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Client Alert

05 January 2016

BRRD – The UK's Approach to MREL

The Bank of England ("BoE") recently published a consultation paper[1] ("Consultation"), detailing its approach to setting a minimum requirement for own funds and eligible liabilities ("MREL") to be maintained by UK banks and other covered entities pursuant to the EU's Bank Recovery and Resolution Directive ("BRRD"). The MREL requirements will apply to all UK institutions within the scope of the bail-in provisions of the Banking Act 2009, which implemented the BRRD into UK law, and the BoE's powers to set MREL for each such institution derive from its status as the national resolution authority for the UK. The Consultation remains open for comment until 11 March 2016.

Background

The BRRD was partially implemented into the laws of the UK in January 2015, pursuant to the Banking Act 2009, with the provisions on MREL taking effect from 1 January 2016. Under the BRRD, each national resolution authority is required to set the applicable level of MREL in relation to each bank and investment firm headquartered in its jurisdiction. In the UK, the BoE's MREL-setting powers apply to (i) banks, building societies and so-called 730K investment firms, (ii) parent companies of such institutions that are financial holding companies or mixed financial holding companies, and (iii) financial institutions that are authorised by the Prudential Regulation Authority ("PRA") or the Financial Conduct Authority ("FCA"), and that are subsidiaries of such institutions or such parent companies. For the purpose of this alert, we will generally refer to all of the above entities as "banks".

It is worth noting here the extensive degree of overlap between the MREL provisions of the BRRD, and the final TLAC Principles published in November 2015 by the Financial Stability Board[2]. Both sets of provisions aim to establish an appropriate level of liabilities that can be bailed-in, i.e. converted into equity instruments or written down, and thereby absorb losses in order to achieve an effective resolution of the relevant entity. However, there are significant differences between the two sets of provisions, in particular in relation to their scope. The FSB's principles currently apply only to the 30 entities designated by the FSB as Global Systemically Important Banks ("G-SIBs"), whereas the MREL provisions apply to all European banks. The BoE must set MREL for all UK banks in accordance with the final binding technical standards drafted by the European Banking Authority ("EBA") pursuant to the BRRD but it states in the Consultation that it will use its MREL-setting powers to implement the FSB's TLAC Principles in relation to UK G-SIBs.

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[1] "The Bank of England's approach to setting a minimum requirement for own funds and eligible liabilities (MREL)" – December 2015, http://www.bankofengland.co.uk/financialstability/Documents/resolution/mrelconsultation2015.pdf.

[2] "Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution" and "Total Loss-absorbing Capacity (TLAC) Term Sheet" – 9 November 2015, http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf. See also the MoFo publication "Resolution of G-SIBs – FSB Final TLAC Principles", http://www.mofo.com/~/media/Files/ClientAlert/2015/11/151109ResolutionGSIBs.pdf.

Proposals

According to the EBA's draft regulatory technical standards in respect of the setting of MREL, a bank's MREL must consist of both an amount necessary for loss absorption prior to and during resolution, and also an amount necessary for the subsequent recapitalisation of the bank. The loss absorption amount must at least equal the minimal capital requirement pursuant to the Capital Requirements Regulation[3] ("CRR"), including any applicable leverage ratio requirement set by the relevant UK competent authority[4].

The BoE considers that UK banks would be resolved by one of three resolution strategies – either a modified insolvency procedure, a deposit book transfer or a bail-in.

For those banks that are small or simple enough that their failure would not require the use of stabilisation powers in the public interest, such banks would enter into one of the UK's modified insolvency procedures, depending upon whether the entity is a bank, a building society or an investment firm. Since these entities would be entering into insolvency proceedings, there would be no recapitalisation element of their MREL requirement. Therefore, the BoE proposes to set their MREL at a level equal to their existing minimum capital requirements[5], and would not require any additional MREL issuance.

The BoE considers that where a bank provides more than 40,000 transactional accounts, it is likely that one or more of the stabilisation powers provided in the Banking Act 2009 would be used, rather than one of the modified insolvency procedures. If the bank's only critical economic functions were the provision of current accounts, the BoE would propose to transfer all deposits from retail customers and small and medium-sized enterprises to a third party purchaser or bridge bank. For these institutions, therefore, the MREL would be equal to the minimum capital requirement (to account for loss absorption) plus a percentage of the existing minimum capital requirements corresponding to the percentage of the balance sheet to be transferred (to account for recapitalisation needs).

For such institutions, the BoE will generally not require MREL to be subordinated to senior operating liabilities (such as uninsured corporate deposits and derivatives liabilities).

Where an institution has reached a certain size and/or complexity, the bail-in tool is likely to be used. The BoE has indicated that it would generally expect a bail-in strategy to be appropriate for a firm with a balance sheet that exceeded a figure of between £15-25 billion. For these banks, the BoE intends to set MREL at a level equivalent to twice the bank's current minimum capital requirements – once for the loss absorption portion, and once for the recapitalisation portion. For such banks, the BoE also proposes that MREL liabilities should be subordinated to senior operating liabilities. Such subordination is not strictly required under the terms of BRRD, although it is consistent with the FSB's TLAC Principles.

The BoE is also responsible for setting MREL for UK subsidiaries of foreign banking groups that are within the scope of BRRD. In a case where the foreign banking group's resolution authority will pursue a single point of entry resolution strategy, the subsidiary would not become subject to the BoE's stabilisation powers, though the BoE would prescribe MREL of a level necessary to support the overall agreed resolution strategy. MREL in such a case would be expected to consist of capital or subordinated liabilities issued to the foreign parent. However, in a case where the foreign banking group's resolution authority will pursue a multiple point of entry strategy, the BoE would apply its resolution tools and powers in the same way as for domestic banking groups.

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[3] Regulation EU No. 575/2013, which, *inter alia*, implemented the Basel III capital requirements in the EU.
[4] The relevant UK competent authority will be either the PRA or the FCA, depending on the entity in question.
[5] This will be the higher of the risk-based minimum requirement under the Capital Requirements Regulation (as implemented in the UK), the minimum leverage ratio requirement in the UK and the Basel I floor.

