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MREL AND TLAC I.E. HOW TO INCREASE THE LOSS ABSORPTION CAPACITY OF BANKS

INTRODUCTION

It seems that the global financial crisis is coming to an end. We have already reached the stage when it is possible to have a preliminary summary of the costs incurred, to formulate conclusions and propose solutions that would be aimed at preventing the recurrence of similar crises in the future.

One of the regulatory initiatives in terms of enhancing the security and resilience of banks is a new prudential requirement concerning the maintenance of the relevant amount on the bank balance equal to the liabilities, so that in case of a crisis they can be converted into equity, serving to cover the losses and recapitalisation. In November 2014, the Financial Stability Board (FSB) published a proposal for a standard of total loss-absorbing capacity (TLAC)[1]. In the European context, a transposition of TLAC is the obligation for the banks to maintain a minimum relevant level of own funds and eligible liabilities (MREL). These standards, although different in some details, have the same purpose and fundamental principles. At this stage, they may still be subject to certain specific modifications influenced by the opinions raised during the public consulta-

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1 FSB, *Adequacy of loss-absorbing capacity of global systemically important banks in resolution*, Consultative Document, Washington, 10 November 2014.

tion[2]. However, the concept itself is advanced and its implementation in the legal order is already a foregone conclusion.

The subject matter of this article is to discuss the main assumptions for the TLAC and MREL, along with an attempt at critical appraisal. In the **first part** of the article, the genesis of new regulatory requirements is recalled by referring to the experience of the last financial crisis. **The second part** is dedicated to the characteristics of the new prudential standards, with particular reference to the standards of MREL, which is to take effect in the European legal order. A brief reference is also made to the differences observed between the TLAC and MREL. **The article finishes** with reflections on the new requirement and preliminary proposals on selected aspects of their implementation.

1. GENESIS OF THE NEW REQUIREMENTS OF TLAC AND MREL

Recently many publications devoted to the post-crisis financial stability architecture begin with a reminder of the volume of public expenditure incurred for the purpose of rescuing banks during the recent crisis. These numbers are usually cited to justify the need for the speedy implementation of regulatory reforms aimed at limiting the risk taken by banks and the increase of their resilience to shocks in the future. Since the new regulations usually entail additional burden for the banks, they produce strong resistance on the part of the latter. Confronting this burden with the costs that taxpayers have suffered to help banks during the recent crisis is justified, because it significantly weakens the argumentation of the banking environment. What is particularly appealing to the imagination is the data related to the EU. Between 2007 and 2014 the European Commission made more than 450 decisions approving state aid for 112 banks whose assets represent more than 30% of the assets of the banking sector in the EU as a whole. Governments spent more than 671 bn euros to rescue the banks in the form of capital and repayable loans (5.4% of the EU GDP in 2008) and 1.3 trillion euro in guarantees for the liabilities (10.3% of GDP)[3]. The amounts were considerable and contributed to a serious increase in the public debt in the EU, and in particular the euro zone, where the crisis was felt most. Public debt there increased from 66% of GDP in 2008 to more than 90% of GDP in 2014. In extreme cases, the banking crisis led the state budget to the verge of bankruptcy. A classic example is Ireland, whose public

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[2] FSB consultations on TLAC lasted until 2 February 2015, while the deadline for the consultation of the draft of the technical standards of the European Banking Authority (EBA) for MREL expired on 27 February 2015.

[3] G. Adamczyk, B. Windisch, *State aid to European banks: returning to viability*, Occasional Paper, European Commission, 2015.

debt increased from the lowest level in the euro zone, i.e. 25% of GDP before the crisis, to more than 123% in 2014.

Expenditure on aid intended for individual aid banks reached tens of billions of euros, and the highest amounts were meant for banks with a global scope of business. Many of them were included on the list of global systemically important banks, as announced by the Financial Stability Board (GSIBs).[4]

Table 1. Value of state aid for the banks in the period 2008-2014

United Kingdom		USA		Euro zone	
Bank	**The amount in bn of GBP**	**Bank**	**Amount in bn of USD**	**Bank**	**Amount in bn of EUR**
RBS	45.5	Bank of America	46.6	Dexia	11.9
Lloyds	20.3	Citigroup	45.0	Fortis	11.2
Nothern Rock	20.0	JP Morgan Chase	26.9	Commerzbank	18.2

Source: *Reuters, Bloomberg*, G. Adamczyk, B. Windisch, *State aid to European banks: returning to viability*, Occasional Paper, European Commission, 2015.

