Client Alert

November 9, 2015

Resolution of GSIBs – FSB Final TLAC Principles

On 9 November 2015, the Financial Stability Board (FSB) published its final principles on the loss-absorbing and recapitalisation capacity of global systemically important banks (G-SIBs) in resolution together with a final version of its term sheet (Term Sheet) for total loss-absorbing capacity (TLAC).

For each bank labelled by the FSB as a G-SIB[1], the FSB principles establish minimum levels of loss-absorbing capital that must be held as a percentage of its risk-weighted assets (RWA). Subject to certain conditions, the TLAC requirements can be partially met by tier 1 and tier 2 capital that meets the Basel III minimum capital requirements. However, capital held by G-SIBs for the purpose of complying with the Basel III capital conservation buffer and counter-cyclical capital buffer requirements will not be counted towards the G-SIB's TLAC requirements. The same is true of the supplemental capital conservation buffer requirements prescribed by the FSB for the 30 G-SIBs (i.e., between 1% and 3.5% of RWAs). Banks designated as G-SIBs before the end of 2015, other than banks headquartered in an emerging market economy (EME), must meet a minimum TLAC requirement as from 1 January 2019 of at least 16% of risk-weighted assets and at least 6% of the Basel III leverage ratio denominator. As from 1 January 2022, such firms must maintain minimum TLAC requirements of at least 18% RWA and at least 6.75% of the Basel III leverage ratio denominator.

Non-EME G-SIBs designated as such between 2016 and the end of 2018 would have to meet the 18% / 6.75% requirements by 1 January 2022, and those designated as G-SIBs after 2018 would have to meet such requirements within three years after such designation.

G-SIBs that are currently headquartered in an EME will need to comply with the 16% / 6% requirement by 1 January 2025 and the 18% / 6.75% requirement as from 1 January 2028, although this staggered compliance period can be accelerated if the EME's outstanding corporate debt securities or bonds exceed 55% of the EME's gross domestic product.

These final calibrations are towards the lower end of the range consulted on by the FSB in its November 2014 proposals, but when added to a fully loaded capital conservation buffer and G-SIB supplemental charge will still mean G-SIBs being required to hold TLAC of between 19.5% to 22% of RWA as from the beginning of 2019 (assuming no counter-cyclical capital buffer). These final figures were based upon a quantitative impact study conducted by the FSB during 2015, as well as a market survey to gauge the depth of markets for external TLAC-eligible instruments, and a study to evaluate the historical losses and recapitalisation needs of large banks.

---

[1] The notice list of banks designated as G-SIBs was published by the FSB on 3 November 2015 and lists 30 global banks. The list is available here: http://www.financialstabilityboard.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf.

Our earlier client alert, "Safe to Fail"[2] summarises the pre-consultation proposals of the FSB in the TLAC Term Sheet. Set out below, we have highlighted the main changes made to the TLAC Term Sheet post consultation.

MPE G-SIBs

The resolution authorities of two of the world's major banking jurisdictions, the Federal Deposit Insurance Corporation and the Bank of England, have both promoted a single-point-of-entry (SPE) approach to resolution for banks in its jurisdictions. However, concerns were raised during the FSB's TLAC consultation about ensuring a level playing field for G-SIB groups that are subject to a multiple-point-of-entry (MPE) resolution strategy and therefore could contain two or more resolution groups within the G-SIB group. The Term Sheet has now clarified that, for MPE G-SIBs, the sub-consolidated balance sheet RWAs of each resolution group should be calculated inclusive of exposures to other resolution groups with the same G-SIB. Where these exposures correspond to liabilities eligible for TLAC, they must be deducted from TLAC resources. This deduction also applies to exposures to external TLAC that are issued from a resolution entity to a parent that is also a resolution entity.

