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Svein Andresen
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Dear Mr. Andresen,

Deutsche Bank response to Financial Stability Board consultation on adequacy of loss-absorbing capacity of global systemically important banks (G-SIBs) in resolution

Deutsche Bank welcomes the Financial Stability Board's (FSB) proposals on total loss-absorbing capacity (TLAC), to ensure that G-SIBs have sufficient resources to absorb losses and continue critical functions in resolution. We strongly support a common global minimum standard to help ensure confidence in resolution, both between authorities and in the market.

We agree that TLAC should not include operational liabilities and that authorities should be able to expose eligible liabilities to loss without significant risk of successful legal challenge. We therefore support the aim of the proposals to avoid contagion and any breach of the principle "no creditor worse off" than in insolvency. However, we have concerns with the current methodology focus on subordination, as this will introduce competitive distortions.

As currently drafted, banks which already have non-operating holding companies could count existing senior debt towards TLAC. All but one of the continental European G-SIBs have operating parent companies, and face significant constraints to changing to non-operating structures under EU corporate and tax law, in addition to the costly restructuring process that entails. European G-SIBs would therefore have to issue large amounts of contractually subordinated debt – currently much more expensive than holding company senior debt - to meet TLAC shortfalls. While there may be a convergence of spreads across TLAC instruments over time, this represents significant additional transitional costs for EU banks.

We estimate TLAC shortfalls within the euro-zone could be several times existing outstanding subordinated debt. Given the already narrow investor base will be further constrained by understandable limits on cross-holdings, we question whether market capacity exists to absorb this, leaving EU banks with significantly higher funding costs to service and further constraining their balance sheets at a time when they need capacity to support growth.

We believe the potential impact of TLAC would be disproportionate for EU banks, especially given that the EU Bank Recovery and Resolution Directive (BRRD) already contains the powers to effectively bail-in senior debt, with safeguards to avoid risk of legal challenge or contagion. We therefore strongly welcome that the FSB's quantitative impact assessment will involve a market survey, and ask that it specifically considers the differentiated impact of subordination.

Beyond that, overall we support the proposed principles and term sheet, although some elements need to be further refined in calibration. Our detailed responses to the questions are below. Please let us know if you have any questions or if you would like to discuss further.

Yours sincerely,

Daniel Trinder
Global Head of Regulatory Policy

Annex - DB responses to consultation questions

Q1: Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement, adequate in the light of experiences from past failures to support the recapitalisation and resolution objectives set out in this proposal? What other factors should be taken into account in calibrating the Pillar 1 Minimum TLAC requirement?

We support a harmonised global minimum standard, and agree that this should aim to recapitalise to Basel III minima. However, we believe that a binding Pillar 1 minimum TLAC requirement should be calibrated at a level that is exactly that - a minimum - especially given:

i) analysis from the crisis shows that - even before the Basel III framework made low levels of capitalisation impossible - bail-in of around 16% of RWAs would have absorbed losses in all but a single extreme case[1];

ii) the fact that, with enhanced capital levels, in order to reach the point of failure, G-SIBs will have to be severely weakened by an ongoing crisis and will have already executed recovery measures, resulting in a much smaller balance sheet;

iii) the likelihood that, to avoid breaches, firms will add on a "management buffer" well above the regulatory requirement, especially given the need to get regulatory approvals for redemptions and maintain remaining maturity over one year;

iv) the wider availability of bail-in liabilities, either TLAC under one year or, where the bail-in regime is broader than debt instruments alone, other eligible liabilities; and

v) the proposal to require authorities to consider an additional Pillar 2 requirement, which could refine the bank's TLAC levels to reflect the firm-specific situation.

We understand the desire that recapitalisation results in capital levels above Basel III minima, as the aim is not only to restore regulatory requirements but also market confidence so that the bank in resolution can be stabilised and continue operating critical functions.

However, for the reasons outlined above, we believe that significant additional CET1 would be realised even if TLAC were set at the lower end of the range. The top of the range seems to aim to recapitalise to a level that includes the capital conservation or G-SIB buffers - which is not logical given the ex-ante TLAC requirement would *de facto* be much higher due to the exclusion of CET1 that counts towards these buffers. This is especially true, given the low likelihood that a firm at the point of failure will be a G-SIB anymore, that any distributions will be paid in resolution, and that the capital conservation buffer is explicitly intended to be drawn down in periods of stress. We therefore believe the minimum should be set at 16% of RWAs.

Finally, while we understand the desire for both a risk-based and a leverage measure, we strongly believe that leverage should act as a backstop, not as a primary binding constraint. It will be the constraint for many EU banks, especially if the level of the leverage ratio is raised following calibration and if TLAC is limited to subordinated instruments. Our concerns with the impact on EU banks of subordination are detailed in our answers to Q6 and Q9.

