# Bank recovery and resolution – the new TLAC and MREL minimum requirements

*The new bank recovery and resolution regime introduced in Europe at the beginning of 2015 is designed to ensure the orderly resolvability of even systemically important institutions without endangering financial stability or exposing taxpayers to losses. Resolution, the thinking goes, can preserve those functions of a bank that have a bearing on the real economy and financial stability, making it a credible alternative to normal insolvency proceedings or government bail-out measures. A key element of the new resolution regime is the bail-in tool, which makes it possible, for the first time, for holders of non-subordinated debt instruments to be exposed to bank losses outside insolvency proceedings, alongside the institution's shareholders and subordinated creditors. While it would be possible in principle to bail in all of a bank's liabilities, some exemptions are permitted to ensure that the resolution objectives can be achieved. These exemptions include deposits covered by a deposit guarantee scheme (up to €100,000) and short-term liabilities. To make sure that banks nonetheless have sufficient "bail-inable" capital, global and European bodies have developed or already enshrined in law minimum standards for bail-inable liabilities which institutions are required to hold. At the G20 level, a new minimum requirement for total loss-absorbing capacity (TLAC) will come into force in 2019 for global systemically important banks (G-SIBs). Once transposed into European law, the TLAC standard will set forth binding requirements governing matters including the amount and eligibility of liabilities as well as other aspects (eg the distribution of loss-absorbing capacity within groups, rules for investments by other banks in TLAC). At the same time, the European Union has already introduced a minimum requirement for own funds and eligible liabilities (MREL) under the Bank Recovery and Resolution Directive (BRRD). MREL will be set by the resolution authorities on a firm-specific basis according to certain rules, making it a more flexible tool in terms of the amount and eligibility of instruments to be held.*

## Introduction

*Lessons from the financial crisis …*

In the course of the financial crisis, governments channelled large sums of taxpayers' money into ailing financial institutions in an effort to prevent them from failing and setting off a chain reaction. Yet government bail-outs not only come at a substantial fiscal expense (which is ultimately shouldered by the taxpayer) but also give rise to negative incentive effects. As a case in point, there have been instances where some of the responsible bank managers took on excessive risk, safe in the knowledge that any losses they incurred would be picked up by government thanks to the existence of implicit government guarantees (known as moral hazard). This is a major issue, particularly where systemically important banks are concerned (which are said to be "too big to fail"[1]), because subjecting them to normal insolvency proceedings can have an undesirable impact on financial stability and the real economy.

*… prompted reforms designed to strengthen the resilience of financial institutions*

As a result, the G20 heads of state and government agreed back in 2008 that global reform initiatives were needed to avert future dislocations. The reforms focused on two areas. First, on strengthening the resilience of financial institutions as a way of reducing the likelihood of a crisis, and on curbing systemic risk (Basel III framework[2]). This topic was addressed by requiring banks to improve the quality and quantity of the capital they hold, and by introducing quantitative liquidity standards and a non-risk-based leverage ratio.[3] Second, a dedicated resolution regime was developed for systemically important financial institutions[4] which, unlike normal insolvency proceedings, aims to ensure the continuity of a bank's critical functions in resolution and thus preserve financial stability. The introduction of dedicated resolution regimes for financial institutions as a credible alternative to insolvency proceedings is intended to put a stop to governments' current tendency to systematically bail out systemically important financial institutions and go a long way towards resolving the too big to fail problem.

*FSB's Key Attributes; EU's BRRD*

This was the backdrop against which the G20 mandated the Financial Stability Board (FSB) to draft an international standard for resolution regimes. The FSB's efforts culminated in the publication, in 2011, of the Key Attributes of Effective Resolution Regimes for Financial Institutions[5] (Key Attributes) which, for the first time at the global level, outline the essential features that should be part of resolution regimes in all jurisdictions. These Key Attributes require jurisdictions to establish resolution authorities and give them resolution powers and tools, such as the new bail-in tool that allows them to allocate losses to creditors as well as the power to sell an institution's business lines or transfer them to a bridge institution. In the EU, the basic principles of the Key Attributes for banks were transposed into European law by way of the Bank Recovery and Resolution Directive[6] (BRRD). EU member states were re-

1 An institution is deemed to be systemically important if its insolvency would severely impair the functioning of the financial system or significant parts thereof, and also have negative effects on the real economy. While "too big to fail", in the stricter sense of the term, refers to a bank's size, it is used here in a broader sense to refer to systemically important institutions as a whole, regardless of whether their systemic importance is down to their size, complexity, interconnectedness or other characteristics. The problem boils down to a government's unwillingness to let a too big to fail institution fail and its use of public funds to bail it out.
2 The Basel III framework agreed upon by the Basel Committee on Banking Supervision in September 2010 builds upon, and gradually replaces, the Basel II rulebook (see Deutsche Bundesbank (2011), Basel III – Leitfaden zu den neuen Eigenkapital- und Liquiditätsregeln für Banken). These standards were implemented in the EU by way of the CRR and CRD IV legislation. For more information, see Deutsche Bundesbank, Implementing Basel III in European and national law, Monthly Report, June 2013, pp 55-71.
3 The leverage ratio is a bank's Tier 1 capital divided by its leverage ratio exposure. Unlike the risk-based capital requirements, the individual exposures counted towards the leverage ratio are not individually risk-weighted but instead included as unweighted numbers. For more information, see Deutsche Bundesbank (2013), op cit.
4 For further information on the new resolution regime for banks, see Deutsche Bundesbank, Europe's new recovery and resolution regime for credit institutions, Monthly Report, June 2014, pp 31-55.
5 Available online at http://www.fsb.org/wp-content/uploads/r_141015.pdf
6 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.

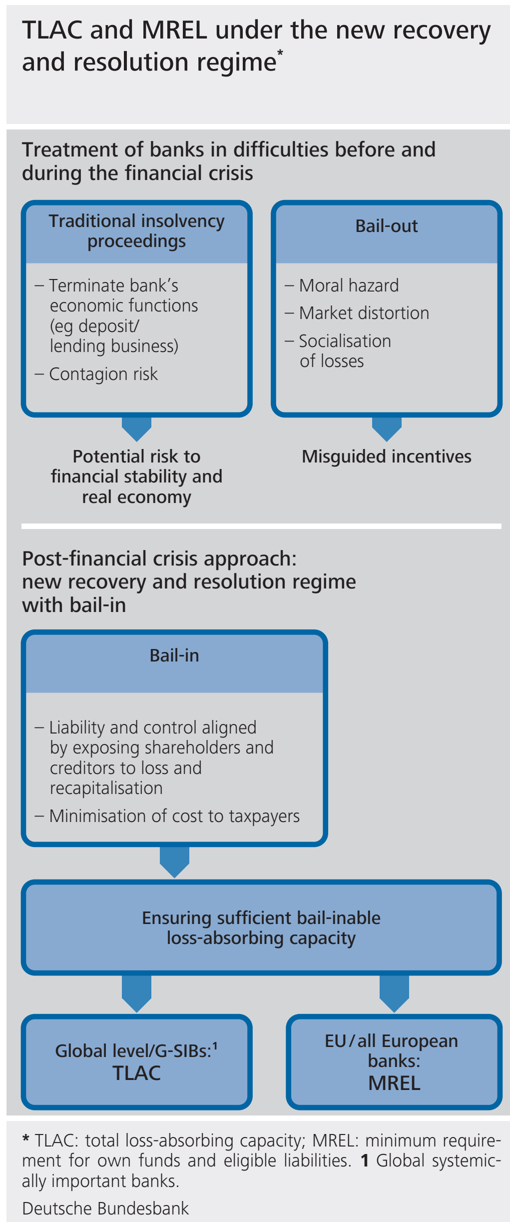
quired to transpose the BRRD into national law by 1 January 2015 (and the bail-in tool by 1 January 2016). For member states that participate in the banking union, the BRRD was flanked by the Single Resolution Mechanism Regulation,[7] which aims to create a level playing field for the resolution of failing cross-border banks that fall within the scope of the Single Supervisory Mechanism (SSM).

