THE REGULATORY LANDSCAPE IS CHANGING, ARE YOU READY?

RECENT UPDATES TO PRA AND TLAC STANDARDS

ALVAREZ & MARSAL

PRA OPERATIONAL CONTINUITY REQUIREMENTS

FURTHER ENHANCEMENTS BUT GREATER COSTS

15 October saw the release of the next set of proposals from the PRA designed to support firm resilience and resolvability in the post crisis world.

PRA Consultation Paper (CP) 38/15 focuses on how firms can ensure the continuity of critical shared services in a stressed scenario, to facilitate recovery options, orderly resolution or post resolution restructuring. Or put simply — how the firm can keep going.

The proposals apply to banks, building societies and PRA authorised investment firms. The precise scope of who will need to comply with the requirements will become clearer when the future consultation on MREL (minimum requirements for own funds and eligible liabilities) is published. However, firms affected by the UK ring-fencing requirements will need to consider these requirements in addition to ring-fencing specific ones.

It is clear however, that the requirements will lead to further costs for firms: potentially up to £200 million in implementation costs for larger banking groups (combined with UK ring-fencing operational arrangements).

The good news for smaller firms is that they are likely to be excluded from further requirements to ensure operational continuity. Instead, reliance for these firms will be placed on Single Customer View and Continuity of Access requirements.

In line with expectations on ring-fencing, the PRA intends any eventual rules to apply from 1 January 2019.

WHAT ARE THE REQUIREMENTS?

The PRA's draft rules and Supervisory Statement have clear and defined objectives for achieving its aims on operational continuity. These include requirements to ensure firms:

- Have well documented arrangements in place that are capable of being continued or replaced in resolution.
- Have sufficient financial resources and capability to allow the firm to operate in resolution and the service arrangements that are capable of being restructured.
- If in a group, have clearly defined reporting lines that are capable of continuing in resolution.
- If in a group, are structured so that upon failure or resolution, no group entity receives preferential access to critical services over another.

What the PRA does not say, or regiment, is how a firm is to achieve these objectives. A firm could choose to:

- Outsource critical shared services to another entity within its group (group provider) or to an external party (non-group provider).
- Operate a business unit within the firm that provides critical shared services to one or more of its business units or firms of the group.
- Use a combination of the above.

Whichever option chosen by a firm, the clear message is that it must be able to demonstrate to the satisfaction of the PRA that its arrangements are effective, realistic and realisable.

WHAT DOES THIS MEAN FOR FIRMS?

What is clear is that the proposed rules will enhance existing PRA expectations, and as such will impact operational arrangements and increase costs to firms. For large banking groups this could be in the region of £200 million in implementation costs and £120 million per year in ongoing costs. The costs may be reduced if internal business units are utilised over a separate entity, and this may influence firm choices as to how to proceed.

So, choices are vital, including:

- How to structure the provision of critical shared services?
- How to document this provision?
- What changes need to be made to existing structures, governance arrangements, controls, contractual service agreements (internal and external)?

Although not elaborated on, what could have a potentially far reaching impact is the possibility of the PRA using "resolutions tools". These tools (included in the Bank Recovery and Resolution Directive) are extensive and could include firm structural changes, organisational requirements and management changes. Getting the solution right is therefore vital for a firm, otherwise a solution could be imposed upon them.

There will also be increased scrutiny from the PRA by way of its continuous supervisory assessment, use of resolution tools and targeted reviews. Recovery and resolution planning will be used to inform views, and capital and liquidity assessments will incorporate reviews on financial resilience expectations. Management, governance, risk management and controls will all need to be considered with a view towards operational continuity. It is clear that firms must be able to ensure not only their operational continuity, but also be able to demonstrate this to the PRA.

TOTAL LOSS-ABSORBING CAPACITY (TLAC) STANDARDS

THE END OF "TOO BIG TO FAIL"?

Global governments, authorities and regulators are determined to end the "too big to fail" dilemma. Amongst the thousands of pages of new requirements a key resolution tool to combat the too big to fail dilemma has been the development and implementation of the bail-in tool.

In short, a "bail-in" would see the losses of a troubled bank absorbed and the bank recapitalised. Claims of shareholders and unsecured creditors would be written down and/or converted into equity in order to restore solvency. This would allow the critical functions of the bank to continue, thus providing time for further actions to be taken such as restructuring of the institution.