To be consistent with its treatment under the Basel framework, we strongly believe that the FSB should be explicit that CET1 towards buffers should count towards the TLAC leverage requirement (as detailed in response to Q10). In addition, if the RWA requirement is greater than 16%, then eligibility of senior debt and ex-ante financing commitments should explicitly be commensurately higher than 2.5% of RWAs under the leverage requirement as well. Our analysis of TLAC shortfalls assumes that senior debt eligibility could rise to 6.5% if the RWA requirement were set at 20%, but still shows significant shortfalls, depending on calibration.

[1] Section 4.102, UK Independent Commission on Banking, Final report, September 2011

Q2: Does the initial exclusion of G-SIBs headquartered in emerging market economies (EMEs) from meeting the Common Pillar 1 Minimum TLAC requirement appropriately reflect the different market conditions affecting those G-SIBs? Under what circumstances should the exclusion end?

In principle, if the purpose of TLAC is to prevent systemic risk from G-SIBs, there is no rationale for treating banks identified as posing a risk to the global financial system differently. We can understand that, at least initially, the FSB wishes to take into account the stage of market development. However, this cannot result in an unlevel playing field by design.

If market conditions in emerging market economies affect G-SIBs headquartered there, then they also affect G-SIBs operating there. As such, a similar exclusion should apply to the internal TLAC for non-emerging market G-SIBs in those jurisdictions. Likewise, if an emerging market G-SIB has a material subsidiary in an advanced economy, they should in principle face a local internal TLAC requirement to preserve the level playing field in the jurisdiction where they are competing. The FSB should also ensure that moving headquarters to an emerging market would not allow a G-SIB to avoid TLAC (even though this approach is very unlikely).

In terms of timing for ending the emerging markets exemption, this will vary country to country if the exclusion is focused on levels of market development. More problematic to reconcile TLAC with emerging market conditions is the prevalence of state-owned banks, which generally look to the government for recapitalisation. However, we note that several jurisdictions are moving towards more market ownership of major domestic banks, which may be a more useful factor to help determine when to end the exclusion.

More important from an emerging market perspective would be to remove the requirement that 33% of TLAC be made up of debt instruments, given small debt markets and - at least in Asia-Pacific - the highly capitalised nature of local banks. In any case, we believe this debt minimum is not necessary as equity is the most effective loss-absorbing instrument.

Q3: What factors or considerations should be taken into account in calibrating any additional Pillar 2 requirements?

As outlined above in our answer to Q1, we believe Pillar 2 has an important role to play in TLAC, as fundamentally the minimum bail-in requirement needs to be tailored to the individual institution's resolution strategy. Factors and considerations should include:

i) Resolvability of the group overall, including feasibility and credibility of resolution strategy and evidence of cross-border effectiveness;

ii) Likelihood of failure, based on objective supervisory assessments of quantitative criteria such as capital, liquidity and asset quality;

iii) Maturity profile and liquidity reserves, including ability of the firm to maintain its TLAC in the event of a sustained period of severe market stress;

iv) Broader availability of bail-in-able liabilities in addition to TLAC, including instruments under one year and other senior liabilities; and

v) Specific features of resolution regime the bank is subject to, including whether resolution financing is available to support resolution.

In addition, we suggest that resolution scenario testing can be a useful tool to help inform Pillar 2 TLAC determinations, as it will help authorities analyse which bail-in liabilities will credibly be available and feasible to bail-in in a crisis. However, we would caution against using it as an automatic determinant, especially as higher capitalisation levels means it is now difficult to come up with more and more extreme scenarios that cause a G-SIB to fail.

Q4: Should TLAC generally be distributed from the resolution entity to material subsidiaries in proportion to the size and risk of their exposures? Is this an appropriate means of supporting resolution under different resolution strategies? Which subsidiaries should be regarded as material for this purpose?

We strongly support ensuring that TLAC is held in the right location of the group for the appropriate resolution strategy for the individual bank's structure and operations. For centrally risk-managed, capitalised and funded banks, this should be single point of entry and TLAC held at group level. For Multi Point Entry (MPA), this should be at each point of entry for resolution.

We also agree that TLAC should be able to be down-streamed to subsidiaries in resolution. Existence of adequate intra-group arrangements to facilitate this and regulatory criteria for allowing these to be used in a crisis should be examined as part of resolution planning.

Only if host authorities are unable to agree with the resolution strategy and the firm-specific cooperation agreement (which should address intra-group funding arrangements to host authorities' satisfaction) should internal TLAC be required. This is consistent with the aim that internal TLAC would promote host authority agreement on a group resolution plan, but where agreement is possible we do not think it is necessary nor should it automatically be required.

