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ADEQUATE LOSS-ABSORBING CAPACITY IN THE RESOLUTION PROCESS

1. INTRODUCTION

Banks function in the surrounding of an institutional safety net, which exists in order to ensure banking sector stability. When the safety net is too strong it evokes positive thinking, which leads to a conclusion that banks will never fail or cause their clients' loss. This approach is the key factor which leads to moral hazard. Banks, with their certainty that they would always receive governmental support, undertake a higher risk intentionally and with full awareness.

Moral hazard, which results from the functioning of banks which are described as "too big to fail" (TBTF) was one of the sources of the financial crisis. The positive belief that systemically important banks are able to privatize profits and socialize loss, encouraged the private sector to undertake excessive risk and this led to huge loss, which was the effect of rescuing the collapsing banks. The TBTF issue is one of the key problems which must be addressed in order to stop the snowball effect of moral hazard[1].

Accounting for global recomendations in the scope of resolution issued by Financial Stability Board, work is carried out worldwide in order to implement

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[1] Pawłowicz L., *Hazard moralny w finansach i bankowości*, „Sektor bankowy w Europie. Co zmienił kryzys?", Zeszyty BRE Bank – CASE Nr 126/2013, p. 27.

more reliable mechanisms of resolution, which would be systematized, transparent and effective in[2]:

(i) reducing the systemic risk and limiting the moral hazard phenomenon by enabling a controlled collapse of TBTF banks,
(ii) breaking the feedback loop between insolvent and non-insolvent sovereigns,
(iii) dissuading from undertaking excessive risk and minimize the need to grant support to the banks.

The main purpose of this article is to present recent regulatory initiatives which are expected to enhance the banks' ability to absorb loss in the process of orderly resolution. The other purpose is an assessment of the influence of such regulations on the costs of financing Polish banks.

2. THE RESOLUTION MECHANISM IN CONTEXT OF THE TBTF DOCTRINE

Although politicians agree that banks should not be rescued with public money, the reality verifies this idea in a negative way. This happens because credit institutions play a particular role in the overall economy and their uncontrolled collapse might lead to a loss of people's trust in the whole banking sector. Financial support provided for restructuring and maintenance of critical functions of banks during the financial crisis may be recognized ex-post as reasonable if the dissemination effect is limited and if it adds to the maintenance of financial stability[3]. However, engaging public financial resources for this purpose and no organized mechanism of such intervention evokes many negative side effects and is not optimum from the social point of view.

The public protective umbrella spread over banks which are "too big to fail" is a source of many negative problems, such as: unfair competition, excessive risk taking and high costs for the public sector. What is more, the experimental research shows that the maintenance of insolvent banks (so called "zombie" banks, with almost zero economic value) caused by fears of a credit crunch often leads to even worse economic consequences, such as stagnation of credit actions, anemic economic growth, costs of financial aid, than in case of a fast recognition of loss and reorganization (or possibly liquidation) of credit institutions[4].

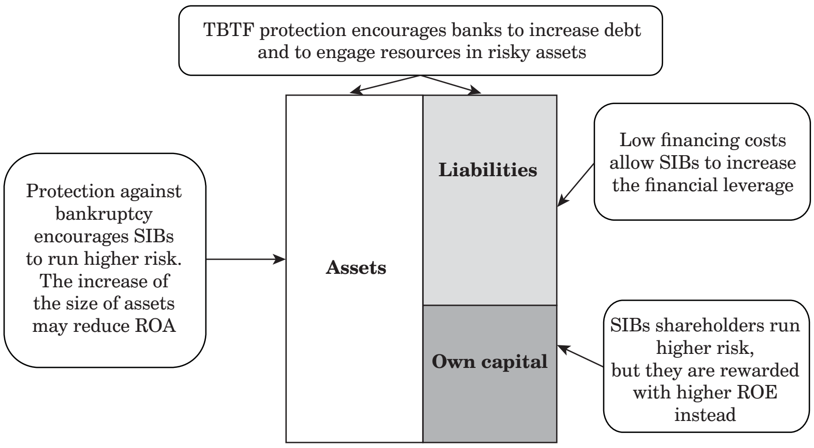
[2] *Adequacy of loss-absorbing capacity of global systemically important banks in resolution*, Consultative Document, FSB, 10 November 2014, http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf (access 28.04.2005).

[3] Laeven L., Valencia F., *Resolution of Banking Crises: The Good, the Bad, and the Ugly, in Financial Crises: Causes, Consequences, and Policy Responses*, IMF, 2014, p. 9.

[4] Admati A.R., DeMarzo P.M., Hellwig M.F., Pfleiderer P., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Regulation: Why Bank Equity is Not Socially Expensive*, Rock Center for Corporate Governance at Stanford University Working Paper 86, 2011, p. 50.

Since bank creditors with systemic importance do not bear the full costs of bankruptcy, they are ready to provide financing without paying enough attention to the analysis of a bank risk profile, which encourages credit institutions to lift financial leverage and take on more and more excess risk. SIBs, with their competitive advantage over banks, which generate smaller systemic risk, may engage more intensely in risky activities and they may increase systemic risk. What is more in such a situation, the TBTF institutions may be more inclined to build their competitive dominance by aiming at a fast increase of assets in order to gain profits through scale of activity and maximize the expected value of implicit public guarantees. In effect, the public financial support granted to rescue SIBs in case of financial difficulties often appears to be huge (image 1).

Image 1. Influence of implicit public guarantees on the TBTF institutions balance



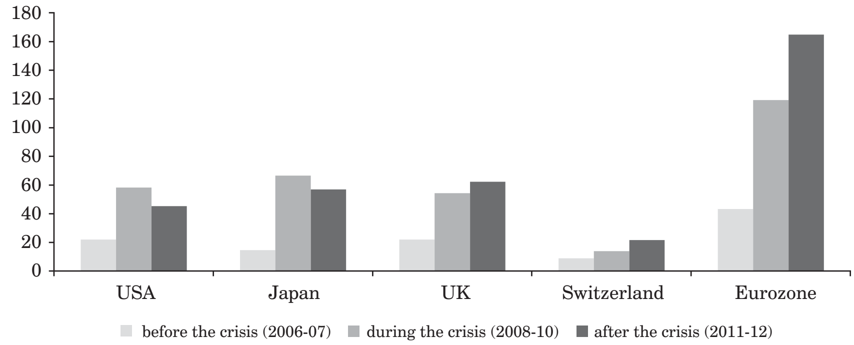
Source: author's conclusions based on: *Global Financial Stability Report*, IMF, April, 2014, p. 103.