However, a bail-in is reliant on the existence of sufficient loss absorbency to convert to equity capital in order to stabilise the firm.

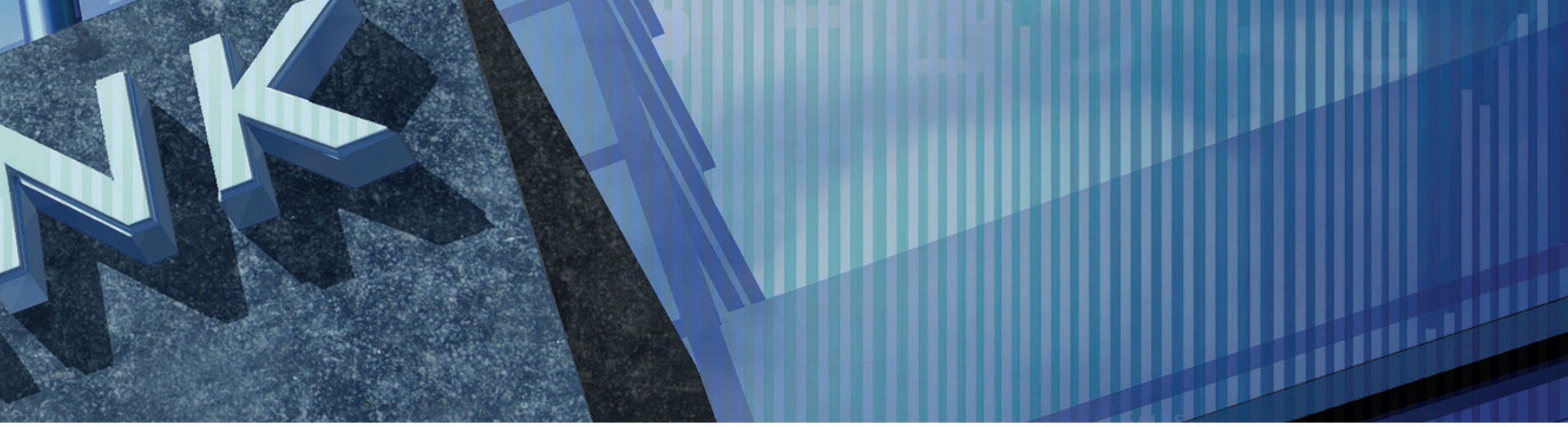
Standards on how loss absorbency would be set and calculated have long been in discussion and development. On 9 November 2015, the Financial Stability Board (FSB) published its Total Loss-Absorbing Capacity (TLAC) standards, and earlier in the summer the European Banking Authority (EBA) published final regulatory technical standards on Minimum Requirement for Own Funds and Eligible Liabilities (MREL) to the European Commission for approval.

For U.S. firms identified by the Federal Reserve Board (FRB) as global systemically important banks (G-SIBs) and to the U.S. operations of non-U.S. G-SIBs the recent draft proposals by the Federal Reserve System (30 October 2015) on loss absorbent capital will be relevant.

THE TABLE OUTLINES THE KEY COMPONENTS OF TLAC, MREL AND THE U.S. PROPOSALS. FROM THIS WE CAN SEE SIMILARITIES, BUT ALSO KEY DIFFERENCES, FOR INSTANCE:

- TLAC standards cover G-SIBs, currently numbering 30, which is a far more restricted number than those banks which are subject to MREL (all institutions within the scope of the BRRD, including the 122 "significant" banks and thousands of non-significant ones, though for smaller institutions this is likely to be covered by their normal capital requirements). The U.S. proposals would be applied to only U.S. based G-SIBs (as identified by the FRB), and operations of non-U.S. G-SIBs with assets over $50 billion in U.S. non-branch assets.
- The minimum level of TLAC is set as a percentage of risk weighted assets and leverage exposure while required MREL is set as a percentage of the aggregate of the total liabilities and own funds of the institution (i.e. total assets).

The U.S. proposals are tougher and more prescriptive than the FSB, in part perhaps because FSB standards must be capable of allowing for national idiosyncrasies. However, for a few European G-SIBs, it means navigating a combination of TLAC, MREL and U.S. requirements.



CONSIDERATIONS FOR FIRMS

The implications for institutions subject to TLAC and/or MREL are material.

First and foremost is that there will most likely be an increase in the cost of funding.