In any case, internal TLAC should not only be waived for material subsidiaries in the same jurisdiction as the resolution entity, but also where legal mechanisms for cross-border recognition and agreement exists, for example under the EU Bank Recovery and Resolution Directive (BRRD) and, in particular, between countries participating in the Single Resolution Mechanism (SRM).

In terms of the definition, material subsidiaries should be identified not only in proportion to the size and risk of exposures, but also their systemic importance in the financial system. However, these criteria should be cumulative with the fourth – material to the exercise of the firm's critical functions. Unless a subsidiary is material in all both senses, internal TLAC should not be required. In addition, we think the current drafting of the fourth criteria may lead to inconsistent identification. To avoid this, we suggest rephrasing to "has been identified by the Crisis Management Group (CMG) as where critical functions are performed".

Q5: To what extent would pre-positioning of internal TLAC in material subsidiaries support the confidence of both home and host authorities that a G-SIB can be resolved in an orderly manner and diminish incentives to ring-fence assets? Is a requirement to pre-position internal TLAC in the range of 75 - 90% of the TLAC requirement that would be applicable on a stand-alone basis, as set out in the term sheet (Section 22), appropriate to satisfy the goals of the proposal and ensure that TLAC is readily and reliably available to recapitalize subsidiaries as necessary to support resolution? Can this pre-positioning be achieved through other means such as collateralized guarantees?

While internal TLAC may increase confidence of host authorities in resolution, requiring it to be "pre-positioned" and set at such high levels comes with major costs, as it will restrict free flow of capital and liquidity across the group, creating rather than preventing fragmentation.

As outlined above, we therefore do not believe that internal TLAC should apply automatically to material subsidiaries, but only if home and the host authority are unable to agree on the resolution strategy and a firm-specific cooperation agreement, addressing *inter alia* intra-group funding arrangements. Otherwise it amounts to ring-fencing to prevent ring-fencing.

In addition, we suggest that, if agreement cannot be reached and internal TLAC is required, then the approach should mirror that of external TLAC, i.e. set a minimum at 75% and giving authorities the ability to set a Pillar 2 requirement up to 90%. To determine this, authorities should be required to take into account the same factors as for group Pillar 2. It should also be clarified by the FSB that leverage-based internal TLAC requirements should be driven by the subsidiary's share of the group leverage ratio, rather than local leverage rules.

In terms of the pre-positioning mechanism itself, while it is understandable that host authorities would require internal TLAC to be met using fully funded loans or collateralised guarantees, several technical considerations need to be taken into account and dealt with in the final design of the term sheet:

i) material subsidiaries may be pass-through entities without central bank facilities and unable to take funding from the parent company to invest. Even if they can, they would either have to hold the funding as cash which would increase leverage and cost, or they would have to pass it back to the parent which would generate RWA and increase TLAC, resulting in a vicious circle of increased funding followed by further increased RWA;

ii) if G-SIBs are required to ring-fence HQLA (High Quality Liquid Assets) for the internal TLAC guarantee, this would prevent it being counted towards the Liquidity Coverage Ratio (LCR). This ring-fenced collateral would also have to be financed using long-term Net Stable Funding Ratio (NSFR) funding and would have an impact on leverage, in turn increasing external TLAC requirements; and

iii) the proposal to require issuance of additional external TLAC if the sum of internal TLAC is greater than the group requirement could give the home regulator cause to raise the Pillar 2 requirement, given the high proportion of group TLAC committed ex-ante to material subsidiaries. This would in turn lead to higher internal TLAC requirements, further increasing trapped capital and liquidity.

As such, we suggest that the final term sheet should clarify that: i) pass-through entities with no RWAs are not required to hold internal TLAC; ii) collateral for internal TLAC guarantees can be held in either the resolution entity or the subsidiary, and can count towards the LCR; and iii) a principle that, if the sum of internal TLAC requires additional external TLAC issuance at group level, this should not result in an additional group minimum requirement.

Q6: Are the eligibility criteria for TLAC as set out in the term sheet (Sections 8-17) appropriate?

We strongly welcome the proposed focus on capital markets instruments rather than operational or customer liabilities, the broad approach with a limited number of exclusions, and the exclusion of secured instruments or liabilities subject to set-off rights.

We are concerned about the requirement to get regulatory consent before redeeming external TLAC instruments. This introduces uncertainty for investors over whether capital instruments will be repaid - leading to potentially higher costs for these instruments - but it is not necessary. This is because authorities will already have powers to: require firms to replenish any breaches in the Pillar 1 requirement in a timely manner; calibrate Pillar 2 requirements to ensure a prudent approach to redemptions is taken; and to ensure prudent management and maturity "buffers" in case market stress makes refinancing TLAC challenging. Regulatory pre-approval would bear real costs and is a very onerous approach, given all these other tools would be available to manage the same risks. At the very most, regulatory approval should only be sought where redemption of an instrument would result in a breach of TLAC requirements.

