Treating the E.U. as a Single Jurisdiction for the Implementation of TLAC

(EBA Report on MREL, December 2016)

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The FSB agreed in November 2015 on the TLAC Term Sheet. The Term Sheet specifies certain requirements applicable to the operations of banking groups in foreign jurisdictions in order to make the implementation of bail-in effective in a cross-border situation. The question for the EU is now to determine whether it wants to implement these internal TLAC requirements considering the EU as a single jurisdiction, or rather opt for a fragmentation of the Single Market. In other words: should the subsidiary of a French banking group in Lisbon or Sofia be treated differently from the Miami subsidiary of a NY bank?

This presentation will consider:

How to apply internal TLAC to banking groups
The EU as a single jurisdiction for internal TLAC
No difference between domestic and intra-EU operations
Risk of fragmentation of the Single Market

Foreword

Global SIBs in the euro area: the specific situation of France

But the points developped hereafter are valid for E.U. cross-border banking groups in general

Bucket[10]	G-SIBs in alphabetical order within each bucket
5 (3.5%)	(Empty)
4 (2.5%)	Citigroup JP Morgan Chase
3 (2.0%)	Bank of America BNP Paribas Deutsche Bank HSBC
2 (1.5%)	Barclays Credit Suisse Goldman Sachs Industrial and Commercial Bank of China Limited Mitsubishi UFJ FG Wells Fargo
1 (1.0%)	Agricultural Bank of China Bank of China Bank of New York Mellon China Construction Bank Groupe BPCE Groupe Crédit Agricole ING Bank Mizuho FG Morgan Stanley Nordea Royal Bank of Scotland Santander Société Générale Standard Chartered State Street Sumitomo Mitsui FG UBS Unicredit Group

EU Council, June 2016 - Draft Council Conclusions on a roadmap to complete the Banking Union

(…) 7. UNDERLINES the importance of the work being carried out by several institutions at Banking Union, EU28 and international level, in particular work by the Commission to:

a) propose amendments to the legislative framework in view of implementing the Total Loss Absorbing Capacity (TLAC) standard and reviewing the minimum requirement for own funds and eligible liabilities (MREL). The Council will seek to ensure consistent rules and adequate amounts for the bail-inable buffers that contribute to an efficient and orderly resolution process in line with BRRD <u>for all credit institutions for which bail-in would be the validated resolution strategy.</u>

b) put forward a proposal on a common approach to the bank creditor hierarchy, to enhance legal certainty in case of resolution.

1. TLAC

TLAC in Context

- **In 2011, G20 Leaders have agreed on the KA as an international standard for resolution regimes.**
- **In november 2015, they have agreed on a TLAC requirement (*TLAC Term Sheet*).**

What is TLAC?

- **It is a requirement on the liabilities side of GSIBs, used to absorb losses and recapitalise failed firms in resolution.**
- **In the EU, it will be implemented via the <u>MREL</u>.**

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The current framework: TLAC (1/2)

Full recognition in the TLAC

- Common Equity Tier 1
- Additional Tier 1 instruments
- Tier 2 instruments
- subordinated debt

Full recognition if excluded liabilities <5% TLAC.
If not, partial recognition (up to 2.5% RWA in 2019 & 3.5% in 2022)

- **Senior debt** (pari-passu with derivatives, corp. depo, etc.)

