JANUARY 2015

# FINANCIAL MARKETS LAW COMMITTEE

## Total Loss Absorbing Capacity

*Discussion of legal uncertainty arising from the proposal of the Financial Stability Board for an international standard on adequacy of loss absorbing capacity*

FINANCIAL
MARKETS
LAW
COMMITTEE

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1 Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.

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# 1. INTRODUCTION

1.1 The role of the Financial Markets Law Committee (the "FMLC" or the "Committee") is to identify issues of legal uncertainty or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks and to consider how such issues should be addressed.

1.2 This paper examines issues of legal uncertainty arising in respect of the proposal of the Financial Stability Board (the "FSB") for an international standard on total loss absorbing capacity ("TLAC") of global systemically important banks ("G-SIBs") (the "FSB Proposal").[2] Further, this paper discusses the potential interaction of that proposal with the relevant European regulatory frameworks and, in particular, with a minimum requirement for own funds and eligible liabilities ("MREL") under Article 45(2) of the Bank Recovery and Resolution Directive (the "BRRD").[3] This paper also refers to a consultation paper issued by the European Banking Authority (the "EBA") on draft regulatory technical standards in respect of the criteria according to which MREL is to be assessed (the "EBA Consultation").[4]

1.3 Under the term sheet included in the FSB Proposal (the "FSB Term Sheet"), the proposed minimum TLAC requirements mainly consist of: (i) (a) a common Pillar 1 TLAC requirement which is set within the range of 16% to 20% of risk-weighted assets ("RWAs") of the resolution group and (b) an additional Pillar 2 TLAC requirement for individual resolution entities which may apply over and above the Pillar 1 TLAC requirement (together with the common Pillar 1 TLAC, "external TLAC"); and (ii) a minimum TLAC requirement applicable to material subsidiaries within a G-SIB group ("internal TLAC").

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2 The FSB, Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in resolution dated 10 November 2014: http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.

3 Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0059.

4 The EBA, Consultation Paper on Draft Regulatory Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU dated 28 November 2014: https://www.eba.europa.eu/documents/10180/911034/EBA+CP+2014+41+(CP+on+draft+RTS+on+MREL).pdf.

1.4 The FMLC applauds the very considerable efforts made by the FSB to achieve international coordination on TLAC requirements and hopes that this paper will assist in developing the detail of this framework in such a way as to ensure legal certainty in the financial markets. The objective of this paper is, therefore, to identify and, where appropriate, suggest potential solutions to issues of legal uncertainty affecting the wholesale financial markets which may otherwise arise from the FSB Proposal.

1.5 The issues identified in this paper are uncertainties arising in respect of:

(1) inconsistency between (i) the FSB Proposal and (ii) the BRRD and the EBA Consultation in respect of frameworks for determining which instruments are eligible for the purpose of TLAC and MREL;

(2) legal interpretational issues arising from the phrase "material risk of successful legal challenge or valid compensation claims" used in Section 13 of the FSB Term Sheet;

(3) lack of clarity on the disclosure requirements under Section 24 of the FSB Term Sheet in relation to issues relating to subsidiaries that are not resolution entities;

(4) eligibility of instruments subject to set-off or netting rights, contracting out of which is not permitted under national laws, in Section 14 of the FSB Term Sheet;

(5) whether a liability embedding (a) feature(s) of derivatives is included in the excluded liabilities referred to in Section 12 of the FSB Term Sheet;

(6) the limit referred to in the penultimate sentence of Section 8 of the FSB Term Sheet;

(7) treatment of legacy instruments which are subject to grandfathering provisions under the Capital Requirements Regulation (the "CRR")[5] in Section 9 of the FSB Term Sheet;

(8) the minimum maturity requirement under Section 11 of the FSB Term Sheet in the case of callable instruments;

[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32013R0575.

(9) failure to carve out minor and ordinary-course liabilities from Section 13 (c) of the FSB Term Sheet;

(10) whether equity-accounted additional Tier 1 capital instruments would be recognised as long-term debts for the purpose of the requirement established under Section 7 of the FSB Term Sheet and the meaning of "expectation"; and

(11) a lack of clarity concerning the application of internal TLAC requirements in the case of a change of control in Article 20(c) of the FSB Term Sheet.