The last financial crisis was no exception. Also in the past, the governments of countries all around the world spent taxpayer's money on injecting capital into banks facing the risk of bankruptcy. Paradoxically, it was the expression of helplessness, stemming from the lack of a legal basis for intervention in the operation of the banks at a respectively early stage and from the lack of tools that would make such intervention effective. Legal provisions did not make it possible to provide for mandatory charge on the creditors due to the losses suffered by the bank without prior notice of the bank's bankruptcy. The insolvency law, in turn, was in most jurisdictions universal for all business entities and did not take into account the specific nature of banks. Bankruptcy of a bank in this legal order, particularly in the case of large banks, inevitably entailed negative systemic implications[5]. The contagion effect would make the problem occurring in one bank transfer to other banks and the rest of the financial system, thus causing crisis in the economy as a whole. To avoid this, governments recognised public aid as a cheaper solution. Their decisions were motivated by the need to protect the stability of the financial system, rather than the desire to save a specific bank.

[4] In November 2011, FSB first published a list of 30 banks identified as G-SIBs and since then, it has performed an annual review of this list.

[5] J. Zhou, V. Rutledge, *From bail-out to bail-in: Mandatory Debt Restructuring of Systemic Financial Institutions*, IMF Staff Discussion Note, Washington D.C., 2012.

However, as a result of such policy, shareholders and creditors did not bear the cost of the crisis. Therefore, they did not have the incentive to monitor bank risk and its correct valuation. The prices of the debt instruments of the banks which could count on government aid did not reflect the risk taken by the banks, as the risk was covered by implicit *guarantees*. That's why these banks had a privileged position on the market and the cost of their funding was lower than other actors, which was contrary to the principles of equal competition[6]. This form of protection also caused immeasurable negative consequences, namely the weakening of market discipline and creating moral hazard[7].

With regard to such experiences, the need for a thorough reform of the financial safety net network has become clear. On the global level, an important contribution in the process of initiating these changes came from the Financial Stability Board, which set the Key Attributes of Effective and Resolution Regimes for Financial Institution (*Key Attributes* – KA)[8]. This procedure, also known as *resolution*, consists in the fact that public institutions have the power and instruments that enable the restructuring of a bank at an early stage of a crisis or alternatively, its liquidation, irrespective of its size, while maintaining its critical functions[9] and protecting insured deposits. This procedure implies the lack of involvement of public funds. The cost of this operation should be borne by the shareholders and creditors of the banks, not the taxpayers[10]. In the European context, the KA have been implemented by the Bank Recovery and Resolution Directive (hereinafter BRR Directive)[11].

The idea of the *resolution* process is reflected in one of its key instruments, i.e., debt conversion or write-off, commonly referred to as *bail-in*. It involves writing off

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6 K. Ueda, B. Weder di Mauro, *Quantifying Structural Subsidy Values for Systemically Important Financial Institutions,* IMF Working Paper, WP/12/128, Washington, 2012, p. 4.

7 G. Stern, R. Feldman, *Too Big to Fail. The Hazards of Bank Bailouts*, Brookings Institution Press, Washington, D.C., 2004.

8 FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions,* Washington, October 2011.

9 A critical function is the kind of activity (service, operation) performed by the bank which is important for the functioning of the real economy and for the maintenance of financial stability, whereas a sudden absence of or disruption in the availability of this feature may have a significant negative impact on third parties, and may be the source of the decrease of general confidence and trust of market participants.

10 O. Szczepańska, A. Dobrzańska, B. Zdanowicz, *Resolution, czyli nowe podejście do banków zagrożonych upadłością,* NBP, Warsaw 2015.

11 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, Official Journal of the European Union, L 173/190.

capital instruments in order to cover the losses, and if this proves to be insufficient for the bank to regain a stable situation, certain liabilities of the bank are subject to conversion into equity, which can also be used to cover the losses or for the recapitalisation of the bank, in order to meet regulatory requirements.