*Bail-in tool integral to new resolution regime and requires reliable minimum loss-absorbing capacity in resolution*

The bail-in tool is integral to the new resolution regime and one of the most important tools available to resolution authorities in a crisis. It is based on the idea that investors should not only benefit from a bank's profits but also be exposed to any losses it incurs. This principle of liability creates stronger incentives to properly consider risks when making investment decisions and to minimise moral hazard behaviour. Once shareholders have been bailed in,[8] holders of debt instruments will also be exposed to losses according to the hierarchy of creditors (liability cascade) by writing down the liabilities in question or converting them into equity. However, bail-in tool effectiveness and the overall credibility of a resolution regime hinge on firms having sufficient capacity to absorb losses in resolution. While it is possible in principle for an institution's entire equity and liabilities to be bailed in, the BRRD contains a number of general and discretionary exceptions to ensure that the resolution objectives are achieved.[9] These exceptions were deemed necessary because bailing in certain liabilities could pose a threat to financial stability (eg bank runs) or because it may be difficult to value some instruments in a timely fashion, thereby impeding efforts to expose all instruments ranking *pari passu* to loss. To nonetheless ensure that a minimum level of loss-absorbing capacity is reliably available in resolution, minimum requirements were developed for loss-absorbing liabilities.

At the global level, the total loss-absorbing capacity (TLAC) standard[10] for global systemically important banks (G-SIBs) was developed by the FSB and published in November 2015. The idea behind this standard is to define a minimum volume of loss-absorbing liabilities that the roughly 30 G-SIBs worldwide need to hold in case they run into difficulties so that they can be resolved in an orderly manner without recourse to public funds. The FSB's TLAC standard still needs to be transposed into European law, and the European Commission is expected to present a proposal this autumn. The BRRD, on the other hand, already contains a provision that shares broadly the same objective: the minimum requirement for own funds and eligible liabilities (MREL). Like TLAC, MREL is designed to ensure that each bank has a certain amount of loss-absorbing capacity in case it needs to be resolved. Since the BRRD applies to all banks[11] in the European Union, institutions

7 Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010.
8 The write-down or conversion of instruments pursuant to Article 59 BRRD (implemented in section 89 of the Act on the Recovery and Resolution of Institutions and Financial Groups (Gesetz zur Sanierung und Abwicklung von Instituten und Finanzgruppen)) precedes the bail-in and is broadly similar without being a resolution tool in the true sense (see Deutsche Bundesbank (2014), op cit, p 31, pp 38-39).
9 Article 44 (2) BRRD (implemented in section 91 (2) of the Act on the Recovery and Resolution of Institutions and Financial Groups) lists a number of liabilities that are generally excluded from the bail-in rule, including covered deposits, secured liabilities and liabilities with a remaining maturity of less than seven days. Furthermore, Article 44 (3) BRRD (implemented in section 91 (3) of the Act on the Recovery and Resolution of Institutions and Financial Groups) allows the resolution authority, in exceptional cases and subject to certain conditions, to exclude or partially exclude certain eligible liabilities, or certain categories thereof, from the scope of application of the bail-in, such as in cases where their exclusion is strictly necessary and proportionate to avoid giving rise to contagion.
10 Available online at http://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/
11 The BRRD is applicable to institutions established in the EU, that is, credit institutions and investment firms (Article 1 (1) letter a, Article 2 (23) BRRD). Under European law, the term "credit institution" refers to deposit-taking and lending business – that is to say that not all enterprises that satisfy the broader definition set forth under German law (section 1 (1) of the German Banking Act (Kreditwesengesetz)) are covered by the BRRD. Other entities covered by the BRRD include EU-based branches of institutions that are established outside the European Union as well as certain financial holding companies (Article 1 (1) letters b to e BRRD).




* TLAC: total loss-absorbing capacity; MREL: minimum requirement for own funds and eligible liabilities. **1** Global systemically important banks.
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throughout the EU must satisfy the MREL standard.

Though both TLAC and MREL share the same objective, their different backgrounds and scopes of application set them apart in a number of important ways (*inter alia* their levels and the notion of subordination as a criterion for eligibility) which are explored in greater detail in the following.

# Total-loss absorbing capacity – TLAC

## Development of the TLAC standard

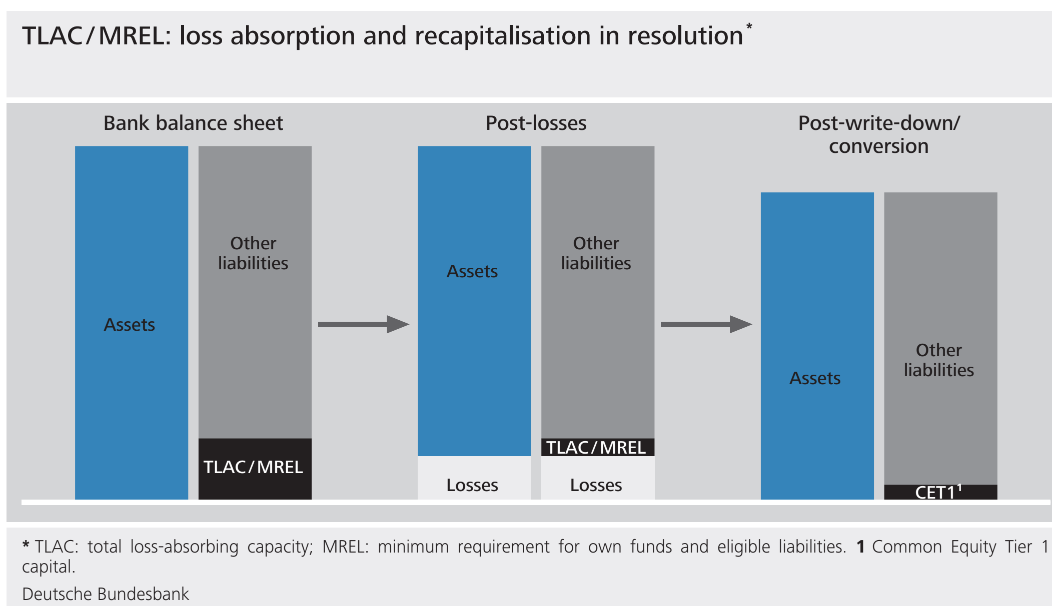
*TLAC standard adopted at G20 summit in November 2015*

In the course of concretising the Key Attributes, it became clear that, because G-SIBs operate across various jurisdictions, they must have sufficient group-wide capacity to absorb losses to ensure that a cross-border resolution is effective. At the St Petersburg Summit in September 2013, the G20 finally called on the FSB to assess and develop proposals by the end of 2014 on the adequacy of G-SIBs' loss-absorbing capacity when they fail. The FSB was asked to draft a new minimum requirement that went beyond the existing Basel III framework, which expects banks to cover unexpected losses on a going-concern basis,[12] by requiring institutions to have additional loss-absorbing and recapitalisation capacity in a gone-concern (ie resolution) scenario as well. While going-concern capital is made up entirely of own funds, gone-concern capital can also comprise liabilities that can be converted in the course of a bail-in. The FSB lead-managed the work on the new standard, but it liaised closely with the Basel Committee on Banking Supervision (BCBS) to address technical issues and ensure compatibility with the Basel III framework.

