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EBF Comments on EU TLAC implementation and MREL Review

As European decision makers are discussing the way forward on TLAC implementation and the expected MREL review in Europe, the European Banking Federation would like to provide the following key principles and comments to facilitate the evolving thinking on TLAC and MREL implementation in Europe:

Key Principles

The implementation of loss absorbency and recapitalisation requirements in the EU should:

- ensure legal certainty and provide all market participants with a stable, predictable and transparent methodology for setting loss absorbing capacity requirements sufficient to ensure the continuity of critical functions provided by banks, without recourse to public solvency support.
- be consistent with the globally agreed TLAC term sheet and fully avail itself of the therein embedded different options for debt subordination that best meet European specificities and business and funding models. Any departure from the TLAC Term Sheet needs to be tested in an impact assessment to ensure the benefits outweigh the costs and that the framework is consistent with the Commission's jobs and growth agenda.
- be consistent with the resolution strategy of individual banks and striking the right balance between avoiding market fragmentation and ensuring a level playing field.
- ensure conceptual and technical consistency with the existing legal framework, notably the CRR and BRRD, and retain the legal framework as simple as possible

Calibration

Minimum TLAC calibration

For GSIB's, TLAC has already been decided at international level. Thus, the EU should in our view avoid re-opening a lengthy debate on the correct level for loss absorbency and recapitalisation for G-SIBs. They should be subject to an MREL requirement consistent with the TLAC requirement.

Other banks should have the necessary MREL levels to permit the implementation of their resolution strategies to preserve the continuity of any critical economic functions they provide. This could mean that if the failure of a bank would not invoke the use of resolution powers, its MREL would be set at the level of minimum capital requirements. Equally, when a bank provides critical economic functions - such as SME lending – then MREL should be calibrated to support the application of the resolution strategy foreseen to maintain these, but not to support the recapitalisation of other group entities, which are not deemed critical, via bail-in. In any case, the MREL calculated should not exceed the standard requirement calculated as per the TLAC Term Sheet plus individual add-ons on the basis as set out below.

These principles should apply equally to entities within larger groups which would not themselves be subject to resolution action. For example non-bank entities which would not be recapitalised through

the implementation of the group resolution strategy should not be included in any consolidated requirement set at the level of the resolution group or material sub-group. We also note that in the case where a bank's resolution strategy aims to scale down its business activities it would not always be necessary to require that such a bank be recapitalised to the same peer group of systemic banks. Hence, systemic buffers would not always need to be included in the recapitalisation amount.

8% of total liabilities should not be a minimum requirement

It follows that MREL should be calibrated at a level to support the resolution strategy. It has been suggested that MREL could be fixed such that it represents 8% of the total liabilities of a bank, in order to ensure access to the resolution fund. We believe that such a calibration is inconsistent with BRRD, which refers to 8% of the resolution entry balance sheet of a bank needing to be bailed in before any call could be made on the resolution fund. That such an 'access barrier' is needed in order to prevent abuse of the resolution fund is entirely accepted. However, this is not the same as requiring 8% of current balance sheet in the form of MREL. There are many liabilities other than MREL that can be bailed-in if necessary (including amongst others formerly MREL-eligible liabilities with less than 12 months to run), and the balance sheet at resolution entry will have been considerably depleted. It is not credible to argue that 'only MREL may be left at the point of entry into resolution', a bank that was in the process of losing all liabilities other than MREL would enter resolution well before these other liabilities were totally exhausted. Furthermore, this would add a third metric to the MREL calibration (RWA's, leverage and total liabilities), which would require banks to manage three different metrics. If this 8% yardstick were retained, some business models, notably for Northern European banks, would be excessively penalised with MREL requirements that could exceed 30% of their RWA's. MREL should be fixed as a function of the resolution strategy to be applied to a group.

Pillar 2 add-ons

References have been made in several instances to Pillar 1 and Pillar 2 requirements for MREL (as indeed was the case in the TLAC term sheet in relation to TLAC). Although the concept of a standard (Pillar 1) requirement, or an additional, institution specific (Pillar 2) layer is well understood, we would suggest that the terms "Pillar 1" and "Pillar 2" should be reserved for use in the context of capital requirements, and that different vocabulary, such as 'standard requirements' and 'add-ons' or 'guidance' be used in order to avoid confusion. This is particularly important in light of the misunderstandings around MDA's that arose in early 2016.