## 2. INCONSISTENCY IN ELIGIBLITY DETERMINATION FRAMEWORKS

2.1 Under (i) the FSB Proposal and (ii) the BRRD and the EBA Consultation, both TLAC and MREL instruments must consist of liabilities which can absorb loss through write-down or conversion into equity in resolution. Although both equity and debts can be eligible for the purpose of the minimum TLAC and MREL requirements, the exact scope of eligible instruments and the legal frameworks for determining scope are not necessarily consistent in material aspects.

2.2 Section 13 of the FSB Term Sheet requires eligible external TLAC to (i) be subordinated to all excluded liabilities;[6] or (ii) rank *pari passu* with excluded liabilities within the limit of a quantum equivalent of up to 2.5% of RWAs (or more) subject to certain conditions. Although Articles 45(13) and (14) of the BRRD envisage the possibility of competent authorities requiring contractual subordination (or equivalent contractual terms) for certain instruments to be eligible, Article 45(2) of the BRRD expressly includes certain "senior unsecured debt" in the scope of MREL-eligible instruments and the BRRD grants a considerable discretion to resolution authorities when determining the scope of MREL-eligible instruments rather than excluding specific categories of unsecured liabilities outright.

2.3 In the EBA Consultation, Article 5 of the draft regulatory technical standards requires the resolution authority to identify any class of liability which is reasonably likely to be fully or partially excluded from bail-in under Article 44(2) and (3) of the BRRD and such liability does not count towards MREL. Each resolution authority could, therefore, exclude certain liabilities from the bail-in power and from MREL, so that

6 The scope of excluded liabilities is proposed in Section 12 of the FSB Term Sheet.

the scope of MREL-eligible instruments becomes consistent with the FSB Term Sheet as much as possible (although the statutory limitation set forth in Article 44(2) and (3) of the BRRD might restrict the resolution authority from defining the scope of eligible instruments at its discretion in a way fully consistent with the FSB Term Sheet).

2.4 In addition, Section 12 of the FSB Term Sheet states that external TLAC must not include liabilities arising from derivatives or debt instruments with derivative-linked features. These criteria are not envisaged by the framework of the BRRD.

2.5 If the scope of eligible instruments under the TLAC and MREL regulatory regimes becomes inconsistent in material aspects, it would pose a risk of substantial overlap and conflict between the EU and non-EU jurisdictions. For example, where a material subsidiary of a non-EU resolution entity within a G-SIB group is located in the EU, that subsidiary would be required to issue MREL-eligible debts in order to comply with the BRRD. Such debts may not, however, count towards the minimum internal TLAC requirement imposed on the material subsidiary by the non-EU resolution authority responsible for the parent company of such subsidiary, i.e. the non-EU resolution entity. Such legal and regulatory conflict and overlap, exacerbated by the application of different standards and rules, tend to cause significant legal uncertainties. Resolution entities and their material subsidiaries within a G-SIB group falling within the scope of both the EU and non-EU regimes may face difficulty coping with the compliance of multiple conflicting and overlapping regimes.

2.6 The FMLC regards it as highly desirable that the scope of eligible instruments under the TLAC and MREL regulatory regimes should be consistent. The FMLC notes that, as pointed out above, there are methods available to competent authorities under the BRRD to try to implement the MREL regime in accordance with the FSB Term Sheet. Nevertheless, the FMLC suggests that appropriate consideration should be given to reconciling the scope of the two regimes, in order to prevent inconsistency which would likely cause unintended legal uncertainty. This issue is elaborated further in the following sections of this paper.

## 3. MATERIAL RISK OF SUCCESSFUL LEGAL CHALLENGE OR VALID COMPENSATION CLAIMS

3.1 In the FSB Proposal, Paragraph 7 of the proposed principles on loss absorbing and recapitalization capacity of G-SIBs in resolution states that "exposing instruments eligible for minimum TLAC to loss should be legally enforceable". Underlying that principle may be the premise that authorities possess the necessary legal powers to expose the TLAC-eligible liabilities to loss without significant risk of successful legal challenge or giving rise to compensation costs. As a result, the phrase "material risk of successful legal challenge or valid compensation claims" is used throughout Section 13 of the FSB Term Sheet. Section 13, entitled "Priority", articulates the manner in which TLAC-eligible instruments are to be subordinated to excluded liabilities so as to provide creditors with certainty but also to avoid potentially successful legal challenges or compensation claims. The FSB Proposal provides three possible approaches to subordination—contractual, statutory and structural—and also sets out certain exceptions to the subordination requirement.