Besides overarching principles, the TLAC standard[13] also includes a Term Sheet containing concrete guidance, and was adopted at the Antalya G20 Summit in November 2015. TLAC, then, addresses a bank's overall ability to absorb losses (including any amount that may be needed to recapitalise it) – as, incidentally, does MREL (see pages 74 to 79). The standard is to

**12** Basel III requires banks to hold equity capital equal to at least 8% of risk-weighted assets (RWAs) (of which at least 4.5% must be Common Equity Tier 1 (CET1), at least 1.5% Additional Tier 1 (AT1) and 2% Tier 2) (see Deutsche Bundesbank, Basel III – Leitfaden zu den neuen Eigenkapital- und Liquiditätsregeln für Banken, 2011).
**13** See footnote 8.

TLAC/MREL: loss absorption and recapitalisation in resolution*




* TLAC: total loss-absorbing capacity; MREL: minimum requirement for own funds and eligible liabilities. **1** Common Equity Tier 1 capital.
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be phased in as a minimum standard for all G-SIBs in two stages (from 2019 and from 2022).[14]

## Scope of application and calibration

*TLAC standard a minimum requirement for G-SIBs*

The new TLAC standard represents a minimum requirement for G-SIBS that still needs to be transposed into European law. Resolution authorities also have the option of levying an institution-specific add-on on top of minimum TLAC, as in the case of minimum regulatory capital requirements. The question of imposing mandatory minimum TLAC on all G-SIBs proved to be a controversial topic during negotiations, however. While some FSB members called for a binding minimum requirement from the outset, others backed a more flexible solution that gives the competent authorities a greater degree of discretionary leeway. In terms of financial stability and competitiveness, however, a mandatory minimum requirement is to be welcomed.

*A breach of minimum TLAC (like a breach of minimum regulatory capital) triggers sanction mechanisms*

TLAC essentially comprises an institution's entire going-concern and gone-concern capital with the exception of the equity capital that institutions need to satisfy their buffer requirements (ie the combined buffer requirement[15]). The Common Equity Tier 1 capital needed to satisfy the buffer requirement cannot also be counted towards TLAC and thus be used twice, since that might impair the way the buffer works; the buffer is supposed to "breathe" – that is, be run down in stress situations – while minimum TLAC must be adhered to at all times. Otherwise, a G-SIB that uses its buffer to cover losses would thus fall short of minimum TLAC. To prevent this scenario from materialising, institutions have to hold buffer capital in addition to minimum TLAC. Sequencing the different requirements in this order ensures that the sanction mechanism that is activated when an institution falls short of the buffer requirement remains intact: if a G-SIB no longer has sufficient CET1 capital to meet the buffer requirement, it can be forced, for instance, to present a capital conservation plan and limit its distributions of dividends or payments of variable remuneration. If that institution's CET1 capital continues to be depleted and it ultimately falls short of minimum TLAC, or is likely to do so in the foreseeable future, the TLAC

**14** An exception is made for G-SIBs in emerging market economies (though this only applies to China at the current time), which will need to comply with TLAC at the latest from 2025 and 2028, respectively.
**15** In the EU, the combined buffer requirement can consist of the following buffers: capital conservation buffer, countercyclical capital buffer, buffer for global or other systemically important institutions and systemic risk buffer. For more information, see Deutsche Bundesbank (2013), op cit.

standard requires the same sanction mechanisms to be activated as when minimum regulatory capital requirements are (likely to be) breached. Sanctions include early intervention measures; as a last resort, a breach of minimum TLAC can, however, also trigger an institution's resolution.

*Criteria for calibrating minimum TLAC*

The level of minimum TLAC was finalised following comprehensive impact assessment studies and should, at the very least, allow for the following criteria. Assuming a firm has exhausted its going-concern capital when it enters resolution, sufficient capacity should be available to absorb any losses still remaining and enable a successor institution[16] to be recapitalised in the amount of at least 8% of RWAs. This target level is deemed to be the least a successor institution needs to achieve to meet the minimum regulatory capital conditions for authorisation. In addition, that institution also needs to hold a capital buffer that is sufficient to create market confidence. At the same time, however, resolution should not lead to a failed institution being "resurrected"; the main resolution objectives here are to preserve the continuity of critical functions, shield client assets and minimise the impact on financial stability.

*Introduction of minimum TLAC requirement in two steps*

Minimum TLAC will be introduced in two steps. According to this standard, from 2019, G-SIBs will be required to maintain TLAC amounting to at least 16% of their RWAs and to 6% of the Basel III leverage ratio denominator (hereinafter referred to as the leverage ratio), whichever is higher. From 2022, the requirement will increase to 18% of RWAs or 6.75% of the leverage ratio. The final requirement is thus at the lower end of the range proposed during consultation with the banking industry and the general public. This is due to the restraining influence of some members of the FSB as well as to the results of impact assessment studies. The scenarios involving higher target levels revealed considerable shortfalls for several institutions. Nevertheless, the Bundesbank believes that with a longer transitional phase, for example, higher minimum TLAC would indeed have been possible and desirable in terms of financial stability. After all, increasing the loss-absorbing capacity of global systemically important institutions would be more helpful in terms of achieving orderly resolution. In Switzerland, for example, far stricter requirements will apply to systemically important financial institutions from 2019. After this date, they will have to hold a total capital ratio[17] of 28.6% of RWAs or 10% of the leverage ratio. Of this, 14.3% of RWAs or 5% of the leverage ratio must be in the form of subordinated bail-in instruments.

The calibration parameters are based on two variables (RWAs or the leverage ratio, whichever is higher) because the calculation of TLAC should take into account both the bank's risk (measured by RWAs) and a component that is independent of the risk measurement (measured using the leverage ratio). On the one hand, institutions with higher risk levels should be subject to a higher minimum TLAC requirement. On the other, the recent crisis has shown that RWAs do not always prove a reliable variable for measuring risk and thus for calculating minimum regulatory capital requirements. This is why the Basel III framework already includes the leverage ratio, a variable that is independent of risk measurement and whose denominator is now used to calculate minimum TLAC.