This instrument reflects the main principle of the resolution process, which has it that the losses of the bank should in the first place be covered by shareholders and creditors. However, for this instrument to be used successfully, provisions must be ensured that give the authorities responsible for the process of *resolution* the right to override the creditors' rights. It is also necessary for the banks to maintain adequate capacity for the absorption of losses in the form of adequate value of liabilities which may be subject to conversion to capital. Too broad a catalogue of obligations excluded from *bail-in* along with the freedom to shape the structure of liabilities by the banks creates the risk that this instrument will not be effectively applied due to the lack of liabilities eligible for conversion from the legal and operational point of view. The liabilities subject to conversion are, as a rule, more expensive for the issuer-bank, due to the higher risk of them being used to cover losses. That's why banks can shape their liabilities so as to avoid the liabilities subject to *bail-in*. In this context, the concept has arisen to introduce a new prudential requirement, obliging the banks to keep a certain proportion of liabilities, which in a crisis situation could be converted into shares, thus becoming an internal source for covering the losses and/or raising the capital in the bank. The ultimate goal of the new regulatory requirement is to increase the internal resilience of banks and to protect public funds (taxpayer's money) from being used to help banks affected by the crisis.

2. TLAC AND MREL-GENERAL CHARACTERISTICS

The Financial Stability Board has proposed a standard for banks concerning the total loss absorption capacity (TLAC). In the European Union, the BBR Directive – the requirement for the banks to maintain a minimum level of own funds and eligible liabilities (MREL). The BRR Directive sets general rules for the MREL requirement, whereas the *European Banking Authority – EBA*) is authorised to develop draft regulatory technical standards (RTS) to narrow down these rules and ensure their harmonization in the EU member states[12]. The following section shows the characteristics of both standards, focusing on selected aspects, i.e. (1) the substantial scope of the impact of the standard, (2) the way of calculating the

[12] *Draft Regulatory Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU*, Consultation Paper, EBA, 28 November 2014.

requirement (3) the allocation of the requirement within the banking group, in the case of banks operating across borders), (4) the categories of eligible instruments, (5) the consequences of violating the requirement. These standards have the same purpose and basic principles, but they differ in certain specific solutions.

2.1. TLAC-basic principles

Substantive scope. The TLAC requirement is addressed to global systemically important banks (G-SIBs). The list of these is published by the FSB. The classification of large international banks in the G-SIBs category has been made by the FSB according to 5 criteria. They focus on the quantitative characteristics, i.e. the value of the assets, financial links, participation in market infrastructure, involvement in complex financial instruments, the scale of cross-border activity. Selected global systemically important banks have been broken down into subgroups (*buckets*) and depending on the affiliation to a particular bucket, they have been assigned additional capital requirements as buffers for global systemically important institutions (*G-SIBs buffer*)[13] from 1.0% to 3.5%[14]. According to the FSB, the TLAC requirement is not subject to differentiation depending on the bank's membership to a particular bucket of G-SIBs.

Calculating the requirement. TLAC is expressed in the form of the capital ratio or financial leverage ratio. It is an additional requirement in relation to the Basel capital requirement 3. As a result, the items on the balance sheet included in the capital ratio are also included in the TLAC requirement. The rules proposed by the FSB provide a common minimum requirement for the total loss-absorption capacity, which all G-SIBs will have to observe, regardless of their belonging to the subgroup – this is the so-called Pillar 1 requirement. Under Pillar 1, a minimum TLAC requirement is proposed in the range of 16–20% of risk-weighted assets and at the level of the double leverage ratio, included in Basel 3, i.e. 6%.

The minimum TLAC requirement without additional capital buffers from Basel 3 = max (16% of risk-weighted assets, 6% of the leverage ratio)

Capital buffers introduced under Basel 3 (security buffer[15] and buffer for system institutions) will not be taken into account for the calculation of the TLAC requirement. If capital buffers were to be taken into account, the total, minimum risk-weighted assets ratio required will increase to 19.5%–22% (16% plus 2.5% of the security buffer, plus 1%–3.5% of the buffer for system institutions).

