

Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs (« Internal TLAC »)

FSB Consultative Document

National Bank of Belgium – Response to the consultative document

1. Introduction

The Financial Stability Board (“FSB”) published on 16 December 2016 a consultative document on possible guiding principles on the internal Total Loss-absorbing Capacity of G-SIBs (“internal TLAC”). The consultative document proposes guiding principles (i) on the identification and composition of material sub-group, (ii) on the size of the internal TLAC requirement, (iii) on the composition and issuance of internal TLAC, (iv) on features of trigger mechanisms for internal TLAC, and (v) on the process for triggering internal TLAC. In this context, the FSB raises 11 specific questions.

The following response presents the main comments of the National Bank of Belgium (“NBB”) on the FSB consultative document. The NBB is the Belgian National Resolution Authority. It is part of the Single Resolution Mechanism.

The response explains the NBB’s views on the calibration of the internal TLAC. It touches upon various elements raised in the 11 different questions of the consultative document, even though none of them is addressed individually. The answer is structured as follows: section 2 recalls why internal TLAC is needed. The subsequent sections present a series of high-level principles which would need to be respected for the internal TLAC model to work. These essential principles respectively relate to the calibration of the external and internal TLAC, to intragroup issues and finally, to the composition of the internal TLAC.

2. The need for internal TLAC

The Key Attributes of Effective Resolution Regimes for Financial Institutions, published by the FSB for the first time in October 2011, describe the set of resolution powers that resolution authorities should have at their disposal. One of these powers is the bail-in within resolution, i.e. the write-down and conversion of own funds instruments and unsecured and uninsured creditors of an institution, to the extent necessary to absorb its losses and recapitalise it. This instrument only works if each institution potentially subject to bail-in has sufficient loss absorbing capacity. The calibration of the Total Loss-absorbing Capacity (“TLAC”) was determined by the FSB on 9 November 2015, in the TLAC term sheet.

The FSB indicates in the TLAC term sheet that the minimum TLAC requirement should be satisfied at the level of the resolution entity. The concept of resolution entity refers to the choice of the resolution

strategy. The FSB, in its guidance on developing effective resolution strategies, published on 16 May 2013, describes two stylised group resolution strategies, namely the Single Point of Entry (“SPE”) and the Multiple Point of Entry (“MPE”) group resolution strategies. In a SPE strategy, resolution tools – including the bail-in – are applied at the level of a pre-identified single legal entity, independently of where the losses and recapitalisation needs materialise. In a MPE strategy, resolution tools are applied at the level of each individual legal entity (or at the level of different resolution groups) so as to absorb its own losses and recapitalise it.

One essential condition for the SPE strategy to work is that entities within a resolution group have the capacity to up-stream their losses to the single point of entry, also known as the resolution entity. When absorbing the losses of the whole resolution group, the resolution entity also down-streams capital to the entities in need. Given the bail-in tool is eventually applied at the level of the resolution entity only, the losses of the whole resolution group are supported by the shareholders and the external creditors of the resolution entity and not by the creditors of the different entities composing the resolution group. The existence of a robust mechanism to up-stream losses and down-stream capital is therefore a key condition to ensure the feasibility and credibility of the SPE resolution strategy. The internal TLAC’s sole objective is to operationalise this condition, i.e. to provide a practical ex-ante binding and legally enforceable mechanism to up-stream losses from ailing entities and down-stream capital from the resolution entity.

If the support offered by the resolution entity to its subsidiaries was unlimited and unconditional, introducing an internal TLAC mechanism would be redundant. Indeed, there would then be no doubt that losses would be absorbed at the resolution entity level. However, resolution groups are composed of separate legal entities, with limited liability and generally different creditors. Against this background, reaching the right calibration for the internal TLAC is of paramount importance to ensure that the SPE resolution strategy can be implemented. Indeed, the capacity to enforce a SPE resolution strategy directly depends on the level of internal TLAC instruments prepositioned by the resolution entity in its subsidiaries. If losses exceed the value of prepositioned internal TLAC instruments, there is a legal risk that the excess losses have to be absorbed directly at the level of the resolution entity’s subsidiary, i.e. to fall back on an unprepared MPE strategy. Indeed, the resolution entity’s creditors would have to absorb losses that, in a liquidation under normal insolvency proceedings, would be absorbed by the creditors of the subsidiary, triggering an issue of no-creditor worse off.