The problem of TBTF institutions grew significantly during the financial crisis. In order to support threatened banks and in order to protect financial stability, governments were ready to grant various kinds of support, such as recapitalization, provision of guarantees for various types of assets and liabilities, supporting mergers and acquisitions[5]. The above actions left no doubt that SIBs could count on support from public resources. The countries that managed to get up after the crisis have been left with even more serious problems. In effect of mergers

[5] Stolz p., Wedow M., *Extraordinary Measures in Extraordinary Times: Public Measures of Support of the Financial Sector in the EU and the United States*, European Central Bank Occasional Paper No. 117, Frankfurt, 2010, p. 7.

and acquisitions the banks appeared to grow even more than before the crisis. In certain countries, smaller institutions, highly complex and with many cross-border connections and political importance also appeared to be too big to fail (see Ireland), and sometimes they were too numerous to fail.

Image 2. Implicit public guarantees in relation to G-SIBs (in billions of USD)



Note: the amount of implicit public guarantees has been assessed based on the average of three methods applied by IMF.

Source: author's conclusions based on: *Global Financial..., op. cit.*, s. 119.

Extensive empirical research confirms the thesis that if a bank has the status of a TBTF institution it leads to profits in the scope of costs of obtaining financing and it leads to a reflection that the expected public support in case of financial difficulties is a hidden form of public donation for such banks[6]. In this aspect it is worth noticing that the IMF research, which – based on a sample of banks defined as TBTF – quantified the value of implicit public guarantees, which make the banks included in the G-SIBs group generate savings in the form of lower costs of financing (image 2)[7]. The competitive advantage achieved in this way disrupts

6 Tsesmelidakis Z., Merton R., *The Value of Implicit Guarantees*, IMF Working Paper No. 12/128, 2012, p. 1.

7 The size and the direction of shaping the TBTF subventions is diverse and depends on geographic location. IMF estimates that the G-SIBs financing costs in 2013 were lower in relation to an average bank by about 15 bp. in the USA, 25–60 bp. in Japan 20–60 bp. in Great Britain, and in the eurozone by about 60–90 bp. In the analyzed period, in all developed economies apart from EU, the subventions dropped after peaks, which occurred during the financial crisis. An increase in implicit subventions in EU in 2012 may result from a debt crisis in the eurozone. In the USA the subventions dropped considerably during a discussion and after resolving a Dodd Frank regulation and from then on, they have been stable. Nevertheless, the expected value of public guarantees for SIBs, which are in financial difficulties, is higher than before crisis. *Global Financial…, op. cit.*, s. 104.

the market mechanism and influences higher and higher risk accumulation in the balances of these institutions. Undertaking additional efforts appears to be necessary in order to deal with the problem of TBTF institutions and finally to lead to a situation in which the advantage of cheaper financing resulting from implicit subsidies is eliminated. That is why due to the already mentioned incentives to undertake irrational risk it is believed that regulations must admit the option of bank collapse and clients' share in loss, at least partially.

3. TOTAL LOSS ABSORBING CAPPACITY – TLAC

For more years than a decade, the global banking system has evolved in the direction of a specific market structure with a small number of giant banks, high level of concentration, relatively low market entry and exit ratio. This trend has been clearly noticeable in recent years. In 1998 five biggest global banks held circa 8 percent of global banking assets. In 2008 the group doubled its share in the market up to the level of 16 percent.[8]

The EU banking sector is still very big in absolute terms (42,9 trillion euro) and in relative terms (it represents almost 350 percent of the EU GDP) (image 3). The size of the biggest EU banks in the individual perspective corresponds more or less to the GDP of the country of origin, or is close to this value. Such banks remain too big to fail and at the same time too big to be rescued, and too complex from the point of view of reorganization and orderly resolution[9].

The above trend shows that banks continued to build their TBTF status, and at the same time they were enhancing their bargaining position in the context of public subsidies. Therefore, even stronger frames of the reorganization mechanism and orderly resolution may fail when it comes to reorganizing or resolving a bank, which belongs to the group of institutions described as TBTF[10].

That is why FSB started in November a process of consultations over regulations aiming at the increase of capital requirements for global banks of systemic importance. The draft new standards shall oblige global banks of systemic importance to build a capital buffer, the Total Loss Absorbing Capacity[11]. The main

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8 Haldane A.G., *Banking on the state*, BIS, BIS Review 139/2009, p. 5, http://www.bis.org/review/r091111e.pdf (access: 25.04.2015).

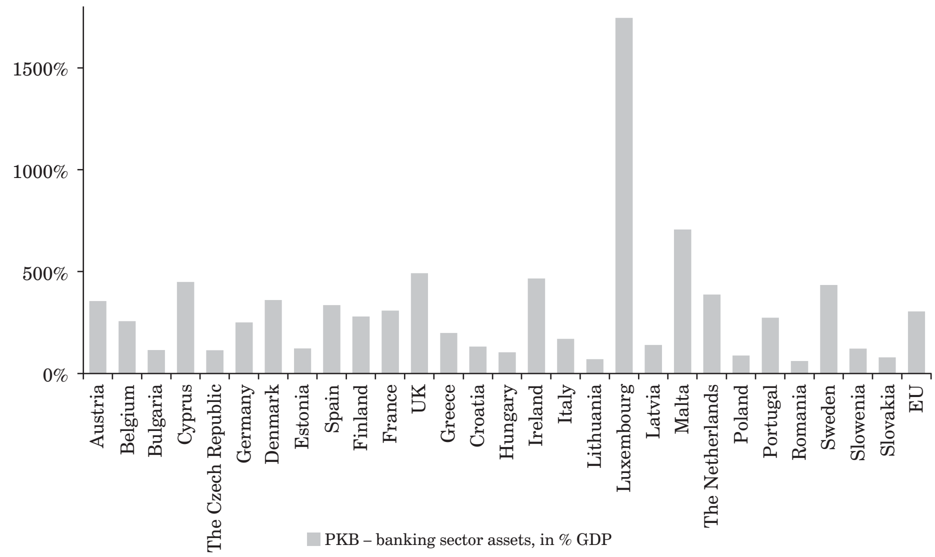
9 *Proposal for a regulation of the European Parliament and of the Council on structural measures improving the resilience of EU credit institutions*, 2014/0020 (COD), http://eur-lex.europa.eu/procedure/EN/1041635 (access: 20.04.2014).

