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TLAC/MREL in practice - Economic and legal issues

Practitioners view

EBI/ ECB Workshop, January 28, 2016

Remarks regarding a Bail-in Tracker for banks

- **A comparable and transparent database regarding Bail-inable debt of banks would be helpful**
- **Beneficiaries would be all stakeholders e. g. investors, banks, authorities, public and academics**
- **The transparency will show that under one label like MREL several heterogeneous solutions could occur**
- **Various subordination solutions could hinder the comparability of a Bail-in Tracker in practice**
- **...but we would be cautious e. g. if market perception should influence the setting of MREL requirements!**

see p. 2 - 3

Various subordination solutions for senior products possible

Illustrative economic view

- A main aspect of MREL/ TLAC is the feasibility of loss allocation on each product
- If an eligible instrument (e.g. senior unsecured bond) ranks pari passu to non-eligible liabilities (e. g. deposits), that could lead to a negative no-creditor-worse-off-test (NCWO) in practice
- A clear subordination of the eligible liabilities could solve that NCWO-issue and can be achieved in various ways:

Structural subordination

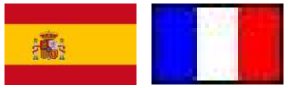
Issuance from a HoldCo

- Structural subordination to outstanding seniors from the operating entity
- Costly and complex to establish a new/ clean HoldCo
- New HoldCo: starting at zero eligible volume

Contractual subordination

New asset class "Tier 3"

- Contractual subordination to "vintage seniors"
- Senior to all outstanding Tier 2
- Cheaper than the issuance of large amounts of Tier 2
- Starting at zero eligible volume



Statutory subordination

Statutory change of waterfall

- Amendments of existing regulation (e. g. insolvency law)
- Senior bonds must be subordinated to operating liabilities of the same entity
- All existing senior volume is eligible

Source: Commerzbank Research; Basel Committee

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Overview of insolvency/ bail-in hierarchies for SSM banks in major markets

Illustrative economic view

Loss Absorp-tion

BRRD

- Secured obligations
- Retail, SME and large corporate deposits < €100,000 under DGS
- Retail and SME deposits > €100,000
- Senior Unsecured Bonds, Large Corporate Deposits, Derivatives, Structured Notes, Interbank deposits*, Other unsecured senior claims
- Tier 2 capital
- AT1 capital
- CET1 capital

Germany

- Secured obligations
- Retail, SME and large corporate deposits < €100,000 under DGS
- Retail, SME deposits > €100,000
- Derivatives, Structured Notes, Interbank deposits*, Other unsecured senior claims, Large corporate deposits
- Senior Unsecured Bonds and promissory notes
- Tier 2 capital
- AT1 capital
- CET1 capital

Italy

- Secured obligations
- Retail, SME and large corporate deposits < €100,000 under DGS
- Retail, SME deposits > €100,000
- Large corporate deposits, Interbank deposits*
- Senior Unsecured Bonds, Derivatives, Structured Notes, Other unsecured senior claims
- Tier 2 capital
- AT1 capital
- CET1 capital

Spain/ France

- Secured obligations
- Retail, SME and large corporate deposits < €100,000 under DGS
- Retail and SME deposits > €100,000
- Senior Unsecured Bonds, Large Corporate Deposits, Derivatives, Structured Notes, Interbank deposits*, Other unsecured senior claims
- Tier 3 capital / Junior-seniors
- Tier 2 capital
- AT1 capital
- CET1 capital

Source: Commerzbank Research, Italian & Spanish BRRD implementation, AbwMechG * BRRD exemptions (e. g. < 7 days)

Layer of "subordinated" senior liabilities

Important points regarding MREL from a practitioners point of view

- **A** MREL is a new steering dimension and will become part of the integrated bank steering
- **B** There are still important issues unclear on how MREL will be calculated and work in practice
- **C** Capital- and funding-strategies will be affected; issuance volume is likely to rise
- **D** Additional costs for SSM banks will be determined by investor perception and demand
- **E** TLAC and MREL should ideally be harmonized; but risk of gold plating for SSM/ SRB banks

