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TLAC and MREL: a new layer in the bank capital structure

- ***Loss absorbency requirements imposed on systemically important banks have been subject to considerable revision and uncertainty but their final shape is now becoming clear.***
- ***TLAC applies only to a small number of global banks with relatively consistent business models; it doesn't rely on national bank recovery and resolution laws.***
- ***MREL applies to a more diverse group of institutions, from complex G-SIBs to smaller national or regional cooperative banks; it's based on a harmonized legal framework.***

Since the 2008 financial crash, one of the biggest issues for regulators is how to prevent a repeat of the taxpayer-funded recapitalisation of banks that were 'too big to fail' due to their importance to the wider economy. The political backlash against this in the years after the crash prompted many regulatory changes, including significantly increased bank capital requirements, with the overall aim of reducing the probability of unexpected losses causing a bank failure in the future. In addition, systemically important banks – those deemed too big to fail – must now have sizeable loss-absorbing liabilities that are easily convertible into capital if a bank is deemed to be failing and becomes subject to 'resolution'.

What regulations have been implemented so far?

The world's 30 largest banks, known as Global Systemically Important Banks (G-SIBs), are identified by the Financial Stability Board (FSB) on an annual basis. The standard used for these banks is Total Loss Absorbing Capacity (TLAC). For Domestic Systemically Important Banks (D-SIBs) in the European Union (EU), a similar standard applies, called Minimum Requirement for Own Funds and Eligible Liabilities (MREL). A number of other jurisdictions such as the US, Canada and Australia have also either implemented or are considering similar requirements for their D-SIBs.

What are the similarities and differences between the two?

Although they are separate regulations, both TLAC and MREL address the same issue. The two standards aim to ensure that resolution authorities are able to recapitalise a failing bank without the need to spend taxpayer money. Using bank resolution jargon, TLAC and MREL eligible liabilities are 'bailed in' to recapitalise the bank instead of relying on a taxpayer-funded bail out. The EU has recently made an effort to incorporate TLAC into MREL.

Nevertheless, there are differences. Most notably, TLAC applies only to a small number of global banks; it doesn't rely on any national bank recovery and resolution laws. In contrast, MREL relies on a harmonised legal framework (principally the EU's Bank Recovery and Resolution Directive (BRRD)), and it applies to a much more diverse group of institutions, from complex G-SIBs to smaller national or regional cooperative banks. Consequently, MREL is more flexible to accommodate different business models and the specificities of different EU member states.

Subordination is the basis for the eligibility of liabilities. It can be achieved in one of three ways:

- Statutory (the instrument is, by law, junior to liabilities excluded from bail-in on the resolution entity's balance sheet);

- Contractual (the terms and conditions state it is junior to excluded liabilities);
- Structural (the instrument ranks ‘senior’ but a ‘clean’ holding company issues it; debt ranks as junior to that issued at operating company level by virtue of the holding company’s dependence on operating company cashflows to pay interest and principal on its debt).

BRRD1, which introduced MREL in 2014, does not specifically require subordination. Instead, it leaves the determination of which liabilities are bail-in-able to the resolution authorities. In theory, this provides more flexibility to adapt the requirement to different business models and capital structures. In practice, due to – among other reasons – the potential impact on competition, it is very difficult for a national resolution authority to draw a line between institutions which should require subordination in order the meet MREL and those that should not. Therefore, the end result is that European D-SIBs, just like their G-SIB competitors, will have to issue, and in some cases are already issuing, instruments that meet the TLAC subordination requirement.

Unlike the TLAC standard which is agnostic with respect to the method used to achieve subordination, some EU jurisdictions have taken actions to ensure that their banks use a specific method. For example, UK banks have issued holding company senior debt which happens to fit well in the context of splitting retail and investment banking activities as recommended by the Vicker’s commission. The Central Bank of Ireland has confirmed to Allied Irish Banks the MREL target expected, with the bank The three major Irish banks have announced that that they will be joining their UK, US, Swiss and Japanese counterparts by issuing MREL in the form of holding company senior debt . Germany has made amendments to its insolvency laws that make already outstanding senior debt junior to excluded liabilities. Italy has passed a law that, starting on 1 January 2019, ‘uplifts’ the ranking of deposits that would otherwise rank equal to senior debt, potentially also allowing outstanding senior debt to meet the subordination requirements (to the extent that there are no, or only a very small amount of, other equally ranking excluded liabilities). France, Spain and Belgium have passed laws that allow banks to contractually select a ‘non-preferred’ ranking for new senior debt, effectively creating a new layer of ‘subordinated senior’ debt that meets the MREL requirements. Notable for its absence in this list is the EU as a whole which has been slow to respond to the needs of its banking sector in spite of recent positive news about ‘fast tracking’ of a ‘partial harmonisation’ directive proposed in November 2016 that would mandate the creation of a ‘non-preferred’ senior layer in the bank creditor hierarchy in all 28 member states.

