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Association for Financial Markets in Europe

AFME Briefing Note: Total Loss-Absorbing Capacity (TLAC)

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This briefing note summarises the final Financial Stability Board ("FSB") Principles and Term Sheet on Total Loss Absorbing Capacity ("TLAC")[1] and highlights key changes since the original proposal prior to the consultation and QIS. [2] The TLAC standard establishes a set of principles and a term sheet which sets out the minimum requirements agreed by the G20.

Purpose

The purpose of TLAC is to set a minimum requirement for loss absorbing and recapitalisation capacity for Globally Systemically Important Banks ("GSIBs")[3]. This requirement builds upon the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions.[4] TLAC should support the resolution strategy for the bank and ensure that it has the resources to facilitate its orderly resolution, minimising the impact on financial stability without taxpayers bearing losses.

TLAC has been described as the final piece in the global bank resolution framework and in his recent letter to the G20, Mark Carney, Chair of the FSB stated that "the FSB has now finalised the tools needed to end "Too Big To Fail" in the banking sector."[5]

Scope

The FSB TLAC requirements apply to all GSIBs. Banks which are designated as GSIBs between 1 January 2016 and 31 December 2018 (and are not headquartered in emerging markets) are subject to the minimum TLAC requirements from 1 January 2022. GSIBs designated thereafter must meet minimum TLAC requirements within 36 months of their designation.

GSIBs headquartered in emerging market economies (e.g. China) are subject to a longer phase-in period (see below).

Calibration

TLAC will be set on a firm-specific basis, but subject to minimum requirements. These include a minimum "external TLAC" which applies at each "resolution entity" within a GSIB group and requirements for "internal TLAC" in the form of intra-group liabilities to certain subsidiaries in the group.

Resolution entities are those (one or more) entities in the group to which resolution tools such as bail-in would be applied under the resolution strategy.

The minimum external TLAC requirement is:

- from 1 January 2019: 16% RWAs and 6% of the Basel III leverage ratio denominator; and

[1] See http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf. Unless otherwise specified, references to paragraphs in this note are to references to paragraphs of the term sheet.
[2] This note provides an overview of the key requirements but does not address every requirement. It also only summarises the FSB standard and does not address national implementation requirements.
[3] See http://www.financialstabilityboard.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf for a list of GSIBs.
[4] See http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf
[5] See http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chairs-letter-to-G20-Leaders-9-Nov.pdf

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- from 1 January 2022: 18% RWAs and 6.75% of the Basel III leverage ratio denominator.

For GSIBs headquartered in emerging markets, there is a longer phase-in period with the 16% RWAs and 6% leverage ratio requirement applicable from 1 January 2025 rising to 18% RWAs and 6.75% leverage ratio from 1 January 2028. The term sheet provides that this conformance period will accelerate in certain circumstances and is subject to review in 2019.[6]

Capital buffers such as the GSIB surcharge, capital conservation buffer and counter-cyclical capital buffer are required to be met on top of the RWA TLAC requirements. Accordingly the total capital and loss absorbing capacity requirements for a GSIB are likely to be significantly higher. A chart showing the total minimum requirements is set out in the annex to this note.

The minimum requirement for a resolution entity is based on the consolidated balance sheet of the resolution entity and its direct and indirect subsidiaries (termed a "resolution group") that are not other resolution entities or part of another resolution group.

For GSIBs with more than one resolution group (i.e. GSIBs with a multiple point of entry resolution strategy), the consolidated balance sheet of each resolution group should be calculated inclusive of exposures to entities in other resolution groups and where those exposures relate to TLAC, they will be deducted from TLAC. The deduction also applies to exposures to external TLAC issued from a resolution entity to a parent that is also a resolution entity.

However, it was clarified in the final term sheet that for GSIBs with more than one resolution group, if the sum of minimum TLAC requirements of the resolution entities is greater than the minimum requirement that would apply if the GSIB had only one resolution entity, the GSIB's Crisis Management Group ("CMG") should discuss and "where appropriate agree an adjustment to minimise or eliminate that difference".[7]

Relationship with capital requirements

TLAC is an additional requirement to minimum regulatory capital requirements. Capital that counts towards satisfying capital requirements may also count towards satisfying TLAC requirements (subject to certain conditions), but Basel III regulatory capital buffers must be met on top of the TLAC minimum RWA requirement, allowing buffers to be utilised without breaching TLAC.