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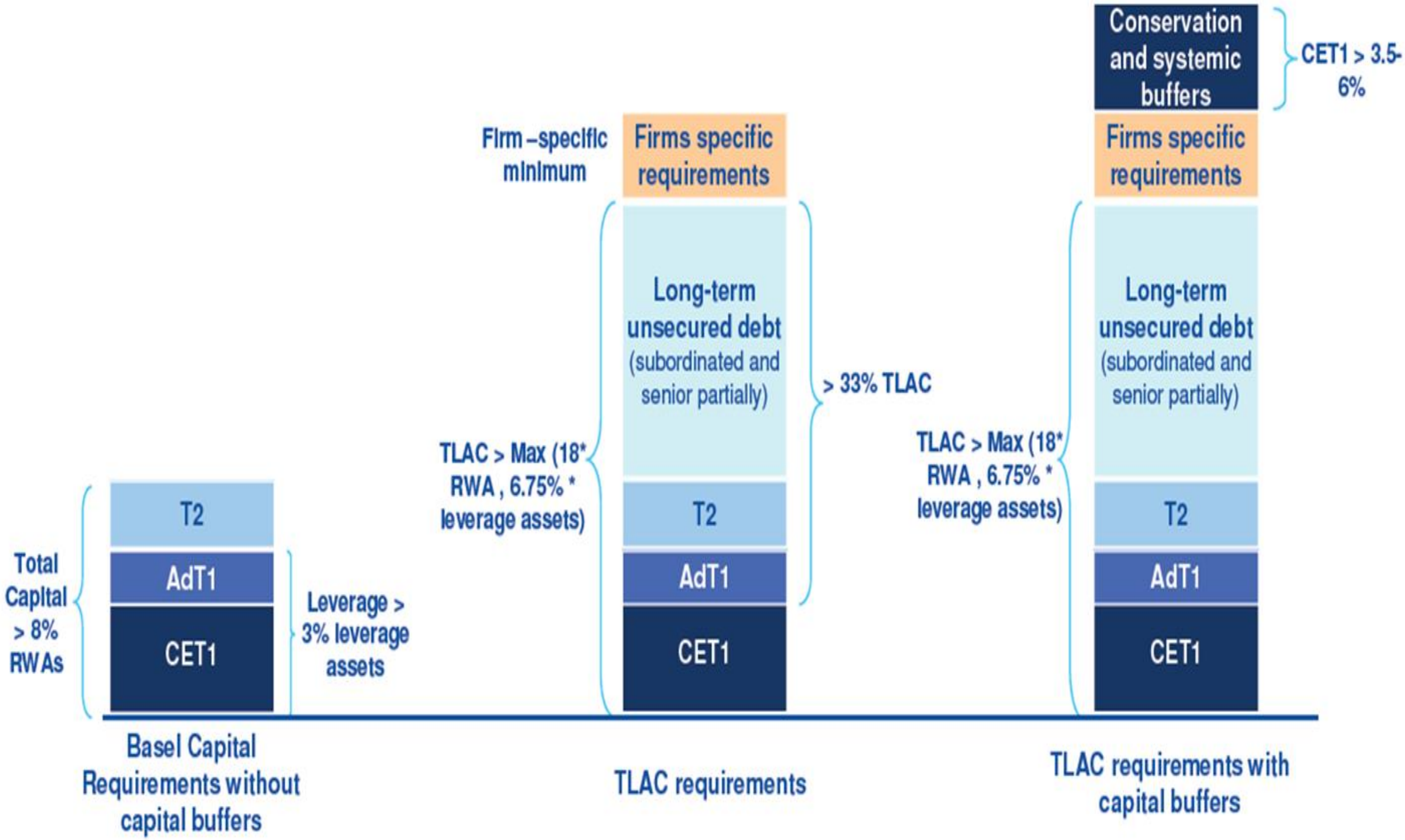
The current framework: TLAC (2/2)



Main differences between MREL and TLAC

		MREL	TLAC
1	Scope	• **All EU credit institutions**	• **Global systemically important banks (G-SIBs)**
2	Rule type	• **No common Pillar 1 minimum** • Institution specific **Pillar 2 Requirement** (Parallel approach)	• **Common Pillar 1 minimum** • Institution specific **Pillar 2 top up** (Integrated approach)
3	Denominator	• % of total liabilities and own funds	• % RWA (FL P1 min. = 18%) • % Leverage ratio (FL P1 min. = 6.75%)
4	Key eligibility criteria	• unsecured • minimum 1-year residual maturity • **No formal subordination req.**	• unsecured • minimum 1-year residual maturity • **subordinated** (with exceptions)
5	Min. Debt Expectation	• **No debt expectation** (so far banks can freely decide on MREL composition)	• **33% min. debt expectation** (Term sheet sets out “expectation” and not a formal requirement)
6	Buffer treatment	• **MREL includes Buffers** (Parallel approach)	• **Buffers sit on top of TLAC** (Integrated approach)
7	Contagion safeguards	• No specific provisions with regard to cross-holding or investments in MREL of other institutions	• Deduction of holdings by banks of TLAC issued by other G-SIBs