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[13] (*G-SIFI buffer*)

[14] Maximum buffer level for G-SIBs is 3.5% and it is applicable to subgroup 5 (*bucket*) of the G-SIBs. At this stage, no bank has qualified for this subgroup and the highest buffer used in practice as imposed on G-SIBs is 2.5%.

[15] (*conservation buffer*)

It is assumed that the Pillar 1 requirement can be supplemented by a specific TLAC requirement, defined for each bank individually under the so called Pillar 2. Regulatory and supervisory authorities in the Crisis Management Group[16] will be responsible for determining an additional, minimum TLAC requirement under Pillar 2, taking into account the characteristics of the bank, its business model, risk profile and organisational structure. Calibration and the composition of the TLAC requirement for a particular company should be evaluated within the so-called process of evaluating the possibility to carry out the recovery and resolution in a particular institution (*resolvability assessment process*).

Deployment of the TLAC requirement within a banking group. In the FSB concept, the *resolution* process in a banking group is considered holistically. A G-SIB is divided into the main entities, or units subject to *resolution* (resolution *unit*) and dependent branches, which alone are not subject to *resolution* process. A *resolution* unit together with its subsidiaries form a group, which is as a whole subject to the procedure of *resolution* (the so called resolution *group*). G-SIB may consist of several *resolution* groups with a corresponding number of *resolution* units. The minimum TLAC requirement will only refer to the *resolution* unit and will be established with relation to the consolidated balance sheet of each *resolution* group. Furthermore, the requirement must be met on a consolidated basis for the G-SIB. FSB suggests that subsidiaries of the *resolution* unit, significant for the group (*material subsidiaries*) be subject to the internal TLAC requirement. The so-called internal TLAC for a particular subsidiary would be equal to 75–90% of the standard requirement that a subsidiary would have to meet if it operated individually (on a *stand-alone basis*). The criteria for the designation of material subsidiaries proposed by the FSB are designed from the perspective of a banking group, rather than markets in which the subsidiary is established. They are related to quantitative indicators for the subsidiaries evaluated with relation to the values registered for the banking group on a consolidated basis (e.g. 5% of risk-weighted assets in the group, 5% of revenues in the group, etc.).

Instruments included in TLAC. TLAC requirement should consist of equity instruments from the first and second category (CET1, AT1 and T2) as well as other instruments not belonging to the regulatory capital. The Financial Stability Board introduces additional restrictions and requires that in addition to equity instruments, at least 33% of the TLAC requirement should be debt instruments. They must be instruments that can be effectively converted to equity in the course of the *resolution* proceedings, i.e. from the legal perspective, they may not contain

[16] Pursuant to the FSB guidelines, for all G-SIBs, the supervisory authorities from the countries where the banking group is present should create the so-called Crisis Management Groups (CMG). The group is chaired supervisory authority from the country where the head office of the banking group is located (i.e. consolidating supervisory authority).

clauses which constitute an obstacle to conversion. Instruments eligible for the minimum TLAC requirement should be long-term (with more than one year to maturity). Furthermore, the ageing of the instruments included by the bank in TLAC in its balance sheet should be differentiated, so that their maturity is evenly distributed over time. The point is that the maturity of debt instruments should not be cumulating at a certain time and that the bank should not have any trouble with the rollover of the obligations, should there be an abrupt deterioration of the market situation. The main categories of instruments excluded from TLAC are deposits covered by guarantees and liabilities. In order to minimise the risk of contagion, G-SIBs have to deduct eligible liabilities acquired by other global systemically important banks from their TLAC requirement.

Violation of the TLAC requirement. A violation or real threat of a breach of the minimum TLAC requirement by the bank is to be treated as a breach of capital requirements. This means that it can constitute a premise for commencing a *resolution* process.

2.1.1 MREL – basic principles

Substantive scope. The BBR Directive includes all the banks in the EU in the MREL requirement. At the same time, the directive lays down no harmonised size of this requirement. It is to be determined by the national resolution authority for each bank individually, taking into account i.a. its size, business model, funding model and risk profile.