The term sheet provides that there is an "expectation" that at least 33% of a GSIB's minimum TLAC requirement is met through debt liabilities (including capital in the form of debt) as opposed to equity.[8] It is uncertain how this provision will be implemented in different jurisdictions.[9]

Eligibility for TLAC

Capital counts towards TLAC requirements provided that it meets certain additional conditions.[10] There is greater flexibility to include existing capital which is not directly issued by a resolution entity towards TLAC until 31 December 2021.

Other (non-capital) TLAC-eligible instruments, and from 1 January 2022, all instruments (including capital), are subject to a number of eligibility criteria, including that they:[11]

[6] See paragraph 21.
[7] See paragraph 3.
[8] See paragraph 6.
[9] The US Federal Reserve has issued a proposal which includes a minimum level of long-term debt.
[10] See paragraph 6.
[11] See paragraphs 7 to 10.

a) are issued directly by resolution entities, subject to certain exceptions;[12]
b) are unsecured, paid in and not subject to set-off or netting rights that would undermine loss absorbency in resolution;
c) have a minimum remaining maturity of at least one year (or are perpetual);
d) are not redeemable by the holder prior to maturity[13] ;
e) are not funded directly or indirectly by the resolution entity or a related party, unless agreed by the relevant home and host authorities;
f) are subject to the law of the jurisdiction in which the resolution entity is incorporated, or if not where the application of the resolution tools is effective and legally enforceable;
g) contain a contractual trigger or are subject to a statutory mechanism which permits the relevant resolution authority to effectively write it down or convert it to equity in resolution.

Additionally, the following instruments are excluded from TLAC ("Excluded Liabilities"):

a) insured deposits, sight deposits and deposits with an original maturity of less than one year;
b) liabilities arising from derivatives;
c) debt instruments with derivative-linked features, such as structured notes;
d) liabilities arising other than through a contract eg tax liabilities;
e) liabilities that are preferred to senior unsecured creditors under the relevant insolvency law; and
f) any liabilities that, under the laws governing the issuing entity, are excluded from bail-in or cannot be written down or converted into equity by the relevant resolution authority without giving rise to material risk of successful legal challenge or valid compensation claims.

The term sheet provides that in certain limited circumstances, ex ante commitments from authorities to recapitalise a GSIB may account for up to 2.5% RWA towards minimum TLAC when the RWA minimum is 16% and up to 3.5% RWA when the RWA minimum is 18%.[14]

Subordination

TLAC is generally required to be subordinated to all Excluded Liabilities. Subordination can be achieved through issuance by a holding company (structural subordination), by statute or by contract.

The term sheet establishes certain exceptions to this subordination requirement:

a) a general "de minimis" exception where the amount of Excluded Liabilities ranking pari passu or junior to TLAC does not exceed 5% of the resolution entity's eligible external TLAC;
b) where all Excluded Liabilities are statutorily excluded from bail-in;
c) where Excluded Liabilities may be excluded from bail-in under discretionary exclusions, up to 2.5% RWAs of the minimum TLAC requirement may be met by liabilities that rank pari passu with Excluded Liabilities, increasing to 3.5% RWAs when the TLAC RWA minimum requirement increases to 18%;

In each case the exception is subject to certain conditions including that the exclusion does not give rise to material risk of successful legal challenge or valid compensation claims. It is also subject to discussion in the CMG and review through the FSB Resolvability Assessment Process.

[12] See paragraphs 6 and 8.
[13] This is subject to an exception permitting an option to redeem prior to maturity where the first call date on which the option is exercisable will be treated as the maturity date.
[14] See paragraph 7.

Internal TLAC

In addition to the external TLAC requirement which applies to each resolution entity, “internal TLAC” is required at certain subsidiaries of resolution entities. The stated objective of internal TLAC is to facilitate cooperation between home and host authorities and the implementation of effective cross-border resolution strategies by ensuring an appropriate distribution of loss absorbing capacity within the group. It is intended to support cross-border cooperation and give host authorities comfort that the resolution strategy will be carried out if required.