3.2 The inclusion of such a test provides resolution authorities with a certain degree of legal uncertainty—whilst it may be perfectly feasible to provide for contractual or even legislative provisions which are designed to ensure that legal challenges are prohibited, once the TLAC-eligible instruments are used to absorb losses during resolution, the authorities cannot rule out the possibility that the original holder will seek to challenge the legality of the resolution action. In a European context, such a challenge could, for example, be brought pursuant to the European Convention on Human Rights, the jurisprudence of the European Court of Human Rights or the national constitutions of Member States.

3.3 Further, the question of whether a valid compensation claim may be made in relation to the write-down or conversion of an instrument is not merely a function of the instrument—rather it is derived from both the place of the instrument in the capital stack of the issuer, and the manner in which the resolution authorities exercise their discretion in implementing resolution. It may be clear, for example, that where any TLAC instrument is written down in circumstances where the application of the "no creditor worse off" principle would result in compensation, there will be grounds for compensation claims. Compensation claims could result from an over-zealous approach to the exercise of write-down powers, rather than from any inherent difficulty in exposing TLAC instruments to losses. Furthermore, it is not only investors in TLAC instruments but also other creditors or other stakeholders who might initiate a legal action in relation to the bail-in and the resolution action based on potentially quite diversified legal grounds.

3.4 The uncertainty that the formulation creates means it will be difficult for the authorities to be able to assess whether such a test has in fact been met when determining which instruments are eligible for inclusion within the minimum TLAC requirements. Whether material risk of successful legal challenge or valid compensation claims exists must be determined at a time when G-SIBs are required to comply with the minimum TLAC requirements, whereas such risk may crystallise at a time close to bail-in or resolution. In light of such difficulty inherent in the timing of determination, national interpretation of the term is likely to give rise to legal uncertainty. Without a more refined test, the perception of the level of litigation risk will likely differ from country to country, which could result in the TLAC requirements being applied inconsistently across the globe. This would have a negative impact on both market certainty and discipline.

3.5 Regional differences are likely to emerge in the course of implementation by national authorities of the final FSB Term Sheet. Unless the European Commission and national authorities are given a strong steer on what the phrase "material risk of successful legal challenge or valid compensation claims" is intended to cover, Paragraph 7 of the proposed principles may not be implemented consistently.

3.6 The FSB Proposal confirms that the risk of successful legal challenge or valid compensation claims is subject to review in the FSB Resolvability Assessment Process (the "RAP")—the RAP is intended to promote adequate and consistent reporting on the resolvability of each global systemically important financial institution as well as promoting confidence amongst home and host authorities, creditors and other stakeholders that effective resolution arrangements are in place for all G-SIBs.

3.7 The FMLC appreciates that the phrase "material risk of successful legal challenge or valid compensation claims" is intended to cover a range of different circumstances relating to the capital structures of different institutions and a variety of legal systems. Nevertheless, in light of the fact that TLAC-eligible instruments may not be completely free from the risk of litigation, the introduction of a practicable materiality threshold (for example, disregarding challenges or claims that cannot be excluded or avoided under applicable law) would reduce uncertainty. Alternatively, guidance indicating the types of circumstance in which a material risk of successful legal challenge can be said to be present would help to clarify the eligibility of TLAC instruments. Even after the FSB Term Sheet has been finalised, the FSB could, perhaps, consider providing guidance on the use of the term "material" as part of the review in the RAP.

## 4. DISCLOSURE REQUIREMENTS AT A SUBSIDIARY LEVEL

4.1 Section 24 of the FSB Term Sheet requires G-SIBs to disclose the amount, maturity and composition of their eligible TLAC maintained by each resolution entity and at each material subsidiary. It also requires material subsidiaries that are not themselves resolution entities to disclose any liabilities which rank *pari passu* with, or junior to, internal TLAC.

