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# G20 likely to raise capital requirements for global banks in "TLAC" proposal

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# Overview

Financial institutions should remain on high alert as global regulators advance towards proposing new requirements that will significantly affect the capital structures of global systemically important banks (**G-SIBs**). The Financial Stability Board (**FSB**) is poised to release its long-anticipated proposal on "total loss-absorbency capacity" (**TLAC**) at the upcoming G20 Leaders' Summit in Brisbane, Australia on November 15-16, 2014. According to FSB Chairman Mark Carney, the Summit will "mark the end" of fundamental reforms of the global financial regulatory architecture in response to the 2008 financial crisis.[1]

While details of the proposal remain sketchy, it is expected to contain three major components:

- A range for the size of the minimum TLAC requirement (16-20% of risk-weighted assets (**RWA**) or at least twice the Basel III RWA requirement excluding all buffers, and 6-8% of total assets or at least twice the Basel III leverage capital requirement);
- Criteria for the types of capital instruments eligible to fulfil the minimum TLAC requirement; and
- Requirements relating to the distribution of TLAC among the entities within a G-SIB group.

In the interest of containing the ripple effects of future bank failures, the proposal is also expected to contain "disincentives" for G-SIBs to hold capital instruments representing part of one another's TLAC.[2]

The TLAC proposal is not expected to be finalized by the FSB until 2015, at which point national governments will be called upon to adopt the measures in anticipation of planned final implementation by 2019. Nevertheless, G-SIBs should begin to evaluate the effects of the TLAC proposal on their capital strategy and recovery and resolution plans. Other financial institutions should also consider how the actions of G-SIBs could affect capital markets and their own capital planning, as it remains unclear how much of the TLAC proposal will eventually "trickle down" to smaller, non-G-SIB banks.

# How TLAC will work: SPOE, internal TLAC, and other acronyms

TLAC replaces the concept of "gone-concern loss-absorbency capacity" (**GLAC**) as the proposed method of "topping off" the capital structure that G-SIBs will be required to maintain as part of the Basel III framework.[3] At the same time, TLAC is conceptually distinct from traditional "going-concern" capital requirements, which are designed to absorb losses and protect an institution against insolvency. Instead, TLAC is intended to ensure that a bank group maintains sufficient consolidated resources not only to reduce the likelihood of insolvency but also to allow for orderly resolution and recapitalization of insolvent operating subsidiaries in the event of a banking group's insolvency. Ultimately, regulators hope that TLAC will facilitate any future resolution of large financial institutions and help to eliminate the so-called "too-big-to-fail" problem without recourse to public funds and direct taxpayer bailouts.[4]

## UNITED STATES

In the United States, banking regulators view TLAC as a key component of the "single point of entry" (**SPOE**) resolution strategy articulated by the Federal Deposit Insurance Corporation (**FDIC**) with respect to large banks and large bank holding companies (**BHCs**).[5]

The SPOE strategy relies on a structural feature of large U.S. banking groups whereby operating subsidiaries (*e.g.*, insured depository institutions, broker-dealers, *etc*.) are held by a top-tier BHC that engages in only limited business activities. A BHC's assets typically consist exclusively of cash, liquid securities (*e.g.*, Treasuries), and debt and equity interests in its various subsidiaries. A BHC's debt and equity claims on its subsidiaries are structurally subordinated to its subsidiaries' direct liabilities to third parties, meaning that customers and creditors of an operating subsidiary do not face losses until the parent BHC's debt and equity claims against its operating subsidiary are exhausted. The TLAC proposal is intended to reinforce this buffer by requiring G-SIB BHCs to have outstanding at all times a minimum amount of equity and long-term unsecured debt that is explicitly subject to "bail-in"[6] in order to interpose an additional layer of capital to shield creditors and customers of their operating subsidiaries from loss.

The write-down of BHC equity and the bail-in of holders of long-term debt, however, will not *ipso facto* result in the recapitalization of a BHC's operating subsidiaries. Thus, the TLAC proposal will reportedly include requirements for the "pre-positioning" of "internal TLAC," *i.e.*, debt or equity extended by a BHC to its operating subsidiaries that can be cancelled, written down, or converted in case of financial emergency and thereby serve to inject capital into those subsidiaries. A BHC also must pre-position TLAC with its "resolution entities," *i.e.*, the top-tier companies for its material operating "silos," and each resolution entity must pre-position internal TLAC with the material subsidiaries in its intramural group. Internal TLAC must have contractual triggers or be subject to statutory provisions that would enable a cross-border recapitalization to proceed rapidly and predictably, notwithstanding local differences in insolvency law and resolution tools.