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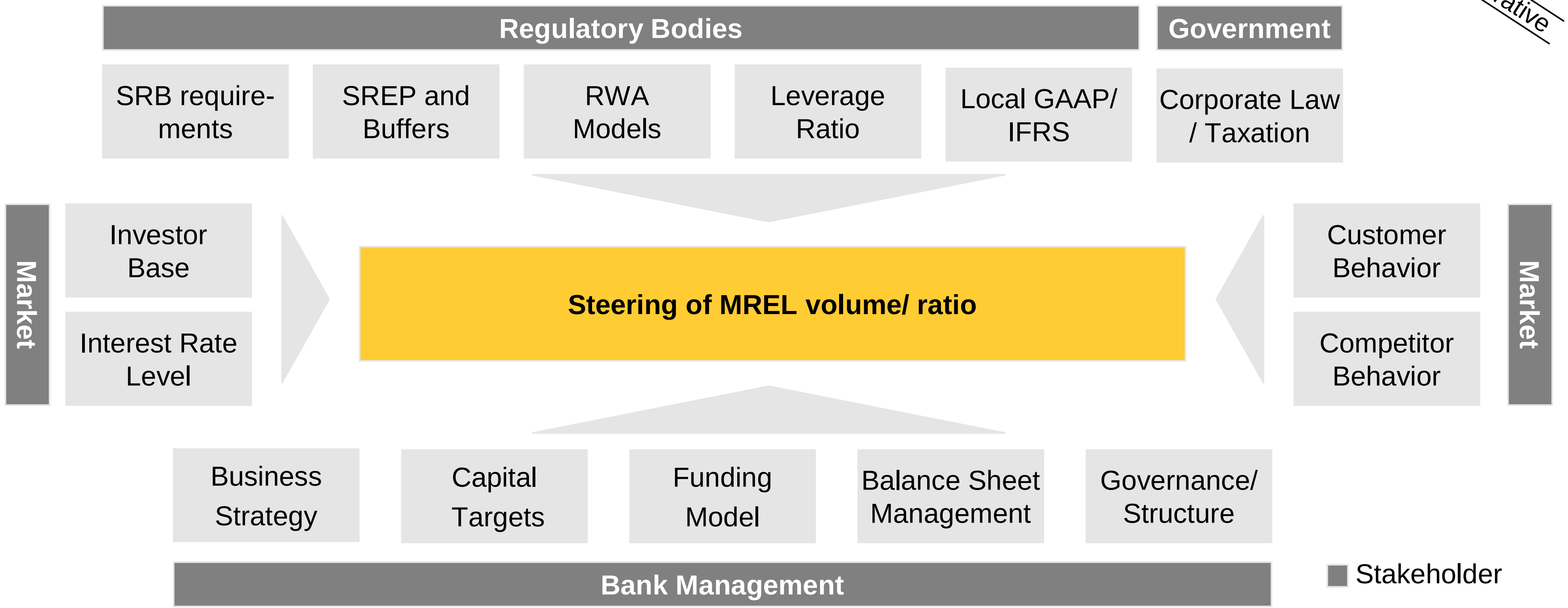
MREL-Stakeholders and influencing forces in practice

Illustrative



Complex management process that requires a clear and stable regulatory framework

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Capital and funding instruments of banks – how does MREL fit in?

Illustrative

Increase of	RoE	P/L (≈ Dividend)	CET1 Ratio	Own Funds Ratio	LR	B/S Volume	Funding	Influencing Force
	Effects on bank steering figures							
CET 1	🔴 ↓	⚪ =	🟢 ↑	🟢 ↑	🟢 ↑	🔴 ↗	🟢 =	SSM
AT 1	🔴 ↘	🔴 ↓	🟢 ↗	🟢 ↑	🟢 ↑	🔴 ↗	🟢 =	
Tier 2	🔴 ↘	🔴 ↓	🔴 =	🟢 ↑	🔴 =	🔴 ↗	🟢 ↗	SSM or SRM?
MREL Debt	🔴 ↘	🔴 ↓	🔴 =	🔴 =	🔴 =	🔴 ↑	🟢 ↗	SRM
Funding products	🔴 ↘	🔴 ↘	🔴 =	🔴 =	🔴 =	🔴 ↑	🟢 ↑	mainly Bank

🔴 negative ⚪ neutral 🟢 positive

MREL Debt results in costs during going concern; benefits mainly in gone concern

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How will the minimum MREL requirements be calculated?