4.2 It is, however, not clear what type of information regarding such liabilities the material subsidiaries are required to disclose. Material subsidiaries of G-SIBs may not be currently subject to public disclosure requirements and the imposition of the disclosure requirement with respect to TLAC logically, therefore, requires a stand-alone disclosure regime. Despite this, the FSB Term Sheet fails to make it clear how such subsidiaries can discharge the disclosure obligation with respect to their liabilities and, therefore, the method and frequency of the required disclosure remain unclear.

4.3 If each jurisdiction introduces a unique disclosure regime without further international coordination, this may result in conflicting and overlapping disclosure regimes. Such a situation could result in a resolution entity and its material subsidiary being required to disclose information on the liabilities of the same material subsidiary in a materially different manner. Noting that the FSB will work with the Basel Committee on Banking Supervision to specify the disclosure requirements, the FMLC is of the view that further details or at least references to existing or proposed specific disclosure frameworks should be provided in due course in order to clarify the content, method and frequency of the disclosure required at a material subsidiary level under Section 24 of the FSB Term Sheet.

## 5. INSTRUMENTS SUBJECT TO SET-OFF OR NETTING RIGHTS

5.1 Section 14 of the FSB Term Sheet states that eligible external TLAC "must not be subject to set off or netting rights that would undermine their loss-absorbing capacity in resolution".

5.2 Since TLAC-eligible instruments could be held by diversified investors including the G-SIBs' counterparties in other transactions, a bundle of rights and obligations may exist between a G-SIB and an investor in external TLAC-eligible instruments issued by the G-SIB. For example, the G-SIB could have a money claim against the investor in external TLAC-eligible instruments, if such investor has also entered into financial transactions with the issuing bank. In addition, a counterparty of a G-SIB may become an investor in the external TLAC-eligible instruments through a transaction in the secondary market in the future. Even though a G-SIB has a counterclaim against the investor in the TLAC-eligible instruments, the G-SIB may well expect such a counterclaim to be set off or netted with other claims which such investor may have against the G-SIB without impairing such TLAC-eligible instruments' loss-absorbing capacity in resolution. In this case, it is unlikely that the existence of such G-SIB's counterclaims against the holder of external TLAC instruments "would undermine their loss-absorbing capacity in resolution".

5.3 For the purpose of ensuring that TLAC-eligible instruments continue to count towards the minimum external TLAC requirement, G-SIBs may consider including a contractual provision which restricts holders of the instruments from exercising set-off or netting rights against the G-SIBs. Such a contractual provision may be practically indispensable in cases where there are a significant number of other transactions between the G-SIB and the investor in TLAC-eligible instruments. Certain statutory set-off rights, however, may not be contracted out of under laws of many jurisdictions. For example, under English law, Rule 4.90 of the Insolvency Rules 1986 provides for the mandatory insolvency set-off rules to apply:

> *where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company.*

Since parties may not contract out of the operation of such insolvency set-off rules,[7] it is unclear whether TLAC-eligible liabilities will be free from mandatory set-off in insolvency or even at an earlier stage. In cases where TLAC-eligible liabilities are contractually subordinated, it is recognised that mandatory set-off should not undermine the loss-absorbing capacity of the relevant instruments, since the amount of the liabilities capable of being set-off would have been reduced or eliminated by the subordination provisions. Nevertheless, contractual subordination provisions may not be present in all cases.

5.4 For the purpose of addressing this issue of legal uncertainty, the FMLC takes the view that TLAC instruments which incorporate contractual provisions which restrict set-off and netting rights to the maximum extent possible under applicable national laws should be allowed to count towards the minimum TLAC requirement, even though they might be still subject to statutory mandatory set-off or netting rules.

## 6. LIABILITIES EMBEDDING FEATURES OF DERIVATIVES

6.1 Section 12(c) of the FSB Term Sheet states that:

> *[e]ligible external TLAC must not include … liabilities arising from derivatives or debt instruments with derivative-linked features, such as structured notes.*

6.2 The purpose of this restriction may be to ensure that the value of TLAC-eligible instruments can be promptly and accurately determined at the point of resolution without giving rise to material risk of successful legal challenge or compensation claims. This category of excluded liabilities could, however, significantly limit instruments eligible as TLAC instruments depending on the interpretation of the phrase “with derivative-linked features”.