Subordination

Where subordination to senior operating liabilities is required, the BoE has indicated that it expects such a subordination to be achieved by way of structural subordination. In practice, this means that the BoE expects that the relevant bank will raise MREL funds at the holding company level and downstream those funds in the form of capital or another form of subordinated claim to material operating subsidiaries, so that the MREL liabilities will be structurally subordinated to the senior liabilities of the operating subsidiaries.

Timing

The BoE, as is the case with all European national resolution authorities, was required to set MREL for all of its banks as from 1 January 2016. However, the regulatory technical standards published by the EBA allow for a transitional period in which lower MRELs can be set for institutions for a period of up to 48 months, i.e. until 31 December 2019. The BoE states that it does not expect to set MRELs at a level any higher than the minimum capital requirements during such period or, in respect of G-SIBs, until 31 December 2018 (to conform to the FSB's TLAC Principles). However, during such period, the BoE expects UK institutions to produce plans as to how they intend to meet their "usual" MREL levels, and to discuss the plans with the BoE.

MREL criteria

Pursuant to the BRRD, MREL can consist of own funds and eligible liabilities. Own funds means capital instruments that qualify as Tier 1 or Tier 2 capital for the purposes of a bank's capital requirements pursuant to the CRR. Eligible liabilities in this context means all liabilities and capital instruments that do not count as Tier 1 or Tier 2 capital and are not excluded from the scope of bail-in according to the prescribed list specified by Article 44(2) of the BRRD.

The prescribed list of excluded liabilities includes:

- deposits (to the extent that they are covered by a deposit guarantee scheme);
- secured liabilities;
- liabilities in respect of client assets or client money;
- liabilities arising by virtue of a fiduciary relationship;
- liabilities to institutions with an original maturity of less than seven days;
- liabilities with a remaining maturity of less than seven days owed to payment and settlement systems; and
- various liabilities owed to employees, commercial or trade creditors, tax and Social Security authorities and deposit guarantee schemes.

In addition to the MREL criteria specified by the BRRD, secondary legislation passed pursuant to the Banking Act 2009 sets out a number of requirements that liabilities must meet in order to qualify as MREL. A number of these specifications have been adopted in order to be consistent with the FSB's final TLAC Principles. One such requirement is that the liability must have an effective remaining maturity of greater than one year, taking into account any rights of early repayment available to the investor. In addition, the BoE states that it expects UK institutions to consider the overall maturity profile of their external MREL resources, to ensure that temporary lack of access to debt issuance markets would not be likely to cause a significant breach of their MREL requirements.

The BoE also states that it expects UK institutions not to structure their MREL instruments in such a way as to create incentives for the issuer to redeem the instruments ahead of their contractual maturity date.

Consistent with the FSB's final TLAC Principles, the BoE does not consider it appropriate to count, as MREL resources, those liabilities whose values significantly depend on derivatives, such as over-the-counter or exchange-traded derivatives, and structured securities. It also states that liabilities which are subject to contractual set-off or netting arrangements are not appropriate to be counted towards MREL.

In addition, where a liability is governed by the law of a non-EEA jurisdiction, the BoE will need to be satisfied that the liability can absorb losses in resolution, as required by the BRRD.

Relationship between MREL and other capital requirements and buffers

Simultaneously with the Consultation, the PRA issued its own consultation paper entitled "The Minimum Requirement for Own Funds and Eligible Liabilities (MREL) – Buffers and Threshold Conditions". In its consultation, the PRA points out that by 1 January 2020, the capital requirements of UK firms will be influenced by 3 elements: the CRR as implemented in the UK; the leverage ratio framework; and MREL. It regards MREL as complementary to the capital and leverage regimes, particularly because both the capital and leverage ratio regimes are satisfied only by regulatory capital, whereas firms will be able to meet their MREL requirements by counting eligible liabilities that are not regulatory capital.

The PRA has stated that it expects UK firms not to double-count Core Equity Tier 1 capital towards, on the one hand, MREL and, on the other hand, the capital buffers that it must maintain pursuant to the CRR. This will mean that UK firms that count their CET1 capital towards MREL will also need to maintain sufficient CET1 capital to meet their capital buffers. The PRA has also stated that it proposes to adopt a policy to prevent the double counting of CET1 capital between MREL and any applicable leverage ratio buffers.

MREL in the context of banking groups

In addition to setting an external MREL at the group consolidated level, the BoE will also set individual MREL for all in-scope entities within the group. The BoE is also allowed to set individual MREL for entities such as holding companies that are important from a resolution perspective. In terms of setting MREL within groups, the BoE will require that internal MREL resources:

- must be subordinated to the operating liabilities of the group entities issuing them;
- must be capable of being written down or converted to equity without the use of stabilisation powers in relation to the operating entity that issues those liabilities; and
- must be appropriately distributed within the group.

The resolution entities will be required to issue external MREL resources that are at least equal to all of the internal MREL resources to be issued by their subsidiaries. The BoE also requires that the distribution of internal MREL resources within the group must ensure that there is sufficient loss-absorbing capacity prepositioned at the individual entities that are within the scope of MREL, and that the distribution within the group ensures that losses can be absorbed and passed up to the resolution entity.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

Client Alert

November 9, 2015

Resolution of GSIBs – FSB Final TLAC Principles

On 9 November 2015, the Financial Stability Board (FSB) published its final principles on the loss-absorbing and recapitalisation capacity of global systemically important banks (G-SIBs) in resolution together with a final version of its term sheet (Term Sheet) for total loss-absorbing capacity (TLAC).

For each bank labelled by the FSB as a G-SIB[1], the FSB principles establish minimum levels of loss-absorbing capital that must be held as a percentage of its risk-weighted assets (RWA). Subject to certain conditions, the TLAC requirements can be partially met by tier 1 and tier 2 capital that meets the Basel III minimum capital requirements. However, capital held by G-SIBs for the purpose of complying with the Basel III capital conservation buffer and counter-cyclical capital buffer requirements will not be counted towards the G-SIB's TLAC requirements. The same is true of the supplemental capital conservation buffer requirements prescribed by the FSB for the 30 G-SIBs (i.e., between 1% and 3.5% of RWAs). Banks designated as G-SIBs before the end of 2015, other than banks headquartered in an emerging market economy (EME), must meet a minimum TLAC requirement as from 1 January 2019 of at least 16% of risk-weighted assets and at least 6% of the Basel III leverage ratio denominator. As from 1 January 2022, such firms must maintain minimum TLAC requirements of at least 18% RWA and at least 6.75% of the Basel III leverage ratio denominator.

