Total Loss-Absorbing Capacity (TLAC): FSB consultative document

---

Executive Summary

- BBVA supports the objective of addressing too-big-to-fail and putting in place a credible and effective cross-border resolution framework where the TLAC is the necessary complement of the bail-in tool.
- Besides endorsing the general principles, the FSB proposal introduces some particular requirements that raise some concerns, especially from an MPE standpoint:
    1. The TLAC's scope should not jeopardise MPE banks' subsidiaries. The TLAC at each subsidiary should be based on the local regime established by the host authority with similar characteristics to the local entities, rather than the regime of the home authority.
    2. A "double-capital" Pillar 1 requirement may overestimate recapitalisation needs. A more prominent role to the Pillar 2 requirement could be given at the expense of the Pillar 1 (similar to the European MREL approach).
    3. The leverage ratio's role and the parity with RWA in the TLAC should be preserved, ensuring a neutral business model approach.
    4. All capital instruments issued at each resolution entity should count towards their TLAC, irrespective of whether it was issued to the parent or to another investor.
    5. The 33% requirement of TLAC debt may jeopardise highly capitalised and deposit-funded banks, especially in Emerging Markets.
    6. The deduction for holding TLAC of other G-SIBs may damage the liquidity profile of TLAC instruments and would likely increase their cost
    7. Before setting the conformance period and a longer phase-in period, TLAC features should be clearly defined.

- Finally, we consider that the TLAC calibration and subsequent QIS are vitally important. We look forward to a comprehensive quantitative impact assessment (QIS) that looks at these issues alongside the individual bank impact. In particular, the QIS should review the impact on: developed and emerging market economies; international banking products; the depth of debt markets; the willingness of investors to buy this type of debt; the base of retail deposit funding; refinancing risks, and financial interconnectedness.

General Comments

- BBVA supports the objective of addressing too-big-to-fail and putting in place a credible and effective cross-border resolution framework.
- As the central premise of the new regulation framework, any banking rescue will have to be supported in the first instance by shareholders and private creditors through the bail-in tool. In order for this new banking rescue philosophy to be effective, banks must, at all times, have enough liabilities to absorb losses. That is, banks need to comply with a minimum Total Loss-Absorbing Capacity (TLAC), which is the complement of the bail-in tool.
- Avoiding bail-outs supported by a credible TLAC framework has more pros than cons. Despite the impact on the banks' liability structure, the introduction of the bail-in enhances banks' fundamentals, encourages positive discrimination between issuers, breaks down the sovereign-banking link, and increases market discipline.
- We endorse the general TLAC principles, and we strongly believe that the TLAC framework should be flexible and neutral from the business model and resolution strategy standpoint, in order not to jeopardise any type of banking model.
- Besides the general principles, the FSB's proposal introduces some particular requirements that raise some concerns.

1. The TLAC's scope should not jeopardise MPE banks' subsidiaries

- The TLAC framework only applies to G-SIBs whose headquarters are not located in emerging markets (EME).[1] This requirement may pose two main challenges:
  1. **Exclusion of emerging market headquarters**.
     - The exclusion of certain G-SIBS is, from the international perspective, contrary to the international level playing field that the FSB has sought to achieve since its founding. The rationale behind the proposed initial exclusion of EME G-SIBs is not well understood, and better-articulated criteria for application of the exemption would be very helpful in creating market confidence in the determination and fairness of the exemption.
     - If the exemption is justified by different market conditions in EME countries, then it should also apply to foreign subsidiaries of G-SIBs competing in such countries, applying the principle of national treatment by adjusting the external requirements for resolution entities. This would be relatively straightforward for MPE banks, but proportionate reflection of the exemption for SPE banks should also be considered.
  2. **Exclusion of Domestic-SIB**.
     - The TLAC guidelines are only proposed by the Financial Stability Board for G-SIBs. However, it will be for each country to put in place the legal framework which implements these proposals. We anticipate that these local resolution regimes will need to be applied to Domestically Systemically Important Banks (D-SIBs) as well as G-SIBs, if they are to be effective in addressing too-big-to-fail in a comprehensive manner within any jurisdiction.

[1] This exclusion only applies to Chinese G-SIBs

  - Therefore, the TLAC requirement should also be extended to those D-SIBs which are not part of a G-SIB, maintaining a level playing field between the local players and foreign subsidiaries.

- The FSB TLAC's term sheet point 2 states that "*the minimum requirement will be applied to each resolution entity within each G-SIB*." From an MPE standpoint, that means that **a consolidated TLAC assessment based on a home requirement of consolidated balance-sheet and RWAs does not make sense**.
- Under an MPE approach, the consolidated TLAC requirement should be the sum of the individual local requirements at each resolution subsidiary. Therefore, if the local variations in the TLAC regime are material, in terms of both instruments and/or levels, for a group with an MPE approach, the consolidated view of TLAC measures across any group will not align with the standards of the relevant home authority. This might be perfectly reasonable, despite the group satisfying each of the underlying local regimes at each point of entry.
- Finally, the external TLAC requirement in a MPE G-SIB should only apply at each material subsidiary in the group. However, the concept of material subsidiaries may have different connotations between an SPE and MPE. Under an MPE scheme, **material subsidiaries could be considered to be those which are relevant in their local market (e.g. D-SIBs) and always based on the local resolution rules**.
  - Requiring external TLAC in a subsidiary does not make any sense, if it is not systemic and its resolution strategy will not consider the use of the bail-in powers locally.

