Client Alert

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Safe to Fail?

On 10 November 2014, the Financial Stability Board (FSB) launched a consultation[1] on the adequacy of the loss-absorbing capacity of global systemically important banks (G-SIBs) in resolution. The Basel III minimum capital requirements for banks have already been implemented in many jurisdictions, including in Europe by virtue of the Capital Requirements Regulation and in the United States in July 2013. These rules require banks to hold certain amounts of different types of loss-absorbing capital, expressed as a percentage of their total risk-weighted assets – common equity Tier 1 capital of at least 4.5%, total Tier 1 capital (common equity Tier 1 + additional Tier 1) of 6% and total combined Tier 1 and Tier 2 capital of 8%.

On top of these minimum capital requirements, Basel III also prescribed the maintenance of capital buffers – a capital conservation buffer and, in certain circumstances, a counter-cyclical capital buffer. Failure to maintain the required levels of buffers leads to restrictions on payments of dividends and discretionary remuneration. The capital conservation buffer must be at least 2.5% of risk-weighted assets, the counter-cyclical capital buffer can be up to 2.5% of risk-weighted assets, and both buffers must consist of common equity Tier 1 capital.

In addition to the Basel III minimum capital and capital buffer requirements, the FSB has prescribed additional common equity Tier 1 capital requirements for those banks considered to be G-SIBs in a range of between 1% and 3.5% of risk-weighted assets. In its latest list of banks considered to be G-SIBs as of November 2014,[2] 30 global banks are named and assigned to various different levels (or "buckets") of required additional capital. This additional loss absorbency is to be implemented by way of an extension of the normal capital conservation buffer of 2.5% that applies to all internationally active banks. In the United States, the largest banks also are subject to a supplemental leverage ratio.

Total Loss-Absorbing Capacity (TLAC)

However, the FSB remains concerned that bank supervisors and markets need to have confidence that systemically important banks are truly no longer "too big to fail" and are resolvable without the use of public funds. It considers that, in order to have confidence that these firms have sufficient capacity to absorb losses, before and during resolution, there needs to be an internationally-agreed standard on an appropriate level of total loss absorbing capacity for G-SIBs.

[1] "Adequacy of loss-absorbing capacity of global systemically important banks in resolution" – 10 November 2014 - http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.
[2] http://www.financialstabilityboard.org/wp-content/uploads/r_141106b.pdf.

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The FSB's consultation paper contains a set of principles intended to ensure that there is sufficient loss-absorbing capacity available in a bank's resolution, such that the resolution authority can minimise any impact on financial stability, ensure the continuity of critical functions and avoid exposing tax payers to loss. It also contains a term sheet with more detailed proposals for implementing those principles in the form of an internationally-agreed standard.

Although maintaining adequate levels of loss-absorbing capacity cannot by itself guarantee either the non-failure of the bank or that a bank resolution would be effective, it is recognised as a vital piece of the framework for ensuring a successful resolution of a failing bank. In Europe, the Bank Recovery and Resolution Directive (BRRD) has now come into force and is to be implemented into national laws of EU member states by 1 January 2015, except for the bail-in provisions which are to be implemented by 1 January 2016. The BRRD includes a requirement for national authorities to establish minimum requirements for own funds and other liabilities that can be "bailed in" to absorb losses. The concept is that a bank should be funded by a minimum level of liabilities that are either designed by their terms to absorb losses, or can be made to absorb losses, in each case either by way of conversion of the liability into an equity instrument or by the permanent writing down of the principal amount of the liability.

In the United States, the Federal Deposit Insurance Corporation (FDIC), in December 2013, also published a notice on its approach to single-point-of-entry (SPOE) resolution, in which it sought comments on the amount and characteristics of loss-absorbing capacity that should be required to be held at the bank's holding company level in order for this approach to be successful.