Any individual add-on should be proportionate to a bank's resolution needs and should be determined by the Resolution Authority in the resolvability assessment subject to harmonised technical standards to ensure consistency and avoid excessive calibration. It should be made clear that an additional requirement is only warranted if the resolvability assessment identifies specific impediments to resolvability which were not or cannot be solved by proposed measures. Article 17(5) BRRD provides resolution authorities with a menu of measures it can take to remove impediments to resolvability with the imposition of additional MREL requirements being only one of the options. An individual add-on should thus not be the default option of addressing identified impediments to resolvability and should be limited to its "soft" component for institutions whose MREL is equal to the TLAC Term Sheet requirement (see below).

Internal TLAC and solo MREL

We support not to automatically apply the provisions on internal TLAC in the term sheet within the European Union as it is one single jurisdiction. We believe this is a correct interpretation of the TLAC agreement to EU conditions such as the single market and single rulebook. For this reason, we do not support an MREL requirement on each regulated subsidiary in the EU to be fixed within an individual add-on, or even worse in the form of a hard TLAC/MREL requirement. A solo requirement is inconsistent with the concept of resolution groups and material sub groups. The application of MREL should follow

the resolution strategy. The principle of setting MREL requirements consistently with the resolution strategy should apply equally to the requirements set in respect of groups headquartered in third countries which should be aligned with the TLAC Term Sheet and with no automatic assumption that internal MREL will be set at the upper end of the FSB's 75-90% range where not justified by the resolution strategy.

It is also worth noting that if a competent authority were to require that the instruments held to meet an individual add on in a sub group (if any) are subordinated, this may *de facto* lead to the introduction of an internal TLAC requirement and would thus be contradictory with the European Commission proposal to set no internal TLAC requirement within the European Union.

Eligibility and sub-ordination

Eligibility criteria and the application of exemptions

We support the adoption of TLAC eligibility criteria, i.e. introducing so called TLAC liabilities consistent with the TLAC term sheet as a new category of MREL eligible liabilities. The EBF supports the concept that additional loss absorbency requirements should not take the form of Tier 2 capital, and that the main conditions for such additional loss absorbency capacity (if it is held in the form of debt) should be subordination (in one of the three possible ways), and remaining maturity, all according to the term sheet.

A requirement to limit TLAC eligible instruments (or make MREL eligibility criteria more severe than those of the TLAC Term Sheet), i.e. by requiring more Tier 1 or Tier 2 capital to meet the loss absorbency requirement would increase the cost of funding, and thereby jeopardise EU banks' ability to be compliant with the TLAC requirement and create an un-level playing field between larger European banks and larger banks outside the EU.

We therefore recommend that EU policy makers make use of the exemptions for non-subordinated senior debt encompassed in the TLAC term sheet e.g. most notably the allowance to hold senior unsecured debt up to 3.5% of RWAs or to make use of the 5% *de minimis* allowance for excluded liabilities to rank alongside TLAC in a holding company. There seems to be an opening for senior debt to be acknowledged as eligible to meet an add-on requirement. This is consistent with the current MREL requirement and should thus be maintained subject to complying with the NCWOL principle.

Furthermore, we support the division of any individual add-on requirement into a "hard" and a "soft" component but consider that only a "soft" add-on should be required for institutions whose MREL is equal to the TLAC Term Sheet requirement.

AT1 and Tier 2 instruments issued by subsidiaries

In order to align the TLAC eligibility criteria (the TLAC term sheet does not allow AT1 and Tier 2 issued by subsidiaries after 2022) with CRR eligibility criteria it has been suggested to exclude AT1 and Tier 2 instruments issued from subsidiaries that are not eligible for MREL also from own funds. We do not consider that it is necessary to make changes to the CRR to exclude AT1 or Tier 2 capital instruments issued by subsidiaries of resolution entities from own funds. There is no need to change the eligibility criteria for capital in this respect and exclusion of existing instruments from own funds is inappropriate as such instruments would still absorb losses under the capital framework.

Any concerns about the impact of the conversion of externally held capital instruments leading to change of control in a manner inconsistent with the resolution strategy should be addressed by firstly, measuring the risk of change of control, and secondly, where necessary to avoid change of control issues, instruments issued toward external investors should receive a write down clause.

Breach of Loss Absorbency requirements

We do not agree that a breach of MREL or capital buffers should result in a determination that a bank is failing or likely to fail. It must be understood that MREL and capital buffers are instruments in resolution and recovery, respectively. They are not indicators that a bank is entering into resolution. The conditions upon which resolution becomes necessary following a MREL breach demand further analysis.