Non-EME G-SIBs designated as such between 2016 and the end of 2018 would have to meet the 18% / 6.75% requirements by 1 January 2022, and those designated as G-SIBs after 2018 would have to meet such requirements within three years after such designation.

G-SIBs that are currently headquartered in an EME will need to comply with the 16% / 6% requirement by 1 January 2025 and the 18% / 6.75% requirement as from 1 January 2028, although this staggered compliance period can be accelerated if the EME's outstanding corporate debt securities or bonds exceed 55% of the EME's gross domestic product.

These final calibrations are towards the lower end of the range consulted on by the FSB in its November 2014 proposals, but when added to a fully loaded capital conservation buffer and G-SIB supplemental charge will still mean G-SIBs being required to hold TLAC of between 19.5% to 22% of RWA as from the beginning of 2019 (assuming no counter-cyclical capital buffer). These final figures were based upon a quantitative impact study conducted by the FSB during 2015, as well as a market survey to gauge the depth of markets for external TLAC-eligible instruments, and a study to evaluate the historical losses and recapitalisation needs of large banks.

[1] The notice list of banks designated as G-SIBs was published by the FSB on 3 November 2015 and lists 30 global banks. The list is available here: http://www.financialstabilityboard.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf.

Our earlier client alert, "Safe to Fail"[2] summarises the pre-consultation proposals of the FSB in the TLAC Term Sheet. Set out below, we have highlighted the main changes made to the TLAC Term Sheet post consultation.

MPE G-SIBs

The resolution authorities of two of the world's major banking jurisdictions, the Federal Deposit Insurance Corporation and the Bank of England, have both promoted a single-point-of-entry (SPE) approach to resolution for banks in its jurisdictions. However, concerns were raised during the FSB's TLAC consultation about ensuring a level playing field for G-SIB groups that are subject to a multiple-point-of-entry (MPE) resolution strategy and therefore could contain two or more resolution groups within the G-SIB group. The Term Sheet has now clarified that, for MPE G-SIBs, the sub-consolidated balance sheet RWAs of each resolution group should be calculated inclusive of exposures to other resolution groups with the same G-SIB. Where these exposures correspond to liabilities eligible for TLAC, they must be deducted from TLAC resources. This deduction also applies to exposures to external TLAC that are issued from a resolution entity to a parent that is also a resolution entity.

In addition, the Term Sheet allows flexibility for the G-SIB's crisis management group (CMG), which consists of various authorities, including the G-SIB's home authority and any relevant host authorities, to agree on the allocation of deductions of eligible TLAC to the various relevant locations so that a deduction of "surplus TLAC" can be made at the level of the subsidiary resolution entity rather than the parent. In addition, in cases where the sum of the minimum TLAC requirements for MPE resolution entities is greater than the hypothetical SPE minimum TLAC requirement, then an adjustment may be made to reduce or eliminate the difference.

Consistency with Basel III

Subject to certain conditions, capital that qualifies towards minimum regulatory capital requirements pursuant to Basel III may also count towards satisfying the minimum TLAC requirement. However, there is a potential inconsistency between Basel III and the TLAC criteria in respect of the actual availability of resources in resolution, for instance, in respect of instruments with an insufficiently long maturity or which are not issued out of the resolution entity itself. Therefore, the Term Sheet provides that, in order for it to be a TLAC-eligible instrument, the instrument must meet all the core eligibility for criteria set out in the Term Sheet and as from 1 January 2022 must be issued directly from the resolution entity. The only exceptions to this rule are in the case of an instrument issued from a subsidiary within the resolution group, to the extent that this is recognised as common equity Tier 1 capital (CET1) for a consolidated resolution entity under the Basel III framework and also in the case of regulatory capital instruments issued by cooperative banks that have in place an institutional protection scheme or something similar that protects the solvency and the liquidity of the affiliated cooperative banks and institutions.

Liabilities eligible for external TLAC

The FSB has retained its stated expectation that at least one third of the minimum TLAC requirements will be met by tier 1 and tier 2 regulatory capital instruments in the form of debt liabilities plus other TLAC-eligible instruments that are not eligible as regulatory capital.

It also continues to emphasise that liabilities that are not eligible for TLAC will still remain subject to potential bail-in in resolution if so provided by the relevant resolution law and resolution strategy for the G-SIB. It considers this an important clarification to make in light of the fact that in many jurisdictions there will be significant differences between those liabilities that can potentially be bailed-in in a resolution, according to the resolution law, and those liabilities that are allowed to be counted towards the FSB's minimum TLAC requirements.

[2] See our client alert of 5 December 2014, http://www.mofo.com/~/media/Files/ClientAlert/2014/12/141205SafetoFail.pdf.

Issuance of external TLAC by non-resolution entities

Generally, external TLAC must be issued and maintained directly by resolution entities, though the FSB has agreed to some accommodations to assist G-SIBs in jurisdictions where there may be legal or practical obstacles to issuing directly out of the resolution entity. Therefore, the Term Sheet allows debt liabilities issued by a wholly and directly-owned funding entity of the resolution entity prior to 1 January 2022 to count towards external TLAC, provided that:

- the issuance is consistent with paragraph 65 of the Basel III framework, including that the assets of the funding entity must meet the eligibility criteria for TLAC instruments;
- there is substantial legal certainty that the TLAC will absorb losses at the resolution entity in its resolution; and
- home and host authorities in the CMG have agreed on the issuance through the funding entity.

In addition, the Term Sheet provides for a phase-out from eligible TLAC of regulatory capital instruments issued from subsidiaries within the resolution group by the end of 2021, except where the instrument constitutes CET1 regulatory capital for the consolidated resolution entity under paragraph 62 of the Basel III framework.

TLAC eligibility and excluded liabilities

The Term Sheet seeks to clarify some of the criteria for liabilities being eligible for TLAC or being excluded from TLAC. In particular, it specifies that, for an instrument to be TLAC-eligible, it must have a minimum remaining contractual maturity of at least one year, or, alternatively, it may be perpetual, i.e., it may have no maturity date at all. In addition, it may not be redeemable by the holder prior to maturity via a put option, with the exception that if the earliest possible date on which the holder can exercise the put option is a date certain, falling at least one year after the assessment of eligibility, it will be TLAC-eligible.

