notes, in particular in relation to transitional arrangements. We believe that certain structured notes are clearly loss absorbing and the operational and valuation challenges can be overcome such that there should not be a blanket exclusion from MREL. Structured notes comprise an important source of unsecured funding for many banks and can provide an additional source of loss-absorbing capacity.

We support the EBA's provisional view within their interim report on MREL, that subordination requirements should focus on establishing to which other liabilities the subordination of MREL eligible liabilities is required, rather than the legal form of subordination. The scope of liabilities to which any subordination should be required should be aligned with the TLAC Standard. A definition of "excluded liabilities" should be introduced to clarify this.

Stacking order, relationship with capital requirements

AFME also supports the EBA's provisional recommendation that capital buffers should stack on top of MREL. However it is essential to carefully consider the interaction between this approach and MDA restrictions. While we support the view that CET1 should not be double-counted and that a breach of MREL should be treated seriously, in our view it would be inappropriate for MDA restrictions to be automatically triggered by virtue of a bank breaching its combined buffer solely as a result of CET1 being used to meet a temporary MREL shortfall. This could occur, for example, due to a temporary debt refinancing issue rather than the bank facing any immediate solvency issues and would result in a substantially higher threshold at which MDA could apply.

Breach of MREL

A breach of MREL should be taken seriously by the authorities. However, the response of the authorities should be tailored to address the cause of the breach. Where a breach of MREL occurs alongside a breach of capital requirements, the existing capital framework provides sufficient powers to address this. However, where a breach of MREL does not involve a breach of capital requirements, resolution authorities should assess the cause of the breach and agree, as necessary, a plan with the institution to remedy the breach as a barrier to resolvability, in close coordination with the competent authority. Such a plan should provide for an appropriate timeframe in which the institution should restore its MREL position, taking into account the cause of the breach, market conditions and the availability of broader bail-in-able liabilities.

We consider that the authorities' existing powers are sufficient to achieve this, although clarification could be provided as to how a breach should be addressed. It is essential that resolution authorities and competent authorities closely cooperate and coordinate in this process.

Internal MREL

It should be a core principle of the framework that MREL requirements are calibrated and distributed in accordance with the resolution strategy for the group and this should be given greater emphasis than under the existing RTS. We strongly support the adoption of the concepts of resolution entity and resolution group and external and internal MREL as applied in the TLAC Standard and recommend that these are expressly incorporated into the MREL framework. A framework based on external MREL at resolution entities and internal MREL at material sub-groups would be much clearer than the current application of consolidated and solo requirements. This would not only align MREL with the resolution strategy, but also enhance resolvability and support cross-border cooperation. It is important to ensure that these concepts are clearly defined within the legislation to ensure consistency of application. It is also important that the further work being done at the FSB and within Crisis Management Groups to develop the application of internal TLAC can be applied.

We believe that greater clarity is required as to how MREL should be allocated and internal MREL calibrated. This would provide greater clarity for banks, investors and counterparties, and promote consistency across the EU and with third countries. We therefore propose that a concept of internal MREL should be introduced for all banking groups in line with internal TLAC. As stated in the TLAC Standard, "the primary objective of internal TLAC is to facilitate co-operation between home and host authorities and the implementation of effective cross-border resolution strategies by ensuring the appropriate distribution of loss-absorbing and recapitalisation capacity within resolution groups outside of their resolution entity's home jurisdiction"[1].

Scope of internal MREL

The scope of internal MREL requirements should be aligned with the scope set out in the TLAC Standard i.e. at material sub-groups. As set out in the TLAC Standard, a material sub-group consists of one or more direct or indirect subsidiaries of a resolution entity that:

1. are not themselves resolution entities;
2. do not form part of another material sub-group;
3. are incorporated in the same jurisdiction outside of their resolution entity's home jurisdiction unless the Crisis Management Group (we suggest the resolution college for non-GSIBs) agrees that including subsidiaries incorporated in multiple jurisdictions is necessary to support the agreed resolution strategy and ensure that internal TLAC is distributed appropriately within the material sub-group; and
4. either on a solo or a sub-consolidated basis meet the specified materiality criteria.