## Eligibility criteria for TLAC instruments

*TLAC instruments and TLAC liabilities*

Besides the calibration of minimum TLAC, it is also important to identify which instruments can reliably be exposed to losses in the event of a crisis, or, in other words, can be bailed in with legal certainty (TLAC instruments[18]). Based

16 The surviving part of the institution following the application of resolution tools/measures which continues to perform the critical functions (eg restructured institution/bridge institution).
17 Including the buffer requirement.
18 TLAC instruments include minimum regulatory capital pursuant to section 6 of the FSB Term Sheet as well as TLAC liabilities, ie liabilities that meet the relevant eligibility criteria (see sections 7-14 of the FSB Term Sheet).

on the assumption that the minimum regulatory capital is intended to help absorb losses in a going-concern scenario, it can generally be counted towards TLAC. However, other eligible debt components (TLAC liabilities) must meet certain criteria. Here, experience has shown that the class of non-subordinated liabilities (senior liabilities) contains a large number of very different instruments which, however, rank *pari passu* in the insolvency hierarchy of most countries. These include, for example, instruments such as unsecured debt securities, which are well-suited to bail-ins, but also instruments that, if used to absorb losses, could cause problems owing to their importance to the real economy (such as covered deposits of large enterprises) or their complexity (such as certain derivatives). While it would therefore make sense for the resolution authority to be able to differentiate between these different instruments in a bail-in, there is no straightforward way to do so because of the *pari passu* principle, under which liabilities belonging to the same class must be treated equally. The BRRD also includes the "no creditor worse off" (NCWO) principle,[19] which states that creditors should not incur greater losses through resolution than if the institution had been wound up under normal insolvency proceedings, otherwise the affected creditors would have to be compensated for the difference from the resolution fund.

Because of the risk of breaching the NCWO principle and the financial burden this would entail, treating non-subordinated liabilities that rank *pari passu* differently in a bail-in event is not expedient and hence unlikely. However, this means that a number of instruments with loss-absorbing potential cannot be bailed in with legal certainty. Some of these problems have already been addressed in the context of the BRRD.[20] Nonetheless, national insolvency regimes are still very heterogeneous and are not harmonised, meaning that any change to the insolvency hierarchy aimed at differentiation within the class of non-subordinated liabilities would have to take place at the national level. A number of countries have now adapted their national insolvency regimes to reduce the potential legal risks arising from the NCWO principle and also to increase the effectiveness of the bail-in tool (see the chart on page 71). In Germany, for instance, the addition of paragraphs (5) to (7) of section 46 f of the Banking Act will change the order in which liabilities are ranked in the event of bank insolvencies with effect from 1 January 2017. In the non-subordinated liabilities class, creditors' claims arising from certain unsecured, non-structured debt instruments will then only be met after claims arising from all other non-subordinated liabilities pursuant to section 38 of the German Insolvency Code have been satisfied. This change means that, when resolving a bank, eligible liabilities in the class of non-subordinated liabilities can now be bailed in first to absorb losses without the risk of breaching the NCWO principle.

*Liabilities excluded from TLAC*

Because certain instruments are more suited to covering losses than others, liabilities which would be very likely to cause problems if bailed in should not be eligible as TLAC. The following liabilities are therefore not TLAC-eligible.

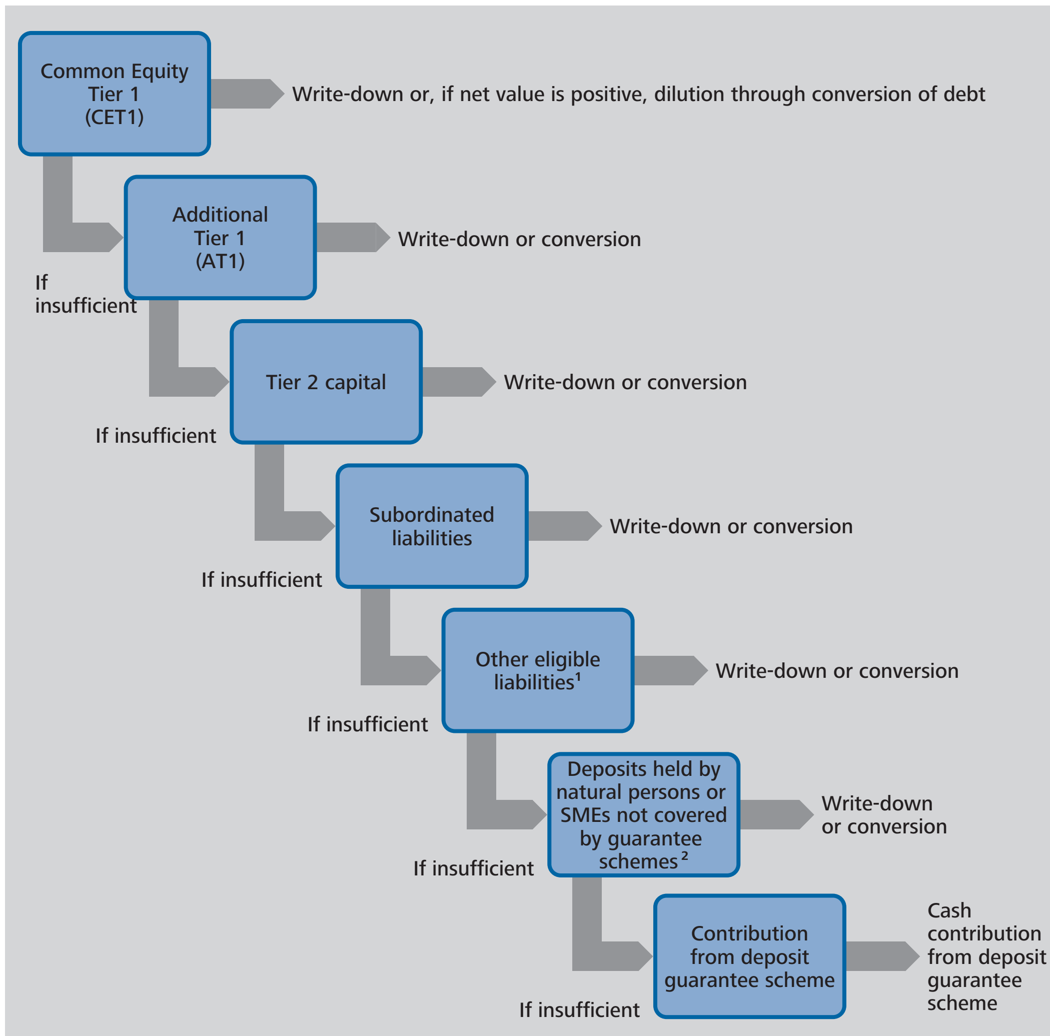
– Covered deposits, sight deposits and short-term deposits (deposits with an original maturity of less than one year)

– Liabilities arising from derivatives and debt instruments with derivative-linked features, such as structured notes

– Liabilities arising other than through a contract (such as tax liabilities)

**19** Article 73 letter b and Article 75 BRRD, implemented in section 146 et seq of the Act on the Recovery and Resolution of Institutions and Financial Groups.
**20** While the BRRD (and its transposition into German law) exempts covered deposits (ie deposits of up to €100,000) from being bailed in, eligible deposits (ie deposits of above €100,000) of natural persons and small and medium-sized enterprises (SMEs) have a preferential ranking in the liability cascade to other non-subordinated liabilities (see the chart on page 70). Furthermore, the resolution authority can exempt liabilities from bail-in under certain circumstances.

**Liability cascade in a bail-in event**




**1** Includes all categories of the class "non-subordinated liabilities" ie including liabilities pursuant to the new section 46 (5) to (7) of the German Banking Act. **2** Small and medium-sized enterprises.
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– Liabilities which are preferred to senior unsecured creditors under the relevant insolvency law (such as eligible deposits of natural persons and SMEs in the EU)

– Any liabilities that, under the applicable law, are excluded from bail-in or cannot be written down or converted into equity during resolution without giving rise to risk of legal challenge or compensation claims.