What other changes have happened since the introduction of these regulations?

In November 2016, changes to the rules on capital in CRD IV, CRR I and BRRD I were proposed by the European Commission (EC). In addition to the creation of a new layer of ‘non-preferred senior’ debt in the bank creditor hierarchy, the proposals include specific new requirements for eligible liabilities:

- No early repayment or acceleration rights for holders;
- No set-off or netting rights for holders;
- Contractual principal loss absorption if the bail-in power is used (even in contracts governed by EU law). While the prospect of an instrument being bailed in has previously been listed as a risk factor, it is now proposed that it should be an explicit term.

The effect of these proposed requirements (in particular, the requirement for contractual loss absorption), is potentially significant, especially if outstanding TLAC/MREL instruments are not appropriately grandfathered.

How will this affect clients?

Nomura’s base case is that instruments issued before the November 2016 proposals will be grandfathered and will therefore remain valuable to the banks concerned. However, In April 2017, Deutsche Bank launched a liability management exercise (LME) asking investors to exchange up to $4.5 billion of senior debt issued in 2016 with new debt on substantially the same terms but taking into consideration the proposed limitation of acceleration rights and set-off. This debt was intended to become MREL-eligible once a German law comes into force making plain vanilla senior debt subordinated to excluded liabilities. The launch of the LME is therefore a clear sign that issuers are cautious about the implications of the November 2016 proposals and the validity of previously issued securities.

For European G-SIBs that must comply with both MREL and TLAC, the November 2016 proposals make comparisons more complex. While the US implementation of TLAC also prohibits acceleration rights for eligible instruments, this is limited to the first 30 days following a non-payment event; in addition the US TLAC rules include generous grandfathering provisions for outstanding eligible debt.

Has the implementation of MREL & TLAC been smooth sailing?

The FSB’s task in setting clear TLAC requirements for G-SIBs has been relatively straightforward: the 30 institutions to which TLAC applies operate on a global scale and have relatively consistent business models.

In contrast, the Single Resolution Board (SRB), which is the resolution authority for participating Member States within the EU's Banking Union, is responsible for setting MREL for the top 130-140 banks in Europe. This group includes G-SIBs, which also have to meet TLAC requirements and therefore seek consistency between the two standards in order to ensure a level playing field in terms of competition. MREL also applies to D-SIBs as well as many much smaller operations and those with unusual business models, such as traditional equity-funded Danish mortgage banks.

As the SRB's mandate is clearly biased in favour of harmonisation, there is no easy solution to the challenge of implementing MREL. Some additional complicating factors are the rules on State Aid and the BRRD requirement for a minimum of 8% of liabilities to be bailed in as a pre-requisite for access to national resolution funds. Although this rule has not been explicitly incorporated into MREL, resolution authorities are required to consider all applicable requirements, including State Aid rules.

So where are we now?

Some important issues relating to TLAC, such as where capital must be held within a group, are unresolved. However, most of the central aspects of the standard – and perhaps most importantly the compliance date – are now clear. In contrast, some critical elements of MREL, including when it will be introduced, remain uncertain – partly as a result of the complexity described above.

Clarification of most outstanding MREL items was expected by the end of 2017 with national implementation of BRRD 2 likely by the end of 2018. This is a year longer than originally envisaged in the CRD V package.

In the meantime, G-SIBs and D-SIBs in jurisdictions with clear eligibility criteria (such as the UK, France and Germany) will continue to press ahead with their issuance plans. An increasing number of issuers from other member states could follow suit even before their national insolvency frameworks are finalised: in January, before the introduction of non-preferred senior debt in Spain, Banco Santander sold 'second ranking' senior notes, which are contractually-subordinated under terms that anticipated the partial harmonisation of the bank creditor hierarchy proposed in BRRD 2.

As with all other bank funding and capital instruments, investors will want to make sure that they are receiving a fair compensation for the risks they are taking. A common misconception is that TLAC and MREL instruments are 'bail-in-able' whereas non-TLAC/MREL eligible liabilities are not. Unfortunately, the reality is more complicated than this.

Market conditions remain historically attractive – with potential rate rises and macro-economic headwinds a spur to early action – and banks that address their regulatory risk by raising loss-absorbing capital continue to be rewarded by investors.

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Further reading

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