Under the SPOE approach in the United States, the bank holding company of a systemically important financial institution (SIFI) would be placed into FDIC receivership. The FDIC would then transfer the SIFI's assets, including any investments in its subsidiaries, to a newly formed bridge financial company. The failed holding company's secured liabilities and possibly limited unsecured liabilities would also be transferred to the bridge financial company. Shareholders' equity, senior unsecured debt and subordinated debt of the failed holding company would not be transferred to the bridge financial company and would remain as claims of the failed bank. In order to ensure the effectiveness of the SPOE approach, the Federal Reserve has for some time been working with the FDIC to formulate a long-term debt requirement at the bank holding company level. Federal Reserve Governor Tarullo has explained that, "while minimum capital requirements are designed to cover losses up to a certain statistical probability, in the even less likely event that the equity of a financial firm is wiped out, successful resolution without taxpayer assistance would be most effectively accomplished if a firm has sufficient long-term unsecured debt to absorb additional losses and to recapitalize the business transferred to a bridge operating company. The presence of a substantial tranche of long-term unsecured debt that is subject to bail-in during a resolution and is structurally subordinated to the firm's other creditors should reduce run risk by clarifying the position of those other creditors in an orderly liquidation process."

How Much Loss-Absorbing Capital?

The proposed approach of the FSB is to require a minimum level of capital that can absorb losses on both a going concern and a gone concern basis. This will include the capital that is held to satisfy the Basel III minimum capital requirements, but will exclude capital held as part of the Basel III capital buffers, such as the capital conservation buffer (and the G-SIB extension of this buffer) as well as the counter-cyclical capital buffer.

The FSB proposes, firstly, that the minimum Pillar 1 TLAC requirement should be in the range of 16 to 20% of risk-weighted assets. This would mean that a global bank that falls in the 2.5% bucket of the G-SIB buffer would have to hold TLAC of between 21% and 25% of its risk-weighted assets, assuming no counter-cyclical buffer applied. Authorities would also be free to set additional, institution-specific Pillar 2 requirements on top of these.

Secondly, the Pillar 1 requirement should also be at least twice the Basel III Tier 1 leverage ratio requirement. The Basel III leverage ratio requirement, instead of looking at a ratio of capital to risk-weighted assets, measures an institution's Tier 1 capital against its total (non-weighted) assets and off balance sheet exposures. As currently proposed by Basel, between 1 January 2015 and 1 January 2017, a leverage ratio of 3% will be tested, with a view to the final, calibrated leverage ratio being in full effect from 1 January 2018. Therefore, if the leverage ratio remains at the proposed 3%, the FSB's proposals will mean that, in addition to the G-SIB holding TLAC of between 16 and 20% of its risk-weighted assets, capital would also need to be at least equal to 6% of the G-SIB's total non-risk-weighted exposures plus off balance sheet exposures.

The FSB intends that a breach of the minimum TLAC requirement should be dealt with by bank supervisors as severely as a breach of minimum regulatory capital requirements.

As stated above, the required minimum levels of TLAC will include capital that already counts towards the G-SIB's minimum Tier 1 and Tier 2 capital requirements, but the FSB has stated that it expects that at least 1/3 of the minimum Pillar 1 TLAC requirement will be satisfied in the form of debt capital instruments and other TLAC-eligible liabilities that are not regulatory capital. The FSB's reason for this specification is not immediately clear. These kinds of liabilities are no more loss-absorbing than other TLAC. In fact those that do not constitute regulatory capital are likely to rank senior to regulatory capital in the statutory insolvency pecking order.

Location of TLAC Within Group Structures

The financial crisis demonstrated the truth of the maxim "global in life, national in death", when applied to international banking groups, or in other words that, in contrast to the international nature of its operations, the responsibility for its failure falls on the authorities in its home state. This can create an incentive for regulators in the jurisdiction of incorporation of a material foreign bank subsidiary to require as much capital as possible to be held locally by that foreign subsidiary, so as to be available to ensure a successful resolution of that entity in the event of its failure.

The FSB's consultation therefore also sets out proposals for where TLAC should be held within the group structure of a G-SIB. Firstly, relevant authorities should determine their preferred resolution strategies and identify which entity within the G-SIB group their resolution tools would be applied to (a "resolution entity"). This may be the top-level parent, an intermediate holding company or a subsidiary operating company. Whichever it may be, a resolution entity and its direct and indirect subsidiaries are considered to form a "resolution group" within the G-SIB group. The FSB also acknowledges that within a G-SIB group there may in fact be more than one resolution group. It therefore proposes that the minimum TLAC requirement will apply to each resolution entity within a G-SIB group and will be set in relation to the consolidated balance sheet of each resolution group.