In addition, the Term Sheet allows flexibility for the G-SIB's crisis management group (CMG), which consists of various authorities, including the G-SIB's home authority and any relevant host authorities, to agree on the allocation of deductions of eligible TLAC to the various relevant locations so that a deduction of "surplus TLAC" can be made at the level of the subsidiary resolution entity rather than the parent. In addition, in cases where the sum of the minimum TLAC requirements for MPE resolution entities is greater than the hypothetical SPE minimum TLAC requirement, then an adjustment may be made to reduce or eliminate the difference.

Consistency with Basel III

Subject to certain conditions, capital that qualifies towards minimum regulatory capital requirements pursuant to Basel III may also count towards satisfying the minimum TLAC requirement. However, there is a potential inconsistency between Basel III and the TLAC criteria in respect of the actual availability of resources in resolution, for instance, in respect of instruments with an insufficiently long maturity or which are not issued out of the resolution entity itself. Therefore, the Term Sheet provides that, in order for it to be a TLAC-eligible instrument, the instrument must meet all the core eligibility for criteria set out in the Term Sheet and as from 1 January 2022 must be issued directly from the resolution entity. The only exceptions to this rule are in the case of an instrument issued from a subsidiary within the resolution group, to the extent that this is recognised as common equity Tier 1 capital (CET1) for a consolidated resolution entity under the Basel III framework and also in the case of regulatory capital instruments issued by cooperative banks that have in place an institutional protection scheme or something similar that protects the solvency and the liquidity of the affiliated cooperative banks and institutions.

Liabilities eligible for external TLAC

The FSB has retained its stated expectation that at least one third of the minimum TLAC requirements will be met by tier 1 and tier 2 regulatory capital instruments in the form of debt liabilities plus other TLAC-eligible instruments that are not eligible as regulatory capital.

It also continues to emphasise that liabilities that are not eligible for TLAC will still remain subject to potential bail-in in resolution if so provided by the relevant resolution law and resolution strategy for the G-SIB. It considers this an important clarification to make in light of the fact that in many jurisdictions there will be significant differences between those liabilities that can potentially be bailed-in in a resolution, according to the resolution law, and those liabilities that are allowed to be counted towards the FSB's minimum TLAC requirements.

[2] See our client alert of 5 December 2014, http://www.mofo.com/~/media/Files/ClientAlert/2014/12/141205SafetoFail.pdf.

Issuance of external TLAC by non-resolution entities

Generally, external TLAC must be issued and maintained directly by resolution entities, though the FSB has agreed to some accommodations to assist G-SIBs in jurisdictions where there may be legal or practical obstacles to issuing directly out of the resolution entity. Therefore, the Term Sheet allows debt liabilities issued by a wholly and directly-owned funding entity of the resolution entity prior to 1 January 2022 to count towards external TLAC, provided that:

- the issuance is consistent with paragraph 65 of the Basel III framework, including that the assets of the funding entity must meet the eligibility criteria for TLAC instruments;
- there is substantial legal certainty that the TLAC will absorb losses at the resolution entity in its resolution; and
- home and host authorities in the CMG have agreed on the issuance through the funding entity.

In addition, the Term Sheet provides for a phase-out from eligible TLAC of regulatory capital instruments issued from subsidiaries within the resolution group by the end of 2021, except where the instrument constitutes CET1 regulatory capital for the consolidated resolution entity under paragraph 62 of the Basel III framework.

TLAC eligibility and excluded liabilities

The Term Sheet seeks to clarify some of the criteria for liabilities being eligible for TLAC or being excluded from TLAC. In particular, it specifies that, for an instrument to be TLAC-eligible, it must have a minimum remaining contractual maturity of at least one year, or, alternatively, it may be perpetual, i.e., it may have no maturity date at all. In addition, it may not be redeemable by the holder prior to maturity via a put option, with the exception that if the earliest possible date on which the holder can exercise the put option is a date certain, falling at least one year after the assessment of eligibility, it will be TLAC-eligible.