Calculating the requirement. The MREL requirement is calculated as the amount of own funds and eligible liabilities in relation to the total liabilities and own funds of the institution. No common, minimum requirement is stipulated for all credit institutions and investment companies. In the RTS draft, the European Banking Authority specifies the criteria which the national *resolution* authorities should apply when determining the level of the MREL requirement for banks under its jurisdiction. It is important that the institutions with a similar risk profile, similar ability to carry out effective recovery and resolution have a similar level of MREL requirement, regardless of the country of origin. The RTS draft develops 6 criteria listed in the BRR Directive, which should be taken into consideration by the national *resolution* authorities when determining the MREL requirement for banks:

- ❖ **The criterion of the ability to carry out the bank *resolution process (resolvability)*** – it requires that a given institution should have sufficient own funds and eligible payables to cover losses and for the recapitalisation of the bank in the event of the implementation of the *resolution* plan.
- ❖ **Capital adequacy criterion** – made up of two elements: 1) loss absorption capacity and (2) recapitalisation capacity. The RTS draft defines how the

authorities should compute the necessary amount for each of these elements. When computing the MREL, the *resolution* authorities should assume a loss equal to capital requirements, including capital buffers. On the basis of the so-called *resolvability assessment*, that is, the evaluation of the ability to carry out the recovery and resolution of the institution concerned, the authorities may additionally assess that a higher level of capital is required for the absorption of losses. The other element of this criterion is the determination of the amount required for the recapitalisation process during a scheduled *resolution* process. For banks where it is anticipated that they can be wound up in a normal bankruptcy procedure, the amount for the recapitalisation process may be zero.

- ❖ **The criterion for covering the needs related to loss absorption and recapitalisation in case of some groups of liabilities are excluded from *bail-in*.** As a rule, the BRR directive excludes certain liabilities from *bail-in*, and in addition, national authorities also have the right to exclude certain liability groups *ad hoc*, in order to ensure an effective *resolution* process. That's why the MREL requirement for a particular bank should be fixed at a level which will cover the identified and potential exclusion of certain categories of liabilities from *bail-in*.
- ❖ **The extent to which the deposit guarantee system could contribute to the financing of the *resolution*** process. In RTS, the EBA proposes that when computing MREL, one should take into consideration the financial means of the Deposit Guarantee Scheme (DGS). The resolution authority should guarantee that MREL is fixed at a level which ensures that the DGS involved in the process of bank resolution is less than 50% of the target level of the deposit guarantee fund (*target level*).
- ❖ **The criterion that requires that the *resolution authorities take into account the size, business model, the funding model and risk profile of a particular institution*.** National *resolution* authorities should consider the extent of the difficulty and the possibility to carry out bank resolution (*resolvability*). As a rule, larger banks with more complex structure should maintain a higher MREL level.

Deployment of the MREL requirement in a banking group. The requirement must be determined and maintained both on the individual and consolidated basis. Subsidiaries of banks operating across borders are subject to the MREL requirement, as designated by the national *resolution* authority in the jurisdiction where the subsidiary is registered.

The instruments included in the MREL. Banks should have sufficient own funds and eligible liabilities to cover the losses and for recapitalisation. The BRR directive indicates that the *bail-in* instrument can cover all liabilities of the bank

(and thus they can be included in MREL), with the exception of the following main items[17]:

- guaranteed deposits,
- collateralized liabilities (e.g. mortgage bonds, repurchase agreements etc.),
- liabilities with an original maturity below 7 days, with the exception of entities that are part of the same group,
- liabilities whose residual maturity against clearing houses or their participants is less than 7 days,
- liabilities due to salaries and retirement benefits.

The BRR directive[18] stipulates that in exceptional circumstances, the *resolution* authority may decide to exclude – wholly or partially – certain liabilities from the scope of the *bail-in*, as long as the following conditions are met:

- the conversion or redemption of liabilities cannot be made within a reasonable time,
- the exclusion of the obligation is necessary to maintain the continuity of critical functions and the main business lines of the bank,
- the exclusion is necessary to prevent distortions in the functioning of financial markets, which may have a negative impact on the economy of a Member State or throughout the European Union,
- failure to exclude the obligation would result in greater losses for the remaining creditors.