*Characteristics of TLAC liabilities*

To be eligible, however, TLAC liabilities must have certain characteristics. This is primarily to ensure that, in the event of a resolution, TLAC is actually available and can be used to cover losses. Thus, for example, TLAC liabilities must be unsecured and, as a general rule, issued by the resolution entity.[21] They must have a minimum residual maturity of one year and must not contain any put options that are exercisable by the investor.

**21** Legal person(s) within a banking group to which the resolution tools are applied. The resolution entity or entities are determined when drawing up the resolution strategy. As well as deciding on a single point of entry or multiple point of entry approach, the resolution strategy specifies, among other things, how resolution tools are to be applied and sets out the decision-making process and the time schedule. For more information, see FSB, Recovery and Resolution Planning for Systemically Important Financial Institutions, Guidance on Developing Effective Resolution Strategies, July 2013.

**Adjustments to national insolvency regimes**

| Germany[1] | France[2] | Italy[3] | Spain[4] |
|---|---|---|---|
| CET1 | CET1 | CET1 | CET1 |
| AT1 | AT1 | AT1 | AT1 |
| Tier 2 | Tier 2 | Tier 2 | Tier 2 |
| Subordinated debt | Subordinated debt | Subordinated debt | Subordinated debt |
| "Subordinated senior instruments" (statutory subordination) | "Non-preferred senior" (contractual subordination) | Other senior debt / Derivatives | Subordinated Tier 3 (contractual subordination) |
| Other senior debt / Derivatives / Corporate deposits > €100,000 | "Preferred senior" / Derivatives / Corporate deposits > €100,000 | Corporate deposits >€100,000 | Other senior debt / Derivatives / Corporate deposits > €100,000 |
| Retail/SME deposits (>€100,000) | Retail/SME deposits (>€100,000) | Retail/SME deposits (>€100,000) | Retail/SME deposits (>€100,000) |
| Covered deposits (<€100,000) | Covered deposits (<€100,000) | Covered deposits (<€100,000) | Covered deposits (<€100,000) |

**1** In Germany, from 1 January 2017, pursuant to section 46f (5) to (7) of the German Banking Act, a new "subordination in the senior class" rule will apply to certain senior instruments under insolvency law. Consequently, creditors of certain unsecured, non-structured debt instruments issued by banks will rank junior to other non-subordinated liabilities that previously belonged to the same creditor class. **2** In France, a legislative proposal establishing a new contractually subordinated creditor class within the "senior debt" class ("standard senior" / "non-preferred senior") is currently being discussed. The class would be positioned between preferred senior debt and subordinated liabilities and would include non-structured liabilities with a maturity of over one year. **3** At the start of 2019, Italy will give general preferential treatment to all deposits over other unsecured liabilities according to its Insolvency Act. This approach, too, generally allows other unsubordinated creditors to be bailed in without infringing the NCWO principle. **4** In the context of the transposition of the BRRD into national legislation, in November 2015, Spain introduced a new creditor class which includes contractually subordinated liabilities which are not recognised as AT1 or Tier 2 ("Tier 3"). The objective of the rule is to strengthen contractual subordination clauses.

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*Subordination of TLAC liabilities*

While there has been general consensus from the beginning regarding most of the above-mentioned criteria, the question of the mandatory, explicit subordination of TLAC liabilities has been the subject of controversial debate. The argument against the mandatory subordination of TLAC liabilities is that it would increase the complexity of the liabilities structure and introduce a new capital class. In addition, some banks have issued large volumes of Tier 2 instruments with very long maturities and contractual clauses that forbid the issuance of further subordinated capital which would take priority over these instruments in the event of an insolvency. On the other hand, the argument in favour of mandatory subordination is that this would ensure that such liabilities could be used for loss absorption and recapitalisation without risk of legal challenge – that is, without conflicting with the NCWO principle. In this context, it is particularly important that potential investors are able to clearly differentiate between and identify these instruments so they can determine their position in the liability cascade. Transparency regarding the insolvency ranking and balance sheet classification of TLAC instruments ensures that their risks can be priced appropriately.

Ultimately, the FSB standard chose the following compromise: TLAC liabilities must generally be subordinated to liabilities excluded from TLAC (meaning, in particular, certain deposits, derivatives and other operational liabilities). This can be achieved in three ways – "statutory subordination", "contractual subordination" or "structural subordination" (see the table on page 73). In addition, a number of exemptions have been included to take into account the specific structures of the financial system in individual FSB member states. Under certain circumstances, for example, liabilities that meet all TLAC criteria except the subordination requirement can be counted as TLAC instruments to a value of 2.5% of RWAs (or 3.5% of RWAs from 2022). This is aimed, in particular, at jurisdictions in which banks rely heavily on non-subordinated liabilities (eg traditional bank bonds) for refinancing in the event of insolvency. Furthermore, if the amount of liabilities excluded from TLAC that rank *pari passu* with TLAC-eligible instruments is limited, an exemption to the subordination requirement can be made *("de minimis* allowance").[22] All in all, the exemptions are a dilution of the subordination requirement.

## Distribution of TLAC within the group (parents/subsidiaries)

*Distribution of TLAC in an international group depends on resolution strategy*

As a general rule, several supervisory and resolution authorities are responsible for supervising and resolving a cross-border G-SIB: the authorities in the home country, which are responsible for the resolution entity, and the authorities in the host country, which are responsible for supervising the institution's foreign subsidiaries. To facilitate cooperation between the home and host authorities and to ensure that sufficient loss-absorbing capacity is available in the right place if a cross-border G-SIB enters resolution, the FSB standard also specifies how TLAC is to be distributed within a cross-border group (internal TLAC). This distribution of loss-absorbing capacity depends, in particular, on which resolution strategy[23] a group has chosen: single point of entry (SPE) or multiple point of entry (MPE). Under the SPE strategy, it is assumed that, in resolution, the shareholders and external creditors of the parent (generally a non-operating holding company) will be the first to bear the losses. The creditors of the operating subsidiary should be protected, provided that the parent has sufficient TLAC. The parent institution should therefore pre-position a share of its TLAC instruments to its material subsidiaries[24] abroad (or to the sub-group if the subsidiary has further subsidiaries), so that the material foreign subsidiaries issue TLAC instruments, which are then held by the parent and recorded in the balance sheet accordingly (by implication, internal TLAC represents a claim of the parent institution vis-à-vis its subsidiary). In this way, if the subsidiary encounters difficulties – once the loss-absorbing capacity of the equity holdings of the parent have been exhausted – the claims of the parent vis-à-vis the subsidiary are used before other creditors must bear losses. In the event of resolution, this allows the subsidiary's losses to be passed on to the parent institution. The resolution tools are then applied at the level of the parent institution, while the subsidiary's core business areas and critical functions are preserved during the resolution proceedings. The MPE strategy would involve maintaining an appropriate TLAC amount for each individual resolution entity, each of which then distributes internal TLAC within its resolution group.

22 According to section 11 of the FSB Term Sheet, the subordination requirement is not mandatory unless the amount of excluded liabilities that rank pari passu or junior to the TLAC instruments exceeds 5% of the institution's TLAC instruments.
23 For more information, see FSB (2013), op cit.
24 According to section 17 of the FSB Term Sheet, a subsidiary or sub-group is considered material if it accounts for more than 5% of the RWAs of the G-SIB.