Many respondents to the consultation requested clarification on the subordination requirements for TLAC-eligible liabilities. As a result, the Term Sheet specifies clearly that eligible TLAC must absorb losses prior to excluded liabilities and, therefore, that, for an instrument to be eligible for TLAC, it must be subordinated to excluded liabilities of the resolution entity, whether by contractual subordination, by statutory subordination or by being issued by a resolution entity that has no excluded liabilities that rank *pari passu* or junior to TLAC-eligible instruments. However, a liability that does not appear on the list of excluded liabilities but which nevertheless does not meet all the requirements for TLAC-eligibility may rank *pari passu* with TLAC- eligible liabilities.

Derivatives and Structured Securities

The list of liabilities excluded from TLAC includes some liabilities that are clearly bail-inable under many resolution regimes but which the FSB perceives as being potentially difficult to bail-in in practice in a resolution. This includes liabilities arising from derivatives and debt instruments with derivative-linked features, such as structured notes. Unlike the recently proposed rule by the Federal Reserve Board in the United States[3], the term "structured note" is not specifically defined by the FSB. During the FSB's consultation, many respondents raised questions regarding classification of structured notes as excluded liabilities, particularly in the case of structured notes which were principal-protected.

However, the FSB stated that it was uncertain as to how easily structured notes could be exposed to loss in resolution in general, as bail-inability depends on a range of factors, including a jurisdiction's preferred resolution

[3] See our client alert of 1 November 2015, http://www.mofo.com/~/media/Files/ClientAlert/2015/11/151101tlac.pdf.

tools, the timeline for valuation of liabilities and for admitting claims and the ability of resolution entities to provide reliable valuations. For these reasons, liabilities arising from derivatives (whether securitised or otherwise) remain excluded from TLAC.

Subordination

Also included on the list of excluded liabilities are insured deposits, as well as sight deposits and deposits with an original maturity of less than one year. Since eligible TLAC is required to be subordinated to excluded liabilities, this therefore means that so-called "senior" unsecured liabilities (such as senior unsecured bonds) will not be able to count towards TLAC unless they are subordinated to liabilities such as deposits, derivatives and structured notes. In reaction to these requirements when they appeared in the FSB's consultation, Germany has proposed statutory rules that would have the effect of explicitly subordinating tradeable senior unsecured bonds both to insured retail deposits and also to non-preferred corporate deposits, derivatives and structured notes, with the intention that tradeable senior unsecured bonds issued by German Banks would become eligible for TLAC as a result of such statutory subordination.

In response to a number of comments during the public consultation, the FSB has agreed to a de minimis exception to the rule requiring subordination of eligible TLAC to excluded liabilities. The de minimis exception applies if:

- the amount of excluded liabilities ranking pari passu or junior to the TLAC-eligible liabilities does not exceed 5% of the resolution entity's eligible external TLAC;
- the resolution authority of a G-SIB has authority to differentiate between pari passu creditors in resolution;
- such differentiation in favour of excluded liabilities would not give rise to material risk of successful legal challenge or valid compensation claim; and
- the de minimis exemption would not have a material adverse impact on resolvability of the institution.

In addition, in jurisdictions where the resolution authority has power, under exceptional circumstances, to exclude from bail-in all of the TLAC excluded liabilities, the authority may permit liabilities ranking pari passu to excluded liabilities (but which would otherwise be eligible for TLAC) to count towards TLAC, up to 2.5% RWA of the minimum TLAC requirement when this requirement is 16% RWA and up to 3.5% RWA when the minimum TLAC requirement is 18% RWA. However, the Term Sheet makes clear that a G-SIB can utilise only one of the above exceptions.

Redemption Restrictions

Following requests for clarification during the consultation, the FSB's final standards specify more clearly that supervisory approval is not required for all redemptions of eligible TLAC, but only those that would lead to a breach of the minimum TLAC requirement.

Internal TLAC

In addition to specifying required amounts of external TLAC, the Term Sheet retains provisions dealing with the internal TLAC requirements for G-SIBs. The main objective of internal TLAC is to foster cooperation between home and host resolution authorities and the effective implementation of cross-border resolution strategies by the appropriate allocation of loss-absorbing capacity and capacity within resolution groups outside of the resolution entity's home jurisdiction.

In this context, a material sub-group is a group consisting of one or more direct or indirect subsidiaries of a resolution entity that:

- are not themselves resolution entities;
- do not form part of another material sub-group of the G-SIB;
- are incorporated in the same jurisdiction outside of the resolution entity's home jurisdiction (unless the CMG agrees otherwise); and
- either on a solo or a sub-consolidated basis have more than 5% of the consolidated risk-weighted assets or total operating income of the G-SIB group or have a total leverage exposure measure larger than 5% of the G-SIB's consolidated leverage exposure measure or have otherwise been identified by the CMG as material to the carrying on of the G-SIB's critical functions.

In terms of the size of the internal TLAC requirement, the final principles remain as per the November 2014 proposals, being that each material sub-group must maintain internal TLAC of between 75% to 90% of the external minimum TLAC requirement that would apply to the sub-group if it were a resolution group. The actual minimum internal TLAC requirement within that range is to be determined by the host authority of the material sub-group in consultation with the home authority of the resolution group. The higher the percentage set by the host authority, the more loss-absorbing capacity would become trapped in that jurisdiction and become unable to be deployed to other parts of the group in financial difficulty.

European Requirements

The Term Sheet and the FSB's final principles will not become binding on any G-SIB until its home jurisdiction has enacted national laws to implement these provisions.

The EU's Bank Recovery and Resolution Directive (BRRD) already provides, in concept, for EU banks to hold certain levels of loss-absorbing capacity. In the case of the BRRD, the loss-absorbing capacity is known as the Minimum Required Eligible Liabilities (MREL) and is to be set by each national resolution authority within the EU in respect of the banks that are headquartered in its jurisdiction on a bank-by-bank basis. The MREL requirement will apply not only to systemically important banks but to all EU banks. However, rather than being expressed as a percentage of risk-weighted assets, it will be stated as a required minimum percentage of the total liabilities and own funds of the bank.