Violation of the MREL requirement. The BRR Directive and EBA guidelines make no mention of the sanctions for a failure to comply with the MREL requirement. European authorities note that violation of the requirement, besides the reasons related to the activities of the bank, may be caused, for example, by systemic problems in the market. The provisions of the BRR directive provide only for the possibility to impose administrative sanctions by the *resolution* authorities or supervisors for the infringement of the national provisions which implement the rules of the directive. At this stage, this issue remains ill-defined in the legal provisions.

2.2. TLAC and MREL-comparison

The requirements of MREL and TLAC, though identical as to the purpose, differ in the details of the solutions. Table 2. summarises the key differences.

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[17] Article 44 (2) of the BRR Directive.
[18] Article 44 (3) of the BRR Directive.

Table 2. TLAC and MREL-comparison

	MREL	TLAC
Purpose	To ensure adequate capacity of the bank to absorb the losses and to recapitalise without the need to involve public funds and without creating adverse effects for the financial system.	
Scope of the institutions (Addressees)	All banks (credit institutions and investment companies)	Global Systemically Important Banks (G-SIBs)
Deployment of the requirement within the banking group operating across borders	*Resolution* authorities have the discretion to determine the size of the MREL requirement individually for each bank, taking into account its characteristics.	All banks should have the same minimum TLAC requirement under Pillar 1. It is possible to add an individual requirement under Pillar 2.
Method of determining the requirement	• MREL is expressed as a percentage of the total own funds and liabilities of the bank. • MREL for the bank is calculated with the consideration of the capital minimum value and capital buffers.	• TLAC is determined by the equity ratio and leverage ratio. • The minimum TLAC requirement does not include capital buffers.
Value	• There is no standard value. The minimum value is determined individually by the *resolution* authority.	• The standard minimum is 16-20% of risk-weighted assets and 6% leverage ratio (Pillar 1). • Possible additional, individual requirement for each Bank (Pillar 2).
The consequences of a breach of the requirement	The issue is not precisely defined in the legal provisions.	• It is treated with the same strictness as a breach of capital requirements. • A breach of the TLAC requirement may constitute a premise for commencing the *resolution* process.

Source: own elaboration on the basis od: *The European MREL: main characteristics and TLAC similarities and differences*, Europe Regulation Watch, BBVA Research, 3 Dec. 2014.

3. REFLECTIONS ON TLAC AND MREL

After analysis of the proposals related to TLAC and MREL, certain reflections come to mind as regards the practical aspects of their implementation, with particular focus on the circumstances of our national financial system. Some of these reflections are presented below:

1. Since half of the banks listed by the FSB as G-SIBs are European banks, in practice, conditions should be created for the MREL implementation to be consistent with TLAC requirements. The RTS draft issued by the EBA seems to provide enough flexibility to the national *resolution* authorities so that they can take into account the specificities of the G-SIB.
2. The banks which will receive TLAC or MREL requirements may expect an increase in the cost of funding, which follows i.a. from the need to introduce changes in the structure of the balance sheet. However, the cost of introducing TLAC and MREL (just like other regulations) should be compared against with the benefits to be expected from the new requirements. One of the positive effects of TLAC and MREL may be strengthening the resilience of banks in a crisis. Additionally, in a situation of crisis they will not take advantage of government aid (at least that's the assumption of the *resolution* process). As a result, banking crises will be less costly for governments and economies. The effect should, therefore, be positive in the long term. One should also bear in mind the fact that the TLAC is one of the mechanisms that can restrict further expansion of global banks, which have so far been considered too big to fail (TBTF).
3. What should be considered right is the approach applied in the EU, pursuant to which the MREL – as a rule – is mandatory for all banks, regardless of their size and systemic importance. Flexibility granted to national *resolution* authorities in terms of determining the MREL requirement individually for each bank is a complementary mechanism, which allows for taking into account the characteristics of individual banks. As a result, it is possible to use a zero MREL requirement in the part allocated to the recapitalisation for very small banks or those not involved in the implementation of critical functions and to use a high level of MREL requirement for banks that create a considerable systemic risk.
4. The rules adopted in the BRR Directive and EBA suggestions of technical standards allow for the possibility of establishing a zero MREL requirement for the purpose of recapitalisation for small and systemically insignificant banks. In practice, however, this option should be approached with caution. On the one hand, we are aware that if the national deposit-guarantee scheme is able to cover the payment of deposits accumulated in the bank and the bank is not involved in the implementation of critical function, then the right procedure in the event of such a crisis is to wind up the bank. Therefore, it is not necessary to build