**The three methods of subordination under the TLAC standard**

| Structural subordination | Contractual subordination | Statutory subordination |
|---|---|---|
| Structural subordination is based on the role of the issuer in the corporate structure. It occurs when issuers function purely as holding companies which transfer capital to the operating subsidiaries and, at the same time, generate their revenue mainly from the dividend payments of the subsidiaries. Because all debt obligations of the subsidiaries must be serviced first in the case of insolvency before funds can be channelled to the holding company, the creditors of the holding company are subordinated in structural terms. | The creditor and issuer contractually agree that, in the case of insolvency, interest and principal payments can only be made on these liabilities once other, more senior liabilities have been serviced in full. | Statutory subordination is established through a statutory provision in national insolvency regimes. The legislation would state that, in the case of insolvency, interest and principal payments may only be paid on certain liabilities once other, more senior liabilities have been serviced in full. |

Deutsche Bundesbank

## Rules to prevent contagion effects

*Constraints on reciprocal investment by banks in TLAC instruments to prevent risks to financial stability*

The TLAC standard is intended to improve the resolvability of G-SIBs, thus helping to achieve orderly resolutions without endangering financial stability. It is therefore necessary to limit the extent to which banks invest in other banks' TLAC instruments. If TLAC instruments are held by other banks, this strengthens the ties within the banking sector and can, in a bail-in, lead to contagion effects at other banks. The plan to extend the deduction rules[25] already in force under the Basel III framework for investments in regulatory own funds to TLAC liabilities is intended to prevent such systemic effects. In future, both G-SIBs and other internationally active banks should therefore deduct their investments in third-party TLAC liabilities above a certain percentage (as the debate stands) from their own Tier 2 capital. The exemption limit would also leave a certain amount of leeway for necessary market-making activities. At the same time, however, it would be strict enough to largely limit reciprocal investments in TLAC, thus preventing greater interconnectedness within the banking sector.

## Enhanced disclosure requirements

*Detailed disclosure requirements for G-SIBS as of 2019*

In the context of the aforementioned subordination and deduction rules, the enhanced disclosure requirements under the TLAC standard play a prominent role. Transparency about TLAC-eligible instruments is vital to enable risks to be priced accurately and to generate sufficient market demand for new issuances of TLAC instruments. This is the only way to ensure that market participants can correctly assess the risks they are taking and hence make sound investment decisions. From 2019, G-SIBs must therefore disclose detailed information about the volume, maturity and composition of external and internal TLAC, and about instruments that, under the applicable insolvency law, rank *pari passu* or junior to TLAC.

Improved disclosure requirements are also desirable from the point of view of investors and rating agencies. They have expressed concerns that the complexity of the new rules could ultimately undermine their effectiveness if investors are no longer clear about their own position in the hierarchy of creditors owing to the

**25** Transposed into European law in Part 2 (Own funds) CRR.

different regulatory and legal approaches to bank resolution.

## Further timetable

*Transposition of TLAC into European law*

At the beginning of this year, the European Commission established a technical working group to discuss the transposition of TLAC into European law as well as potential amendments to the BRRD in terms of MREL. The working group is due to submit its proposals by mid-2016. Taking into account these findings, the European Commission plans to propose a legal act by the end of the year.

## Minimum requirement for own funds and eligible liabilities (MREL)

*Minimum requirement for own funds and eligible liabilities in force under the BRRD since 2016*

While the TLAC standard was developed by the G20, the EU has already introduced a similar concept, MREL,[26] by implementing the Key Attributes by way of the BRRD. This is to ensure that institutions that are established in the EU meet a minimum requirement for own funds and bail-inable liabilities at all times. Unlike TLAC, which is based on RWAs, this requirement is expressed as a percentage of an institution's total liabilities[27] including regulatory capital (hereinafter referred to as total liabilities). Like TLAC, the aim of MREL is to ensure that an institution structures its liabilities such that a sufficient buffer of bail-inable capital is available for a resolution. MREL is to be set by the competent resolution authorities from 2016 in order to make the application of the bail-in tool credible in practice.

*MREL applies to all European institutions within the scope of the BRRD and is set on a firm-specific basis*

Although both concepts cover the same objective, TLAC and MREL nevertheless differ in a number of key elements. There are two major reasons for this. First, MREL was already enshrined in the BRRD before the TLAC standard had been finalised. Second, because the two concepts have different scopes, they must be structured differently. While TLAC is explicitly designed for G-SIBs, MREL is aimed at all European institutions within the scope of the BRRD. This encompasses a far larger range of institutions, regardless of their size or systemic importance. Since a uniform, binding minimum requirement such as TLAC was not considered effective given the heterogeneity of the European banking sector, the resolution authority is to set an individual MREL for each institution. When determining MREL, the resolution authority will therefore take into account institution-specific features and the principle of proportionality. Since the German banking sector consists of a large number of smaller institutions, it can be assumed that the resolution authority will probably envisage normal insolvency proceedings rather than resolution for the majority of institutions. To ensure that MREL is set appropriately, the competent supervisory authority for the institution in question is also to be involved and must be consulted by the resolution authority before the MREL is set. This is beneficial since the supervisory authorities have specific knowledge and detailed information regarding the institutions.

*Qualitative criteria to be considered when determining the firm-specific MREL*

Even though, for the above-mentioned reasons, no minimum level has been legally defined, the resolution authority nevertheless has to take into account certain qualitative criteria laid down in the BRRD[28] when determining the MREL for each institution.

– The resolution authority must ensure that the resolution objectives can be met (this means, in particular, safeguarding financial stability and protecting taxpayers' money as well as deposits and client assets).

26 Article 45 BRRD, implemented in sections 49 et seq of the Act on the Recovery and Resolution of Institutions and Financial Groups.
27 Here, derivative liabilities are included in the total liabilities on the basis that recognition is given to netting agreements (Article 45 (1) BRRD, implemented in section 49 (1) of the Act on the Recovery and Resolution of Institutions and Financial Groups). Depending on the institution, this amount may differ significantly from the total liabilities calculated according to IFRS.
28 Article 45 (6) BRRD, implemented in section 49 (4) of the Act on the Recovery and Resolution of Institutions and Financial Groups.

- In the event of a bail-in, an institution must hold sufficient capital to absorb losses. In addition, sufficient capital has to be available for recapitalisation so that the successor institution can comply with the requirements necessary for authorisation. Further to this, a certain capital buffer should be maintained for restoring market confidence which, under ideal circumstances, makes it possible for the successor institution to refinance itself following the resolution.

- If the resolution plan anticipates that, on an exceptional basis, certain classes of MREL-eligible liabilities might be excluded from bail-in, it must be ensured that sufficient other MREL-eligible liabilities are available for a potential bail-in.

- The size, business model, funding model and risk profile of the institution are to be taken into account.

- The MREL may be reduced if the deposit guarantee scheme is able to contribute towards financing the resolution.

- The resolution authority should consider possible effects on financial stability that could arise from the institution's failure. In order to avoid contagion effects, MREL must therefore be set higher for systemically important institutions than for institutions whose collapse is unlikely to adversely affect the stability of the financial system.