Firms will face serious considerations on implementing and creating transitional plans to meet requirements, including:

- What are the legal terms of existing capital and financial instruments in issuance
- What are the type and quantum of capital and funding instruments planned for issuance
- What are the transitional arrangements for live instruments and planned issuances

Careful examination of the appropriate capital structure and capital injection into the group would be sensible, especially depending on whether there is a Single Point of Entry (SPE) or Multiple Point of Entry (MPE) resolution strategy in place. Firms will need to determine outcomes to complex issues:

- Requirements around subordination of bail-in-able instruments versus excluded liabilities.
- Alternative structuring scenarios of bail-in-able capital (regulatory, commercial, credit rating implications).
- Form and method of injection of bail-in-able instruments into group subsidiaries where applicable.

The implications are far-reaching with potential consequences on distributable reserves and dividend strategy, double leverage and/or concerns around capital inefficiencies and even legal entity reorganisation.

IMPLICATIONS FOR AUTHORITIES

Arguments abound that TLAC standards in addition to MREL requirements will lead to a level playing field for worldwide G-SIBs. It will be vital that international authorities coordinate and collaborate on their arrangements and requirements for those institutions subject to TLAC and / or MREL, as well as possible jurisdictional differences including those within the E.U., as well as between the E.U. and U.S.

Authorities will need to be cognizant of local legislation (bankruptcy, property, contractual versus structural subordination etc). The interaction between meeting the different requirements, resolution planning and local legislation will have significant impacts.

Fortunately there are frameworks in place to ensure the required level of cooperation. The FSB Key Attributes envisage co-operation agreements to describe a common resolution plan for individual G-SIBs. The BRRD includes similar requirements with the underpinning principle of co-operation.

WILL IT END TOO BIG TO FAIL?

The current purpose and drive of policy makers worldwide cannot be denied. There is real intent to end the "too big to fail" dichotomy.

However, the framework and principles will only be proven in a real life scenario. It would require strength of purpose to impose a resolution on an institution with potentially significant implications for retail and wholesale consumers. Further natural nationalistic protectionism would need to be curtailed. In the midst of a crisis, whether systemic or institution specific, "pulling the trigger" would be neither an easy nor enviable decision.

	FSB TLAC Term Sheet	Federal Reserve TLAC Notice of Proposed Ruling (NPR)	EBA MREL Draft Requirements
Covered Firms	Global systemically important banks (G-SIBs)	U.S. top-tier banks (G-SIBs) and systemically important foreign banking organisation with $50 billion or more in U.S. non-branch assets	Institutions / entities subject to the BRRD (e.g. European banks)
Calibration	From January 2019 (January 2022), minimum TLAC must be at least: (i) 16 percent (18 percent) of the resolution group's RWAs (ii) 6 percent (6.75 percent) of the Basel III leverage ratio denominator ("TLAC LRE Minimum") This requirement does not include any applicable regulatory capital (Basel III) buffers, which must be met in addition to the TLAC RWA Minimum Total eligible debt liabilities should be equal to or greater than 33 percent of minimum TLAC requirements	From January 2019 (January 2022), a U.S. Bank Holding Company ("covered BHC" or "BHC") would be required to maintain outstanding minimum levels of eligible external TLAC of at least: (i) 16 percent (18 percent) of total RWAs (on a fully phased-in basis), and (ii) 9.5 percent of the covered BHC's total leverage exposure An external TLAC buffer would apply in addition to the risk-weighted assets component of the external TLAC requirement. A covered BHC's external TLAC buffer would be equal to the sum of 2.5 percent plus the G-SIB surcharge applicable to the covered BHC plus any applicable countercyclical capital buffer At least one third of TLAC requirement should be met with eligible long-term debt ("LTD") rather than equity The position for non-U.S. G-SIBs structured via Intermediate Holding Companies ("covered IHC" or "IHC") is described below.*	Minimum requirement shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds Individually set per institution Criteria considered: ▪ Resolvability ▪ Capital adequacy ▪ Exclusions ▪ Deposit guarantee scheme contributions ▪ Size, business model, ▪ Funding model and risk profile systemic risk
Bail-in-able Instruments	Any capital instrument, debt instrument, liability or other item that is eligible as TLAC under the term sheet	The sum of (a) the tier 1 regulatory capital of the covered BHC and (b) the covered BHC's eligible external LTD	In addition to equity, own fund instruments, other subordinated debt and senior unsecured bonds, senior unsecured instruments (in particular uncovered deposits with residual maturity of more than one year) may qualify
Resolution Strategy	Facilitates both Single Point of Entry (SPE) and Multiple Point of Entry (MPE) resolution strategies equally	Primarily focuses on implementing the SPE resolution strategy however does not preclude MPE	Facilitates both SPE and MPE resolution strategies equally