[1] See paragraph 16 of the TLAC term sheet.

This definition should be applied in the revised MREL framework. As required by these criteria, material sub-groups are only located in a jurisdiction outside of the resolution entity's jurisdiction. Consideration should be given to how this should work within the European Union and the Banking Union in light of the BRRD framework for group resolution planning, resolution colleges and automatic recognition of resolution actions. We believe that at a minimum there should be no requirement for internal MREL between resolution entities and material sub-groups within the Banking Union in light of the single supervisor and single resolution authority which should remove home/host concerns.

Subparagraph iv of the materiality criteria enables resolution authorities to identify additional subsidiaries of resolution entities that are material to the exercise of the group's critical functions. This should be done through the group resolution planning process and agreed through the CMG and resolution college. Importantly the composition of material sub-groups is required to be reviewed by the home and host authorities within the CMG. Branches should not be subject to internal MREL requirements separate from any requirement applied to the legal entity of which they form a part.

It is necessary for the EU to implement internal TLAC for GSIBs and we believe that the adoption of these principles for all groups would significantly improve upon the existing MREL structure and provide an appropriate balance between the interests of home and host authorities. It would also align the European Union with the global standard and facilitate cross-border cooperation with third countries. The EU should also implement the TLAC principles regarding cooperation with authorities in jurisdictions outside the EU, both in relation to banks headquartered outside the EU with operations in the EU and banks headquartered in the EU with operations in third countries.

It is also important that there should be no additional external or internal MREL requirements in excess of minimum regulatory capital requirements at entities that are not resolution entities or part of a material sub-group. This should be clarified and the existing solo requirement should either be replaced or if retained, should expressly provide for this. While internal MREL at material sub-groups should facilitate the group resolution as noted in the Interim Report, additional requirements would duplicate and increase requirements without improving resolvability, reduce flexibility to enable funds to be transferred to where they are needed and could lead to greater fragmentation.

Calibration of internal MREL

The TLAC Standard requires that each material sub-group must maintain internal TLAC within a range of 75% to 90% of the external minimum TLAC requirement that would apply to the material sub-group if it were a resolution group, with the calibration within this range being determined by the host authority in consultation with the home authority of the resolution group. As stated in the TLAC Standard, internal TLAC "*should be sufficient at this level to facilitate effective cross-border resolution strategies*"[2].

We support the implementation of this requirement for the calibration of internal MREL at material sub-groups of all groups in the EU. Appropriate adjustments should also be applied to avoid consolidation effects which could mean that the sum of the requirements set for individual entities within a resolution group is greater than the external MREL requirement applied at the consolidated level of the resolution entity. These consolidation effects would, unless addressed, increase requirements[3].

Eligibility criteria for internal MREL

The eligibility criteria for internal MREL should generally be aligned with the TLAC principle, i.e. subordinated instruments that absorb loss without the need to place the relevant subsidiary into resolution, as discussed in the EBA Interim Report. However the flexibility to use instruments that are not fully pre-positioned on the balance sheet of the subsidiary, such as capital contribution agreements, guarantees or

[2] Paragraph 18, TLAC Standard.
[3] The need for an adjustment is acknowledged in the TLAC Standard (see para. 18).

other contractually binding mechanisms, should be accommodated through revisions to the existing framework.

The eligibility criteria for internal MREL should not require instruments to be issued directly to the resolution entity. Such a requirement would prevent internal MREL being issued to, for example, an intermediate holding company, which might be necessary to hold internal MREL within a material subgroup.