While we agree that derivatives generally should be out of scope, we believe it should be possible to include structured notes, as long as the bank can sufficiently demonstrate that the instrument can be effectively and operationally bailed-in in practice. We appreciate that this will require significant further work on the part of firms and authorities, which will be undertaken irrespective of their inclusion in TLAC, to ensure that they are available in overall bail-in. We therefore believe that structured notes should be eligible for TLAC to the extent that the bond can be separated from the derivative and the position re-hedged. One way to incorporate this into the term sheet may be to allow structured notes to count towards TLAC with a haircut applied, depending on the extent to which the authority can assess they can feasibly and credibly be bailed-in. Given the issues we outline below around investor base for TLAC, we do not believe there is sufficient difference between many structured notes and plain vanilla debt instruments to draw a clear line between them for exclusion.

Our one major concern with the eligibility criteria is the focus on subordination, which we address in further detail in answer to Q9. As outlined in our cover letter, we understand entirely the objective of the requirement to subordinate TLAC, which is to ensure that creditors for eligible liabilities that rank alongside excluded liabilities cannot challenge the write-down / conversion on the basis of a breach of the “no creditor worse off” principle.

However, as it stands, the focus on subordination creates a distortion between banking structures, as it favours jurisdictions which already have non-operating holding companies or whose corporate law environment is conducive to their creation. Particularly given the broad scope of the EU bail-in regime and the constraints in corporate law, EU banks will be disproportionately impacted by this distortion between bank structures.

Subordination and its impact should therefore be an explicit part of the impact assessment - and market survey - as we estimate euro-zone G-SIBs would have to at least double or potentially issue up to 4 times the current outstanding stock of subordinated debt to meet TLAC.

Q7: What considerations bear on the desirability of an expectation that a certain proportion of the common minimum Pillar 1 TLAC requirement consists of (i) tier 1 and tier 2 capital instruments in the form of debt plus (ii) other eligible TLAC that is not regulatory capital?

We believe equity is the most loss absorbing instrument. Additional CET1 on top of regulatory minima will also help to avoid resolution, and regulators should encourage its formation. In addition, it is extremely unlikely that G-SIBs in resolution would entirely deplete their CET1. Authorities are likely to intervene significantly in advance of that becoming a possibility.

It is therefore appropriate that TLAC – both external and internal – should recognise high levels of capital, and so the FSB should either be explicit that the “expectation” that a certain proportion should be made up of debt and non-regulatory capital is not be binding, or not set a specific percentage. This would allow authorities and banks flexibility to meet TLAC in instruments that are appropriate to their capital strategy and local market conditions.

Q8: Are the conditions specified in the term sheet (Section 8) under which pre-funded commitments from industry-financed resolution funds to provide resolution funding contribute to TLAC appropriate?

We appreciate that this provision seeks to take into account those resolution regimes which rely on industry-financed mechanisms to provide capital in the event of failure. These mechanisms may be deemed appropriate in jurisdictions where banks are heavily deposit-funded or issue little wholesale debt, or where local market conditions mean additional issuance is challenging.

However, it should be recognised that other jurisdictions – in particular the EU – may also have ex-ante-financed resolution funds, even where there is no explicit commitment to provide capital, or the ability to use these funds for capital is limited to extreme or specific circumstances. This still provides a form of "collective insurance" which, as outlined above, we think should be taken into account when authorities when determining Pillar 2 TLAC requirements.

Q9: Is the manner in which subordination of TLAC-eligible instruments to excluded liabilities is defined in the term sheet (Section 13) sufficient to provide certainty regarding the order in which creditors bear loss in resolution, and to avoid potentially successful legal challenges or compensation claims? Where there is scope for liabilities which are not subordinated to excluded liabilities to qualify for TLAC, are the transparency and disclosure requirements set out in section 13 and 24 sufficient to ensure that holders of these instruments would be aware of the risk that they will absorb losses prior to other equally ranking but excluded liabilities? If not, what additional requirements should be adopted?

We agree that the FSB has correctly identified the three forms that subordination can take. However, it has to be recognised that as the current funding markets and different national corporate laws stand, the focus on subordinated debt creates a distortion between jurisdictions where banks already have non-operating holding companies (or a regulatory environment conducive to their creation) and those which do not.

In particular, this means TLAC has the biggest impact on euro-zone G-SIBs, as Swiss, US, UK and Japanese G-SIBs all have non-operating holding companies and either already have existing large senior debt stacks that will be recognised or can meet TLAC more cheaply than euro-zone G-SIBs, allowing them to meet shortfalls by issuing cheaper senior debt.