Steps to calculate the MREL Minimum*

Base MREL = max of

A)
- Total Capital requirements (CRR)
- 1 Combined buffer requirement (CBR)
- 2 Pillar 2 requirement

B) Basel I Floor

C) Leverage Ratio requirement

SRB Adjustments

+ 2 **Additive adjustments:**
  - Business model
  - Funding model
  - Risk profile
  - Res. impediments
  - MREL holdings

− **Decreasing adjustments:**
  - 1 Some parts of CBR
  - 2 Pillar II based on stress tests or macro prudential risks

= 3 Loss absorbing amount (LAA)

+ 4 Recap Amount (equivalent to to LAA)

+/− 5 Peer comparison

− 6 DGS adjustment

= MREL requirement

X Major unclear issues in the calculation scheme

Major unclear issues

LAA and Recap

1 How should the buffers be treated (e.g. CBR on top or included)?

2 Granularity and transparency of Pillar II/ SREP requirements known by SRB (e.g. concentration risk)?

3 How realistic is an entire loss of capital (e.g. all issues hits simultaneously)?

4 Which LAA-items are solved after resolution (e.g. surcharge due to certain assets)?

Peer comparison

5 What's the right ratio (CET1 v. Own Funds)?

Why should a "clean" bank have the same capital level as peer banks?

Deposit Guarantee Scheme (DGS)

6 How will the DGS adjustment be calculated?

* Elements see Presentation of SRB on the 2. industry dialogue, p. 13 and 14, 12.01.2016, http://srb.europa.eu/sites/srbsite/files/2nd_industry_dialoge_12-1-2016_-_mrel.pdf

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Approximation of issuance volumes to fulfill MREL/ TLAC

Figures for illustrative purposes

Approximation* in bn, rounded		G-SIBs	thereof: SSM G-SIBs	SSM Banks
Assets**		42.300	11.100	21.400
RWA**		21.100	3.600	8.000
MREL/ TLAC Minimum	@8% B/S	./.	**890**	**1.700**
	@20% RWA	**4.200**	730	1.600
Debt Issuance p.a.***	@8% B/S	**./.**	**90**	**170**
	@20% RWA	**420**	70	160

Limiting requirement

Open Issues

- MREL-requirement of "8 % total assets" could gold plate MREL compared to TLAC
- MREL minimum of > 8 % for the SRF usage could give unintended signals to investors (e. g. bail-outs?)

Could the assumed volume be covered by future market capacity?

* Assumptions: MREL/ TLAC Minimum = 20 % of RWA and is split in existing capital (50 %) and new MREL-debt (50 %), MREL-Debt maturity: 5 years; MREL proxy: 10,1 % (average SREP) X 2 ≈ 20 %
** Data per 12/2014: G-SIBs + SSM G-SIBs = SNL; SSM Banks = https://www.bankingsupervision.europa.eu/banking/supervisory-statistics/html/index.en.html; 18.01.2016 16:00; own calculations
*** Debt Issuance includes AT I, Tier II and Senior Unsecured Bond issuances