10 *Thematic Review on Resolution Regimes-Peer Review Report*, FSB, April 2013, https://www.financialstabilityboard.org/publications/r_130411a.pdf (access 28.04.2005).

11 *Adequacy of loss-absorbing capacity of global systemically important banks in resolution*, Consultative Document, FSB, 10 November 2014, http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf (access 28.04.2005).

intention of FSB is to overcome the problem of TBTF institutions by a guarantee that G-SIBs have enough loss absorption and recapitalization capacity. Only in such a case the process of reorganization and orderly resolution may ensure continuing financial and economic functions and the institutions and taxpayers' money shall not be used to rescue them.

Image 3. Assets of the banking sector in relation to GDP of a given country



Source: author's conclusions based on: Eurostat (http://ec.europa.eu/eurostat/web/national-accounts) i ECB (http://sdw.ecb.europa.eu/browse.do?node=71390).

Following the new proposal, G-SIBs shall be obliged to maintain in the I Pillar capital in the amount of 16–20 percent of risk weighted assets and the leverage ratio at least twice as high as the level of 3 percent proposed by Basel III (image 4).

Image 4. Minimum TLAC level in relation to G-SIBs

Note: TEC – total exposure measure, which is the basis to calculate the financial leverage ratio.

Source: author's conclusions.

The proposed capital reserves and eligible liabilities is supposed to ensure continuity of critical bank functions in its reorganization process and orderly resolution and to protect taxpayers against covering costs of such insolvency by eliminating the necessity to apply the bail-out mechanism by the state or the central bank[12]. Simultaneous reference of TLAC to the level of risk weighted assets and the financial leverage ratio allows for a possible correction of the TLAC requirement in a situation in which appears to be decreased in effect of a risk assessment method which is applied internally by a bank (IRB approach). Thus, the proposal to implement a buffer is a development of the earlier presented idea that the Basel III framework should constitute a lower, not an upper limit in the scope of minimum capital requirements for cross – border bank institutions.

Table 1. G-SIBs at the end of November 2014

Category (Buffer)	G-SIBs in the alphabetical order
5 (3.5%)	none
4 (2.5%)	HSBC, JP Morgan Chase
3 (2.0%)	Barclays, BNP Paribas, Citigroup, Deutsche Bank
2 (1.5%)	Bank of America, Credit Suisse, Goldman Sachs, Mitsubishi UFJ FG, Morgan Stanley, Royal Bank of Scotland
1 (1%)	Agricultural Bank of China, Bank of China, Bank of New York Mellon, BBVA, Group BPCE, Crédit Agricole Group, Industrial and Commercial Bank of China Limited, ING Bank, Mizuho FG, Nordea, Santander, Société Générale, Standard Chartered, State Street, Sumitomo Mitsui FG, UBS, UniCredit Group, Wells Fargo

Note: G-SIBs at the end of November 2014 assigned to particular categories reflecting the required level of additional loss absorbing buffer.

Sources: http://www.financialstabilityboard.org

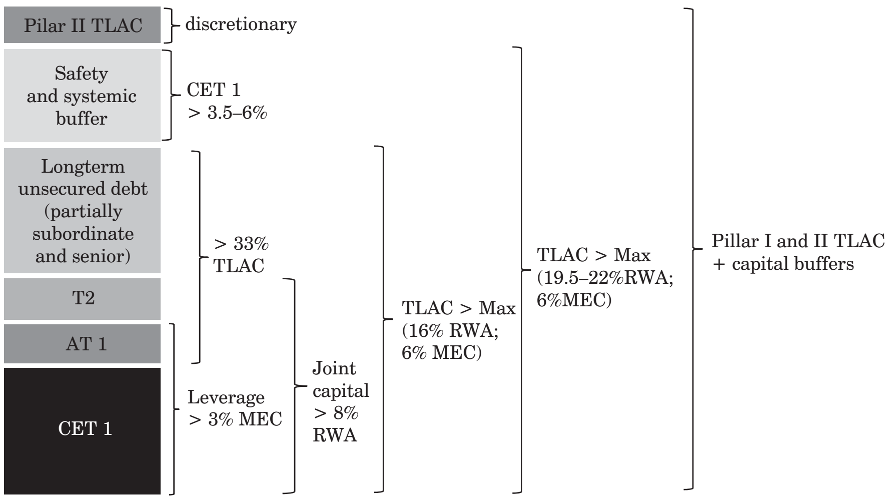
TLAC may be composed of instruments which, in accordance with the Basel III framework, belong to the regulatory capital (among others: stocks, subordinated debt), as well as other forms of obligations, which will have to meet specific conditions. First, it is required that the obligations are subordinate to secured bonds, obligations resulting from derivative instruments and first of all guaranteed

[12] Gracie A., *Total Loss-Absorbing Capacity – the thinking behind the FSB Term Sheet*, BoE, Citi European Credit Conference, December 2014, p. 2, http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech783.pdf (access 28.04.2005).

deposits. It means that at the moment of a bank resolution, the owners of such debt instruments should take losses without exception. Second, such obligations must have maturities at least one year. Apart from the above, the FSB admits the possibility that qualified obligations shall include unsecured senior debt, but it will have to be contractually, regulatory or structurally subordinate, in a way which ensures that the obligations to such creditors are paid after satisfying the senior debtholders' claims in case if a bank fails[13].

Moreover, the TLAC buffer should be composed in one third of eligible liabilities in order to ensure that the bank which experiences financial difficulties has enough resources to absorb loss and is able to undertake effective recapitalization in the resolution process. If a bank has not enough eligible liabilities, then the CET1 capital will have to be assigned to cover the minimum TLAC requirements[14].

Image 5. TLAC requirement proposed by FSB (Pillar 1 and Pillar 2)



Source: author's conclusions.