Under the three forms of subordination allowed, euro-zone G-SIBs face three options:

i) **Creation of non-operating holding companies**: most EU countries face significant barriers to this in corporate law, with unrealistically high thresholds to squeeze out non-consenting shareholders, plus a requirement to compensate squeezed out shareholders in cash. This contrasts with the possibility under Swiss law to compensate them with a share swap. This difference creates significant disincentives for shareholders to consent to non-operating holding companies. Even if these laws were changed, significant tax costs would accompany their creation, on top of the considerable cost and complexity of restructuring the group globally (reapplying for licenses, model approvals etc).

ii) **Issue subordinated debt:** banks which are from jurisdictions with constraints on creating non-operating holding companies could issue contractually subordinated debt. We estimate that to meet TLAC, euro-zone G-SIBs would have to at least double and - depending on leverage ratio calibration and treatment of buffers – potentially have to issue up to four times the current outstanding stock of subordinated debt, even with 2.5-6.5% of RWAs senior debt counted. To frame it another way, this could require issuance of up to 65% of existing TLAC-eligible instruments, including capital. Even if sufficient market capacity existed, given the narrower investor base for subordinated debt, this issuance would be at a much higher cost than for senior debt, placing them at a competitive disadvantage to other G-SIBs. This would be true even if banks issue long-term "Tier 3" instruments, ranking above Tier 2 but below other senior liabilities, as these instruments will be new to investors and will price - at least initially - on a par with Tier 2. This may change over time, but costs of implementing TLAC will still be substantially higher than for banks with non-operating holding companies who can meet shortfalls issuing senior debt.

iii) **Encourage a statutory approach:** the FSB draft term sheet would allow for two types of statutory approach, either i) total alignment with the scope of TLAC or ii) statutory subordination of TLAC-eligible instruments. As the EU bail-in regime has to cover a broad range of banks and business models, not only G-SIBs with large amounts of existing senior debt, it is entirely appropriate that it retains its broad scope, as it would not be in the interests of financial stability in the EU to exclude other senior liabilities from bail-in and force largely deposit-funded banks to raise large amounts of wholesale funding to meet minimum bail-in requirements. Instead, statutory subordination - such that existing senior debt ranks above Tier 2 but below other senior liabilities - may benefit overall financial stability as it would result in all EU banks having a clear layer of debt available for bail-in without risk of operational impact or legal challenge. Financial stability will also benefit from a clear and transparent statutory approach to subordination, rather than relying solely on disclosure to clarify where they rank in insolvency.

We therefore believe that statutory subordination is the best approach to address the distortions between EU banks and other jurisdictions, and indeed within the EU single market between the UK banks who already have non-operating holding companies and continental Europe where the legal barriers to their creation are very significant. The impact assessment should therefore also consider the different impacts on the EU funding market of these three approaches to subordination, taking into account the particular impact given existing banking structures and the broad scope of the EU bail-in regime.

While the European Banking Authority and EU Commission will examine whether legislative changes are necessary to implement international standards for minimum bail-in requirements by October 2016, we believe these TLAC issues should be analysed much earlier, given that G-SIBs are likely to face investor pressure to make decisions about the three options as soon as the FSB TLAC principles and term sheet are finalised.

Q10: Do you agree that the TLAC requirement for G-SIBs should be integrated with Basel III such that the minimum TLAC requirement should be met first, and only after TLAC is met should any surplus common equity tier 1 (CET1) be available to meet the Basel III buffers?

Given TLAC is proposed as a binding Pillar 1 requirement, we support the principle that G-SIFI, CCB and countercyclical buffer should sit on top of the RWA requirement to allow them to be used as designed under the Basel framework. However, this should result in a lower calibration of the TLAC requirement, given it will ensure a substantial additional amount of CET1 will be available at the point of resolution. As outlined under Q1, we do not believe the buffers need to be included in the “recapitalisation” target, especially given the broader availability of bail-in-able instruments and the high likelihood that banks will in practice apply ample management buffers to avoid the risk of breaching regulatory capital buffers and facing restrictions on distributions.

We also encourage the FSB to be explicit that this treatment of buffers is only applicable to the RWA-based TLAC requirement. Currently, this seems to be the intention of item 4. in the term sheet. However, this is not consistent with current wording under item 7., which just broadly refers to “minimum regulatory capital requirements”. We suggest changing this to “minimum risk-based regulatory capital requirements”. This will ensure consistency with the Basel III framework for leverage, where all Tier 1 capital counts towards the ratio. It also helps to ensure that the TLAC leverage requirement acts as a backstop, as intended under the Basel framework.