2. A "double-capital" Pillar 1 requirement may overestimate recapitalisation needs

- The requirement of **double capital and leverage minimum requirements overestimates the recapitalisation needs after resolution**.
  - The bank is likely to have been through recovery and early intervention phases prior to resolution, and the result of actions taken prior to resolution (such as deleveraging) would be likely to leave the bank smaller at the point of resolution, therefore reducing the amount of resources required for recapitalisation.
  - The degree of recapitalisation should be focused on facilitating the group resolution plan. As noted in the FSB TLAC's principle 5, resolution is not resurrection but is focused on ensuring the continuation of critical functions.
  - The resolution plan may not imply that the entire group is recapitalised in the same form in which it enters resolution. Resolution plans may involve discontinuing or winding down some non-critical functions and/or business lines, rather than continuing the entire business. This would require fewer resources for recapitalisation, to implement the group resolution plan and ensure the continuity of critical functions.
- The solution could be given a **more prominent role to the Pillar 2 requirement at the expense of the Pillar 1**. This would complicate market analysis, but it ensures that the minimum TLAC is tailored to the preferred resolution strategy and each bank's characteristics.

- This is the approach adopted by the European authorities. The minimum loss-absorbing requirement in resolution (so-called MREL) would be tailored to each bank's characteristics and the recapitalisation needs after the implementation of the preferred resolution strategy.[2]

3. The leverage ratio's role and the parity with RWA in the TLAC should be preserved

- The introduction of **the leverage ratio rightly recognises the diversity of business models among G-SIBs** developing a flexible and business-model neutral TLAC approach.
- As a starting point, it should be mentioned that capital prudential requirements are composed of two ratios: the capital and the leverage ratios. Both are included, or will be included soon, in most jurisdictions as a minimum Pillar 1 requirement. Therefore, banks with low RWA density (mainly investment and mortgage banks) may breach the leverage ratio before the capital ratio. Therefore, the TLAC liabilities and the bail-in tool would be used to restore the leverage ratio first. The opposite would be true for global retail banks (RWAs would be binding, and not the leverage ratio).
- In particular, the current 16% of RWA and 6% of leverage ratio thresholds imply that banks with RWA density up to 37.5% would be driven by the leverage, and the rest by the RWA. The 37.5% equilibrium is roughly in line with the average of the RWA density among European G-SIBs (35% as of June 2014). It seems that the current TLAC approach, with both ratios, is not meaningless and only jeopardises G-SIBs located at the extremes, either with very low or very high RWA density.
- Against this backdrop, the introduction of the leverage ratio **challenges the calibration of the minimum TLAC**. It may be worth highlighting that the **parity between the RWA and the leverage threshold should be carefully assessed** during the calibration period.
    - For example, if the minimum TLAC based on RWA increases to 20%, then the minimum TLAC based on leverage assets should also increase to 7.5%, in order to maintain the 37.5% equilibrium.

4. All capital instruments issued at each resolution entity should count towards their TLAC

- The FSB TLAC's term sheet point 9 states that "*All regulatory capital instruments issued by the resolution entity or resolution entities of a firm and held by third parties are eligible to satisfy Minimum TLAC requirements*". Additionally, the FSB TLAC's term sheet point 12 requires the agreement of the CMG to count in the TLAC eligible liabilities issued to the parent.
- In the FSB proposal, it is not clear whether the parent institution or other subsidiary which is not part of the resolution entity may be considered a third party. It is our understanding that any **additional tier 1 and tier 2 instruments, that are either eligible for the purpose of the subsidiary's capital or rank *pari passu* with them, should count towards the TLAC irrespective of whether it was issued to the parent or to another investor**.
- Moreover, under an MPE approach, those liabilities will absorb losses locally without the need of the home authority approval. Therefore, the need of the CMG agreement may be a bureaucratic procedure that has more drawbacks than merits.

[2] See the European Banking Authority Consultation Paper on the criteria for determining the MREL (EBA/CP/2014/41, November 2014)

- Recognising that all capital instruments absorb losses locally and count towards the TLAC, the asymmetry of the capital requirements with the TLAC approach is questionable. There are two particular examples: i) whether capital instruments issued at subsidiary level could not be included in the consolidated capital requirements under European rules (CRR), and ii) under Mexican rules whether capital instruments with full loss-absorbing capacity could not count towards capital ratio due to local listing requirements..