Many respondents to the consultation requested clarification on the subordination requirements for TLAC-eligible liabilities. As a result, the Term Sheet specifies clearly that eligible TLAC must absorb losses prior to excluded liabilities and, therefore, that, for an instrument to be eligible for TLAC, it must be subordinated to excluded liabilities of the resolution entity, whether by contractual subordination, by statutory subordination or by being issued by a resolution entity that has no excluded liabilities that rank *pari passu* or junior to TLAC-eligible instruments. However, a liability that does not appear on the list of excluded liabilities but which nevertheless does not meet all the requirements for TLAC-eligibility may rank *pari passu* with TLAC- eligible liabilities.

Derivatives and Structured Securities

The list of liabilities excluded from TLAC includes some liabilities that are clearly bail-inable under many resolution regimes but which the FSB perceives as being potentially difficult to bail-in in practice in a resolution. This includes liabilities arising from derivatives and debt instruments with derivative-linked features, such as structured notes. Unlike the recently proposed rule by the Federal Reserve Board in the United States[3], the term "structured note" is not specifically defined by the FSB. During the FSB's consultation, many respondents raised questions regarding classification of structured notes as excluded liabilities, particularly in the case of structured notes which were principal-protected.

However, the FSB stated that it was uncertain as to how easily structured notes could be exposed to loss in resolution in general, as bail-inability depends on a range of factors, including a jurisdiction's preferred resolution

[3] See our client alert of 1 November 2015, http://www.mofo.com/~/media/Files/ClientAlert/2015/11/151101tlac.pdf.

tools, the timeline for valuation of liabilities and for admitting claims and the ability of resolution entities to provide reliable valuations. For these reasons, liabilities arising from derivatives (whether securitised or otherwise) remain excluded from TLAC.

Subordination

Also included on the list of excluded liabilities are insured deposits, as well as sight deposits and deposits with an original maturity of less than one year. Since eligible TLAC is required to be subordinated to excluded liabilities, this therefore means that so-called "senior" unsecured liabilities (such as senior unsecured bonds) will not be able to count towards TLAC unless they are subordinated to liabilities such as deposits, derivatives and structured notes. In reaction to these requirements when they appeared in the FSB's consultation, Germany has proposed statutory rules that would have the effect of explicitly subordinating tradeable senior unsecured bonds both to insured retail deposits and also to non-preferred corporate deposits, derivatives and structured notes, with the intention that tradeable senior unsecured bonds issued by German Banks would become eligible for TLAC as a result of such statutory subordination.

In response to a number of comments during the public consultation, the FSB has agreed to a de minimis exception to the rule requiring subordination of eligible TLAC to excluded liabilities. The de minimis exception applies if:

- the amount of excluded liabilities ranking pari passu or junior to the TLAC-eligible liabilities does not exceed 5% of the resolution entity's eligible external TLAC;
- the resolution authority of a G-SIB has authority to differentiate between pari passu creditors in resolution;
- such differentiation in favour of excluded liabilities would not give rise to material risk of successful legal challenge or valid compensation claim; and
- the de minimis exemption would not have a material adverse impact on resolvability of the institution.

In addition, in jurisdictions where the resolution authority has power, under exceptional circumstances, to exclude from bail-in all of the TLAC excluded liabilities, the authority may permit liabilities ranking pari passu to excluded liabilities (but which would otherwise be eligible for TLAC) to count towards TLAC, up to 2.5% RWA of the minimum TLAC requirement when this requirement is 16% RWA and up to 3.5% RWA when the minimum TLAC requirement is 18% RWA. However, the Term Sheet makes clear that a G-SIB can utilise only one of the above exceptions.

Redemption Restrictions

Following requests for clarification during the consultation, the FSB's final standards specify more clearly that supervisory approval is not required for all redemptions of eligible TLAC, but only those that would lead to a breach of the minimum TLAC requirement.

Internal TLAC

In addition to specifying required amounts of external TLAC, the Term Sheet retains provisions dealing with the internal TLAC requirements for G-SIBs. The main objective of internal TLAC is to foster cooperation between home and host resolution authorities and the effective implementation of cross-border resolution strategies by the appropriate allocation of loss-absorbing capacity and capacity within resolution groups outside of the resolution entity's home jurisdiction.