additional buffers in the bank for its recapitalisation. However, such an approach is rational when we look at the bank as a single case, in the micro-scale. The situation becomes complicated when the issue is examined on the macro level. When a crisis affects a group of small banks, which is not a rare phenomenon, the situation begins to have a systemic dimension. Winding up several banks at the same time means much higher costs for the deposit guarantee system or even poses a threat of depleting to its resources. When a particular function exercised by the bank is not a critical function due to the small scale of its execution, in the situation when a few banks cease to execute this function at the same time, it begins to acquire a critical dimension. Therefore, in the process of defining individual MREL requirement, the *resolution* authority should – in addition to the size of the bank – consider also the structure of the national banking system. When there are many banks and they have similar features, which makes them a homogeneous group, the *resolution* authority should lay down the MREL requirement for the recapitalisation of these banks at a level higher than zero, properly considering the systemic risk created by these banks as a group.

5. In the case of the European solutions, what is interesting is the criterion for calculating the individual MREL requirement, which requires that the share of the deposit guarantee scheme in financing the *resolution* process be taken into account. This means that the higher the target level of the deposit guarantee fund the greater the leeway for the *resolution* authority in terms of the possibility to reduce individual MREL requirements. This is why, paradoxically, it is in the interest of the banks to have a higher target level of the fund mandatory in the country – higher than the minimum. The Directive sets only a minimum requirement, but countries are free to increase it. Meanwhile, the banks can be expected to increase their resistance to the increase of the target level of guarantee funds as this means a higher annual premium. Therefore, the discussion should show that a higher target level of the guarantee fund creates a leeway for the national *resolution* authorities to reduce individual MREL requirements for the banks.
6. While the MREL requirement does not specify the structure of eligible liabilities, in the case of TLAC it is proposed that at least 33 percent of it was kept in the form of debt instruments. This principle seems right because it is supposed to contribute to keeping the risk of the bank currently reflected in the cost of obtaining its funding on the market. This requirement also aims to prevent the practice under which banks would issue only those debt instruments which would include appropriate clauses exempting them from the possibility of conversion into capital.
7. In the European context, for the banking systems dominated by the traditional formula of financing banks through the deposits of retail customers (households

and businesses), the MREL requirement could mean the need to seek new ways of securing liabilities. This challenge will concern, among others, Poland, where in some banks more than 60% of liabilities are retail deposits. Furthermore, even those banks that have so far relied on funding from their parent entities (parent banks), have recently started to change the financing strategy to one oriented towards local sources, the majority of which are own deposits. Meanwhile, deposits are excluded from *bail-in* (this applies to deposits covered with warranties, i.e. up to the equivalent of 100 thousand euros) and may not be included in the MREL requirement. The banks, therefore, have two options to meet the new requirements:

a. maintain a relevant higher level of capital in the first category or subordinated debt, or
b. issue debt instruments.

It should be emphasised that the issuance of debt securities refers to unsecured bonds, because secured bonds, for example mortgage bonds are excluded from the *bail-in* instrument and are not subject to conversion. Issuing unsecured debt securities requires the development of the local market and the demand for such assets from investors. At the same time, however, it has the advantage that it offers the opportunity to look for savings beyond the local market. Meanwhile, the collection of deposits is restricted to the local savings, which are limited, especially in less developed countries. Thus, paradoxically, the MREL requirement may encourage banks to be more active in seeking new sources of funding, other than deposits. At the same time, however, MREL does not impose the obligation on the banks to maintain the proper ratio of liabilities in the form of debt, as does TLAC, so banks will be able to meet MREL requirement only in the form of equity instruments. The choice of instruments included in MREL will be their decision.