Unlike the FSB's principles, the MREL provisions are to apply as from 1 January 2016 once the European Commission has adopted the European Banking Authority's (EBA) proposed regulatory technical standards, although the EBA has recommended that national resolution authorities should have the discretion to apply a transitional period whereby banks could comply with reduced MREL requirements until as late as January 2020.

Although there are some obvious differences between the MREL requirements and the FSB's TLAC requirements, the European Banking Authority, in drafting the MREL regulatory technical standards to be observed by national resolution authorities, has noted that its work has considerable overlap with the work of the FSB. The EBA has stated that it aims for the MREL requirements to be implemented in a way that is consistent with the FSB's TLAC requirements while at the same time ensuring proportionality in the MREL requirements in relation to banks that are not G-SIBs.

U.S. Requirements

On 30 October 2015, the Federal Reserve Board (Board) issued for comment a notice of proposed rulemaking (Proposed Rule) that would require U.S. bank holding companies that are G-SIBs to maintain a minimum amount of loss-absorbing instruments, including capital and unsecured long-term debt. In addition, the U.S. intermediate holding companies (IHCs) of non-U.S. banking organisations would be required to maintain a minimum amount of upstream loss-absorbing instruments, including unsecured long-term debt.

For a G-SIB that is a non-U.S. banking group and is active in the United States and subject to an IHC requirement, the Proposed Rule would mean the G-SIB would have to comply with its parent home jurisdiction's enactment of the FSB's final TLAC rules, in addition to having to comply with the Board's final rule at IHC level. Non-U.S. banking organisations that are active in the United States may therefore wish to submit comments on certain aspects of the Board's Proposed Rule for IHCs.

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We have produced a TLAC quick reference summary, accessible here:
http://www.mofo.com/~/media/Files/PDFs/150831TLACCheatSheet.pdf

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Client Alert

November 1, 2015

TLAC, and Then Some...

A Preliminary Assessment of the Federal Reserve Board's NPR

On Friday, October 30, 2015, the Federal Reserve Board ("Board") reaffirmed its commitment to both the bank holding company model and single point of entry resolution. In a departure from historical views of the purpose and function of bank capital, but building on a proposal by the Financial Stability Board ("FSB"), the Board proposed to require globally systemically important banks ("G-SIBs") to issue long-term debt for the purposes of capitalizing a bridge institution that would succeed the G-SIB in the event of the G-SIB's failure. The Board also proposed to limit the liability structure of G-SIBs and to limit other banking institutions' investments in G-SIBs in order to facilitate the resolution of G-SIBs. Specifically the Board issued a notice of Proposed Rulemaking ("Proposed Rule") seeking comment on: a proposed requirement for U.S. bank holding companies ("BHCs"), which are G-SIBs, to maintain a minimum amount of loss-absorbing instruments, including capital and a minimum amount of unsecured long-term debt. The intermediate holding companies, or IHCs, of foreign banking organizations ("FBOs"), with $50 billion or more in U.S. non-branch assets would be required to maintain a minimum amount of upstream loss-absorbing instruments, including a minimum amount of unsecured long-term debt. The Proposed Rule also introduces the concept of a "clean holding company" by imposing a number of significant restrictions on the other liabilities that a covered BHC may have outstanding.

This alert is intended to provide a brief overview, which we will supplement with a more detailed analysis in the coming days.

The Proposed Rule was issued as news circulated that the Financial Stability Board ("FSB") has come to agreement on its requirements for total loss absorbing capacity ("TLAC"). A leaked August 24, 2015 FSB TLAC term sheet published by various media outlets outlines an approach that, while theoretically consistent with the objectives underlying the Board's proposal, takes a different approach. The FSB solely sets out a TLAC requirement, not a long-term debt requirement. It is anticipated that the FSB TLAC final requirements will be released prior to or in conjunction with the mid-November G-20 meeting.

Underpinnings of the Proposed Requirements

The purpose of the Proposed Rule is to address concerns about "too-big-to-fail" and to facilitate the Dodd-Frank Act's resolution scheme under a single point of entry ("SPE") approach. The proposed SPE approach would require that the BHC of the failed G-SIB be placed in receivership while the subsidiaries would remain intact. Title II of the Dodd-Frank Act requires that the BHC be liquidated with losses imposed on the stockholders and creditors of the BHC. The stockholders of the BHC would bear the first losses and the claims of holders of the BHC's long-term debt obligations would be converted into equity that would be used to capitalize the successor entity, the bridge financial company. This approach assumes that the BHC truly functions as a holding company, that business is conducted by the entity through its operating subsidiaries, and that the holding company essentially operates as unified whole— assumptions that have been the cornerstone of the Board's approach to bank holding company supervision for decades. The bridge financial company would initially be capitalized by the bail-in of outstanding long-term debt of the failed BHC, which presumes that sufficient long-term unsecured debt would be outstanding at the holding company level in order to stabilize the bridge financial company.

External TLAC and External Long-Term Debt

The Proposed Rule would establish a two-pronged requirement—a long-term debt requirement and a separate TLAC Requirement.

A covered BHC would be required to maintain outstanding eligible external long-term debt at least equal to the greater of: (i) 6% of RWAs, plus the applicable G-SIB buffer, and (ii) 4.5% of total leverage exposure.

Eligible external long-term debt is unsecured, "plain vanilla" debt issued by the covered BHC and governed by U.S. law. Eligible external long-term debt with a remaining maturity of between one and two years is subject to a 50% haircut for purposes of the requirement. Debt with a remaining maturity of less than one year would not count toward satisfying this requirement.

A covered BHC would be required to maintain outstanding minimum levels of eligible external TLAC, or instruments issued by the BHC to third party investors, which are set in the proposal at not less than the greater of: (i) 18% of total risk-weighted assets ("RWAs") (on a fully phased-in basis), and (ii) 9.5% of the covered BHC's total leverage exposure.

Total eligible external TLAC would be the sum of the entity's Tier 1 capital issued directly by the covered BHC and the covered BHC's eligible external long-term debt. Tier 2 capital that meets the definition of eligible external long-term debt would count toward the external TLAC requirement.

An external TLAC buffer is added on top of the 18% risk-based capital component of the external TLAC requirement, which can be met only with common equity Tier 1 capital, and which equals the sum of 2.5%, any applicable countercyclical capital buffer, and the G-SIB surcharge as calculated under Method 1 of the G-SIB surcharge calculations.