This reflects the current approach to the leverage ratio, as implemented in the EU under CRD4. For TLAC to raise questions about that approach by excluding capital held towards buffers from the TLAC leverage requirement would have severe implications for many banks and introduce confusion and inconsistency between the TLAC and Basel regimes.

Q11: What disclosures (in particular in terms of the amount, nature and maturity of liabilities within each rank of the insolvency creditor hierarchy) should be required by resolution entities and material subsidiaries to ensure that the order and quantum of loss absorption in insolvency and resolution is clear to investors and other market participants?

We agree the proposed disclosure requirements for resolution entities are consistent with the need to provide investors certainty and predictability about their potential treatment in resolution. In particular, knowing where in the creditor hierarchy they rank and how broad a base exists to absorb potential losses.

However, this only allows investors to assess their loss given default, not the probability of default. We believe investors need significantly more clarity about triggers for resolution to help with predictability and certainty. Of course, resolution authorities need some degree of discretion, but where concrete resolution triggers are lacking in legislation, authorities should provide some public guidance on their approach to resolution decisions.

We also agree that disclosure for external TLAC in resolution entities should be taken forward FSB in tandem with the Basel Committee, to ensure consistency with Pillar 3 requirements.

Beyond resolution entities, we are concerned that the term sheet is not very clear on which entities are in scope, and suggest changes to clarify that:

i) disclosure should not be necessary for all material legal entities, as currently suggested in the draft under Principle 11 - this should be amended to refer only to resolution entities and, if applicable, material subsidiaries; and

ii) public disclosure for material subsidiaries should not apply where those subsidiaries either are not required to meet internal TLAC (including for the reasons we suggest above under Q4 and Q5) nor where the subsidiary has no external issuance.

While supervisory reporting should of course be required, we believe given the volume and complexity of existing external reporting, additional disclosures should only be required where relevant and meaningful to the wider market. Particularly given G-SIBs already need to disclose information on possible limitations on the use of liquidity reserves held in any material subsidiary under FSB enhanced disclosure task force recommendations, we do not see the benefit to requiring disclosure of internal TLAC where there is no external issuance.

Q12: What restrictions on the holdings of TLAC are appropriate to avoid the risk of contagion should those liabilities be exposed to loss in resolution?

We completely understand the intention to prevent contagion by limiting cross-holdings of TLAC. However, it also needs to be recognised - especially if these restrictions are expanded beyond G-SIBs - that this will affect the investor base for TLAC, as banks are large buyers of each others' debt feeding into the market capacity concerns cited throughout this response[2].

Also understandable is the proposal to adopt a similar model to capital deductions. However, while this framework is well understood and allows for market making and underwriting exceptions for regulatory capital (i.e. Tier 2 and other hybrid capital instruments), banks'

[2] *Bloomberg* and *Dealogic* data suggest avg, 50% of EU financials' new issuances < 3yr maturity are purchased by banks

holdings of other types of TLAC-eligible debt (including senior unsecured bonds) would be far higher, as there is a bigger market and more liquidity, which requires higher holdings. The final term sheet should be explicit that holdings for market making and underwriting will be exempt from these restrictions and deductions.

It should also be recognised that in addition to acting as investors in other bank debt instruments for market making and underwriting purposes, banks may also do so for their own liquidity portfolio and they also act as intermediaries for internal distribution channels, e.g. for corporate treasuries, small local pension funds or high net worth investors.

If banks are subject to a 100% deduction for holdings of TLAC, then these sources of demand for bank debt would likely disappear, with a knock-on effect on market liquidity in TLAC instruments. This seems extreme given that TLAC is a “gone-concern” measure. We therefore suggest that the FSB, in tandem with the Basel Committee and drawing on the large exposures regime, designs a progressive deduction as holdings increase, rising to 100% once they reach a level that could have a destabilising effect.

When considering eligibility of instruments and the design of restrictions, it should also be recognised that other holders of bank debt will also be limited from holding TLAC, even more so if it is limited to subordinated instruments. For example, pension funds and asset managers may be prohibited from owning TLAC due to ratings’ restrictions or may have asset allocation thresholds which could quickly be saturated if eligibility is limited. This would leave hedge funds and retail investors. Given the growing use of conduct rules to restrict retail buying of convertible instruments, this leaves a very narrow unrestricted TLAC investor base.

Q13: Should G-SIBs be required to conform with these requirements from 1 January 2019? Why or why not? What, within the range of 12 to 36 months following the identification as a G-SIB, should be the conformance period for banks identified as G-SIBs at a future date?

We strongly agree that the conformance period should be determined following the quantitative impact assessment and market survey, including the assessment of current funding profiles, maturities, market capacity for issuance of instruments with these features (especially subordination) and potential funding cost impacts.