8. The FSB proposal and BRR Directive differ in the approach to the issue of the deployment of the loss-absorption capacity requirement within a banking group operating across borders. MREL is supposed to apply to banks on an individual and consolidated basis, while TLAC is to be maintained by the *resolution* authorities and material subsidiaries (in a limited scope, i.e. 75–90%). In addition, it is worth noting that according to the FSB proposal, the evaluation of the materiality of a subsidiary is derived from its significance in the banking group rather than in the financial system of the host country. Meanwhile, from the point of view of stability of the host markets, it is of special importance what share of the local market a particular subsidiary (branch) has and what functions it holds there. A very common phenomenon is in fact the presence of subsidiaries that are relevant to the local market, but do not have so called material importance (*material subsidiary*) in the balance sheet of the entire banking group. This applies particularly to small countries and less developed

financial systems. Then the lack of adequate loss-absorbing capacity at a subsidiary level may have adverse effects for the financial stability of the host country, expose the funds of local depositors to risk and involve public funds. It is very important from the point of view of countries where a large part of the banking sector are the subsidiaries of global capital groups with relatively high independence of their parent entities (e.g. self-financing on the local market). This problem has been limited in the case of banking groups operating in the EU, which are bound by the provisions of the BRR Directive. However, in jurisdictions outside the EU, where global systemically important banks are present, it can be a problem. It is therefore worth proposing a modification to the FSB approach to defining a systemic entity. Not only subsidiaries perceived as important in a group should be treated as systemic, but also those that have important economic functions in the financial systems of host countries they operate in (significant share in the assets of the relevant market or important functions). If the authorities of the host country recognise the subsidiary (branch) as a systemic entity for the local market, these authorities should have the right to impose the TLAC requirement on the subsidiaries (branches) to such an extent as to ensure the ability of the entity to carry out *resolution* without disrupting the financial stability of the local market.

4. SUMMARY

New regulatory requirements, TLAC and MREL, are the next step towards reducing the cost of banking crises for the taxpayer. A common feature that both concepts share is striving to achieve the following objectives:

- ensuring that banks at all times have a minimum level of liabilities in their balance sheets which could be used to cover the losses and recapitalise the institution;
- increased confidence in the fact that big banks can be subject to *resolution* without the need to reach out for public aid;
- abolishing the *implicit* State Treasury guarantees on liabilities, which resulted in lower financing costs (especially for G-SIBs) and interfered with fair competition.
- mobilising investors to improve the monitoring of the banks to which they entrust their funds, which is especially relevant for G-SIBs.

The final shape of the new requirements will be affected by the results of consultations with key stakeholders. However, the underlying principles and objectives will definitely not be subject to material changes. At the same time, it is worth emphasising that the introduction of the TLAC and MREL requirement is not in itself a sufficient condition for carrying out a successful *resolution*. In

order for the new standards to be able to fulfil their role in practice, a relevant law is absolutely required, which will remove the barriers to effective conversion of certain liabilities to equity. The efforts of the *resolution* authority aimed at the redemption or conversion of the liabilities must have guaranteed legal security, which in most jurisdictions will mean the need to make significant changes in the provisions. In the EU, the adjustment of the national law is inspired by the BRR Directive, which should have been implemented by the Member States at the beginning of 2015 and the provisions concerning *bail-in* should take effect as of 2016. Considering the huge impact of the MREL and TLAC requirement on banks and financial markets, it is assumed that the MREL requirement will be introduced gradually until 2020. Similarly, TLAC is expected to be in full force and effect no earlier than in 2019. This provides enough time and comfort to banks and other market participants to adjust to the new regulatory conditions.

Abstract

During the recent financial crises, the cost of the aid provided to banks was mostly borne by taxpayers. This resulted in increased budget deficits and bred moral hazard among banks. The latest reforms introduce regulatory requirements and legal provisions, which in the first place put the burden of the costs related to the bank crisis on institutional shareholders and creditors. The Financial Stability Board has proposed a standard for the total loss-absorbing capacity of banks (TLAC). In the European context, the equivalent of this requirement is the minimum relevant level of own funds and eligible liabilities (MREL). Both standards require that banks maintain an appropriate value of liabilities that, in the event of a crisis, can be converted into capital and used to cover losses. This article describes the new requirements, pointing out the similarities and differences between them. The paper also presents reflections on the practical aspects of the implementation of TLAC and MREL, with particular emphasis on the perspective of the domestic financial system.

Key words: recovery and resolution, global systemically important banks, banking crisis, crisis management

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