The Proposed Rule solicits comment on an internal TLAC requirement for covered BHCs that would be designed to ensure that losses at holding company subsidiaries are passed upstream to the holding company where they can be absorbed by external TLAC.

"Plain Vanilla" Debt

Consistent with the FSB TLAC requirement, the Proposed Rule emphasizes the need to facilitate a quick and orderly resolution for a failed covered BHC. Valuing a complex instrument would create uncertainty during the resolution process. As a result, under the Proposed Rules, an eligible external long-term debt instrument would be prohibited from:

- Being structured notes (as discussed below);
- Having a credit-sensitive feature, such as a reset (similar to the regulatory capital requirements for Tier 2 instruments);
- Including a contractual provision for conversion or exchange into the equity of the covered BHC (such as contingent capital type instruments); or
- Including a provision that gives the holder a contractual right to accelerate payment (including automatic acceleration), other than a right that is exercisable on one or more dates specified in the instrument in the event of the covered BHC's resolution or on a payment default.

IHC Internal TLAC and Long-Term Debt

Again, to facilitate orderly liquidations in a cross-border context, a covered IHC would be subject to both an internal TLAC requirement and an internal long-term debt requirement. This would be debt, in the case of the long-term debt requirement, and capital and long-term debt in the case of the TLAC requirement issued from the covered IHC to its foreign parent so that the foreign parent (rather than another U.S. entity) bears losses in the event of a resolution.

The amount of the IHC requirements for internal TLAC depends on whether the foreign parent of the covered IHC will be separate be a resolution entity or will be resolved by the foreign home country authorities as a part of the resolution of the foreign parent.

Internal TLAC

A covered IHC that is not itself expected to enter resolution would be required to maintain internal TLAC in an amount not less than the greater of: (a) 16% of the covered IHC's RWAs, (b) for IHCs subject to the supplementary leverage ratio, 6% of the covered IHC's total leverage exposure, and (c) 8% of the covered IHC's average total consolidated assets computed for purposes of the U.S. Tier 1 leverage ratio.

An IHC that would be expected to undergo resolution would be required to maintain internal TLAC in an amount not less than the greater of: (a) 18% of the covered IHC's RWAs, (b) for IHCs subject to the supplementary leverage ratio, 6.75% of the covered IHC's total leverage exposure, and (c) 9% of the covered IHC's average total consolidated assets computed for purposes of the U.S. Tier 1 leverage ratio.

An internal TLAC buffer would apply to the RWA component of the internal TLAC requirement equal to the sum of 2.5% and any applicable countercyclical capital buffer (therefore equal to the existing capital conservation buffer applicable to covered IHCs).

Internal TLAC would be defined to include the sum of: (a) the Tier 1 regulatory capital issued by the covered IHC to its foreign parent and (b) the covered IHC's eligible internal long-term debt.

Internal Long-Term Debt

A covered IHC would be required to maintain outstanding eligible internal long-term debt in an amount not less than the greater of: (a) 7% of total RWAs; (b) 3% of the total leverage exposure, if applicable; and (c) 4% of average total consolidated assets, as computed for purposes of the U.S. Tier 1 leverage ratio. The long-term debt requirement does not depend on whether the IHC is a separate resolution entity.

An IHC's internal long-term debt is subject to requirements similar to those set forth above for external long-term debt. In addition, it must:

- Be issued to the foreign parent entity that controls the covered IHC;
- Be contractually subordinated to third-party liabilities of the covered IHC; and
- Include a contractual going-concern trigger that results in conversion to common equity.

The contractual conversion feature would allow the Board to require the covered IHC to cancel the eligible internal long-term debt or convert or exchange it into Tier 1 common equity on a going-concern basis if: (a) the Board determines that the entity is in danger of default, and (b) any of the following circumstances apply: (i) the top-tier FBO or any subsidiary outside of the United States is placed in resolution proceedings; (ii) the home country authority consents to the cancellation, exchange, or conversion, or does not object to such action after 48 hours' notice; or (iii) the Board makes a written recommendation to the Secretary of the Treasury that the FDIC should be appointed as receiver under Title II of the Dodd-Frank Act.

Clean Holding Company Requirement

In order to further simplify the process of resolving a G-SIB and to reduce the potential for liquidity pressures on the holding company, the Proposed Rule introduces a new concept of a "clean holding company." As a "clean holding company" a covered BHC would be prohibited from:

- Issuing short-term debt to third parties (including deposits) (defined as debt having maturities of less than one year);
- Entering into qualified financial contracts ("QFCs"), such as securities contracts, commodities contracts, forward contracts, repos, swaps, and security-base swaps;
- Having liabilities that are subject to upstream guarantees from the covered BHC's subsidiaries or that are subject to contractual offset rights for subsidiaries' creditors; or
- Issuing guarantees of its subsidiaries' liabilities if the issuance of the guarantee would result in the covered BHC's insolvency or resolution would be an event of default on the subsidiary's part.

A covered BHC's liabilities (other than eligible external TLAC and other than eligible external long-term debt) that are *pari passu* with or junior to its eligible external long-term debt would be capped at a maximum of 5% of the value of the covered BHC's eligible external TLAC. This limitation would apply only at the holding company level and not to subsidiaries of the covered BHC. The cap would not apply to eligible external TLAC or to instruments that were eligible external TLAC when issued but are no longer due to an approaching maturity as long as the holder of such instrument no longer has an exercisable put right, or to payables that are not associated with such liabilities. The NPR explains that structured notes are among the types of liabilities that would be expected to be subject to this cap.

Public Disclosure Requirements

A BHC would be required to disclose publicly that its unsecured debt would be expected to absorb losses ahead of other liabilities, including liabilities of the covered BHC's subsidiaries, in a resolution.

The required disclosure could be made on the covered BHC's website or in a publicly filed financial or regulator report and in the applicable offering documents. This is similar to the current disclosure requirements regarding the possibility of "bail-in" of certain unsecured senior debt instruments issued by entities subject to the Bank Recovery and Resolution Directive in Europe. We would expect to see additions to a variety of sections of U.S. offering documents, including the "Risk Factors" section, to address these terms.