However, it also needs to be recognised that market pressure will come much earlier than any implementation deadline for G-SIBs to be issuing TLAC-compliant instruments and / or taking restructuring decisions. The FSB could examine accelerated implementation of Basel III by G-SIBs when determining the deadline, to try to factor in the “market pressure” effect and balance this against the optimum phase-in period.

Finally, the conformance period for TLAC for new G-SIBs should in principle be aligned with that for the capital surcharge. This is currently fourteen months after identification in November.

Q14: How far is the TLAC proposal, if implemented as proposed, likely to achieve the objective of providing sufficient loss-absorbing and recapitalization capacity to promote the orderly resolution of G-SIBs?

As outlined under Q1, we believe as currently proposed, the TLAC requirements would provide more than sufficient loss-absorbing and recapitalisation capacity, given:

i) experience from the crisis, where only one bank lost more than 8% of liabilities and the wider availability of bail-in-able liabilities beyond TLAC;

ii) the low likelihood that the group will be as large as it was pre-crisis at the point of resolution; and

iii) that some non-critical functions may be able to be easily and quickly wound down post-resolution.

Aligning TLAC with a “double Basel” baseline means the level should already be commensurate with potential losses, given Basel III was calibrated to take these into account.

Q15: What will be the impact on G-SIB’s overall funding costs of the adoption of a Pillar 1 Minimum TLAC requirement?

The ultimate funding cost depends on the extent to which banks face shortfalls against the final Pillar 1 calibration and eligibility criteria. Given the current focus on subordination, without statutory changes, most continental EU banks would have to issue new contractually subordinated debt to meet the currently proposed TLAC minimum requirements.

Even if banks were to issue “Tier 3” debt (i.e. contractual terms rank the instrument above Tier 2, but below other senior unsecured liabilities) we believe this would price at least initially roughly at par with Tier 2, given its untested nature. Even at current, post-crisis low spreads, this would result in funding around three times more expensive, e.g. for DB current price of 10y bonds for senior is 6mE +65 bps, whereas subordinated debt current pricing is +235bps.

However, given the significant shortfalls across European G-SIBs, we would not expect these spreads to remain static. Even with the ability to count a limited amount (2.5-6.5%) of senior debt towards TLAC, we estimate across the nine European G-SIBs with operating parent companies at least a EUR 120 billion shortfall and – depending on leverage ratio, calibration and treatment of buffers – up to around EUR 360 billion. This compares with the current outstanding stock of subordinated debt of around EUR 100 billion across these banks.

In our view, a maximum of EUR 50 bn p.a. in Tier 2 can be issued in aggregate without impacting spreads, but for an individual issuer this is around EUR 3-5 bn p.a. At the lower end of calibration - 16% of RWAs and 6% leverage ratio, with buffers able to count towards the TLAC leverage requirement – this could be digested by the market over the proposed conformance period. However, at the upper end of calibration, if the leverage ratio increased and buffers were excluded, in some individual cases a phase-in period of 10 years would be needed even to maintain the current funding cost differential (around 150 bps average across the EU G-SIBs with operating parent companies). This is before considering the substantial amount of currently TLAC-eligible instruments that will require refinancing in the same period, the impact of a significantly narrowed investor base as outlined in answer to Q12, or pressure for accelerated implementation of TLAC regardless of phase-in.

In terms of how we expect spreads to change, we do anticipate some compensating decreases in senior debt pricing, as a result of higher ratings due to increased subordinated debt in the capital structure. However, to compensate entirely for TLAC even at 16% of RWAs and 6% leverage requirement, senior spreads would have to decrease by an unrealistic amount. For example, assume DB changed some of our outstanding senior unsecured instruments into subordinated debt to cover the TLAC shortfall. As current funding costs mentioned above, assuming all instruments are refinanced at once and capital towards buffers is excluded, issuance levels for senior unsecured debt would have to fall to around 6mE-75 bps, or more than 40 bps below current levels of 10y German government bonds, to be neutral in terms of funding cost. This would presently imply a negative yield for such instruments, so the move in senior pricing is very unlikely to be able to compensate for the cost of switching.

Although we expect pricing of TLAC instruments to converge over time, due to the impact of many banks issuing around the same time period, plus the narrowed investor base, we do anticipate increased spreads for subordinated debt initially. For example, if all the operating parent company G-SIBs in our sample issued subordinated debt to meet the shortfalls outlined above at the same time, this would result in an aggregate change in funding mix from operating company senior debt to Tier 2 of at least EUR 120 billion and up to EUR 360 billion. Again, taking the most extreme calibration, assuming this cost change was absorbed simultaneously across all portfolios, we believe that senior spreads would decline by a maximum of -10bps, while Tier 2 spreads would increase by potentially as much as +75-100 bps. This would result in an incremental impact of implementing TLAC of at least EUR 2.5 bn and up to EUR 9.8 bn p.a., in terms of increase in funding costs across these nine European G-SIBs. Compared to the current overall funding costs of these banks, this would represent a significant incremental and ongoing cost of implementing TLAC for European banks.