In terms of where within the resolution group the TLAC should be held, the FSB proposes that the foreign subsidiaries of the resolution entity that are material (i.e., that constitute at least 5% of the G-SIB group by risk-weighted assets, revenues or total leverage, or that are otherwise material to the group's critical functions), but are not themselves resolution entities, should be subject to an internal TLAC requirement in proportion to the size and risk of their exposures. The FSB intends that this "pre-positioning" of TLAC within foreign subsidiaries should reassure host authorities that there will be sufficient capital available to allow them to implement their resolution strategy and allow them to ensure continuity of critical functions and maintenance of financial stability.

It therefore proposes that the amount of internal TLAC to be pre-positioned in material subsidiaries should be equivalent to between 75% and 90% of the TLAC requirement that would apply to that material subsidiary on a stand-alone basis. This figure, however, is a tentative figure and will be the subject of a quantative impact study in early 2015, which is intended to assist in the calibration of the Pillar 1 minimum TLAC requirements.

TLAC-Eligible Instruments

The FSB has not been prescriptive as to what instruments should be eligible to count towards TLAC, but has expressly excluded certain liabilities. It expects minimum maturity restrictions to be applied, to ensure that resolution loss absorbency will not be diminished by the withdrawal of short-term funding to an institution in the lead-up to its failure. It therefore proposes excluding all liabilities of less than one year's maturity or that are callable on demand. In addition, the FSB has excluded the following from the list of eligible liabilities:

- insured deposits;
- liabilities funded directly by the issuer of the liability or a related party (unless relevant home and host authorities waive this exclusion);
- liabilities under derivatives, including securitised derivatives such as structured notes;
- secured or insolvency-preferred liabilities;
- tax and other non-contractual liabilities; and
- any other liabilities that cannot effectively be written down or converted under the laws governing the issuing entity.

The FSB's proposed exclusion from TLAC of structured notes and other securitised derivatives should prove controversial, especially for those containing a prescribed level of principal protection, and European banks would have been expecting to be able to count such liabilities towards their minimum loss-absorbing liabilities requirements under BRRD. Given that such securities can, in principle, be bailed-in in a resolution, it seems difficult to justify not being allowed to count them as bail-inable for the purpose of calculating TLAC.

The FSB states that operational liabilities to providers of critical services should not be included within TLAC, and in the EU, the BRRD also expressly excludes such liabilities from eligibility for bail-in.

Characteristics of TLAC-Eligible Liabilities

The FSB also stresses that authorities need to possess the necessary legal powers to impose losses on TLAC-eligible liabilities, without fear of legal challenge or compensation costs. In Europe, the BRRD implements this requirement by providing resolution authorities with a "bail-in" tool to require conversion or write-down of bail-inable liabilities, and also enshrines in statute the power of resolution authorities to write down or convert Tier 1 or Tier 2 capital at the point of the bank's non-viability.

In order to be eligible for TLAC, an instrument must be either:

- contractually subordinated to all excluded liabilities on the resolution entity's balance sheet, although it may rank senior to Tier 1 and Tier 2 capital; or
- junior in the statutory creditor hierarchy to all such excluded liabilities; or
- issued by a resolution entity that has no excluded liabilities on its balance sheet, e.g., a holding company.

However, the above does not apply for those jurisdictions in which all of the liabilities excluded from being TLAC, as discussed above, are excluded from the scope of any bail-in tool and therefore cannot legally be written down or converted to equity.

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In addition, where a liability eligible for TLAC is subject to set off or netting rights, the FSB states that only the net amount of the liability should be counted towards the TLAC requirement.

In the same way as for minimum regulatory capital, the FSB states that institutions should require prior supervisory approval before redeeming eligible TLAC instruments, unless they are being replaced with instruments of the same or better loss-absorbing capacity and the liability replacement will not impose unsustainable conditions on the bank.

TLAC-eligible instruments should be governed by the law of the resolution entity's jurisdiction of incorporation, or should contain legally enforceable contractual bail-in provisions that recognise the home state bail-in action, unless appropriate statutory cross-border bail-in recognition provisions apply.

Transparency

The FSB also mandates adequate disclosure, for each material legal entity, on the hierarchy of its different legal liabilities, so that creditors, investors, depositors, counterparties and customers will have as much clarity as possible as to whom losses would be absorbed by, and in what order.