The notice explains that the Board intends to propose a requirement for regular reporting by covered BHCs of their amounts of eligible external TLAC and eligible long-term debt, as well as by IHCs of their eligible internal TLAC and eligible internal long-term debt.

Investments by Other Banks in Unsecured Debt of Covered BHCs

In order to avoid the risk that the resolution of a G-SIB cause losses to other banking institutions, banks, savings and loans and other institutions having total consolidated assets of at least $1 billion as well as IHCs formed to address the enhanced prudential standards requirements would suffer a regulatory capital reduction for any investment in unsecured debt issued by covered BHCs.

Structured Notes and Long-Term Debt and TLAC

A "structured note" is defined as a debt instrument that (a) has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of a reference asset or embedded derivative, (b) has an embedded derivative that is linked to one or more reference assets, (c) does not specify a minimum principal amount due upon acceleration or early termination, or (d) is not classified as debt under U.S. GAAP. The proposed prohibition, therefore, applies both to principal protected and to non-principal protected structured notes. However, the definition expressly excludes non-dollar dominated instruments as well as some rate-linked notes, such as floating rate notes linked to LIBOR.

Since the Proposed Rule applies at the covered BHC only, the Proposed Rule does not affect structured bank notes (issued by a bank subsidiary) or market-linked certificates of deposit issued by a bank subsidiary. Of course, one also could envision structured notes issued by subsidiaries of the covered BHC (not guaranteed by the covered BHC).

"Replacement" Debt

The Proposed Rule provides that outstanding debt of a covered BHC that satisfies the eligibility criteria for external TLAC and for external long-term debt would qualify to meet the two requirements. In the NPR the Board suggests transition strategies noting that covered BHCs might consider replacing "near eligible debt" with eligible external long-term debt presumably through exchange offers or similar liability management exercises prior to issuing new qualifying debt. Footnote 60 of the draft text of the Federal Register notice notes that covered BHCs could meet a substantial portion of the anticipated funding shortfall by replacing near-eligible debt with eligible external long-term debt.

Compliance Dates

Covered BHCs are required to comply with the external long-term debt and TLAC requirement as of January 1, 2019; however, the proposal contemplates phasing in the RWA component of the external TLAC requirement in two stages, such that a 16% requirement would apply as of January 1, 2019 and the 18% requirement would apply as of January 1, 2022. Covered IHCs will be required to comply on the same schedule. The clean holding company requirement would become effective as of January 1, 2019. The regulatory capital deduction would become effective as of January 1, 2019.

Comment Period

The comment period will close on February 1, 2016. We believe that the Board is committed to the resolution strategy described in the NPR and will be reluctant to make wholesale changes in the key components of the Proposed Rule. Comments that are consistent with that resolution strategy are more likely to be viewed favorably.

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Client Alert

July 22, 2015

Valuing Derivatives in a Bank Bail-In

Under the EU's Bank Recovery and Resolution Directive ("BRRD")[1], one of the key powers given to national resolution authorities is the ability to impose losses on, or "bail-in", certain financial liabilities of the failing bank in a resolution action, either by writing down the principal amount of the liability or converting it into equity. One of the main aims of a bail-in is to ensure that creditors and/or shareholders can be made to bear an appropriate proportion of the failing institution's losses, in order to minimise the need for the application of public funds (a "bail-out").

The BRRD provides that all liabilities of the bank in resolution can be bailed-in, unless they are contained on an express list of excluded liabilities, or are excluded from bail-in pursuant to the discretion of the relevant resolution authority, which can be exercised in exceptional circumstances. As a result, derivatives liabilities are eligible for bail-in, except to the extent that they meet the criteria for one of the express exclusions. In order to facilitate such a bail-in of a derivative liability, however, such transactions firstly need to be terminated and closed-out and valued for the purpose of Article 36 of the BRRD. This process raises significant issues for market participants, who will no doubt be keen to ensure that, in the event that their derivatives transactions are mandatorily terminated earlier than intended, their net exposure is valued in a way that is consistent with expectations resulting from their contractually negotiated trading documentation.

The European Banking Authority ("EBA") recently published draft regulatory technical standards (the "RTS")[2] applicable to the valuation of derivatives following the application of the bail-in power to such contracts. The EBA's authority to release the publication stems from Article 49(5) of the BRRD, which requires it to set out (i) appropriate methodologies for valuing derivative transactions, (ii) principles for establishing the relevant point in time at which valuations should be established, and (iii) methodologies for comparing the destruction in value that might arise from close-out and bail-in, with the amount of losses that would be borne by derivatives in a bail-in. We consider the EBA's approach to each of these issues below.

Scope

There are general exclusions from the scope of bail-in under Article 44(2) of the BRRD, including (but not limited to) covered deposits, certain liabilities with a maturity of less than seven days and liabilities to employees, trade creditors or taxing authorities. Some of these exclusions will be relevant to derivatives as well as other financial instruments. In particular, it should be noted that secured liabilities are excluded to the extent that the value of the liability does not exceed the value of the collateral, as are liabilities of less than seven days' remaining maturity to payment and settlement systems. Accordingly, since over-the-counter derivatives of EU banks are increasingly

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:32014L0059
[2] http://www.eba.europa.eu/documents/10180/1073039/EBA-CP-201-10+CP+on+RTS+on+derivatives+valuation.pdf.

likely to be subject to either (a) mandatory clearing (resulting in the mandatory application of stringent margin requirements) or (b) collateralisation requirements in respect of uncleared trades (in each case, under the European Market Infrastructure Regulation ("EMIR"[3])), the universe of derivatives that are likely to be subject to bail-in is likely to become increasingly limited in the future.

Close-Out and Netting

As a first step in the bail-in process, the BRRD itself lays down the parameters for valuing derivatives liabilities. In particular, Article 49(2) of the BRRD provides that write-down and conversion powers apply only upon or after relevant derivatives have been closed-out. Accordingly, resolution authorities have the power to terminate and close-out any derivative contract (that is not excluded from application of the bail-in tool) for that purpose. In addition, Article 49(3) requires that, where derivative transactions are subject to a netting agreement, the liability arising from such transactions must be determined on a net basis, in accordance with the terms of the underlying netting agreement.