The benefit of this approach is that the resolution can be effected at the level of the BHC rather than its operating subsidiaries, avoiding the inevitable financial or operational disruption that would occur were an operating bank or major operating subsidiary to be put into resolution.

## UNITED KINGDOM/EUROPEAN UNION

In the United Kingdom, the Bank of England continues to believe that an SPOE resolution strategy represents the optimal structure to achieve resolution with minimal financial and operational disruption to operating banks. Authorities elsewhere in Europe have been less vocal on the topic, and European banks, unlike U.S. and UK G-SIBs, generally do not start with a BHC structure. The move to a BHC-style structure to enable an SPOE strategy would represent a fundamental change to funding, and in some cases corporate, structures for a number of banks, imposing considerable transitional costs. In addition, a number of non-U.S. banks operate along nationally subsidiarised lines, with more-or-less independent subsidiaries. Such banks are expected to be resolved along national lines under a multiple point of entry (**MPOE**) resolution strategy. It is expected that banks that adopt an MPOE strategy will be pressured into creating national holding companies, so as to obtain the resolvability benefits of the SPOE structure at the local level.

The European Bank Recovery and Resolution Directive (**BRRD**),[7] in the context of its provision for bail-in powers, requires member states to impose on European banks a minimum requirement for eligible liabilities (**MREL**). The BRRD states that MREL is to be calculated as the sum of a firm's own funds (*i.e.*, its capital) and liabilities that are eligible for bail-in (subject to certain conditions), expressed as a percentage of the firm's total liabilities and own funds. In addition, the European Banking Authority (**EBA**) is tasked with drafting regulatory technical standards specifying the criteria by which the amount of MREL to be required of each firm is to be assessed. While the conditions that must be satisfied for instruments to count as MREL overlap with the FSB's reported conditions for TLAC, the difference in the denominator (*i.e.*, total liabilities as opposed to RWA) gives rise to a number of uncertainties for European G-SIBs and European subsidiaries of non-European G-SIBs. Other key differences are that the BRRD does not explicitly require that any portion of MREL be met by subordinated debt, nor does it treat Basel III capital buffers as separate and additional requirements. It is understood that the European authorities do not intend for MREL and TLAC requirements to be imposed simultaneously, and, indeed, the EBA has expressed the view that the FSB's TLAC requirements should be capable of being implemented in Europe via secondary legislation under the BRRD, without amendment to the BRRD. However, this view appears difficult to reconcile with the text of the BRRD.

# The significance of the TLAC proposal to global banks

Until the TLAC proposal is released and the details regarding permissible instruments, convertibility criteria, and quantitative limits on the use of particular instruments are known, it will be difficult to assess with any certainty the effects of the TLAC proposal on the balance sheets of individual G-SIBs. For example, a "long-term" debt instrument will reportedly include any instrument with a maturity of more than one year, which raises several related questions:

– Will qualifying debt instruments be subject to a haircut or other quantitative limits as their maturity shortens and approaches one year?

– If qualifying debt instruments include a call option that can be exercised by the issuer (with supervisory approval) before roll-off, what will be the price?

– Will certain debt instruments be grandfathered, or will other transitional measures be applied?

Another set of issues concerns the specific levels of TLAC that will be required and the restrictions that may be placed on the use of specific types of capital instruments. To name but a few:

– Published estimates of the TLAC shortfall of G-SIBs in the aggregate range widely, from USD237-870 billion (GBP147-540 billion), based primarily on the specific percentage requirements.[8] How much capital must G-SIBs actually raise, and how soon to satisfy market expectations?

– The "stacking" of TLAC and other Basel III requirements may significantly influence the type of capital instruments that a G-SIB issues to meet its TLAC requirement. For example, it is expected that Tier 1 common equity that is used to meet a G-SIB's capital conservation and countercyclical buffer requirements (which may constitute up to 5% of its RWA) may not be included as part of its

TLAC. This may incentivize G-SIBs to meet as much of their TLAC requirements above their Basel III minimum capital requirements (which may be included as part of their TLAC) with subordinated debt, in order to preserve their Tier 1 common equity for their buffer requirements.[9]

– G-SIBs with higher levels of Tier 1 common equity may be whipsawed if the TLAC includes minimum requirements for the percentage of subordinated debt or other capital instruments that do not satisfy other Basel III regulatory capital requirements. Pillar 2 TLAC requirements may also be imposed on G-SIBs based on their individual characteristics.

