Box 6

REGULATORY INITIATIVES TO ENHANCE OVERALL LOSS-ABSORPTION CAPACITY

One of the key objectives of the resolution frameworks introduced in response to the recent crisis, such as the Bank Recovery and Resolution Directive (BRRD) in the EU, is the shifting of the cost of bank failures from the taxpayer to, first and foremost, the shareholders and creditors of the failing bank. This is important for many reasons, not least that of solving the too-big-to-fail problem of large banks, which – unless there is a credible resolution option – often have to be bailed out by the public at huge cost. These banks have often been perceived by markets as having an implicit state guarantee, which creates not only a moral hazard problem, but also an uneven playing field among banks, in that large banks in fiscally strong countries can fund themselves far more cheaply than smaller banks or banks in countries with weaker public finances. Thus, the introduction of a credible resolution framework contributes to weakening the link between banks and their sovereigns, which proved to be both costly and destabilising in the recent crisis.

An important tool for attaining this objective is the bail-in tool, which enables the resolution authority to write down, or convert into equity, the claims of a broad range of creditors. However, some types of liabilities are excluded from the scope of a bail-in, such as secured liabilities and covered deposits. Furthermore, in exceptional circumstances, other liabilities may also have to be excluded on a case-by-case basis, either because it is not possible to bail them in quickly enough or because this is necessary in order to attain the resolution objectives. Consequently, in order to ensure that the bail-in tool will still be efficient in resolution, there is a need to make sure that there are sufficient own funds and liabilities in banks for bail-ins, when needed.

Under the BRRD, Member States are required to ensure that institutions meet a minimum requirement for own funds and eligible liabilities (MREL) for bail-ins.[1] An adequate level of own funds and eligible liabilities will be key to ensure that there is sufficient loss-absorbing capacity within institutions when they fail, thereby underpinning the efficient application of the bail-in tool. It will also protect the resolution funds, including the Single Resolution Fund, as own funds and eligible liabilities, as defined by the MREL, and other bail-inable liabilities will be used before a resolution fund may contribute to the funding of any resolution.

Some technical details on the MREL remain to be finalised before it becomes operational along with the bail-in tool in 2016. In particular, the European Banking Authority will draft regulatory technical standards by July 2015 which will specify how the MREL is to be determined for each institution. By December 2016, the European Commission will submit a legislative proposal on the harmonised application of the MREL. Such a proposal may include the introduction of an appropriate number of different MRELs that take account of the different business models of institutions and groups, as well as possible adjustments to ensure consistency with any international standards that have been developed by international fora in this area.

Currently, an international standard is also under discussion within the G20 and the Financial Stability Board (FSB) so as to end the too-big-to-fail problem of the global systemically important banks (G-SIBs). The FSB, in consultation with the Basel Committee on Banking Supervision, has developed proposals on the adequacy of loss-absorbing capacity of G-SIBs in resolution, in response to a call by G20 leaders at the 2013 St Petersburg summit. The proposal is subject to public consultation and a quantitative impact study, before being finalised by the FSB in 2015. This proposal would be the international equivalent of the MREL in the BRRD, applicable to G-SIBs only. Although similar, the draft FSB proposal for G-SIBs' total loss-absorbing capacity (TLAC) in resolution differs from the MREL in some key areas (see the table below).

Key features of the MREL and the TLAC

	MREL	TLAC
Scope	All banks in scope of the BRRD	G-SIBs only
Set-up	A minimum requirement in parallel to Basel III minimum capital requirements for banks, calculated as the amount of own funds (including buffers) and eligible liabilities.	A minimum requirement incorporating Basel III minimum capital requirements and excluding Basel III buffers for G-SIBs.

1 Within the SRM, the SRB will be the authority, after consulting competent authorities, including the ECB, which determines the MREL for all entities under direct ECB supervision and for all cross-border groups.

Key features of the MREL and the TLAC (cont'd)

	MREL	TLAC
Determination	Determined on an individual basis for each institution.	A common minimum Pillar 1 requirement set within the range of 16-20% of RWAs and at least twice the Basel III Tier 1 leverage ratio requirement[1] as a floor for all G-SIBs, with the possibility for authorities to top it up on an individual basis through a Pillar 2 component. Also sets out how TLAC is distributed among material institutions within a group when the whole group is resolved or when various sub-sets of the group are resolved together.
Eligible instruments	Capital instruments can simultaneously satisfy both minimum regulatory capital requirements (including buffers) and the MREL. To be eligible, liabilities need to fall within the scope of bail-in. This will exclude e.g. covered deposits and, in principle, secured liabilities. Additionally, eligible liabilities must satisfy certain criteria, such as issued and fully paid up, not owed to, secured or guaranteed by the institution itself, not arise from a derivative or from a preferred deposit, and have a remaining maturity of at least one year.	Capital instruments can simultaneously satisfy both minimum regulatory capital requirements and TLAC, but only CET1 capital in excess of that required to satisfy these requirements may count towards the capital buffers. Certain liabilities are excluded from consideration for TLAC, e.g. liabilities arising from derivatives, insured deposits and liabilities which are preferred to normal senior unsecured creditors under the relevant insolvency law. Eligible external TLAC must be unsecured, must have a minimum remaining maturity of at least one year and must not be subject to set off or netting rights. Credible ex ante commitments by authorities to recapitalise a G-SIB, which may be required to contribute to resolution funding, may count towards a firm's Pillar 1 minimum TLAC, subject to certain strict conditions (e.g. the commitments must be pre-funded by industry contributions).
Priority	Priority is not a precondition in the BRRD.	Eligible external TLAC must absorb losses prior to excluded liabilities in insolvency or in resolution without giving rise to material risk of successful legal challenge or compensation claims.
Regulation of investors	Without prejudice to the existing large exposure regime Member States have to ensure that in order to provide for resolvability of institutions/groups, resolution authorities limit the extent to which other institutions hold liabilities eligible for the bail-in tool, save for liabilities that are held at entities that are part of the same group.	G-SIBs must deduct from their own TLAC or regulatory capital exposures to eligible external TLAC liabilities issued by other G-SIBs in a manner generally parallel to the existing provisions in Basel III that require a bank to deduct from its own regulatory capital certain investments in the regulatory capital of other banks. Further provisions, also for non G-SIBs, are envisaged.

1) The calibration is subject to a quantitative impact study and market survey which will be carried out in early 2015.