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2. Internal TLAC

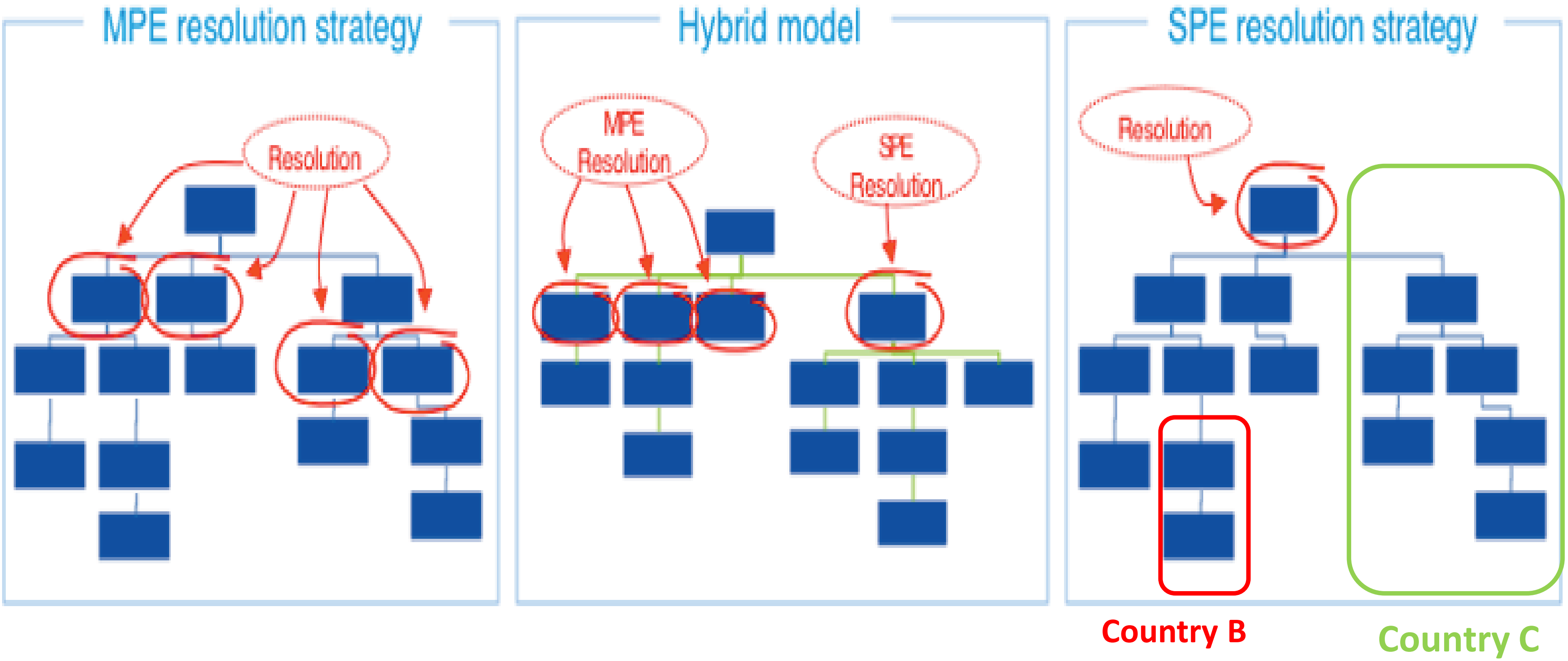
What is Internal TLAC ?

Resolution of banking groups and TLAC requirement

- A GSIB group may be composed of one or more resolution groups and may have one or more resolution entities.
- TLAC must be issued externaly by resolution entities.

- When resolution is triggered, these resolution entities are subject to resolution tools in accordance with a preferred resolution strategy.
- Subsidiaries, including *'material subsidiaries'*, stay out of resolution.
  - Losses at *material subsidiaries* level need to be up-streamed to the resolution entity.