These qualitative criteria are further described and specified in the Regulatory Technical Standards (RTS) of the European Banking Authority (EBA). Following a three-month public consultation period, the RTS were adopted with amendments by the European Commission on 23 May 2016.[29]

Despite the resolution authorities determining MREL on a case-by-case basis for each institution, the aim of the RTS is to ensure a comparable approach and consistent interpretation of the individual criteria amongst EU member states. Since RTS are immediately binding in the EU members states when they enter into force, these serve as a tool for achieving a harmonised approach to determining MREL. However, it should be noted that RTS must not go beyond the provisions of the primary legislation – in this case, the BRRD. As the European Commission and the EBA differ on this matter, the European Commission has refrained from quantifying a required minimum level for the firm-specific MREL.

## Loss absorption amount

*Loss absorption amount is essentially composed of minimum regulatory capital requirement, firm-specific add-on set by supervisory authority, and buffer requirement*

The loss absorption amount is determined as a starting point based on the minimum capital requirements to be met under Basel III.[30] The background to this is that the minimum regulatory capital requirements already aim to cover unexpected losses incurred through ongoing business operations. The loss absorption amount for calculating MREL is thus composed of the minimum regulatory capital requirement (ie total capital ratio amounting to at least 8% of RWAs), the firm-specific add-on set by the supervisory authority, and the buffer requirement; alternatively, it may instead consist of the future leverage ratio requirement, should this be higher. Where justification is provided to the supervisory authority, the resolution authority may, under certain conditions, set a different loss absorption amount from the minimum capital requirements; for instance, if this is necessary to remove obstacles to resolution (eg additional capital or liquidity needs that arise during the resolution process, continuity of critical functions, access to financial market infra-

**29** Proposed Commission Delegated Regulation (EU) supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities (Commission document No C(2016) 2976 final). This Regulation will enter into force, provided it is not opposed by the European Parliament and the Council within a timeframe of three months.
**30** Transposed into EU law by way of CRR and CRD IV.

structures). This is intended to prevent the resolution authority from acting as a "shadow supervisor". Where the resolution plan provides for the winding up of an institution under normal insolvency proceedings,[31] MREL should merely correspond to the amount of the minimum regulatory capital requirement. Hence, such institutions do not need to hold additional capital or MREL-eligible liabilities in reserve in order to meet the MREL requirement.

## Recapitalisation amount

*Recapitalisation amount is set depending on resolution strategy outlined in resolution plan*

If the resolution authority decides normal insolvency proceedings would not be appropriate for achieving the resolution objectives and instead envisages a resolution in an institution's resolution plan, this institution is also required to maintain a recapitalisation amount in addition to the loss absorption amount. An institution's recapitalisation amount is determined according to the resolution strategy set out in the resolution plan. As critical functions (ie those affecting the real economy and financial stability), such as lending and deposit business, are to be continued in the event of a resolution (eg by transferring them to a bridge institution), it is essential that the successor institution taking over these functions is sufficiently capitalised to establish itself in the market. At the very least, the institution must meet the minimum regulatory capital requirements necessary for authorisation amounting to 8% of RWAs, or the leverage ratio requirement, as well as a pre-determined firm-specific add-on. Further to this, the successor institution – in addition to the minimum regulatory capital requirements – should also comply with the buffer requirement as well as maintaining a comparable level of equity capital (including buffers) as similar institutions (ie its peer group). This therefore needs to be taken into account by the resolution authority when determining the recapitalisation amount.[32] It is particularly important that the successor institution be appropriately recapitalised so that it is considered solvent by the market, ie market participants have confidence in it and are prepared to conduct business with it.

## Adjustments to MREL

Resolution planning plays a key role in determining both the loss absorption and the recapitalisation amounts. In particular, the resolution authority specifies in the resolution plan which resolution tools[33] should be used to achieve the resolution objectives. This decision has a major impact on the size of the recapitalisation amount, for example. When the bail-in tool is to be applied, or when certain functions are to be transferred to a newly established bridge institution, the recapitalisation amount is likely to be set higher than in the case of a plan to sell the institution or parts thereof to one or more market participants. Moreover, resolution planning may reveal that certain classes of MREL-eligible liabilities might not be available at the time of resolution. This would be the case if, for example, in the context of resolution planning, the resolution authority determines that certain theoretically bail-inable liabilities – which are also MREL-eligible liabilities – might, in exceptional cases, have to be excluded from bail-in the event of a resolution.[34] Reasons for exclusion could be, for example, that it is not possible to bail in these liabilities within a reasonable timeframe or that the exclusion is necessary to ensure the continuity of critical functions. The resolution authority must take this into account when determining MREL so that even after allowing for such exceptions,

31 See Deutsche Bundesbank (2014), op cit.
32 Article 7 et seq. Proposed Commission Delegated Regulation (EU) supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the criteria relating to the methodology for setting the minimum requirement for own funds and eligible liabilities. Commission document No C(2016) 2976 final.
33 Sale of business, bridge institution, asset separation ("bad bank"), bail-in (see Article 37 (3) BRRD, implemented in section 77 (1) of the Act on the Recovery and Resolution of Institutions and Financial Groups).
34 Article 44 (3) BRRD, implemented in section 92 of the Act on the Recovery and Resolution of Institutions and Financial Groups.

sufficient MREL-eligible liabilities are available on the whole for the resolution strategy's implementation.

By contrast, the resolution authority may reduce MREL if it can be assumed that the deposit guarantee scheme would contribute towards financing the resolution. The background to this is the liability cascade outlined in the BRRD: since covered deposits are excluded from bail-in, costs may potentially be borne by the responsible deposit guarantee schemes if they are required to make a cash contribution towards financing the resolution. The size of this contribution would then be the amount by which the covered deposits would have been written down had they not been excluded from bail-in.[35] Therefore, a deposit guarantee scheme contribution can only be expected if it is likely, in the event of resolution, that the end of the liability cascade would be reached and the depositors would be relied on. However, for the majority of resolution cases, such a scenario is considered rather unlikely.

As a general rule, the resolution authority should take into account each institution's business model and risk profile when determining MREL using, *inter alia,* information from the supervisory review and evaluation process (SREP). This serves as the basis for determining the institution-specific prudential requirements and provides banking supervisors with a common framework for assessing an institution's overall risk situation. Amongst other things, this should include analysing the business model, assessing the adequacy of internal control systems and risk management procedures, ensuring capital adequacy as well as assessing the institution's liquidity and funding situation.

Given their size and significance for financial stability, particular attention is paid to institutions within the SSM from which systemic risk would emanate in the event of their failure. Since – in the event of these institutions' resolution – it may be necessary to draw on the Single Resolution Fund (SRF), the resolution authority should ensure that the criteria for accessing the SRF are met when determining the MREL for systemically important institutions. For example, SRF contributions are only permissible if shareholders and creditors have already contributed an amount equivalent to at least 8% of the institution's total liabilities to loss absorption and recapitalisation.[36]

## Eligibility criteria

*Requirements for MREL-eligible liabilities*

As with TLAC, both the volume and quality of eligible liabilities are important for MREL, since in the event of resolution, it needs to be ensured that MREL is actually available and that the resolution objectives can therefore be achieved. In view of this, European legislators have defined criteria which MREL-eligible liabilities must meet.[37] The aim is to ensure that these liabilities are able to help absorb losses without any legal difficulties and, in particular, that bank runs and contagion effects are prevented. In addition, it should be possible to evaluate MREL-eligible liabilities reliably and they should also be readily available at the time of resolution. To this effect – similarly to TLAC – covered deposits and the deposits of natural persons and small and medium-sized enterprises in excess of the protection ceiling, as well as derivatives, for example, are not considered MREL-eligible liabilities. Furthermore, MREL-eligible instruments must not be collateralised and have to have a residual maturity of at least one year. On the one hand, these criteria ensure a certain quality of MREL-eligible liabilities; on the other, they provide for a minimum level of comparability and thus a level

35 Article 109 BRRD, implemented in section 145 of the Act on the Recovery and Resolution of Institutions and Financial Groups.
36 In this context, for the majority of Germany's systemically important institutions, it can be concluded that a requirement of 8% of total liabilities is likely to be higher than the minimum TLAC of 18% of RWAs or 6.75% of the leverage ratio that will apply from 2022.
37 Article 45 (4) BRRD, implemented in section 49 (2) of the Act on the Recovery and Resolution of Institutions and Financial Groups.

playing field between banks in the EU member states.