5. The 33% requirement of TLAC debt may jeopardise highly capitalised and deposit-funded banks

- The basic approach to TLAC, combining going- and gone-concern resources, makes sense as a broad matter. The inclusion of capital instruments will provide banks with greater flexibility to optimise their liability structure with their preferred and available instruments. However the “expectation” of 33% debt needs to be approached with due regard to the facts and circumstances of specific business models, capital structures, and local debt markets characteristics.
- In highly capitalised firms, the requirement sets up a conflict between prudential policy and resolution policy in that it would create incentives for them to reduce CET1 and increase reliance on debt, a result that seems odd in light of traditional prudential concepts and policies. If authorities do not allow banks to reduce the CET1, they may be forced to leverage their balance sheets artificially or to reduce the deposit funding base.
- In particular, there will be cases where, for various business or regulatory reasons, it makes sense to maintain the entity on a highly capitalised basis rather than resorting to debt. This is the case, for example, of MPE subsidiaries located in financial systems founded mainly with deposits (loan-to-deposit <100%), often located in Emerging Markets, where the subsidiaries may be forced to leverage their balance sheets or be driven to a riskier “yield searching” strategy to compensate for the TLAC cost.
- In such cases, the “expectation” of maintaining a minimum of **33% of TLAC debt should not be considered mandatory, but rather a point of reference for the authorities in order to open a discussion between authorities and bank managers**.

6. The deduction for holding TLAC of other G-SIBs may damage the liquidity profile of TLAC instruments and would be likely to increase their cost

- The deduction for holdings of TLAC of other firms raises several concerns. Which investors would be found if G-SIBs are effectively excluded and similar restrictions are likely to be imposed on D-SIBs (or even non-bank SIFIs)? If banks are excluded, the impact on the market appetite will be critical, increasing the funding cost and jeopardising the liquidity of those instruments.
- A particular **side-effect may arise in the context of market-making activity,** as it makes no allowance for underwriting TLAC instruments. Therefore, it makes sense to allow an exception for market-making, and include in the QIS an analysis of what the absence of such an exception would mean for the market. Two main reasons hold the key:
    - As is likely, such a deduction would make it uneconomical for dealers to make a market in TLAC instruments, and such debt therefore could not trade after issuance, so **the costs of issuance could rise significantly**.

    - Of equal significance would be the likely **further reduction of liquidity** in many equity and debt markets, which is at least in part related to new liquidity, leverage, and structural requirements.

- The reason why the FSB is proposing to exclude banks from holding TLAC instruments is to limit the contagion risk. In this context, there is an obvious question of why **existing large-exposures limitations should not be sufficient to meet the concern about contagion** if large amounts of TLAC instruments were held by other GSIBs. Alternatively, if more conservatism is found necessary, perhaps lower large-exposure limitations could be proposed. Consideration could also be given to the allowance of some holdings, subject to requirements of geographic dispersion (to avoid excessive cross-holdings in a given country). We urge that the FSB should analyse the **TLAC framework not in isolation but holistically** taking into account the broad regulatory reform.

7. Before setting the conformance period and a longer phase-in period, TLAC features should be clearly defined.

- Nowadays, the characteristics and requirements with which TLAC instruments must comply are unclear. **The FSB should delay the decision of setting the conformance period** until all the TLAC features are defined.
- In particular, there are a few areas of concern:
    - **Maturity restrictions should be very carefully reviewed, since they could create a cliff effect in funding markets** (FSB TLAC's term sheet point 11). The effect of the current proposal would appear to be to incentivise banks to redeem funding with a residual maturity of less than one year. Consideration should be given to means of alleviating such cliff effects. An alternative worth considering might be to allow no more than a concrete percentage of a firm's TLAC requirement to be met by instruments that have a remaining maturity of less than 12 months or apply a haircut to those liabilities following the same philosophy as the liquidity Net Stable Funding Ratio (for example 50%).
    - The **requirement for supervisory approval before eligible external TLAC can be redeemed is overly broad** (FSB TLAC's term sheet point 15). The requirement that firms must receive supervisory approval when redeeming eligible external TLAC (except when replacing eligible TLAC with liabilities of the same or better quality, and when the replacement is done under conditions which are sustainable for the income capacity of the bank) gives rise to a concern that institutions may be put in the position of constantly having to seek regulatory approval for ordinary course events (general retirements, calls, tender) in relation to plain vanilla debt.
    - As we mention above in point 4, all capital instruments issued at each resolution entity should count towards their TLAC.
- Regardless of where the final dead-line is established, It make sense for the requirement to be phase-in over time to advert any negative impacts on economic growth from the ever increasing capital intensity of "lending to the real economy". In fact, it will be difficult for banks to issue TLAC-compliance instruments before the framework is closed and such minimum period is needed to bring funding structures into compliance. A further positive effect is that the potential impact on Distributable Items and restrictions on payments on other instruments will be pushed out as well.