The TLAC requirement in Pillar I shall definitely include all global banks of systemic importance. In order to account for the variety within particular G-SIBs, the supervisory authorities and resolution authorties shall be responsible for imposing additional requirements in the TLAC II Pillar. The requirement level in the II Pillar will depend on the recovery and resolution plans, systemic

[13] The maximum contribution is to be limited to 2.5 percent RWA or more if the minimum TLAC requirement exceeds 16 percent of RWA.

[14] Gracie A., *Total…, op. cit.*, s. 4.

meaning of the institution, business model, complexity and risk profile as well as the organizational structure. A threat of the additional TLAC requirement in the II Pillar will be a positive framework of incentives to simplify the structure and will make the institutions act in order to develop possibilities to complete effective resolution.

TLAC is the new prudential measure, which might influence the bank sector in a similar way as Basel III (especially with reference to G-SIBs) in terms of capital, risk and profitability management. Partial implementation of an uncovered privileged debt into the resolution process, as well as introducing high minimum capital requirements in Pillar I, will mean relevant changes in the way in which banks manage their financial structure. As visible in image 5, if capital buffers are binding, the capital requirements will considerably exceed 20 percent RWA.

Based on initial settlements the new capital norm of Pillar I will be enforced as of the beginning of 2019. It should be emphasized that the FSB proposal is a draft and that is why the consultation period and calibration of the ration shall have the key meaning in establishing the optimum TLAC level.

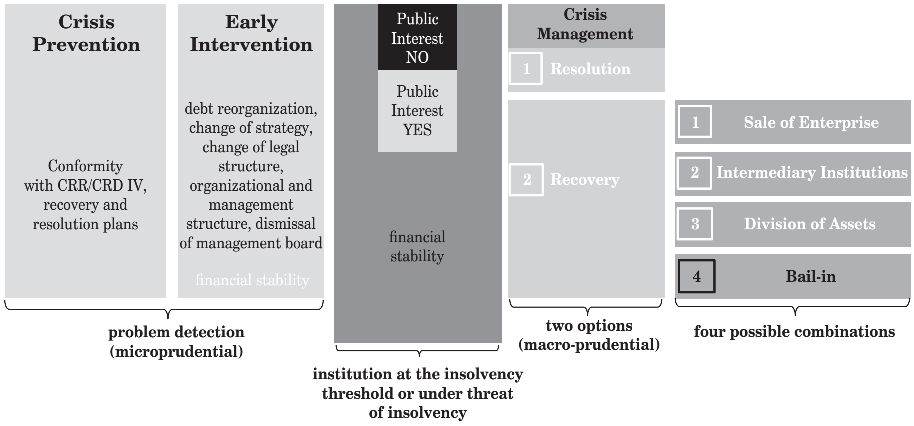
4. THE RESOLUTION MECHANISM IN EUROPE

In the European Union the document, which establishes a common European legal framework of recovery and resolution of banks threatened with insolvency is the Bank Recovery and Resolution Directive (BRRD). It is based on three main pillars, which reflect various planning phases and recovery and orderly resolution: crisis prevention, early intervention and crisis management (image 6)[15].

The Directive equips public authorities with a reliable set of instruments enabling an early and rapid intervention in relation to institutions with financial problems on at the verge of collapse, in order to guarantee continuity of critical financial and economic functions of a given institution, with a simultaneous possibly maximized decrease of the impact of the institution's insolvency on the economy and financial sector. The provisions of the directive are transposed in EU members states based on minimum harmonization rules. In the bank union the supervision over banks and their resolution will be carried out at the same level of competence and based on maximum harmonization rule.

[15] *European Parliament and Council Directive 2014/59/UE of May 15th 2014 establishing framework for the needs of recovery and resolution tasks with reference to credit institutions and investment institutions, Official Gazette* EU 2014 L 173.

Image 6. System recovery and orderly resolution of banks



Source: author's conclusions based on: *European Covered Bond Fact Book,* ECBC, 2014, p. 60.

In this way, irrespective of whether if member states opted for their participation in SRM or against it, they will have to apply the same rules of consolidated prudential supervision and the provisions concerning resolution of banks. The fundamental difference consists in the fact that based on the directive the responsibility shall be given to public authorities, whereas the resolution mechanism will lead to a Single Resolution Board at the EU level and the procedure of transformation of financial institutions on the verge of insolvency[16].

When analyzing the influence of the regulation on the costs of financing Polish banks it is worth paying special attention to:

(i) the resolution mechanism,
(ii) minimum requirement of own funds and eligible liabilities (MREL),
(iii) the influence of the resolution strategy on the TLAC/MREL inside the bank group.

4.1. The bail-in mechanism

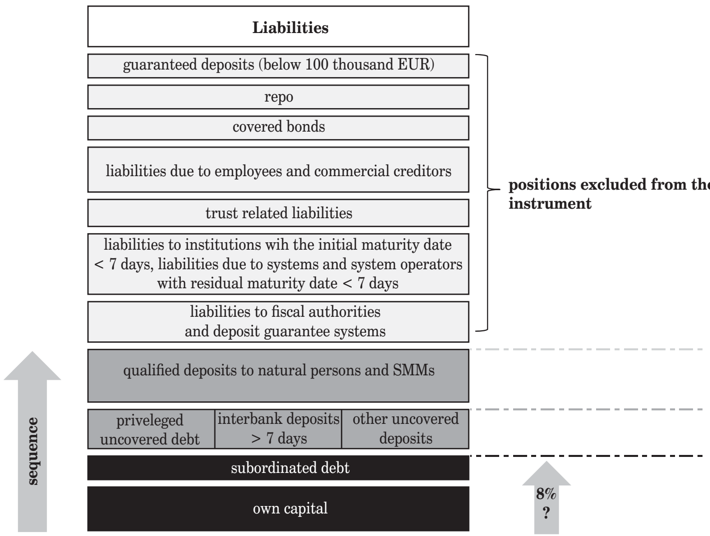
Bail-in is one of the key tools among the resolution toolkit and is based on creditors' participation in public support granted to financial institutions in crisis,

16 *Proposal for a regulation of the European Parliament and of the Council stablishing 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 Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council*, 2013/0253 (COD), http://www.ipex.eu/IPEXL-WEB/dossier/document/COM20130520.do (access: 27.04.2015).

which is supposed to restrict the phenomenon of moral hazard[17]. The mechanism is supposed to lead to the fact that costs of bank insolvency shall be first borne by its owners (shareholders), and then creditors, whose debt shall be converted into capital.