6.3 The FMLC agrees with the principle that TLAC-eligible instruments should consist of liabilities that can be effectively written down or converted into equity. A blanket exclusion of instruments with derivative-linked features could, however, result in uncertainty as to which instruments should be deemed to be “derivative-linked” and therefore ineligible to count as TLAC. In addition, failing to recognise certain

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7 See *Stein* v *Blake* [1996] AC 243; and *National Westminster Bank Ltd.* v *Halesowen Presswork and Assemblies Ltd.* [1972] AC 785.

structured notes as TLAC notwithstanding their eligibility to be written down or converted in a bail-in could cause additional problems from a legal certainty perspective, e.g. if ineligibility as TLAC instruments would be misread by a counterparty or a resolution authority as an implicit exclusion from bail-in.

6.4 Delineating between instruments that have derivative-like features and those that do not have such features has given rise to extensive legal debate in the past and could result in inconsistent approaches being taken by different authorities of various jurisdictions in relation to TLAC. In practice, it is only the most vanilla debt securities, such as fixed-rate notes, where the amount payable on the securities is predetermined at issuance and is not subject to variation depending on the fluctuation of one or more reference values. There are many examples of structured notes and many other bond obligations which could potentially be bailed-in on a resolution but are subject to debate as to whether they possess derivative-like features, including, for example, fixed rate notes that may switch to a floating rate, inflation-linked notes, zero coupon bonds and both callable and puttable bonds. An example in the EU of situations in which similar distinctions between derivative and non-derivative instruments have caused legal uncertainty includes a familiar debate about whether the product categories of transferable securities and derivatives listed in Paragraph (C) of the Annex to the Markets in Financial Instruments Directive are mutually exclusive or whether some products, for example, a structured note, can be regarded as both a derivative and a transferable security for certain purposes.[8]

6.5 The approach to the eligibility of structured notes in the FSB Proposal is notably different to that in the BRRD and the EBA Consultation in relation to MREL, (although the EBA expressly expects its own proposal to be compatible with that of the FSB). Structured notes are not excluded from MREL, provided that they meet the more general eligibility criteria set out in the BRRD and the EBA's draft regulatory technical standards on MREL. The EBA has also proposed a more flexible approach to managing potential legal challenges or compensation claims around loss absorbency. Under the approach of the EBA Consultation,

> *MREL should be set to avoid … a risk of compensation arising, but leaves the resolution authority to determine whether this is best done by increasing the*

[8] Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC: http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1398325978410&uri=CELEX:02004L0039-20110104.

*MREL, requiring part of the MREL to be met through contractual bail-in instruments as permitted under Article 45(13) of the BRRD, or through alternative measures to remove impediments to resolvability.*

In other words, under MREL categories of unsecured liabilities are not excluded outright just because they may be seen to give rise to a risk of successful legal challenge, so long as that risk can be managed through other means, but rather only if their exclusion is appropriate for reasons of financial stability or other public policy concerns (e.g. insured deposits). In practice, a resolution authority may be strongly incentivised to bail in debt instruments with derivative-like features where they have the power to do so, since a decision to exclude them could result in an increased risk of challenges or claims for compensation from other creditors. It is not for the FMLC to comment on issues of policy but it would surely be an unusual legislative outcome if holders of structured debts were insulated from a bail-in whilst holders of conventional debt instruments (which may in practice include both retail investors and pension funds) were written-off or converted.

6.6 In light of the issue of uncertainty inherent in the phrase "with derivative-linked features", the FMLC is of the opinion that outright exclusion of specific categories of debt instruments as currently proposed is likely to entail material legal uncertainty. The FMLC recognises that certain types of instruments with derivative-like features may pose issues, in particular where (i) the amount payable on a debt instrument is subject to fluctuation based on an underlying reference asset; and (ii) where the value of the underlying is not readily observable. The FMLC considers, however, that alternative approaches specifically addressing such issues,[9] or approaches along the lines of the BRRD framework, would be also capable of addressing concerns around fluctuations in TLAC or potential shortfalls in loss-absorbing capacity, without giving rise to legal uncertainty as to which instruments are in or out of scope of the applicable rules.