Valuation Methodology

Uncleared Transactions

Once the derivative liabilities in the relevant "netting set" have been closed-out, the principal guiding methodology of the RTS, in valuing the closed-out liability, is that of the "replacement cost" of the relevant derivatives. A derivative's value is intended to be determined by reference to the costs incurred by a non-defaulting party in replacing the terminated contract (having taken any posted or received collateral into account).

This methodology may therefore result in a different valuation from one derived from the methodology elected by the two counterparties in their contractual agreement, the latter being disregarded for the purpose of the Article 36 valuation.

Article 2 of the draft RTS sets out the following steps for closing-out and valuing trades that are not centrally cleared:

1. The resolution authority must notify the relevant counterparty that its derivative contract(s) is/are to be terminated, specifying the proposed date for close-out.

2. The resolution authority will also notify the relevant counterparty of a date by which the counterparty must provide (a) evidence of commercially reasonable replacement trades and (b) a summary of any replacement trades. For more illiquid trades where replacement quotes might be less forthcoming, a counterparty may find it difficult to present the required valuation evidence. There is also no guidance with respect to precisely what constitutes appropriate evidence in this regard.

So long as evidence of actual commercially reasonable replacement trades is provided within the requisite time period, the applicable valuer (an independent valuation agent appointed in accordance with Article 36 of the BRRD or, where this is not possible, the resolution authority) will determine the early termination amount at the prices of those replacement trades.

However, in circumstances where the valuer concludes that the replacement trades were not concluded on commercially reasonable terms, or where the counterparty fails to provide sufficient or acceptable evidence by the deadline provided, the valuer will determine the close-out amount based on (1) mid-market end-of-day prices on the specified close-out date or (if that is not commercially reasonable) the time at which a price is available in the

[3] Regulation (EU) No. 648/2012.

market for the underlying asset, (2) the mid-to-bid or mid-to-offer spread (depending on the direction of the netted risk position) in order to estimate loss or cost incurred as a result of close-out in liquidating, obtaining or re-establishing a hedge or related trading position, and (3) adjustments to (2) above in order to reflect the size of the exposure and credit-worthiness of the counterparty.

For this purpose, the valuer may take into account valuations generated on its own systems, data extracted from the institution under resolution (such as internal models and valuations) and third-party market and price information, as well as any other relevant data.

In order to provide certainty for the resolution authority in relation to the valuation, the BRRD provides for no automatic right of challenge or appeal for a creditor. However, it is a fundamental principle of the BRRD, contained in Article 73, that no creditor should be worse off in the bail-in action than it would have been in a conventional insolvency action. In order to give effect to that principle, Article 74 provides for a second independent valuation to be performed as soon as possible after the bail-in action has been effected. The purpose of this valuation is to assess whether shareholders or creditors would have fared better in an insolvency proceeding and, if so, by how much, so that the resolution authority can assess how much compensation would be payable to the relevant shareholder or creditor in order to reflect the "no creditor worse off" principle.

Cleared Transactions

For derivatives trades that are centrally cleared, the resolution authority will notify the central clearing counterparty ("CCP") that it wishes to terminate the applicable transactions, and close-out shall take place either immediately or at a later close-out date specified in the notification. In these circumstances, the valuer must establish the value of liabilities which arise from derivatives contained in groups of transactions covered by the same netting agreement ("netting sets") entered into between the institution under resolution (in its capacity as a clearing member) and the CCP. The RTS suggest that, in this case, the CCP will assume responsibility for determining the early termination amount in accordance with its standard default procedures. CCPs are required (under EMIR) to have default procedures in place which will typically include, as a first step, compulsory efforts to transfer or "port" the cleared trades to another clearing member and, failing that, an attempt by the CCP to auction off the defaulted trades to non-defaulting clearing members. The auction price will represent a cost or gain for the CCP and should therefore adequately reflect such transaction's replacement cost. Following this procedure, the CCP will then have to report the early termination amount applicable to each affected netting set and provide the resolution authority with the default management steps undertaken to liquidate or re-hedge the positions of the defaulted clearing member.

In most cases, the defaulting clearing member is highly unlikely to generate losses in excess of posted collateral. As such, the bailing-in of cleared derivatives is itself generally unlikely to occur in normal market conditions because of the express bail-in exclusion for secured liabilities.

Point in Time for Establishing Derivatives Liabilities

The value of derivative liabilities shall be determined by the applicable valuer at the following points in time:

1. where the valuer determines an early termination amount at the prices of replacement trades provided by the counterparty, the day and time of the replacement trades;

2. where the valuer determines an early termination amount in accordance with CCP default procedures, the day and time when the early termination amount is determined by the CCP; or

3. in all other cases, the close-out date or, if that is not commercially reasonable, the date and time when a price for the underlying asset is available in the market.

Destruction in Value

As an additional step in the valuation process, the BRRD requires that resolution authorities should also make efforts to avoid any unnecessary destruction in value in relation to the relevant derivatives transaction.

Therefore, Article 44(3)(d) of BRRD provides that one ground on which a resolution authority is permitted to exclude a liability from bail-in is where the bail-in of that liability would cause a destruction in value resulting in the losses borne by other creditors being higher than if that liability were not bailed-in. For this purpose, Article 49(5) of BRRD directs the EBA to develop RTS, specifying appropriate methodologies for comparing the destruction in value that would arise from the close-out and bail-in of derivatives liabilities with the amount of losses that would be borne by the bailed-in derivatives liabilities. Article 8 of the RTS therefore provides an additional safeguard, by requiring that resolution authorities must (prior to making a decision that results in close-out of the applicable transaction(s)) make a comparison between (a) the amount of losses that would be borne by derivatives contracts in a bail-in scenario and (b) the destruction in value based on an assessment of the costs, expenses or other impairment of value that is expected to be incurred as a result of the close-out of the derivatives contracts. Elements to be considered as part of the possible destruction in value include (i) the risk of an increased counterparty close-out claim arising from re-hedging costs, (ii) the cost expected to be incurred by the bank in resolution in re-establishing hedges or maintaining an acceptable risk profile, (iii) any reduction to franchise value arising from close-out and any impact to funding costs or income levels, and (iv) any precautionary buffer against possible adverse implications from close-out, such as errors and disputes in respect of transactions or collateral exchange.

Implementation

ESMA has invited market participants to provide comments on the draft RTS by 13 August 2015. The draft RTS are required to be submitted to the European Commission by 3 January 2016.

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