Resolution authorities should have proper rights and tools to convert all eligible labilities of institutions into own capital as necessary and with respect to the hierarchy of creditors' claims. That is why the resolution strategies prepared for banks envisage recapitalizations in the form of bail-in, which is supposed to support the process of recovery or resolution of credit institutions in a way which ensures continuity of critical functions of such institutions[18]. The reduction of the scale of obligations of a rescued institution to creditors is supposed to improve the bank's financial condition and the vision of loss is supposed to prevent financing such institutions by lenders at non-market interest rates[19].

Image 7. Categories of liabilities in relation to the bail-in process



Source: author's conclusions based on: *European Covered Bond Fact Book,* ECBC, 2014, p. 61.

17 *Bail-in* is the opposite to the widely applied mechanism during the last financial crisis – bail-out, which consisted in the protection of credit institutions against insolvency using public resources.

18 *Key Attributes of Effective Resolution Regimes for Financial Institutions*, FSB, October 2014, p. 9, http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf

19 Bańbuła P., *Polityka makroostrożnościowa: przesłanki, cele, instrumenty i wyzwania*, NBP, Materiały i Studia nr 283, 2013, p. 73.

Shareholders and creditors will have to bear the losses of a failing institution and cover them to the size of at least 8 percent of all liabilities of a bank in resolution. Losses not covered in the above way may be financed from a resolution fund[20]. Creditors are ascribed losses based on the agreed sequence of satisfying claims. Bail-in does not apply to guaranteed deposits up to 100 thousand euro, secured bonds, liabilities connected with trusts, liabilities resulting from inter-bank operations with maturity dates up to seven days, liabilities to employees and commercial creditors, tax liabilities and the deposit guarantee system[21]. Therefore the application scope covering subordinated liabilities is very broad. All other ones, first of all subordinated debt – may be converted. If the law on resolution enters into force as of 1 January 2016, the bail-in mechanism may be applied only a year and a half later.

From the point of view of financing costs, it is worth noticing that the bail-in mechanism influences the profitability of debt instruments. In case of covered liabilities, further decrease of their profitability is probable, because just like guaranteed deposits they will be excluded from the bail-in mechanism, which considerably limits the risk for potential investors. What is more, existing signals flowing from rating agencies indicate to the possibility of raising rating assessments of issues rated below the AAA level[22].

On the other hand, in case of unsecured bonds, the bail-in mechanism proposed in the directive means that lenders will bear higher financial risk, because in the situation of a resolution of a credit institution, the debt shall be written down or converted into shares. Eligible liabilities may be recognized as a kind of a substitute of share capital because their role is supposed to be loss absorption in a situation of a financial institution. If investors assessed correctly the risk connected with such instruments, it is difficult to expect that they are willingly acquired by investors, when profitability is considerably lower than the required return from engagement in shares[23].

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20 Other rights of public authorities cover the possibility of sale or a merger of the bank during reorganization with another entity.

21 In accordance with the BRR directive natural persons and small companies with deposits over 100 000 euro shall be treated with preference ("depositor preference"). They will not be charged with losses before other creditors subject to protection, namely in the sequence of bail-in mechanism application they will appear in the last position. Member states in the framework of their flexibility margin may in some situations decide on a full exclusion of natural persons and small companies from this mechanism. Preferential treatment of depositors should influence a higher stability of depositors, which, from the point of view of a bank, will limit liquidity risk.

22 Marsh A., *Covered Bond Bail-in Benefit Prompts Moody's Ratings Proposal*, 2013.

23 For an issuing institution an incentive to use such instruments might still potentially be the tax issues, if payments for investors in the period before the bail-in were recognized as costs of gaining income.

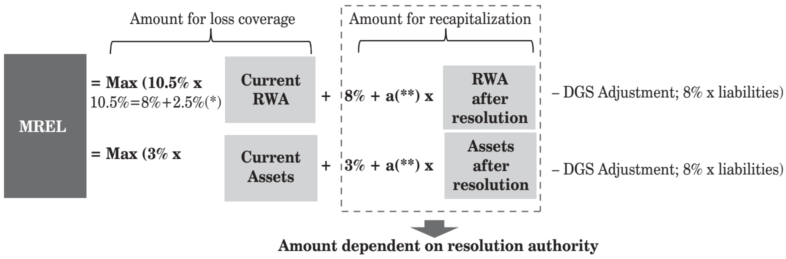
Due to reallocation of risk to creditors, further revision of ratings is expected for the issues of unsecured banks, which is visible by the way, in the changes which external rating agencies undertake in their procedures and rating assessments[24].

4.2. Minimum requirement of own funds and eligible liabilities – MREL

In order to avoid a situation in which institutions reorganize their liabilities in a way which restricts the effectiveness of the bail-in or debt conversion, the banks in the European Union will be obliged to fulfill the so called minimum requirement for own funds and eligible liabilities, MREL). The entities covered by the directive shall be obliged to maintain a minimum size of own funds and eligible liabilities in relation to the joint value of liabilities and own funds in case if the bail-in mechanism is to be applied. Such an approach is supposed to ensure that banks will have enough available capital in order to absorb loss and carry out effective recapitalization.

Based on Regulatory Technical Standards prepared by the European Banking Authority[25], MREL will be estimated for every bank (group of banks) separately, which will allow to account for individual features of a credit institution, namely the risk profile, business model, financing structure, systemic significance, resolution. Considering the fact that the resolution authority will have to deal with harmonized criteria as to MREL calibration, it is worth seeing the most important guidelines specified in RTS (image 8).

Image 8. Sample MREL calibration based on RTS criteria



Source: *EU loss-absorbing capacity requirement: final MREL guidelines*, BBVA, 2015, s. 5.

[24] *How A Bail-In Tool Could Affect Our Ratings On EU Banks*, S&P, 2012, May 10.

[25] *EBA Final Draft Regulatory Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU*, (EBA/RTS/2015/05).