– The ability of G-SIBs to issue TLAC-compliant debt, and the cost to do so, may also be affected by restrictions on cross-ownership by other G-SIBs, and by how those restrictions affect underwriting and market-making activities.

– What role, if any, will guarantees to provide resolution funding be permitted to play?

The coordination of cross-border resolution activities by a global organization that raises capital and is subject to insolvency regimes in multiple jurisdictions raises issues of its own, which the FSB has sought to address in a report it issued alongside its TLAC proposal.[10]

The resolution of these issues may determine whether the effect of TLAC for a particular institution ranges from being a nuisance tax to being another, substantial G-SIB surcharge.

# A more modest proposal?

TLAC would be another layer on top of the other, numerous capital requirements to which G-SIBs are now subject. Those requirements and other reforms, such as capital stress testing, are intended to ensure that G-SIBs maintain sufficient capital and liquidity at all times to minimize the risk of transmission of financial distress to financial and non-financial institutions, even during periods of extreme financial instability. In view of those efforts, how large an additional requirement is appropriate, and how much flexibility should individual organisations be permitted in how they prepare for an event of insolvency that should be rendered highly remote by other Basel III requirements and for a resolution exercise that is untested and largely hypothetical?

The TLAC proposal also may not sufficiently take into account the structural differences among G-SIBs, which affect the relative difficulty of recapitalization efforts.

– Should a G-SIB that is able to fund itself in multiple local markets at relatively low cost be required to replace some of that diverse funding with higher cost funding at the parent level in order to conform with the SPOE model?

– In the United States, how well can the TLAC requirement of top-tier loss absorbency be coordinated with the requirement of the U.S. Board of Governors of the Federal Reserve System (**Federal Reserve**) that non-U.S. banks with large U.S.-domiciled banking and non-banking operations place those operations under an intermediate holding company that is intended to be funded relatively independently from its parent company?[11]

– For international organisations, how far will host regulators permit TLAC to be retained at the home jurisdiction, given the risk that the home jurisdiction does not make the TLAC available at the point of resolution?

– Is a consolidated measure for TLAC appropriate for an MPOE resolution strategy at all, given that such an organization will be resolved as a collection of local banks rather than as a single group?

Further, the legitimate interests of investors in certainty as to where they stand in the creditor hierarchy need consideration. Resolution within a banking group involves substantial discretion on the part of resolution authorities to allocate losses to stakeholders within the group, and the outcome may be inconsistent with the creditor hierarchy or “waterfall” that would ordinarily apply in the event of a G-SIB’s insolvency.[12] The exercise of discretion by resolution authorities means uncertainty for investors, which will result in increased funding costs and a less efficient banking system. The introduction of the TLAC regime should be used as an opportunity to provide greater certainty to creditors as to their standing.

# Conclusion

The wide array of potential consequences that are packed in the FSB’s impending TLAC proposal merit close attention by G-SIBs and by other financial institutions that may be affected by their response. When TLAC is proposed nationally for implementation, beginning in 2015, the costs and benefits of compliance should garner a significant volume of comments and close analysis.

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# Endnotes

[1] Mark Carney to G20 Finance Ministers and Central Bank Governors, "Financial Reforms—Completing the Job and Looking Ahead" (15 Sept. 2014), available at http://www.financialstabilityboard.org/publications/r_140921.pdf.

[2] Huw Jones, "Top Global Banks Face 16-20 PCT Combined Capital Buffers—G20 Draft" (Thomson Reuters, 11 Sept. 2014), available at http://www.reuters.com/article/2014/09/11/g20-banks-capital-idUSL5N0RC42X20140911.

[3] While GLAC would consist solely of debt instruments that would be converted to equity at or near the point of the issuer's insolvency and would not count toward meeting its Basel III regulatory capital requirements, TLAC would include both debt and equity instruments, which may also count toward meeting its Basel III minimum capital requirements (but not its capital conservation or countercyclical buffer requirements).