Internal TLAC is loss-absorbing capacity committed by a resolution entity to “material sub-groups” within a GSIB. Material sub-groups are defined as one or more direct or indirect subsidiaries of a resolution entity that meet certain materiality criteria.[15] TLAC requirements are set on a legal entity basis and branches are not subject to any separate external or internal TLAC requirements.

The term sheet provides that internal TLAC should be between 75% and 90% of the minimum external TLAC requirement that would apply to the material sub-group if it were a resolution entity. However, the actual requirement will be determined by the host resolution authority in consultation with the home authority and could be higher.

Internal TLAC is generally required to be in the form of intra-group liabilities pre-positioned on the balance sheet of the subsidiary which would enable losses to be transferred to the resolution entity and the subsidiary to be recapitalised. Internal TLAC should also provide host authorities with comfort that the resolution strategy will be performed. However, internal TLAC is likely to reduce flexibility in group funding and the precise extent of internal TLAC required by host authorities and the impact of this on GSIBs’ funding structures remains to be seen.

Internal TLAC is required to meet the same general eligibility criteria as external TLAC, including the subordination requirements. However, home and host authorities may agree to substitute pre-positioned internal TLAC with collateralised guarantees, subject to certain conditions.

Internal TLAC requirements remain an area where further clarity is required, for example in relation to the identification of material sub-groups and setting of requirements by host authorities. The FSB is undertaking further work to provide guidance to support implementation of TLAC, including mechanisms for internal TLAC.

Breach of TLAC

The term sheet provides that a breach or likely breach of minimum TLAC “should ordinarily be treated by supervisory and resolution authorities as seriously as a breach, or likely breach, of minimum regulatory capital requirements”. If a firm exhausts its regulatory capital buffers and has breached or is likely to breach its minimum TLAC requirement, authorities should require the firm to take prompt action to address the situation. It will be interesting to see how this is applied in implementing legislation.

[15] See paragraphs 16 to 17.

Disclosure

Principle xi provides that "investors, creditors, counterparties, customers and depositors should have clarity about the order in which they will absorb losses in resolution" and that there should be "as much clarity as possible ex ante about how losses are absorbed and recapitalisation is effected in the resolution."

From 1 January 2019, GSIBs will be required to disclose the amount, maturity and composition of external and internal TLAC that is maintained by each resolution entity and each legal entity that issues internal TLAC to a resolution entity. Additionally, the amount, nature and maturity of any liabilities which rank pari passu or junior to TLAC is also required to be disclosed. The BCBS will specify these requirements further.

These requirements should provide the market with much more information about the preferred resolution strategy for GSIBs and the likely impact of resolution on different liabilities.

Cross holdings deductions

To minimise contagion between GSIBs, the TLAC term sheet provides for banks to deduct holdings of other banks' TLAC from their capital. The deductions framework is the subject of a BCBS consultation paper which proposes that all GSIBs and other internationally active banks deduct any holdings of TLAC and instruments ranking pari passu with TLAC from their Tier 2 regulatory capital.[16]

Review

The FSB has emphasised that technical issues arising in implementation should be reviewed in CMGs and discussed within the FSB, which will play a coordinating role. The FSB will also conduct a "review of the technical implementation of the term sheet" by the end of 2019.

Implementation

TLAC will be required to be implemented into national law. The US Federal Reserve has recently issued a proposed TLAC and long-term debt requirement which goes beyond the FSB standard.[17] In Europe, the implementation of TLAC is to be considered by the European Banking Authority in its review of the Minimum Requirement for Own Funds and Eligible Liabilities ("MREL") under the Bank Recovery and Resolution Directive in 2016.

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[16] See http://www.bis.org/bcbs/publ/d342.pdf
[17] See http://www.federalreserve.gov/aboutthefed/boardmeetings/20151030openmaterials.htm

Annex

Minimum TLAC and capital requirements (%RWAs), excluding pillar II