## Determining MREL for German institutions

*SRB and FMSA as resolution authorities*

For institutions supervised directly by the ECB and for cross-border groups for which the Single Resolution Board (SRB) is directly responsible in the context of the SRM, as well as in cases where member states have transferred this responsibility pursuant to Article 7 (5) of the Single Resolution Mechanism Regulation,[38] MREL is determined by the SRB after consultation with the competent supervisory authorities. The SRB communicates its decision to the national resolution authority (in Germany, the Financial Market Stabilisation Agency (FMSA)), which then implements the decision at the institution level. For the other institutions domiciled in Germany, the FMSA sets MREL in consultation with the Federal Financial Supervisory Authority (BaFin), based on any guidelines drawn up by the SRB to ensure the MREL requirement is applied in a coherent manner throughout the banking union. Moreover, the SRB may issue general instructions to the national resolution authorities.[39]

In order to set MREL, the resolution authorities must have a sufficient basis of information at their disposal. While limited data is already available in the existing reporting system, a large proportion of the data required has to be collected from scratch. The Bundesbank is involved in the MREL setting process owing primarily to its responsibility for the ongoing supervision of banks, which means it assists in providing and obtaining information, amongst other things.

*Resolution colleges for cross-border groups of institutions*

Since the MREL requirement depends, *inter alia,* on the resolution strategy of the respective institution, MREL is determined in the context of resolution planning. In the case of cross-border groups of institutions, collaboration within the resolution colleges[40] is especially important. The SRB and the FMSA, as well as the other national resolution authorities, are currently working intensively on preparing resolution plans, with the first MREL requirements therefore likely to be determined for large banks in the EU initially. It is not yet known to what extent this is to be communicated publicly. Even though the SRB stresses that a firm-specific decision is called for in the case of MREL, the MREL requirement of 8% of total liabilities is considered the likely benchmark for all banks under SRB responsibility, since the SRF can only be used following a bail-in of at least 8% of an institution's liabilities.

## Outstanding issues

*European Commission expected to clarify final outstanding issues*

A number of key points concerning the application of the new MREL requirement are currently still unresolved even following publication of the RTS and should be addressed as part of the European Commission's planned legal act on the implementation of TLAC with a view to amending the BRRD.

*Treatment of the buffer requirement*

– While it was stipulated for TLAC that the buffer requirement needs to be met in addition to minimum TLAC, thus preventing double usage of CET1 capital, no such clarification exists for MREL. Should it be possible for CET1 capital to be used to meet both the buffer requirement and the MREL requirement, the proper functioning of the buffers would no longer be ensured and a breach of MREL would occur before the buffer requirement is breached. However, this would render the capital buffers ineffective, as they are intentionally placed ahead of the other capital requirements to allow them to "breathe" in times of stress, ie they are able

38 See Deutsche Bundesbank (2014), op cit.
39 Article 31 (1) letter a of the Single Resolution Mechanism Regulation.
40 Where institutions have at least one subsidiary or branch in a euro-area country and another in a non-SSM EU member state or a third country, resolution colleges facilitate cooperation and coordination among the various authorities involved in a cross-border resolution.

to be reduced, while the other capital requirements, including the MREL requirement, have to be met at all times.

*Sanction mechanisms*

– Further to this, in a similar manner to TLAC, it should also be made clear in the MREL requirements that if there is a (likely) MREL shortfall, the same consequences apply as when the minimum regulatory capital requirements are undershot. Any further sanctioning should also be defined in this context.

*Subordination*

– While there is a requirement for TLAC-eligible liabilities to be ranked junior to liabilities excluded from TLAC, the same is not currently stipulated for MREL-eligible liabilities. This would, however, be desirable in order to ensure that the requirements in terms of MREL and the bail-in tool are formulated in an effective and legally sound manner and that there is greater transparency for market participants.

*Holding restrictions*

– The BRRD does not specify how institutions' reciprocal investments in MREL-eligible liabilities are to be handled. However, such investments harbour risks of contagion, which – as is the case with TLAC – should be addressed by way of regulatory provisions.

## Conclusion

*TLAC and MREL are essential requirements for proper functioning of bail-in tool and credibility of new resolution regime*

One of the primary objectives of the reform initiatives in the wake of the recent financial crisis was to resolve the too big to fail problem. Amongst other things, it should be possible in future to resolve even systemically important institutions in an orderly manner without jeopardising the stability of the financial system or burdening taxpayers. In this context, dedicated resolution regimes have been in place for banks since 2011 and an important step has thus been taken towards restoring the market economy principle of aligning liability and control. Notably, the bail-in tool was introduced to make sure that losses are borne by shareholders and creditors. As sufficient loss buffers are necessary to ensure the proper functioning and thus the credibility of the bail-in tool, two new minimum requirements were developed for banks at both the global and European levels. One is the TLAC standard, which was adopted at the G20 level and is to be binding for all G-SIBs from 2019. The other is MREL: an institution-specific requirement which will be determined by the competent resolution authorities for European institutions.

A look at the liability cascade in resolution financing reveals the key significance of the new minimum requirements TLAC and MREL: as the first line of defence against threats to financial stability and burdens on taxpayers, the bail-in tool can only function if institutions that are to be resolved have sufficient loss-absorbing capacity which can be used to cover losses in a timely and legally sound manner. The new minimum standards, in the shape of TLAC and MREL, are therefore essential requirements for the proper functioning of the bail-in tool and thus the credibility of the new resolution regime. At the same time, clear criteria need to apply to TLAC and MREL so that the availability of these liabilities is assured in the event of resolution. A key part of this is the subordination criterion that was implemented as a mandatory requirement for TLAC but should also apply to MREL. While it is important that the MREL is set at a sufficiently high level, at the same time, institutions must not be overburdened; this means appropriate transitional periods for fulfilling the requirements should be allowed. Finally, it should be noted that a number of issues concerning the MREL requirement's definition, such as the treatment of buffers and final agreement on the criteria for MREL-eligible liabilities, are still outstanding. These issues should be addressed promptly and effectively to provide banks and investors with clarity.

Ultimately, the resolution regime can only be credible and effective if its implementation and application are consistent. There is evidence of

a number of policy initiatives aimed at softening the new rules; however, doing this would be sending the wrong signal and would compromise the resolution regime's credibility. A functioning resolution mechanism is an important step towards severing the close ties between banks and sovereigns. Other measures must now follow, such as imposing limits or capital requirements on bank lending to sovereigns and improving the consistency of insolvency legislation at the international level.