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[9] For example, one working group member suggests that applying haircuts to the value of debt instruments that may count towards TLAC where those instruments possess the features mentioned in (i) or (ii) above might be considered by the FSB. The FMLC does not, however, wish to advocate any one approach in preference to others.

## 7. LIMIT ON CONTRIBUTION THROUGH *EX ANTE* COMMITMENTS

7.1 According to Section 8 of the FSB Term Sheet, credible *ex ante* commitments to recapitalise G-SIBs, such as pre-funded industry contributions, may count towards satisfying the minimum TLAC requirement up to 2.5% of RWAs (or more), subject to the relevant authorities' agreement, and so long as there are no legal impediments to so doing. Although the concept of "legal impediments" is not defined in the FSB Term Sheet, Section 8 provides two examples of such impediments: (i) the requirement that senior creditors are exposed to loss when a contribution is made; and (ii) a particular limit specified in law in respect of the amount which may be contributed.

7.2 These examples, however, would not sufficiently clarify the scope of legal impediments which would prevent *ex ante* commitments from counting towards external TLAC. First, the requirement that senior creditors are exposed to loss would not legally prevent a G-SIB from receiving a contribution from *ex ante* pre-funded commitments. Second, a legal limit on the amount of contribution would not be a legal impediment insofar as the amount within the limit is concerned. If the concept of legal impediments is broadly construed to include any potential practical hurdles which may be caused by laws, it would become unclear what sort of *ex ante* arrangements would actually count towards the minimum external TLAC requirement.

7.3 Furthermore, the scope of the relevant authorities, to whose agreement the eligibility of pre-funded commitments would be subject, is unclear. More specifically, it is unclear whether such relevant authorities are limited to authorities that may be required to contribute to resolution funding, or whether other local and overseas resolution authorities may be included.

7.4 The FMLC is of the view that both the concept of legal impediments and the scope of the relevant authorities in Section 8 are less than clear and would, therefore, welcome clarification of these issues in order to set an appropriate limit on contributions through the *ex ante* commitments.

## 8. TREATMENT OF LEGACY INSTRUMENTS

8.1 Section 9 of the FSB Term Sheet states that all regulatory capital instruments issued by the resolution entity are eligible to satisfy minimum TLAC requirements. According to Section 7, items that count towards satisfying minimum regulatory capital requirements set out in the Basel III framework may also count towards satisfying the minimum TLAC requirement. Section 23 of the FSB Term Sheet also states that internal TLAC that comprises regulatory capital instruments must comply with the relevant provisions of Basel III.

8.2 In the EU, under Articles 484 to 488 of the CRR, certain legacy capital instruments are allowed to count towards the capital requirements, even though they are not eligible as capital instruments fully compliant with the CRR if issued after the specified transition period. Further, the EBA has recently proposed guidelines on the appropriate treatment of capital instruments—including legacy capital instruments which are grandfathered under the CRR—in bail-in or the write-down and conversion of capital instruments.[10]

8.3 Owing to the lack of clarity in the scope of regulatory capital eligible for the purpose of TLAC and its potential incompatibility with the CRR-eligible capital instruments, there is a risk that such grandfathered legacy capital instruments, which might not be fully in compliance with Basel III, do not count towards the minimum TLAC requirements. The implementation of Basel III in each jurisdiction reasonably incorporates grandfathering arrangements in order to mitigate impracticality and uncertainty inevitable during a transition period. A lack of appropriate grandfathering mechanisms under the TLAC minimum requirement may conflict with such existing transitional regulatory arrangements, and therefore would cause a concern about legal uncertainty on the treatment of the legacy capital instruments for the purpose of TLAC.

8.4 It would be helpful for the FSB to confirm that legacy, non-Basel III compliant, capital instruments that are subject to grandfathering provisions are eligible to count towards the minimum TLAC requirements. For this purpose, the definition of regulatory capital under the FSB Term Sheet should be clarified so as to ensure clarity that each

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10 The EBA, Draft guidelines on the treatment of shareholders in bail-in or the write-down and conversion of capital instruments dated 11 November 2014: https://www.eba.europa.eu/documents/10180/890569/EBA-CP-2014-40+CP+on+GL+on+shareholders+treatment+in+bail-in.pdf.

resolution authority may include grandfathered instruments in the scope of TLAC instruments as a transitional measure.