In this context, and given the risks that a wrong calibration of the internal TLAC would pose to the capacity of resolution authorities to enforce SPE strategies, the NBB considers that a series of essential principles should be respected. The objectives followed by these principles is to maximise the chances of success of SPE strategies and at the same time to provide sufficient safeguards that, should the SPE strategy collapse, entities belonging to the resolution group would not end up in a comparatively worse situation than if a MPE strategy had been chosen from the beginning. If they are satisfied, these principles will contribute to fostering the adoption of SPE strategies they would be justified by the structure and business model of the banking group.

3. Calibration of the external and internal TLAC

Principle 1. External TLAC should be calibrated on the basis of the SPE perimeter and be internally allocated to ensure a smooth implementation of the resolution strategy.

The first step when planning a SPE strategy is to define the scope of the resolution strategy, i.e. the fate of each legal entity, or material subgroup, that is part of the group should it reach its point of non-viability. Resolution authorities should determine for each legal entity whether (i) the entity is covered by the SPE resolution strategy and benefits from the support of the resolution entity in terms of loss absorption and recapitalisation needs; or (ii) whether it does not fall into the scope of the SPE resolution strategy and is liquidated under normal insolvency proceedings, should it reach its point of non-viability.

External TLAC should then be calibrated on the basis of the SPE perimeter and be internally allocated to ensure a smooth implementation of the resolution strategy (i.e. the application of the bail-in tool at the level of the resolution entity, combined with the up-streaming of losses/down-streaming of capital from/to in-scope subsidiaries). However, supervisory and accounting consolidation scopes are not always perfectly aligned on the perimeter of the resolution strategy, which may for instance cover non-regulated entities which provide critical shared services, or are highly interconnected with regulated entities. Consequently, when calibrating the external TLAC requirement and allocating the internal TLAC to the resolution group's subsidiaries, resolution authorities should adjust the supervisory and/or accounting information to fully reflect the resolution strategy's perimeter. This implies for instance an adjustment of supervisory risk measurements (e.g. RWA) and/or levels and methods of consolidation.

Principle 2. The internal TLAC of a subsidiary covered by the SPE strategy should be sufficient to absorb its losses, allow its recapitalisation and restore market confidence where relevant. It should not be artificially limited by a top-down approach.

In a SPE strategy, all the losses of the resolution entity and of its subsidiaries are eventually absorbed by the shareholders and external creditors of the resolution entity, who also have to cover all the recapitalisation needs of the resolution group. The quantum of external TLAC issued at the level of the resolution entity should therefore be consistent with the quantum of internal TLAC prepositioned by the resolution entity.

The need for consistency between external and internal TLAC implies that the top-down approach currently used to calibrate the TLAC requirement should be back-tested on the basis of a bottom-up analysis of the loss absorption capacity needs of the subsidiaries which are included in the perimeter of the SPE resolution strategy. If the sum of the loss absorption capacity that needs to be prepositioned in each of the subsidiary of the resolution group to ensure a smooth implementation of the SPE resolution strategy exceeds the external TLAC requirement, resolution authorities should have the capacity to adjust the external TLAC requirement upwards. Such a bottom-up approach would be fully consistent with the philosophy of the additional firm-specific external TLAC requirement (see paragraph 5 of the TLAC term sheet). According to the TLAC term sheet, the additional firm-specific external TLAC requirement should be set by resolution authorities if this is necessary and appropriate to implement the preferred resolution strategy and achieve resolution objectives.

The surplus TLAC¹, as envisaged in Guiding Principle 7, cannot credibly be used to cover the loss absorption and recapitalisation needs of the resolution entity's subsidiaries. Such a surplus may provide additional assurance that the loss-absorbing capacity constituted at the resolution entity's level is sufficient for the group as a whole but is not a substitute for a mechanism of loss up-streaming and capital down-streaming. Indeed, in absence of such a mechanism, the holders of the instrument constituting the surplus TLAC could claim that the resolution entity is not liable for losses exceeding the prepositioning, as they would not have to absorb these losses in the event of liquidation under normal insolvency proceedings of the resolution entity's subsidiaries.

In addition, the nature and quality of the surplus TLAC depends on the form of subordination chosen for the external TLAC and on the status of the resolution entity. When the resolution entity is a holding company, the surplus TLAC is structurally subordinated and not allocated to any operations. When the resolution entity is an operating company, the surplus TLAC cannot be disentangled from the operations of the operating company. As soon as a shock simultaneously affects the resolution entity and its subsidiaries, any surplus TLAC available at the parent level is de facto allocated to the operations of the resolution entity. There is thus no certainty that this surplus TLAC would remain available for the subsidiaries of the resolution entity.