First, the starting point to determine CRD are minimum capital requirements, including Pillar 2, the "supervisory floor" ("Basel 1 floor") and capital buffers resulting from the CRD pack IV[26]. It means that resolution authorities must implicitly rely on supervisory assessment of the loss level, which banks should be able to absorb and the capital level indispensable to continue activity[27].

Second, the component connected with recapitalization is supposed to serve two main purposes. After reorganization the bank must meet supervisory requirements in the scope of capital norms accounting for capital buffers and it must be considered reliable in the market. In effect, the bank after reorganization should maintain at least such a level of capital as before reorganization. For big banks, which shall be subject to the resolution process, MREL will be equal at least to a double amount of minimum capital requirements. On the other hand, for smaller banks which may be liquidated in the normal insolvency procedure, the recapitalization buffer will be equal to zero. The amount to carry out recapitalization will considerably depend on the resolution strategy preferred by the authorities.

Third, the resolution authorities must account for the scale in which the deposit guarantee system may participate in financing the resolution (DGS adjustment). The above criterion may appear relevant for banking systems, where the financial structure is based on clients' deposits.

What is more, the resolution authorities, while determining MREL, must account for the fact that resolution plans may entail certain categories of obligations which will be excluded from the resolution process. In such cases MREL should be corrected "upwards" in order to compensate the shortage of eligible instruments. What is more, in case of systemically important institutions (mainly G-SIBs and O-SIBs) the resolution authority should evaluate if the MREL level is sufficient to ensure that the conditions which allow for the use of resources from the resolution fund will be fulfilled (8 percent of shareholders' and creditors' own share). Due to high priority of the border point at the level of 8 percent pursuant to the BRR directive, it may be a benchmark for other credit institutions which are not identified as systemically important institutions.

Accounting for the rule of proportionality the systemically important banks, in accordance with the FSB guidelines, shall be covered with the above requirements. In their case MREL should be compatible with the Total Loss Absorbing Capacity buffer proposed by the Financial Stability Board. Contrary to TLAC, MREL shall

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[26] However, it should be noted that if capital requirements based on risk weighs are less binding for banks than the financial leverage ratio, then the amount absorbing loss shall be the amount resulting from the financial leverage ratio.

[27] In certain circumstances the resolution authorities can decide to correct them on account of the idiosyncratic risk of an institution, namely the size, the business model, the financing model and the bank risk profile. By the way, institutions which may be subject to the resolution process are awarded.

concern all banks acting in the territory of the EU and will be enforced as of 1 January 2016, although a transitional period is planned, which may last until 2020.[28]

4.3. Influence of resolution strategy on the placement of the TLAC/MREL buffer in a group

If the resolution authority states during the planning process that undertaking resolution is in public interest, then one of the key issues is the choice of the target resolution strategy and undertaking a feasibility study. In case of bank capital groups and bank holdings it has a dominating influence on the placement of MREL/TLAC within such structures[29]. FSB guidelines how to prepare effective recovery and resolution strategies distinguish two possible approaches to apply on the cross-border level.

(i) **Single point of entry (SPE)**, in which the powers and tools applied in the resolution process are implemented by the home resolution authority – both with reference to the controlling entity as well as dependent entities. This strategy is based on loss absorption on the highest consolidation level by write down or conversion of debt into capital issued by the home entity. Assuming that there is a sufficient LAC amount on the highest consolidation level in the bank group, dependent entities may continue their activity without the need to be subject to the resolution process.

(ii) **Multiple point of entry (MPE)**, in which the powers and tools applied in the resolution process are implemented by two or more resolution authorities (so also by the host country authorities) to several entities within the group (so also to dependent companies). Every entity within the group should have appropriate external LAC so that the bail-in tool may be applied on the level of every dependent entity.

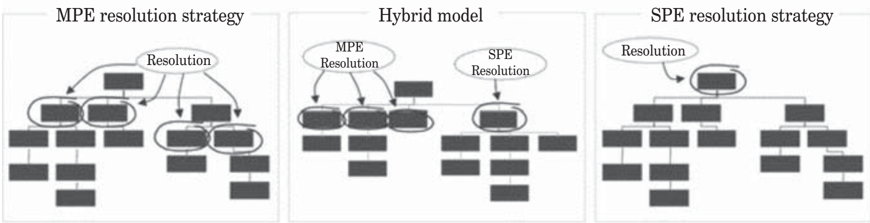
In the FSB consultancy document concerning the total loss absorbing capacity the so called external and internal LAC are distinguished. The external issue of capital and eligible liabilities debt is undertaken by an entity subject to the resolution mechanism or another recovery mechanism. The internal LAC issue is based on transactions within the group and it is carried out by relevant dependent

28 Specifying a minimum standard by FSB (Pillar I) is one of the main differences in relation to the EBA approach. The European authority assumes that supervisory authorities and the resolution authorities are responsible for ensuring equal conditions of work for all entities subject to the regulation by establishing a minimum MREL level separately for every group of banks. That is why MREL in Europe may be fully treated as Pillar II requirement due to the fact that there is no common requirement in Pillar I.

29 Due to the fact that MREL and TLAC are mostly compatible, further in this work the Author shall use the abbreviation LAC.

companies[30], which are directly subject to the resolution mechanism. The above solution is to serve mutual trust between the home and the host supervisors.

Image. 9. Resolution strategies



Source: http://european-economy.eu

The location of the loss absorption buffer within a group, as well as its form should be fully adjusted to a given resolution strategy (MPE, SPE). The choice of the internal group resolution strategy shall bear considerable consequences for dependent companies. When applying the SPE approach, the external LAC issue will have to be carried out by the controlling entity, which will later on transfer the capital down the organizational structure with the support of balance instruments or secured guarantees (internal LAC). It should be emphasized, however, that the internal LAC should be placed only in dependent companies with a relevant meaning for the group. In the MPE model the external LAC is required from every relevant dependent entity, which is the resolution or sub-group entity, but not at the consolidated level[31]. Nevertheless the "relevance" logic in the MPE model is a little bit different, because it assumes that the dependent companies, which play an important role in the local market (e.g. D-SIBs) should be entities which are directly subject to the resolution process and by the same token they can carry out external LAC issues regardless of their significance in the group. What is more, in the framework of MPE approach the LAC requirement in every point of entry should be based on the rules of the system shaped by a resolution authority from the home country, which also applies in relation to other institutions acting in the local market. Therefore the internal LAC is no more compatible with the MPE model.