## 9. MINIMUM MATURITY OF CALLABLE INSTRUMENT

9.1 Section 11 of the FSB Term Sheet states that eligible external TLAC must have a minimum remaining maturity of at least one year. Section 12 of the FSB Term Sheet also stipulates that any liability that is callable on demand without supervisory approval is excluded from eligible external TLAC. Furthermore, Section 15 prohibits G-SIBs from redeeming eligible external TLAC without supervisory approval, except when replacing eligible TLAC with other liabilities and meeting certain conditions.

9.2 Certain instruments issued by a G-SIB may be redeemable at the option of the issuing bank on certain specified events (e.g. a substantial change in tax treatment) and/or after a specified period of time (which would typically be considerably longer than one year after issue). It is unclear whether the existence of such features would make the instrument ineligible for treatment as TLAC because the minimum maturity requirement under Section 11 of the FSB Term does not specifically refer to a liability which becomes redeemable in one year or more. In particular, it is unclear in the case of possible redemption after a specified period of time whether the instrument would be eligible for TLAC treatment in the final year of that period. Section 12 appears to capture instruments redeemable on demand by investors rather than those redeemable at the option of the issuing bank because Section 15 clearly intends to address the situations where the issuing bank may be able to redeem eligible external TLAC. Furthermore, although Section 12 excludes liabilities "callable on demand" from external eligible TLAC, the instruments stated above do not become redeemable until any of the specified events occurs or the specified period of time passes.

9.3 Ideally, in the view of the FMLC these matters should not be left to the determination of national authorities, as different approaches taken by various jurisdictions could cause substantial overlap and conflict among national TLAC-eligibility rules. If this issue is not resolved, there will be uncertainty for banks as issuers and for investors in such instruments. Since a clear statement as to eligibility if these features exist would resolve the problem, the FMLC would welcome the FSB's initiative in clarifying how the minimum maturity requirement under Section 11 of the FSB Term Sheet applies to instruments redeemable at the option of an issuing bank. Should such guidance be required, the FMLC suggests that the FSB clarify that the existence of redemption features as discussed above does not, of itself, render any instrument ineligible to count towards the minimum TLAC requirements. In the case of undated instruments, because Section 15 of the FSB Term Sheet prohibits redemption without supervisory approval, the redeemable instrument should continue to be eligible until any redemption option is exercised. In the case of a dated instrument, the FMLC suggests that the instrument should remain eligible to count towards the minimum TLAC requirements until the last year before the maturity date, recognising that the instrument may be replaced as considered by Section 15 of the FSB Term Sheet.

## 10. CARVING OUT MINOR AND ORDINARY BUSINESS LIABILITY

10.1 Section 13(c) of the FSB Term Sheet provides that eligible external TLAC instruments may be issued by a resolution entity which does not have excluded liabilities on its balance sheet so that TLAC-eligible liabilities are not *pari passu* or senior to any excluded liabilities, and refers to a holding company as an example of such a resolution entity.

10.2 Arguably, Section 13(c) appears to deal with issues by holding companies of G-SIBs with no banking business. It is, however, unlikely that such holding companies will in practice have no liabilities at all because they typically have certain minor liabilities arising from the ordinary course of business on their balance sheets. For example, a holding company may in the ordinary course incur tax liabilities or liabilities to its advisers which may not be written down under the local law. If the existence of such liabilities impairs structural subordination, this exemption for a holding company could become almost meaningless in practice. As a result, there may be uncertainty as to whether Section 13(c) implicitly excludes some minor liabilities so as to serve the objective of this exemption.

10.3 The FMLC is, therefore, of the opinion that the uncertainty as to the applicability of Section 13(c) should be resolved by making it clear that, for this purpose, excluded liabilities arising in the ordinary course of business of a holding company can be disregarded, at least within a specified value limit.