Resolution strategies for groups: SPE or MPE ?



Source: BBVA Research + ACPR

What is Internal TLAC ?

Objectives of internal TLAC

"It facilitates 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" (TLAC TS)

- **Inter-jurisdiction tool :** how losses are absorbed and recapitalisation is effected in the resolution of cross-border groups
- "resolution groups outside of their resolution entity's home jurisdiction" => mainly a concern for host authorities

- **Intra-group arrangement to up-stream losses**
- Ex ante agreement on allocation of losses in a cross-border group; BRRD Currently only refers to the '*group financial support agreement'* (Art. 19), in recovery.

What is Internal TLAC ?

How is internal TLAC prepositioned?

- GSIBs have to preposition internal TLAC in *material subsidiaries* in other jurisdictions (ie these *material subsidiaries* need to issue TLAC to the resolution entities).
- The **host resolution authority** determines the distribution of internal TLAC in its jurisdiction, in consultation with the home resolution authority and the Crisis Management Group.
- **The Internal TLAC requirement at a *material subsidiary* level** must be at 75-90% of the size of the external TLAC requirement that would apply to the material sub-group if it were a resolution group.
- **The US authorities may go beyond these figures.**

Home and host authorities may agree to use other instruments instead of full prepositioning: e.g. (collateralized) guarantees.

3. The E.U. as a Single Jurisdiction for the Implementation of Internal TLAC

Intra-EU LAC: The EU as a single jurisdiction

The EU should be considered as a «single jurisdiction» *(EBA Report on MREL*, December 2016):

- **A common statutory resolution framework (BBRD)**
- **A decision body for cross-border groups (Resolution college), deciding both on the adoption of resolution plans and MREL requirements, and on resolution schemes for groups**
- **A common mediation mechanism (EBA)**
- **A common court for appeals (European Court of Justice)**

Such FW can be supplemented by other non compulsory elements:

- A common State Aid control (DG competition)
- A harmonised deposit guarantee framework (DGS) or a European Deposit Re-insurance Scheme (EDRIS)

Intra-EU LAC: The EU as a single jurisdiction

- **Resolution measures for a cross-border group are taken by a joint decision of the Resolution college:**

- Adoption of group resolution plans: A. 13 BRRD + EBA mediation (A. 19.3 EBA Regulation) + A. 13.9 BRRD “unless any resolution authority concerned assesses that the subject matter under disagreement may in any way impinge on its Member States’ fiscal responsibilities. “ (UK clause)
- Adoption of a group resolution scheme: A. 91.7 and 92.3 BRRD + EBA mediation (A. 31.c EBA Regulation).
- These long and very detailled procedures create **binding obligations on EU resolution authorities whatever their Member State.**

Intra-EU LAC: The EU as a single jurisdiction

- **Binding obligations on EU resolution authorities, whatever their Member State, regarding decision-making on cross border groups:**

➢ A. 87 BRRD (”General principles regarding decision-making involving more than one Member State”): “when making decisions or taking action pursuant to this Directive which **may have an impact in one or more other Member States** (…)”

➢ “due consideration is given to the **interests of each individual Member State where a subsidiary is established**, in particular the impact of any decision or action **or inaction** on the financial stability, fiscal resources, resolution fund, deposit guarantee scheme or investor compensation scheme of those Member States;”

➢ “due consideration is given to the objectives of balancing the interests of the various Member States involved and of avoiding unfairly prejudicing or unfairly protecting the interests of particular Member States, including **avoiding unfair burden allocation across Member States**;”

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Intra-EU LAC: The EU as a single jurisdiction

- **EBA legally binding mediation:**

"(…) the Authority may, in accordance with the procedure set out in the third and fourth subparagraph of Article 44(1) take a decision requiring them to take specific action or to refrain from action in order to settle the matter, with binding effects for the competent authorities concerned" (Art. 19.3 EBA Regulation)

- **This mechanism, together with the BRRD, implies that resolution measures concerning a banking group taken in one EU jurisdiction will be fully recognized and enforced throughout the EU, whatever the preferred resolution strategy for this group.**

- In a single jurisdiction such as the European Union, no need for either internal TLAC or "internal MREL". "**Intra-EU MREL" should ensure loss absorption by the parent entity in a SPE strategy.**

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No difference between domestic and intra-EU operations

What would this « intra EU MREL » look like?