30 The internal TLAC shall cover subsidiares which fulfill at least one of risk or size criteria: more than 5 percent of group RWA more than 5 percent of group revenue, more than 5 percent of the group leverage, significance for performing critical functions of the company.

31 The subgroup is composed of units, out of which one is the unit, to which the resolution mechanism is applied and all direct and indirect dependent entities, which are not subject to resolution or entities depending on a different entity subject to the resolution mechanism.

Table. 2. Differences between SPE and MPE

	SPE	MPE
Point of entry	Controlling company – insolvency of a consolidated group	Dependent company – insolvency of a dependent company
Entity authorized to carry out resolution	Home country resolution authority	Host country resolution authority
Roles of Authorities	Home – global executive authority Host – secondary executive authority	Home – coordinator/local executive authority Host – local executive authority
Loss/bail-in	Losses transferred to the controlling company/obligatory financial support addressed to a dependent company	Losses on a local level – voluntary support of the controlling entity
External LAC	On the level of the controlling company	On the individual level
Legal/ organizational structure	Department/dependent unit	Dependent unit
Operational services	Decentralized, but independent	Decentralized – the units are operationally independent

Source: own work based on the TLAC consultancy document.

The choice between the MPE and SPE approach depends on particular features of cross-border institutions (size, interconnectedness, legal structure and the scope and level of complexity of the activity carried out by the company). The MPE Model fits the institutions whose business model is based on traditional retail banking, which have a big share of deposits in the structure of assets and act in the form of dependent companies with a high operational independence. The SPE model is applicable to strongly integrated entities, with a harmonized risk management system, generously financed in the wholesale market (by the controlling entity) and based on the internal group support. Practically it is possible to apply a combination of such strategies, as much adjusted to the specifics of the group as possible.

5. TLAC/MREL INFLUENCE ON THE COSTS OF FINANCING POLISH BANKS

In relation to organized bank groups acting as local subsidiares it is possible to apply various and independent recovery and resolution strategies by home resolution authorities. What is crucial, the nature and the scope of exposure in the framework or the group is strictly connected with the assumed resolution strategy. In the MPE model the mutual exposures practically do not exist or have a market nature, because their share in the form of a debt subject to write-down would bear a risk of infecting other units within the group. Whereas with the SPE approach, exposures of this type make the strategy pillar, because thanks to the purchase of eligible debt issued by the controlling entity, internal bail-in becomes possible and in consequence it may lead to the reresolution of the controlling entity.

The above solutions naturally beget questions what resolution strategies will be adopted with reference to cross-border bank groups which are composed of Polish subsidiares. As already mentioned the assumed strategies will determine the type (external vs. internal) and LAC locations within the group.

Considering that the Polish subsidiares are covered by BFG guarantees and their main clients are households and enterprises, the liquidity and capital management happens on the local level, the banks are characterized with a high degree of financial independence and the support inside the group is not systemic, the MPE approach seems to be more suitable. The scenario of adjustment of the MPE strategy would also fit in the supervisors' expectations, who perceive the local financing and proper capitalization of dependent entities as more and more important.

The MPE approach bears a lot of consequences in the scope of resolution. Most of all, the MPE strategy basically does not envisage meaningful exposures inside the group, so almost every independent entity within the group which may be subject to the resolution procedure must have an adequate loss-absorbing capacity resulting from its activity. In consequence, the biggest problem with the MPE approach for the banks defined as resolution entity may appear to be the fulfillment of the LAC requirement on the individual level, by a share capital issue or issue of another uncovered debt for external investors. The problem may be particularly troublesome in poorly developed countries, local capital markets and it may refer mainly to deposit banks with relatively lower ratings. It may be assumed that such banks, unable to carry out new issues of qualified debt, will be forced to meet the LAC requirement by the issue of a share capital and/or limitation of a dividend, which will influence the general increase of financing costs. In result it may lead to an increase of systemic risk, because the banks with deficits may try to compensate the financing costs increase by engaging in riskier yield searching strategy.

They account for a very low share of uncovered debt securities in the liabilities of Polish Banks and the shortage of eligible instruments may be disproportionately higher than the shortage in 128 European banks participating in the research presented by EBA (0.1–0.2% assets)[32].

Although the decentralized MPE model is advantageous from the point of view of financial stability[33] and fits better in the business model of Polish banks, from the point of view of G-SIBs it may appear less attractive than SPE. The decentralized model is recognized as less effective in terms of capital and liquidity management and its application does not require obtaining more capital and debt, which is subject to conversion in the whole group (additionally with a relatively higher cost), which leads to a failure in the use of the synergy effect inside the group. The above factors may lead to a situation, in which the bank transnational groups will be more willing to deploy an SPE type strategy, based on which the parent entities must have the internal LAC in required quantity and quality, because potential losses are shifted to a higher level within the group, whereas the capital and liquidity support is provided to dependent entities by parent entities.

Adopting the SPE strategy by resolution authorities with reference to G-SIBs would mean that the Polish subsidiares would have to fulfill the internal LAC requirement in the amount of 75–90 percent of the minimum LAC requirement of I Pillar (respective division borders will be established based on QIS)[34], because some of them exceed the relevance threshold.

The amount of the internal loss absorbing buffer should be located based on balance transaction, if the home-host agreement between resolution authorities does not stipulate otherwise[35]. Then, in order to distribute funding and the loss absorption capacity in the group, the resolution entity (based on the model – holding company) invests in the internal LAC issued by operational authorities. Next, the resolution entity issues instruments in the market, possibly based on operations consistent with internal group regulations[36].

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32 *EBA Final Draft Regulatory Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU, (EBA/RTS/2015/05).*

33 The present experience indicates that the potential of the SPE model may be too highly idealized. During the last financial crisis many situations were observed, in which the cooperation between departments and parent institutions mainly accounted for the interest of controlling entities. That is why in many jurisdictions the regulatory authorities were more friendly to the model of foreign bank activity in the form of subsidiares. Home supervisory authorities have little trust in the activity of foreign banks in the form of branches, which leads to doubts if the home authorities will be ready to accept the strongly integrated SPE model, which is based on a deep trust between the resolution authorities of various countries. Fiechter J., Otker-Robe I., Ilyina A., Hau M., Santos A., Surti J., *Subsidiaries or Branches: Does One Size Fit All?*, IMF Staff Discussion Note, 7 March 2011: chapter II).