While US, UK, Swiss and Japanese G-SIBs would also face shortfalls, they could meet these by issuing new senior debt. This would be at a lower cost and through issuance into a deeper market, with capacity to absorb significantly more additional issuance, in a shorter time period. Subordination creates a structural funding cost disadvantage for European G-SIBs.

Q16: What will be the impact on the financial system and its ability to provide financing to the real economy?

Given the significant shortfalls, need for additional issuance, and differential impact for European banks outlined above, we expect a direct impact of TLAC on the broader economy in terms of increased funding costs and the resulting effect on lending availability and pricing.

In addition, there are several other ways in which we consider new TLAC requirements may impact the financial system, with potential negative consequences for the cost and availability of financing to the broader economy:

- We would expect the exclusions for short-term debt and need to maintain maturity and management buffers to have the overall effect of lengthening maturity profiles further, which, while potentially helpful for stability, may negatively impact pricing and availability of short-term funding, especially when combined with NSFR impacts;
- Focus on capital markets instruments would result in currently largely deposit-funded banks having to issue significant quantities of debt. This may result in them having to turn down deposits, including those taken for clearing, given leverage constraints. In addition, greater reliance and servicing costs from wholesale funding may negatively impact product pricing or incentivise greater risk taking to compensate;
- Additional issuance – particularly of subordinated debt by European banks – may quickly saturate market capacity and investor appetite, affecting funding cost and availability for non-G-SIBs – and potentially also wider corporate debt markets;
- Potential knock-on effects of restrictions on cross-holdings and generally narrowed investor base, resulting in mainly hedge funds holding banks’ TLAC and an impact on institutional investors’ portfolios of generally lower yields and volumes of senior debt;
- Changes to debt markets may facilitate the build-up of “shadow banking”, with savings from households channeled into higher yielding assets away from bank balance sheets, but increased dependence on this sector for bank funding;
- Requiring TLAC for only G-SIBs may have competitive implications and lead to greater market concentration within BRRD jurisdictions, as corporate depositors may migrate to G-SIBs as they perceive they are less “at risk” of bail-in;

- As it is not feasible for operating parent company banks to create non-operating holding companies, due to corporate law restrictions and tax implications, and given the potentially unsustainable cost of meeting TLAC by issuing contractually subordinated debt, deleveraging may be required to meet TLAC requirements;
- Even if legal and tax barriers to creation of non-operating holding companies were removed, significant restructuring costs would limit the amount of retained earnings that can be put towards building capital and supporting lending.

We strongly support the FSB's intention to conduct a thorough impact analysis, in tandem with the Basel Committee, and encourage consideration of these potential indirect impacts, as well as interaction with ongoing changes in the Basel framework (RWA harmonisation, leverage ratio calibration, NSFR implementation) to inform calibration and finalisation of TLAC proposals.

Q17: Do you have any comments on any other aspects of the proposals?

One issue not dealt with in the draft proposals is the treatment of non-G-SIBS. On the one hand, we understand that the intention is to address only these institutions, at least initially, but it should be recognised that:

i) some jurisdictions without G-SIBs headquartered there will likely wish to impose TLAC or a similar minimum loss-absorbency requirement on large domestic banks;

ii) in their home jurisdictions, G-SIBs will be competing alongside banks also designated as systemically important (e.g. EU O-SIIs) but not subject to TLAC; and

iii) there are emerging different approaches to implementation of the Basel Committee D-SIB framework, especially with respect to treatment of branches, which may result in additional local TLAC requirements and fragmentation of capital and liquidity.

Given the likelihood of TLAC being replicated beyond G-SIBs, we urge the FSB to consider the applicability of its eligibility criteria – particularly subordination – in light of the potential impact on a broader set of banks, business models, resolution regimes and funding markets.

We also encourage the FSB, in developing the final principles and term sheet, to consider an additional principle covering D-SIBs which clarifies that:

i) where a D-SIB has been identified and is subject to capital surcharges in line with FSB requirements, authorities should also consider TLAC for those institutions taking into account appropriate calibration of the minimum requirement; and

ii) G-SIBs should not, in principle, be subject to additional local TLAC requirements unless their local operations have been identified as subject to D-SIB surcharges, in line with the Basel Committee methodology.

We believe direction from the FSB will be important to maintain the international level playing field created by the Basel Committee and to avoid further fragmentation of capital and liquidity.