Principle 3. If the internal TLAC of a subsidiary covered by the SPE strategy is not sufficient to absorb its losses, allow its recapitalisation and restore market confidence, it could be complemented by external TLAC instruments issued from that entity.

The whole TLAC framework should be calibrated so that resolution authorities are confident that there is sufficient loss-absorbing capacity available in each relevant entity. This means that the subsidiaries of the resolution entity which are covered by the resolution strategy should have sufficient loss-absorbing capacity to absorb their losses, and be recapitalised up to a level which would restore market confidence where relevant.

Internal and external TLAC form a continuum, as SPE and MPE do. Even in an MPE situation, part of the TLAC – namely the CET1 of the subsidiary – is subscribed internally by the parent entity. In a crisis situation, if the CET1 is not sufficient to absorb the losses of that subsidiary, and if the parent entity does not want, or has not the capacity to recapitalise its subsidiary, the subsidiary is resolved on a stand-alone basis, under a MPE resolution. Increasing the level of internally subscribed loss-absorbing instruments extends the capacity to implement a SPE strategy, but, in absence of unlimited and unconditional support, does not completely rule out a MPE resolution.

The nature of the person subscribing to the TLAC instruments should, however, not affect the level of the requirement. It is not because an instrument is subscribed internally that its loss-absorbing capacity increases. In this respect, internal TLAC is only different from external TLAC because the creditor is the

¹ The FSB defines the surplus TLAC as the TLAC at a resolution entity, in excess of that required to cover risks on the resolution entity's solo balance sheet, and that is not distributed to material sub-groups. The concept of surplus TLAC needs, however, to be clarified. The TLAC requirement for each resolution entity is set on the basis of the consolidated balance sheet of the resolution group and no requirement is specifically designed to assess the TLAC needs of the resolution entity on an individual basis.

resolution entity. In addition, if the nature of the person subscribing to the TLAC instruments influences the level of the requirement, and in particular if, for a given entity, the requirement depends on the choice of the resolution strategy, there will be an incentive for firms to defend the model which would minimise the requirement, and this at the expense of the resolvability of the subsidiaries. In this context, it is important to recall that the SPE resolution strategy has never been tested in practice and thus that it is not certain that mechanisms to up-stream losses and down-stream capital beyond the prepositioning will be sufficiently robust to allow a smooth implementation of the SPE resolution strategy.

Consequently, if the internal TLAC of the subsidiary of a resolution entity is not sufficient to absorb its losses, allow its recapitalisation and restore market confidence, and the support of its resolution entity beyond that internal TLAC is uncertain, it should be complemented by external TLAC issued from that subsidiary.

Another case where internal TLAC may need to be complemented with external TLAC is the case of joint-ventures. If the objective of a SPE strategy is to maintain a group structure, the existence of a joint-venture covered by a SPE strategy would force it to issue TLAC instruments to different subscribers, some of which will not be the resolution entity.

4. Intragroup issues

Principle 4. The capacity to up-stream losses to the resolution entity should not be counterbalanced by financial linkages leading to a down-stream of losses from the resolution entity to its subsidiaries. Where such financial linkages exist, compensation mechanisms should be set-up to avoid jeopardising the existing loss up-streaming and capital down-streaming mechanism.

The internal TLAC mechanism establishes financial wires through which losses of subsidiaries can be channelled to the resolution entity. The efficiency of this mechanism could be jeopardised by reverse financial linkages resulting from normal group operations, such as e.g. uncollateralised exposures of a subsidiary on its resolution entity². Indeed, in the European Union, intragroup liabilities are explicitly not excluded from the scope of bail in. If the resolution entity is financed by one of its subsidiaries and the bail-in is sufficiently severe to affect this form of intragroup liabilities, resolution authorities will have to bail-in those intragroup positions, which would imply to down-stream losses. This would clearly not be consistent with the SPE strategy, especially if the down-stream of losses exceeds the capacity to up-stream losses. In a MPE strategy, a bail-in of intragroup exposures would not undermine the fundamental principle of the strategy, as it is the case with the SPE, but it would nevertheless create contagion between entities, and in case of conversion, could lead to group structures in which the subsidiary becomes the parent of its resolution entity.