- Requested from material subsidiaries within the EU in view of impediments to resolvability or specific risks that could not be covered by alternative options

- Set by the group's Resolution College

- Quantum: requirement between 50% to 80% of the size of the external TLAC requirement?

Comparison of (i) intra-EU LAC and (ii) internal TLAC with a third country

	Resolution involving the EU and a 3rd country (US, JAP, … UK)	Intra-EU resolution
1 Jurisdictions	• **Two jurisdictions**	• **One single jurisdiction sui generis**
2 Decision	• **CMG consultation** • **Host authority's decision**	• **Resolution college** • **Joint decisions (resolution plan and resolution scheme)**
3 Tool	• Internal TLAC	• MREL Solo« for institutions submitted to that requirement » • Intra EU MREL
4 Criteria	• Subordinated instruments • collateralized guarantees	• Subordinated instruments • Collateralized guarantees • **Within the EU single jurisdiction: simpler forms of guarantees or committments** • Adjusting internal TLAC Framework for building internal MREL (requirement between 50% to 80% of the size of the external TLAC requirement?)

Risk of Fragmentation of the Single Market

- **The TLAC implementation must strengthen the Single banking Market or there will be a strong risk of « ringfencing »**

- One could draw an analogy with a regime for fighting fires in a town.

- The town could either fund a **central fire department** that would move and intervene at any house experiencing trouble (SPE), or it could instead forsake the fire department and require each house to have a **fire sprinkler system** (MPE).

- The MREL should be required at the appropriate level in the group in order to reflect the multiple-point-of-entry approach or single-point-of-entry-approach contained in the resolution plan. **Otherwise, it would be akin to the State allowing a town to build a fire department, and then requiring a fire sprinkler system for each house anyway.** This is unnecessarily costly and contradictory with the idea of the Single banking market.

How to Strengthen the EU Single Jurisdiction?

Cooperation challenges

- Home – host: smooth and effective functionning of Resolution colleges, including EBA mediation whenever needed (« post Brexit »?)
- Consistency between the distribution of the LAC internaly and the resolution strategy
- Process for triggering intra-EU MREL

Legal challenges

- Insolvency law fragmentation => complexifies (comp. U.S. where all banks are subject to the same Federal insolvency regime)
- June 2016 Council Conclusions: « put forward a proposal on a common approach to the bank creditor hierarchy, to enhance legal certainty in case of resolution »

4. The Commission’s Proposal to Transpose (i)TLAC in the European Union

The Commission's legislative proposal to implement TLAC in the EU (« BRRD 2 »)

- A revision of BRRD, CRR, CRD IV, SRMR
- Unveiled by the European Commission in November 2016

- Introduction of definitions of "resolution entity" and "resolution group"

  - Resolution entities subject to external MREL at consolidated resolution group level (Art 45f of BRRD)

  - Subsidiaries of resolution entities subject to internal MREL (Art 45g of BRRD)

  ⇒ Similar to the TLAC Term Sheet

The Commission's legislative proposal to implement TLAC in the EU (« BRRD 2 »)

❑Internal MREL mechanism:

- Subsidiaries issue internal MREL eligible instruments to the resolution entity
- Internal MREL liabilities to be subordinated to non-regulatory capital liabilities issued externally
- Allows up streaming of losses and recapitalisation of subsidiary to resolution entity at PONV of subsidiary without a need to place it in resolution (SPE strategy)

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The Commission's legislative proposal to implement TLAC in the EU (« BRRD 2 »)

- Decisions on external and internal MREL to be taken in resolution colleges (Art 45h)

  - Joint decision on external and internal MREL requirements for entities of the group

  - A number of conditions to be respected (eg conditions of Article 45g(2))