Financial Contagion

Due to the interconnectedness of the financial system, the failure of a major financial institution can cause severe financial stress to other participants in the system and, as a result, the FSB proposes that bank supervisors should place prudential limits on the ability of banks to invest in liabilities that are eligible for a G-SIB's TLAC. The BRRD in Europe similarly prescribes that resolution authorities shall have the power, as part of an EU bank's resolution planning, to limit that bank's investment in liabilities eligible to be bailed-in.

Resolution Funds

The consultation proposes that, subject to certain conditions, including the agreement of the relevant authorities, if there exist "credible ex ante commitments" from resolution funding schemes to recapitalise a G-SIB in resolution as necessary to facilitate an orderly resolution, then such commitments may be counted towards the G-SIB Pillar 1 TLAC. The BRRD in Europe provides for each member state to establish a national resolution fund, funded mainly from ex ante contributions from its banks. However, the precise circumstances surrounding the permitted use of this fund, including the minimum levels of other loss absorption that must have first been effected, proved very controversial during the law-making stage of the BRRD, since this question is linked very closely to the ability of EU resolution authorities to exempt, on an ad hoc basis, a class of liabilities from being bailed-in. It remains to be seen to what extent this provision is of assistance to EU G-SIBs.

Emerging Markets

G-SIBs that are headquartered in emerging market jurisdictions are stated not to be subject, initially, to the minimum TLAC requirements. The FSB has not offered any reasoning for this stance, but based on the most recent list of G-SIBs, it will mean that the three largest Chinese banks will be exempt from these requirements.

United States

In the United States, as discussed above, the Federal Reserve has been studying a long-term unsecured debt requirement for some time. In speeches and in testimony, various Federal Reserve representatives have described it as a "requirement that large financial institutions have minimum amounts of long-term unsecured debt that could be converted to equity" and as "gone concern" capital. Already, in public remarks, Federal Reserve Governor Tarullo has noted that the U.S. TLAC requirements are likely to be more rigorous and may permit a

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more limited number of instruments to be issued. This would be consistent with the "super-equivalency" approach that the U.S. banking agencies have taken in implementing Basel III requirements for U.S. banks. Also, under the capital rules adopted in July 2013, U.S. banks have far fewer options than do their European counterparts in terms of the types of financial instruments that are considered eligible for Additional Tier 1 (AT1) capital.

Europe

The European Banking Authority, on 28 November 2014, released a consultation on its draft regulatory technical standards (RTS), specifying further criteria to be applied by EU member states in determining a minimum level of own funds and bail-inable liabilities for each institution under the BRRD. These RTS firstly consider the relationship between the institution's going concern capital requirements, on the one hand, and on the other hand the resolution authority's assessment of the amount of loss that the bank should be able to absorb (which may be the same as the overall capital requirements, including buffers, Pillar 2 requirements and backstop capital measures, prescribed by the bank's supervisor).

Secondly, they go on to consider how to determine the amount of recapitalisation that would be necessary to implement any preferred resolution strategy. This may be zero if the bank can be liquidated, or if the bank is to continue as a going concern, it will include the minimum capital amount necessary to meet the conditions for continuing authorisation, plus an additional amount determined by the resolution authority to be necessary to maintain sufficient market confidence in the recapitalised institution.

Market Impact

Although it may be premature, it seems reasonable that market participants may be concerned about the potential impact of the TLAC requirement on bank securities. For example, just as European investors in the securities of banks reacted sharply in 2011 when the bail-in regime first took shape, one might anticipate that investors in senior bank debt might be more focused on spreads. Perhaps the more noticeable impact may be on contingent capital AT1 instruments given that it may be more difficult to price differences between AT1 securities in a new capital structure that includes TLAC. Finally, if one considers that the Basel III requirements (both regulatory capital and the liquidity requirements) are already causing banks to reconsider their capital structures, the introduction of TLAC and possibly some new measure to reduce reliance on short-term wholesale funding will certainly lead to a shift in funding costs and in investor behavior.

Timing

Banks would be required to comply with the minimum TLAC requirements as from 1 January 2019, and would be subject to earlier reporting and monitoring provisions. This timing would coincide with the date on which the minimum capital, liquidity and leverage requirements of Basel III should be fully in effect. Comments on these policy proposals of the FSB can be made until 2 February 2015.

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