This problem is likely to increase in the run up to a crisis, especially if a SPE resolution strategy is pursued. Indeed, such a strategy tends to assimilate the resolution group to a single legal entity. Liquidity

² Such linkages arise e.g. for subsidiaries located in economies with surplus savings, or when liquidity is centralised at the parent level.

is then expected to flow from entities with liquidity surpluses to entities which need liquidity, with the resolution entity playing the role of a central hub. The resulting increase in intragroup exposures would exacerbate the risk that losses are eventually down-streamed to entities which initially had liquidity surpluses.

Resolution authorities should have the capacity to impose compensation mechanisms where such intragroup relationships are threatening their capacity to smoothly implement the SPE strategy. The clearest way to address such an issue would be to exclude these intragroup transactions from the scope of bail-in. In absence of any legislative change, this can be achieved e.g. through the collateralisation of these intragroup positions. Alternatively, other mechanisms could contribute to mitigate the risk that such an issue materialises. For instance, a limit on large intragroup exposures would cap the risk to have to down-stream losses to subsidiaries.

5. Composition of the internal TLAC

Principle 5. The composition of the internal TLAC should not alter the capacity of resolution authorities to smoothly implement the resolution strategy.

In order to guarantee a smooth implementation of the SPE strategy, the internal TLAC should remain available at the subsidiary level, so that losses can be up-streamed and capital down-streamed as soon as this is needed. Internal TLAC instruments should be subordinated to operational liabilities of the subsidiary so as to absorb losses in priority, i.e. before any other creditor.

The FSB proposes to authorise the substitution of internal TLAC by collateralised guarantees. A guarantee is a mechanism to secure a contractual relationship or claim. Normally, a guarantee is part of a multi-party relationship, which counts at least three different parties: the principal debtor, the creditor and the guarantor. The guarantee aims to secure the contractual relationship between principal debtor and creditor by providing the creditor with a second debtor (the guarantor). In other words, the guarantee should be considered as the security, not as the secured claim.

However, this is not the case when internal TLAC is substituted by a guarantee granted by the resolution entity. Indeed, the guarantee loses its value as a mechanism to secure a contractual relationship, since it does not provide the creditor (in this case the subsidiary) with an alternative debtor. In addition, the specific obligations of the guarantor under the guarantee agreement are unclear. In fact, the proposed guarantee seems to function as a conditional³ substitute for the principal relationship, weakening the position of the creditor.

In addition, the idea of replacing internal TLAC with a guarantee (which should be conceived as a contractual and conditional commitment in this case) creates a number of legal and operational drawbacks both outside and during resolution proceedings rendering it less effective:

- First, as regards the guarantee itself questions arise regarding the validity of such a guarantee and the possibility for other interested parties to challenge it. Challenges could be based e.g. on the

³ The guarantee is conditional upon the subsidiary reaching the point of non-viability.

corporate interest test⁴, on rules for financial assistance, on general contract law or corporate law, or on the satisfaction of the condition of the guarantee.

- Second, the enforceability of the collateral depends on the validity of the guarantee. Even if the guarantee is not challenged, it is questionable whether the collateral would be enforceable in the event that resolution proceedings are commenced at the level of the resolution entity, especially if the moratorium powers are used. The collateral in case of crisis may rapidly lose its value or become illiquid, and if the resolution entity faces difficulty to respond to margin calls to restore the value of the collateral, the resolution entity's subsidiary may end up in a situation where its guarantee is no longer backed by sufficient collateral.

These drawbacks constitute a firm basis for legal claims challenging the validity and enforceability of both the guarantee and the collateral securing it. The litigation risk can constitute an actual impediment to the enforcement of the collateralised guarantee, in particular in the event that an interested third party would obtain an interim injunction temporarily staying the performance of the guarantee and/or the enforcement of the collateral (until the court makes a final decision on the third party's claim).

From the above it appears that the substitution of internal TLAC with collateralised guarantees is currently still subject to legal uncertainty and requires further analysis as regards the implementation and operationalisation. As a consequence, it is currently impossible to establish that (even in theory) the capacity of the host and home resolution authority to smoothly implement the resolution strategy would not be altered by the substitution of internal TLAC by a collateralised guarantee.

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⁴ It is not sure that such a guarantee would pass the corporate interest test, knowing that certain jurisdictions do not recognise the concept of the corporate group, but only that of the individual corporate entity (such as e.g. Belgium).