  - Possibility of EBA binding mediation retained in case of disagreements

  ⇒ For SRM entities, decision to be taken by the SRB

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The Commission's legislative proposal to implement TLAC in the EU (« BRRD 2 »)

- Several questions are still open:
  - Date of final adoption? Transition period?
  - What links with the resolution strategy?
  - Is Bail in suitable for everybody? No bail in = no MREL?
  - Quantum vs quality?
  - Role of sub debt? What sub debt?
  - Calendar
    - For adopting the new regulation
    - For implementation by RA

The Commission’s legislative proposal to implement TLAC in the EU (« BRRD 2 »)

- **<u>On (i)MREL / transposition of (i)TLAC:</u>**

  - MREL remains in principle required for each individual institution.

  - <u>Internal MREL</u> would be required and could be constituted of 50% of collateralized guarantees.

  - Can be fully waived but under strict conditions, including that both the resolution entity and the subsidiary be subject to « supervision by the same Member State » (?). No Single Market perspective as in the EBA Report? Not even a reference to the Banking Union?

  - The resolution authority may impose more stringent requirements.

- **A fast-track revision of article 108 BRRD on <u>creditor hierarchy</u>, in order to harmonise creditor hierarchy accross Europe.**

Conclusions

- If we are not able to achieve in the EU what has been achieved by the US - and which was the situation at domestic level prior to the Banking Union - , then people may legitimately wonder:

- **What has happened to the Single Market?**

- **Where is the Banking Union?**

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Annex – French Non-Preferred Senior Bank Bonds

French Non-preferred Senior Bank Bonds

Context: implementing TLAC/MREL

- **A changing international and European framework in 2015 / 2016**

  - Adoption of TLAC standards by FSB/G20 in November 2015

  - At EU level: need for greater legal certainty on bail inable debts, forthcoming MREL requirement

  - Changes to insolvency hierarchy of bank creditors introduced in Germany and Italy

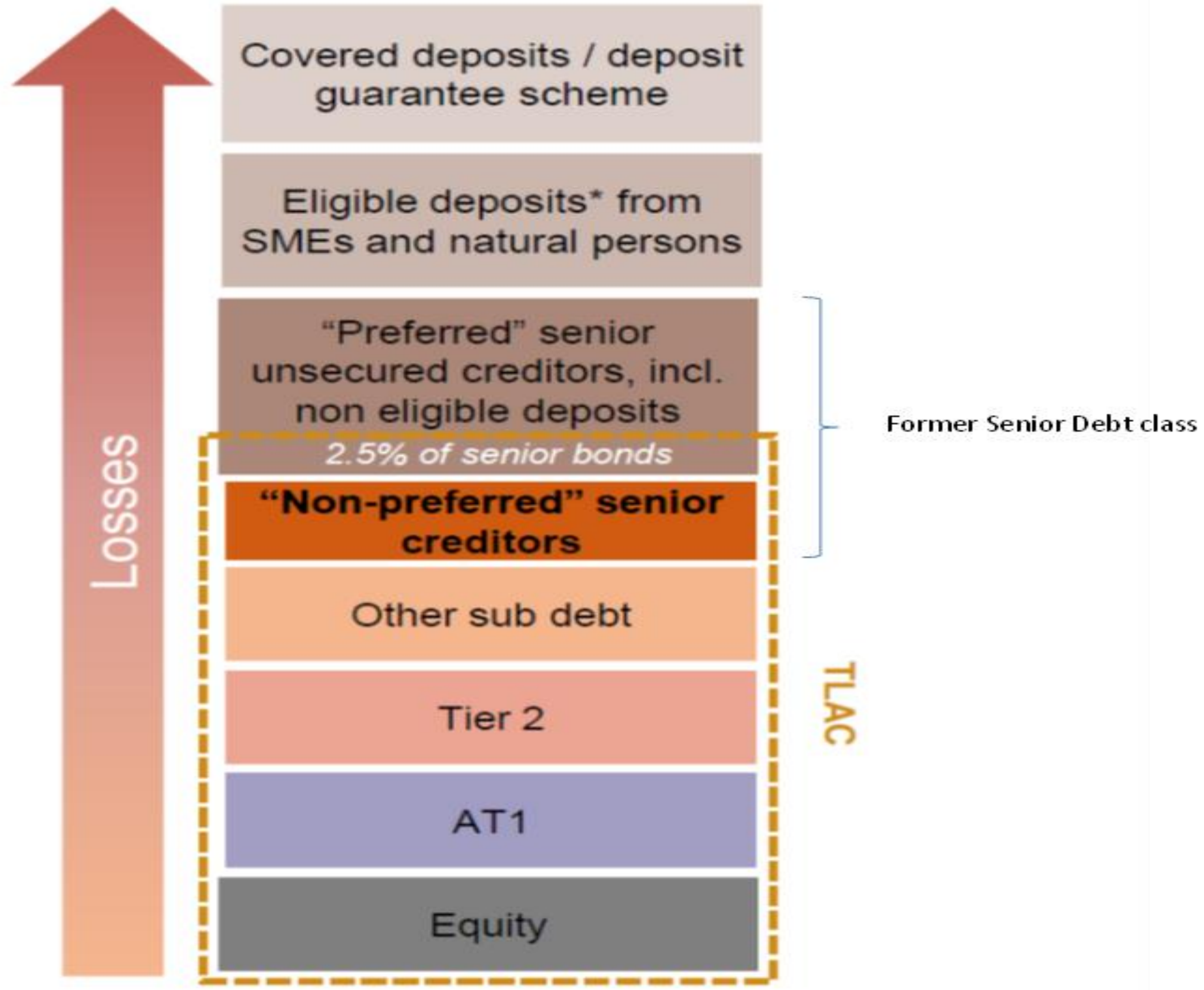
  - Let's not overemphasize the differences between these approaches. They also reflect the different funding structures of the different banking systems