## 11. ELIGIBLE INSTRUMENTS UNDER LONG-TERM DEBT REQUIREMENT

11.1 Section 7 of the FSB Term Sheet expresses an "expectation" that the sum of a resolution entity's (i) Tier 1 and Tier 2 capital instruments in the form of debts and (ii) other eligible TLAC instruments which do not constitute regulatory capital is at least 33% of its minimum TLAC requirement.

11.2 According to these criteria, it is not clear whether equity-accounted additional Tier 1 capital, which is legally a debt, would be permitted to count towards the long-term debt requirement under Section 7 if it satisfied all other TLAC eligibility criteria. In addition, it is unclear how the word "expectation" should be interpreted. Uncertainties include the circumstances in which such expectation would apply and the consequences of breaching it.

11.3 The FMLC would, therefore, welcome clarification of the scope of equity-accounted additional Tier 1 capital instruments which are eligible under these criteria and further consideration as to the legal meaning of "expectation", including the circumstances in which such expectation may have any legal implication and the consequences of the breach.

## 12. INTERNAL TLAC REQUIREMENTS IN CHANGE OF CONTROL

12.1 Section 20(c) of the FSB Term Sheet states that Tier 1 and Tier 2 regulatory capital instruments issued externally by a material subsidiary may count towards that subsidiary's internal TLAC requirement only to the extent that home and host authorities agree that the quantum of such capital do not cause a "change of control" risk in resolution that would be inconsistent with the agreed resolution strategy. According to this Section, this does not limit a host authority's legal power to impose TLAC requirements on such a subsidiary.

12.2 A "change of control" may be triggered by the application of bail-in tools which could entail conversion or write-off of TLAC instruments issued by resolution entities or other G-SIB group entities. Since such conversion or write-off could occur at all levels of the G-SIB groups, it is unlikely that the bilateral agreement between home and host authorities would eliminate a change of control risk in resolution. For example, where a resolution entity in London ("A") has a control over a resolution entity in Hong Kong ("B") and B has a control over a material subsidiary in Tokyo ("C"), an agreement between B's resolution authority and C's resolution authority would not eliminate a change of control risk on C if the application of bail-in tools to A by A's resolution authority causes a new controller of C to arise. In addition, capital structures of G-SIBs may change over time. Even if the resolution authorities were able initially to agree on the removal of unwelcomed change of control risk, a subsequent change in capital structures at all levels of the G-SIB group, at least some of which would be outside the control of such resolution authorities, could pose a change of control risk.

12.3 Unless the circumstances where a change of control risk can be deemed negligible are clearly specified, it would become difficult for relevant authorities to reach an agreement. In the case where the home and host authorities cannot agree on the elimination of a change of control risk, the resolution authority of a material subsidiary may still consider introducing local TLAC requirements applicable to such subsidiary. In such a case, the subsidiary may be required to issue Tier 1 and Tier 2 regulatory capital instruments externally, but such instruments may not count towards the material subsidiary's internal TLAC requirement.

12.4 The impracticability of eliminating a change of control risk makes it uncertain under what circumstances the home and host authorities may agree that the quantum of externally issued regulatory capital can count towards the material subsidiary's internal TLAC requirement. The FMLC is, therefore, of the view that such circumstances should be clearly identified rather than leaving the issue solely to bilateral negotiation between various jurisdictions for the purpose of facilitating an agreement between home and host authorities.

## 13. CONCLUSION

13.1 The FMLC welcomes the FSB's initiative and the introduction of the minimum TLAC requirements in an internationally coordinated manner. The FMLC also notes that the FSB Proposal is still at an early stage. The Committee is concerned, however, that a number of legal uncertainties may arise from the provisions of the FSB Term Sheet and believes that the importance of the issues raised in this paper warrant their timely consideration. The FMLC would welcome further clarification from the FSB with respect, in particular, to the details of the proposed terms and their possible interaction and conflict with existing and proposed local regulatory frameworks such as those under the BRRD and the CRR in the EU.  To address these uncertainties, this paper has set out a number of proposed solutions and invites the FSB to take further initiative to promote international coordination.

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[11] Note that Members act in a purely personal capacity. The names of the institutions that they ordinarily represent are given for information purposes only.