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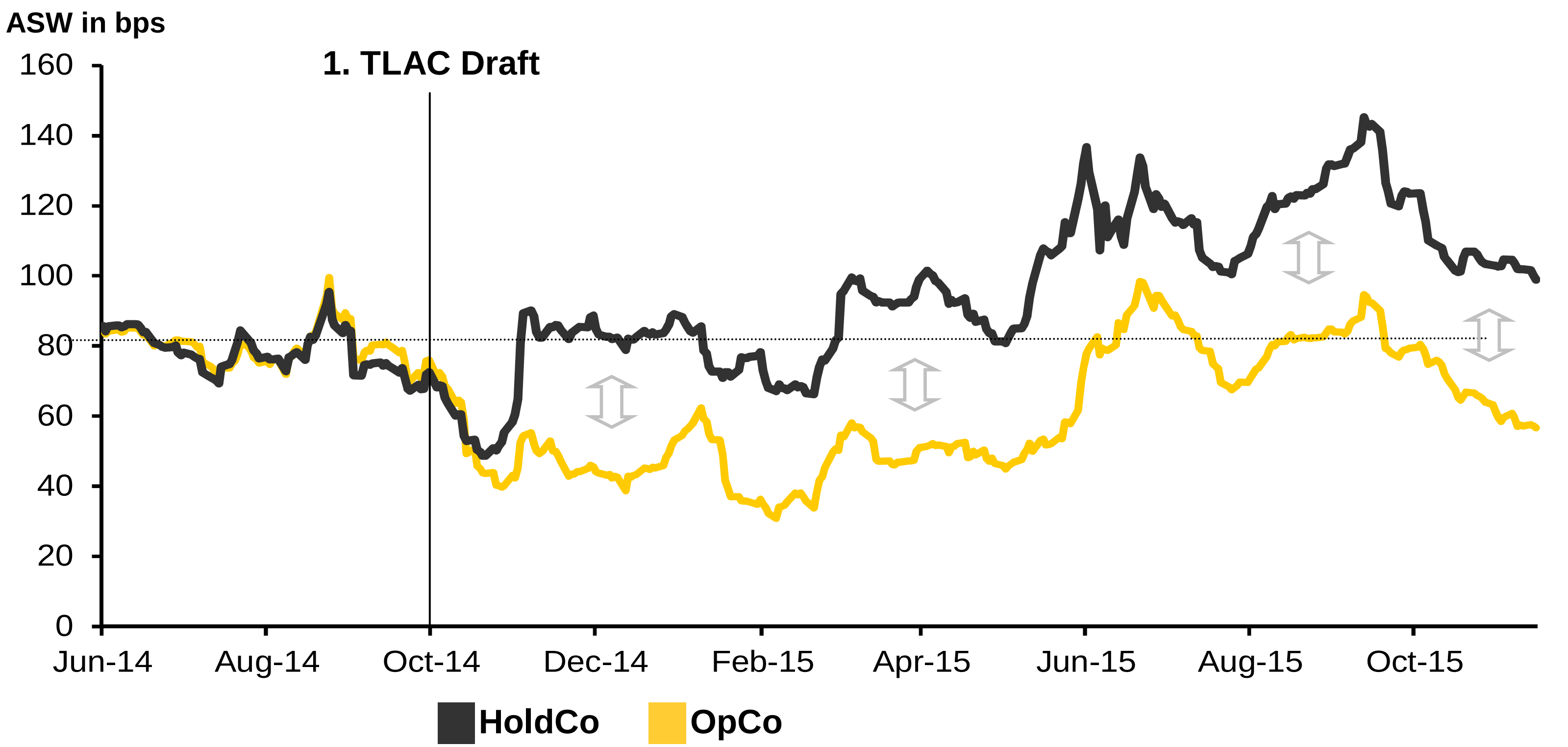
What will be the reaction of investors?

Spread movement between HoldCo and OpCo debt* - illustrative -



Around 30 bps widening due to higher bail-in risk

Source: Commerzbank Research
* based on issuances of a large European commercial bank which is not in the SSM

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Same goals, different implementation approaches

	TLAC (30 global banks, thereof 8 SSM Banks)	MREL (SSM banks: 123 direct + around 3.500 indirect)
Basis	› % of RWAs; Leverage Ratio (LR)	› % of TLOF** but underlying calculation on RWA
Basel III	› TLAC will focus on Pillar I; CBR Buffers sit on top	› MREL will focus on Pillar I and II (=doubling CBR?)
Minimum	› 16% (2019) to 18% (2020) of RWAs plus CBR or 6% to 6.75% of LR	› Individually. SRB currently signalling: double of Pillar I and II requirements, Basel I Floor or LR*
Debt Floor	› min. 33% of TLAC	› ./.
Phase-in	› 2019 until 2022	› 2016 until 2020
Deductions	› Deduction as "TLAC holdings" (in consultation)	› TBD
Usage of Public Funds	› ./.	› 8 % of total assets (= SRF threshold in BRRD)

Both concepts are mainly driven by RWA → pro-cyclical effects during crises?
SRB signal "8 % of assets" as MREL minimum → higher requirement than under TLAC?
TLAC-styled debt floor could be hard to maintain → market access during crises?

Source: Commerzbank Research, SSM EBA, Basel Committee
* Presentation of SRB on the 2. industry dialogue, p. 15, 12.01.2016 http://srb.europa.eu/sites/srbsite/files/2nd_industry_dialoge_12-1-2016_-_mrel.pdf; MREL proxy: 10,1 % (average SSM SREP) X 2 ≈ 20 %
** TLOF = Total liabilities and own funds according to BRRD - article 45

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