34 The real value within the range shall be specified by a resolution authority of the host nation, which will also consult this decision with a home country resolution authority.

35 *Key Attributes…, op.cit.*

36 With reservations of specific conditions the home and host authorities, which make up the *Crisis Management Group, CMG*) may undertake a common decision admitting a replacement

When analyzing the advantages of the SPE model from the point of view of its influence on profitability of Polish banks it should be emphasized that it might limit the necessity to carry out huge issues of eligible liabilities with reference to external investors. However, a lot will depend on whether the above mentioned off-balance sheet instruments in the form of secured guarantees shall be applicable in practice. If relevant subsidiares are obliged to issue classical on-balance sheet instruments with reference to controlling entities, savings in terms of financing costs will be low (compared to the MPE strategy). Whereas it should be remembered that with the SPE approach a relevant increase is expected between the controlling entity and the dependent entity, which in consequence may lead to the increase in concentration and systemic significance.

The application of a hybrid strategy may not be excluded either. Then in key jurisdictions, in which G-SIBs operate demonstrate a high level of activity and operational integrity might be subject to resolution with the application of rules resulting from the SPE approach. Whereas operationally independent entities in other jurisdictions might be subject to an MPE based resolution.

6. SUMMARY

New regulatory proposals in the scope of capital buffers which allow for effective undertaking of the resolution process constitute the next solution established on the international level, which is a part of the trend of strengthening banks' capital position. Although the structure of the Total Loss Absorption Capacity is not much different from the proposal presented by EBA (MREL), both initiatives will imply the necessity to issue many eligible instruments, which may be relevant in terms of costs of bank financing.

The structure of the loss absorbing buffers will be the strongest, and by the same, token the most transparent transmission channel of financial effects of the BRR directive on banks. Whereas LAC obliges financial credit institutions to maintain a certain level of financing in the form of eligible liabilities, it should be expected that in case of many institutions it will be necessary to change the financing structure, which may be reflected in the funding costs eventually.

The solutions proposed by FSB are indisputably important for credit institutions acting in the Polish market and they are subsidiaries in relation to cross border bank groups. The banks whose owners are foreign groups had over 60 percent of assets of the Polish banking sector at the end of 2014. The owners of eight domestic

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of the internal LAC made of balance positions covered with guarantees. Also in certain specific cases the capital instruments, which are parts of Tier I and Tier II capital acquired by outside investors may be included in the internal TLAC requirement.

banks are controlling entities on the G-SIBs list. It means that certain relevant subsidiaries will have to maintain additional capital buffers. The level and the type of loss absorbing buffer (internal vs. external), will mostly depend on the resolution strategy assumed by the authorities. In case of banks controlled by domestic investors, MREL will be appointed in accordance with indicated risk criteria by the Polish resolution authority, whereas banks of systemic importance can expect that this requirement may amount to 8 percent of liabilities or even double the capital requirement (with respective buffers). Whereas small institutions, which may be liquidated in normal insolvency procedure, will not be subject to resolution and by the same token they will not have to have the loss absorption and recapitalization capacity.

From the point of view of the whole banking sector it should be assumed that the introduction of TLAC/MREL in proposed quantities leads to a considerable increase of demand for capital, both own capital as well as the debt (especially long term) capital in the European market. The LAC requirement in a way penalizes credit institutions which have traditional banking based on retail deposits. For such banks LAC will create a conflict risk between prudential policy and the resolution policy by encouraging deposit based banks to issue debt and artificially increase leverage[37].

Banks which finance their activity with traditional deposits will have to redirect the financing model even more to uncovered debt instruments, which are classified under Total Loss Absorption Capacity. It means a high supply of capital instruments with a limited demand for such instruments, which may impede the ability to obtain capital quickly and at a good price.

Due to the necessity to reorganize the capital structure, this factor in the average period will probably add to the general increase of financing costs for banks, but in the longer run it will have a positive influence on their stability, and by the same on the risk assessment by investors. In case of the Polish banking sector the BRR directive may constitute an additional incentive of a longterm development of the securities market. On the one hand the potential drop of interest rates on mortgage bonds should encourage banks to higher diversification of sources of funding based on these types of instruments. On the other hand the minimum MREL requirement will impose a pressure on the issue of eligible liabilities.

However it should be noted that the practice of resolution is at nascent stage in Europe, whereas in Poland no proper legislative solutions have been introduced

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37 This adverse effect may be mitigated to a certain degree, because RTS enables resolution authorities to reduce MREL by accounting for an estimated contribution from the deposit guarantee system. In case of Poland this factor may appear important, because the main source of financing home banks are guaranteed deposits and the deposit guarantee system belongs to the most capitalized ones in Europe.

so far in this area. It means that until the resolution authority determines MREL, Polish institutions will run their activities with a high level of uncertainty. This is why banks should aim at a maintenance of relatively high capital buffers (also composed of debt instruments) in order to anticipate future trends in the scope of regulatory solutions, as well as to avoid the necessity to undertake a sudden capitalization process at unattractive prices.

Abstract

The recent financial crisis had a turbulent onset when professional institutional investors decided to withdraw their funding from banks, sparked by fear of credit losses and unmanageable capital requirements in, most notably, the investment portfolios of these banks.

In recent years regulators developed a comprehensive set of reform measures aiming to improve the banking sector's ability to absorb shocks arising from financial and economic stress, improve risk management and governance, strengthen banks' transparency and disclosures.

At the same time, steps were taken to better prepare for the event of a gone concern situation: recovery plans and resolution plans were drafted by banks and regulators respectively. For G-SIBs, on top of these plans, additional loss absorbing capacity is needed to ensure that, in case of a default, these financial institutions can be resolved in an orderly manner without taxpayer support.

The purpose of this article is to present recent regulatory initiatives in the field of loss-absorbing capital buffers and their impact on banks' capital structure and cost of financing.

Key words: capital buffers, capital management, TLAC, MREL, bank resolution and recovery, capital requirements, banking regulations, G-SIBs, financial safety net, costs of financing banks

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