While we understand that internal MREL instruments should be subject to write-down and/or conversion without the need for the subsidiary to enter resolution proceedings, it is vital to understand how this interacts with other regulatory capital that is intended to convert at the point of non-viability, namely Additional Tier 1 and Tier 2. It is important that the creditor hierarchy is preserved and therefore write-down or conversion of non-regulatory capital MREL should occur only after capital instruments. Consideration should be given to the need for contractual triggers (including for guarantees) or the extension of the scope of the power under article 59 BRRD to include MREL instruments other than own funds to address this.

Article 55 BRRD - Third country recognition

AFME welcomes the consideration of third country recognition of resolution powers by the Commission on previous occasions and in the EBA Interim Report. We have previously highlighted a number of very significant practical difficulties with the current scope of article 55 BRRD ("Article 55"). These concerns appear to have been understood by a number of authorities and reflected in, amongst others, responses to the Call for Evidence and pragmatic approaches adopted by resolution authorities.

We strongly support the EBA's provisional recommendation that a reduction of the burden of compliance with third country recognition requirements is necessary, and agree that this should be achieved by narrowing the scope of the requirement while maintaining the effectiveness of contractual recognition for MREL instruments. We propose that the scope should be narrowed to include MREL and other debt instruments in line with the FSB guidance on cross-border effectiveness of resolution actions. Beyond this resolution authorities would retain their powers to require contractual recognition clauses in any other contracts which they identify as being necessary for the resolvability of the institution.

In addition to the limitation in scope, which should be the primary objective, consideration should also be given to providing resolution authorities with express powers to grant waivers where they believe that this is appropriate based on certain criteria e.g. impracticability, proportionality and not threatening resolvability, so as to take into account the variety of bank structures and national insolvency regimes across the EU. However the power to grant waivers should not be seen as a substitute for the need to limit the scope of Article 55. Limitation of the scope is necessary to provide a clear and consistent approach across the EU which is essential for banks, counterparties and authorities.

Cross-holdings

As highlighted in the GFMA response[4] to the BCBS consultation, while we agree with the goal of avoiding contagion, it needs to be ensured that cross-holdings treatment does not adversely affect the market for TLAC, for example by penalising market-making in TLAC instruments. We therefore proposed a "like-for-like" deduction from TLAC and the inclusion of an express dealer exemption for market making purposes amongst other comments. The treatment of MREL holdings will undoubtedly have a significant impact on overall levels of MREL issuance, especially if this is intended to be deducted from Tier 2, as was proposed by

[4] The GFMA/IIF response is available at http://www.afme.eu/WorkArea/DownloadAsset.aspx?id=13829. A summary of AFME's key comments is also available at http://afme.eu/WorkArea/DownloadAsset.aspx?id=14343

the BCBS for consultation. We encourage the Commission to consider how the final standard should be implemented in the EU and would welcome assessment of the impact on banks in the EU.

Approval for redemption of MREL-eligible liabilities:

We do not believe that it is necessary or proportionate for regulatory approval to be sought for every redemption of MREL-eligible instruments where the institution retains sufficient eligible liabilities to meet its requirements. Instead we support the approach provided for in the TLAC Standard for approval to be required only if the redemption would lead to a breach of MREL requirements.

Disclosure

Appropriate disclosure is necessary to support the market for MREL issuance. However disclosure requirements should only apply once the final framework and requirements are clear. Disclosure prior to this point could be unhelpful and be misinterpreted by investors. For this reason an appropriate transitional period for disclosure is required. We encourage the European authorities to apply the international disclosure standards once finalised by the BCBS to avoid divergence between the EU and other jurisdictions. The finalisation of disclosure standards for MREL should take into account the comments provided by the industry during the Basel consultation process. The Commission together with the EBA and other European members should work with the BCBS and the industry to determine how to coordinate disclosures regarding the creditor hierarchy, regulatory capital stack and the quantum of eligible MREL. Given the variation in creditor hierarchies within the EU, it is essential that a well-defined disclosure framework is in place well before any regulatory initiative to limit banks' holdings of MREL liabilities.

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