In this context, a material sub-group is a group consisting of one or more direct or indirect subsidiaries of a resolution entity that:

- are not themselves resolution entities;
- do not form part of another material sub-group of the G-SIB;
- are incorporated in the same jurisdiction outside of the resolution entity's home jurisdiction (unless the CMG agrees otherwise); and
- either on a solo or a sub-consolidated basis have more than 5% of the consolidated risk-weighted assets or total operating income of the G-SIB group or have a total leverage exposure measure larger than 5% of the G-SIB's consolidated leverage exposure measure or have otherwise been identified by the CMG as material to the carrying on of the G-SIB's critical functions.

In terms of the size of the internal TLAC requirement, the final principles remain as per the November 2014 proposals, being that each material sub-group must maintain internal TLAC of between 75% to 90% of the external minimum TLAC requirement that would apply to the sub-group if it were a resolution group. The actual minimum internal TLAC requirement within that range is to be determined by the host authority of the material sub-group in consultation with the home authority of the resolution group. The higher the percentage set by the host authority, the more loss-absorbing capacity would become trapped in that jurisdiction and become unable to be deployed to other parts of the group in financial difficulty.

European Requirements

The Term Sheet and the FSB's final principles will not become binding on any G-SIB until its home jurisdiction has enacted national laws to implement these provisions.

The EU's Bank Recovery and Resolution Directive (BRRD) already provides, in concept, for EU banks to hold certain levels of loss-absorbing capacity. In the case of the BRRD, the loss-absorbing capacity is known as the Minimum Required Eligible Liabilities (MREL) and is to be set by each national resolution authority within the EU in respect of the banks that are headquartered in its jurisdiction on a bank-by-bank basis. The MREL requirement will apply not only to systemically important banks but to all EU banks. However, rather than being expressed as a percentage of risk-weighted assets, it will be stated as a required minimum percentage of the total liabilities and own funds of the bank.

Unlike the FSB's principles, the MREL provisions are to apply as from 1 January 2016 once the European Commission has adopted the European Banking Authority's (EBA) proposed regulatory technical standards, although the EBA has recommended that national resolution authorities should have the discretion to apply a transitional period whereby banks could comply with reduced MREL requirements until as late as January 2020.

Although there are some obvious differences between the MREL requirements and the FSB's TLAC requirements, the European Banking Authority, in drafting the MREL regulatory technical standards to be observed by national resolution authorities, has noted that its work has considerable overlap with the work of the FSB. The EBA has stated that it aims for the MREL requirements to be implemented in a way that is consistent with the FSB's TLAC requirements while at the same time ensuring proportionality in the MREL requirements in relation to banks that are not G-SIBs.

U.S. Requirements

On 30 October 2015, the Federal Reserve Board (Board) issued for comment a notice of proposed rulemaking (Proposed Rule) that would require U.S. bank holding companies that are G-SIBs to maintain a minimum amount of loss-absorbing instruments, including capital and unsecured long-term debt. In addition, the U.S. intermediate holding companies (IHCs) of non-U.S. banking organisations would be required to maintain a minimum amount of upstream loss-absorbing instruments, including unsecured long-term debt.

For a G-SIB that is a non-U.S. banking group and is active in the United States and subject to an IHC requirement, the Proposed Rule would mean the G-SIB would have to comply with its parent home jurisdiction's enactment of the FSB's final TLAC rules, in addition to having to comply with the Board's final rule at IHC level. Non-U.S. banking organisations that are active in the United States may therefore wish to submit comments on certain aspects of the Board's Proposed Rule for IHCs.

* * *

We have produced a TLAC quick reference summary, accessible here:
http://www.mofo.com/~/media/Files/PDFs/150831TLACCheatSheet.pdf

Contacts

Jeremy C. Jennings-Mares
London
+44 (20) 79204072
jjenningsmares@mofo.com

Oliver I. Ireland
Washington D.C.
+1 (202) 778-1614
oireland@mofo.com

Anna T. Pinedo
New York
+1 (212) 468-8179
apinedo@mofo.com