However, we agree that a breach of MREL should be taken seriously and thus advocate in such cases that authorities start a supervisory dialogue to identify corrective actions, i.e. to eliminate any impediments to resolvability in respect of the relevant MREL-eligible own funds and liabilities and other impediments to resolvability. This would be in line with the TLAC Term Sheet that asks authorities to require a firm which breached or is likely to breach its TLAC requirement to take prompt action in the first place and only afterwards to place such a firm into resolution if it is deemed to be failing or likely to fail and there is no reasonable prospect of recovery. Consideration should be given to the need to ensure that the consequences of the infringement of MREL are consistent between G-SIBs and non-G-SIBs, which may have differing MREL requirements but comparable capital requirements.

In this respect, EU policy makers seem to currently advocate flexibility if a bank would not be able to renew MREL eligible debt due to problems in financial markets. In that case, restrictions on distributions applied to buffer capital, would not have to kick in immediately. This is a step in the right direction, but whether this flexibility is sufficient, e.g. under stressed market conditions, demands further and deepened analysis. MREL should not form part of the MDA restrictions so long as minimum capital requirements continue to be met. Failing to refinance loss absorbency instruments should prompt increased attention and dialogue between a bank and the authorities to take remedial action. In no case should this initiate resolution actions.

TLAC and Leverage ratio as a minimum back stop

Regarding the stacking order of regulatory capital buffers as mandated by Basel III, i.e. G-SIB, capital conservation and countercyclical buffers, and the proposed TLAC/MREL minimum requirements, it is essential to recognise the important distinction in part 4 of the TLAC Term Sheet between the “TLAC RWA Minimum” of 18% (as from 2022) of the resolution group’s RWA and the “TLAC LRE Minimum” of 6.75% of the leverage ratio denominator.

As regards the TLAC RWA Minimum, any of the applicable Basel III capital buffers must be met in addition to the TLAC RWA Minimum. This is not the case for the TLAC LRE Minimum. The TLAC Term Sheet merely allows authorities the discretion to set requirements above or put in place buffers in addition to the TLAC LRE Minimum.

The leverage ratio is still under discussion in the Basel Committee. The primary intent of a leverage ratio when it was first introduced in the Basel III agreement, was for it to function as a backstop. The ambition to introduce it as a backstop could be lost if the distinction between the TLAC RWA Minimum and the TLAC LRE Minimum in the TLAC term sheet in relation to the regulatory Basel III capital buffers is not recognised in EU regulation.

TLAC Holdings

We oppose the extension of the deduction approach as proposed by the Basel Committee to all (internationally active) banks. The deduction approach should, if introduced at all, be limited to G-SII holdings of G-SII TLAC instruments and be a like-for-like deduction from TLAC eligible liabilities (corresponding deduction approach). This would replicate the current deduction approach, which

deducts Tier 2 holdings from own Tier 2, AT1 holdings from own AT1 and CET1 holdings from own CET1, subject to any 'excess' deducted from higher quality capital. Further, in Europe the deduction should also be able to be made from MREL.

For all other institutions, the existing large exposure rules (especially as implemented in the EU, where exposures to other financial institutions are subject to the same limits as exposures to corporate counterparties) should be adequate to limit the potential risk of contagion. This is in particular the case as the majority of exposures to other financial institutions (and hence the majority of the LE limit utilisation) are short term exposures with maturities under one year. As a result, the amount of holdings of TLAC/MREL eligible liabilities is appropriately limited. It should also be noted that any TLAC/MREL in the form of own funds instruments is already subject to deduction under the CRR, i.e. the Large Exposure rules would only be needed for other TLAC-eligible liabilities, which are by definition the least risky portion of TLAC.

The industry has also voiced its disagreement with the proposed treatment of instruments ranking *pari-passu* to excluded liabilities in the Basel consultation. We believe it to be premature to comment on any alternative approaches before the final shape of the Basel rules is known. In our view, it would be very helpful if the European Commission played a key role in the Basel negotiations, taking into account stakeholder responses. This would then serve as a basis for a common European standard. In any case, the final Basel standard should be awaited before proposing a European approach to deductions and large exposure rules.

Finally it will be important to ensure where senior unsecured might be part of the MREL that deductions will not go against the HQLA requirements for bank liabilities which fulfil the HQLA definition in the LCR requirements.