[4] *See* U.S. Secretary of the Treasury Jacob J. Lew, "Remarks of Secretary Jacob J. Lew at G-20 Press Conference" (21 Sept. 2014) ("[T]he largest economies of the world have taken the next step towards eliminating the risk that any firm is too big to fail by coming to a broad consensus on total loss absorbency capacity. This important standard will help facilitate the orderly resolution of systemically important banks, and protect taxpayers from bearing the burden of any global bank's failure."), available at http://www.treasury.gov/press-center/press-releases/Pages/jl2643.aspx.

[5] *See* FSB, "Progress and Next Steps Towards Ending 'Too Big to Fail' (TBTF)" (2 Sept. 2013) ("An adequate amount of [TLAC] should facilitate the implementation of a resolution strategy with a recapitalisation at a level that promotes market confidence and, at a minimum, meets going-concern regulatory capital requirements."), available at http://www.financialstabilityboard.org/publications/r_130902.pdf; Remarks by Governor Daniel K. Tarullo of the Federal Reserve, "Evaluating Progress in Regulatory Reforms to Promote Financial Stability" (3 May 2013):

> There is clear need for a requirement that large financial institutions have minimum amounts of long-term unsecured debt that could be converted to equity and thereby be available to absorb losses in the event of insolvency. . . . Debt subject to this kind of bail-in would supplement the increased regulatory capital in order to provide greater assurance that, should the firm become insolvent, all losses could be borne using resources within the firm. This requirement for additional 'gone concern' capital would increase the prospects for orderly resolution and, thereby, counteract the moral hazard associated with expectations of taxpayer bailouts.

Available at http://www.federalreserve.gov/newsevents/speech/tarullo20130503a.htm.

[6] In a bail-in, holders of long-term unsecured debt are required to forfeit a portion of their claims or accept their conversion into Tier 1 common equity before other creditors with similar claims suffer losses or taxpayers are called on to bail-out the creditors. *See* Financial Times Lexicon, available at http://lexicon.ft.com/Term?term=bail_in.

[7] 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.

[8] John Glover and Jim Brunsden, "Too-Big-to-Fail Banks Face Up to $870 Billion Capital Gap" (Bloomberg, 16 Oct. 2014), available at http://www.bloomberg.com/news/2014-10-13/too-big-fail-banks-seen-facing-capital-gap-of-up-to-870-billion.html.

[9] G-SIBs and other banks that fail to meet their combined buffer requirements will face a series of mandatory restrictions on their ability to pay dividends, redeem capital, and make discretionary payments to staff (such as bonuses).

[10] *See* Financial Stability Board, *Cross-Border Recognition of Resolution Action—Consultative Document* (29 Sept. 2014), available at http://www.financialstabilityboard.org/publications/c_140929.pdf.

[11] *See* Federal Reserve, "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations," 79 Fed. Reg. 17240 (27 Mar. 2014), available at http://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf. In the notice of final

rulemaking, the Federal Reserve addressed commenters' concerns that its rule would prevent foreign banking organizations from managing capital and liquidity on a centralized basis. In response, the Federal Reserve noted:

> A firm that relies significantly on centralized resources may not be able to provide support to all parts of its organization. The Board believes that the final rule reduces the need for a foreign banking organization to contribute additional capital and liquidity to its U.S. operations during times of home country or other international stresses, . . . Finally, the Board notes that requiring foreign banking organizations to maintain financial resources in the jurisdictions in which they operate subsidiaries is consistent with existing Basel Committee agreements and international regulatory practice.

79 Fed. Reg. at 17266-17267. *See also* Allen & Overy LLP, "Federal Reserve Takes Aggressive Position on Non-U.S. Banks" (Feb. 2014), available at http://clientlink.allenovery.com/images/Allen_%26_Overy_LLP_eAlert_February_2014.pdf.

[12] Indeed, regulators have recognized the difficulties of devising a mechanism that would allocate bail-in losses between long-term, vanilla unsecured bonds and derivatives and other liabilities that are less reliably loss-absorbing in a manner that is straight-forward, well understood, and not subject to legal challenge that would destabilize the intended resolution. *See* Speech by Andrew Gracie, Executive Director for Resolution of the Bank of England, "Making Resolution Work in Europe and Beyond – The Case for Gone Concern Loss Absorbing Capacity" (17 July 2014), available at http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech749.pdf.

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