French Non-preferred Senior Bank Bonds

Main features of the Law promulgated in December 2016 :

- **The new law will facilitate the bail in of the new category of <u>senior</u> debt instruments by:**
  - Preventing NCWO and *pari passu* issues
  - Providing greater legal certainty

Creditor hierarchy under the proposed insolvency law:



French Non-preferred Senior Bank Bonds

Main elements of the Law:

- The existing stock of senior <u>debt</u> (claims and negotiable debt instruments) would be maintained in the «preferred senior» category.

- Creation of a new category of senior <u>debt instruments</u> («non-preferred senior») which will rank junior to existing senior debt but senior to the subordinated debt

- Instruments under this category
  - must have a <u>maturity longer than one year</u>
  - and must <u>not be structured</u>

French Non-preferred Senior Bank Bonds

Main advantages:

- No retroactivity => Stronger legal certainty
  => Predictability for investors.

- Protects the short term ratings of French banks

- Any «non-preferred senior» issuance would need to contractually specify its ranking (by default, it will be ‘preferred senior’)

- After the entry into force of the law, any bank will be able to issue either in the «preferred senior» category or in the «non-preferred senior» category

Reactions to the proposal:

ECB :

Opinion of the European central bank of February 23 : « *The ECB welcomes that the draft law aims to increase the resolvability of banks, by creating legal certainty about the loss-absorbing capacity of the newly created class of senior non-preferred debt instruments.*"

Credit Rating Agencies :

Moody's : « *the French amendments provide better legal certainty for resolution authorities in their requirement to respect the 'no creditor worse off' (NCWO) principle that protects creditors from suffering more significant losses in a bail-in and resolution than they would in an insolvency."*

S&P : « *we considered that German operating entities' senior unsecured bonds were unlikely to be eligible for inclusion in our ALAC measure. The French approach, by contrast, would not alter the ranking of "legacy" senior unsecured investors whose claims date from before the draft amendment becoming effective.*"

Banks :

Rabobank : « *We note that of the various solutions discussed so far, the rationale behind the French solution is most in line with Rabobank's approach towards its capital strategy, i.e. building up high capital buffers to protect its senior unsecured funding base. The proposal is also in line with the Basel 3 reform to increase the quantity and quality of buffers. It allows for several ways to achieve these buffers/ loss absorbing capacity."*