	FSB TLAC Term Sheet	Federal Reserve TLAC Notice of Proposed Ruling (NPR)	EBA MREL Draft Requirements
Resolution Entity	Resolution entities and Resolution groups are defined and minimum TLAC requirements for each resolution entity would be set in relation to the consolidated balance sheet of each resolution group	A U.S. covered BHC would be required to maintain a minimum outstanding amount of loss-absorbing instruments for U.S. G-SIBs and a U.S. covered IHC to maintain a minimum outstanding amount of intra-group loss-absorbing instruments for foreign G-SIBs	Resolution plans may provide for arrangements for loss absorption and recapitalisation within group structures (per the group's preferred resolution strategy), including through capital instruments or eligible liabilities issued by institutions to other institutions or entities within the same group
Subordination	Allows for (a) contractual subordination (b) statutory subordination or (c) structural subordination of eligible instruments	Requires structural subordination of eligible external LTD through the BHC and contractual subordination of internal LTD through an IHC (contractual subordination is not required for liabilities in the BHC)	Defines contractual bail-in instrument as (i) allows write-down or conversion to the extent required before other eligible liabilities and (ii) is subject to a binding subordination agreement
Disclosure	Requires disclosure of information on the hierarchy of liabilities on a legal entity basis for, at a minimum, all resolution entities and each legal entity that forms part of a material sub-group and issues internal TLAC to a resolution entity	BHCs to disclose to the public that their unsecured debt would be expected to absorb losses ahead of other liabilities including the liabilities of the BHC's subsidiaries in the event of a failure	Whether it is appropriate for institutions and groups to be required to disclose their minimum requirement for own funds and eligible liabilities, or their level of own funds and eligible liabilities, and if so the frequency and format of such disclosure is under discussion
Capital Distribution Constraints	Not explicitly stated however such distributions are usually made in consultation with home and/or host Regulators	Requests for capital distribution from a BHC would require appropriate levels of external TLAC buffer levels	Not explicitly stated however such distributions are usually made in consultation with home and/or host Regulators
Contagion Risk Management	G-SIBs must deduct from their own TLAC or regulatory capital exposures to eligible external TLAC instruments and liabilities issued by other G-SIBs	Requires state member banks, bank holding companies, savings and loan holding companies, and intermediate holding companies (subject to the Board's capital rules) to deduct from their regulatory capital investments in unsecured debt issued by covered BHCs	Requirements shall be set by considering risk of contagion and the extent to which the failure of the institution would have adverse effects on financial stability, including, due to its interconnectedness with other institutions or with the rest of the financial system through contagion to other institutions

* In the case of an **Intermediate Holding Company ("IHC")**, there are internal TLAC requirements for non-U.S. G-SIBs with assets over $50 billion in U.S. non-branch assets. "Internal" TLAC refers to the fact that these instruments would be required to be issued internally within the foreign banking organisation, from the covered IHC to a foreign parent entity.

Covered IHCs that are not expected to enter resolution themselves would be required to maintain eligible internal TLAC in an amount not less than the greater of: (a) 16 percent of the covered IHC's total risk-weighted assets; (b) for covered IHCs that are subject to the supplementary leverage ratio, 6 percent of the covered IHC's total leverage exposure; and (c) 8 percent of the covered IHC's average total consolidated assets, as computed for purposes of the U.S. tier 1 leverage ratio.

Covered IHCs that are expected to enter resolution themselves would be required to maintain outstanding eligible internal TLAC in an amount not less than the greater of: (a) 18 percent of the covered IHC's total risk-weighted assets; (b) 6.75 percent of the covered IHC's total leverage exposure (if applicable); and (c) 9 percent of the covered IHC's average total consolidated assets, as computed for purposes of the U.S. tier 1 leverage ratio.

For all covered IHCs, an internal TLAC buffer would apply in addition to the risk-weighted assets component of the internal TLAC requirement.

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