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TLAC: An Additional Capital Requirement for G-SIBs

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The Financial Stability Board recently issued for consultation proposals to increase the loss-absorbing capacity of global systemically important banks over and above the fully loaded Basel III capital standards.

Overview

The Financial Stability Board ("**FSB**"), in consultation with the Basel Committee on Banking Supervision (the "**Basel Committee**"), recently issued a long anticipated public consultation on requirements for sufficient "**total loss-absorbent capacity**" or "**TLAC**", which requires certain banks and bank groups to hold an increased amount of capital relative to both risk-weighted assets and non-risk-weighted assets. The new rules, once finalized, will be applicable to 29 global systemically important banks ("**G-SIBs**") and their related entities[1] and are expected to be implemented at national level in all relevant jurisdictions.

- The proposed TLAC, as set out in a detailed set of principles and a term sheet, has the following components:
- A minimum TLAC level of 16-20% of risk-weighted assets ("**RWAs**") – which is double the current Basel III capital level;
- A minimum of a 6% leverage ratio – which is twice the Basel III leverage requirement;
- Certain eligible types of debt instruments eligible; and
- The placement of TLAC among the various entities within a G-SIB group.

G-SIBs headquartered in emerging markets are to be excluded from the TLAC requirements, at least initially. The FSB will hold a Quantitative Impact Study ("**QIS**") over the next year and is expected to finalize the rules by the G-20 Summit in 2015. The effective date is to be no later than January 2019 and will be subject to change based on the results of the QIS.

[1] The FSB agreed a new list of G-SIBs on 6 November 2014, available at: http://www.financialstabilityboard.org/wp-content/uploads/r_141106b.pdf.

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Background

The TLAC proposal is one of the final components of a long-standing reform effort laid out in 2010 by the FSB to limit the probability and impact of the failure of large global systemically important financial institutions, *i.e.*, ending the too-big-to-fail (or "**TBTF**") phenomenon. At its core, TLAC bolsters capital and leverage ratios, thereby creating a greater capital cushion intended to further pre-empt any need for a taxpayer funded bail-out. TLAC will apply in addition to the capital requirements set out in the Basel III framework, including the countercyclical, G-SIB and other capital buffers.[2]

Other measures to tackle the TBTF issue include improved bank resolution legislation such as the bank recovery and resolution regimes in both the EU (as set out in the Bank Recovery and Resolution Directive ("**BRRD**")[3]) and the US (through the Orderly Liquidation Regime ("**OLA**")). US and EU rules both mandate each systemically important bank to submit a "living will" setting out detailed plans on how the bank would handle stress. Both the BRRD and OLA further give regulators wider powers for resolving bank distress, including the ability to write down or convert some of the bank's liabilities with so-called "bail-in" debt. TLAC debt is specifically required to be bail-in-able, that is, convertible into equity or written down.

Minimum Level of TLAC

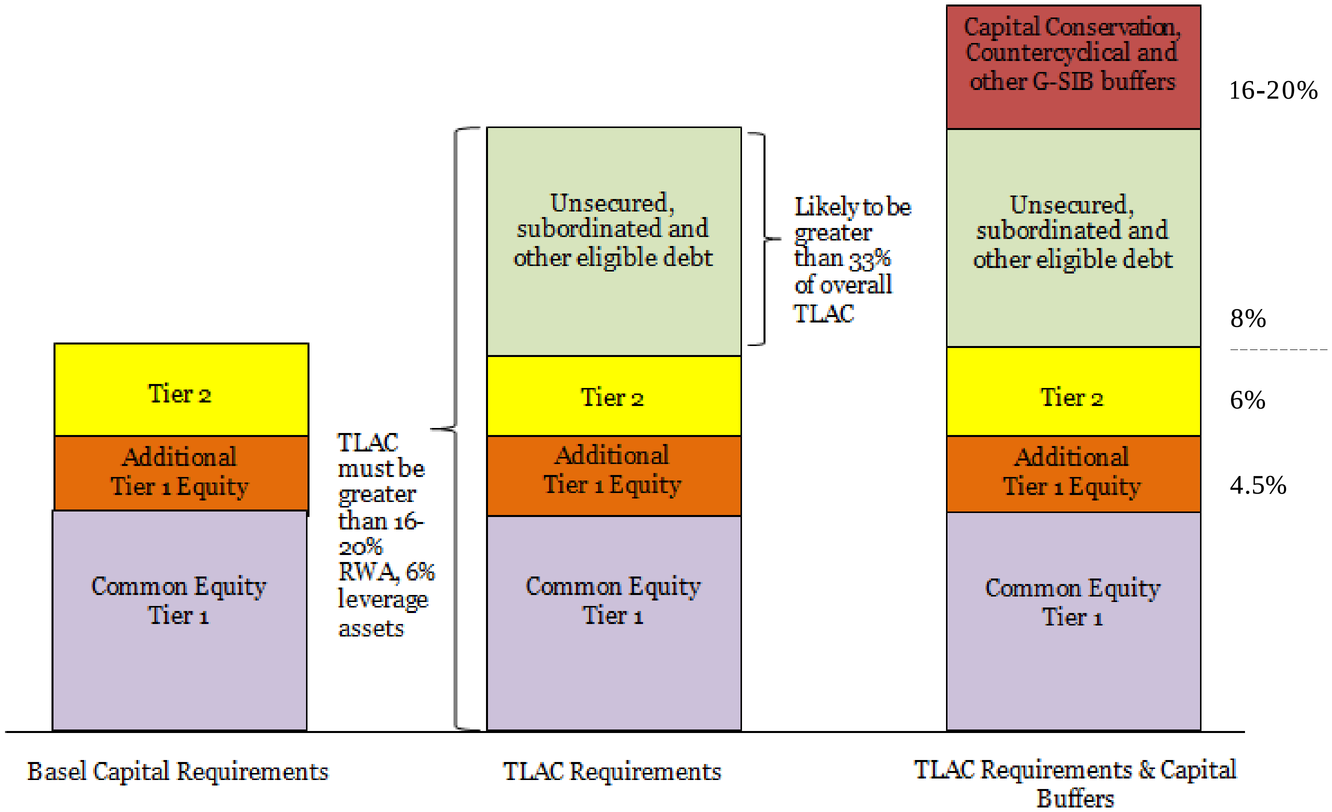
The minimum TLAC requirement will be within the range of 16%-20% of the group's RWAs and at least 2x the fully loaded Basel III leverage ratio requirement. This is considered the "Pillar 1" requirement according to the FSB. Regulatory authorities may set additional requirements above their so-called minima, also known as the "Pillar 2" component of TLAC.

It is expected that TLAC, in the form of debt instruments meeting certain TLAC eligibility criteria (apart from instruments comprising regulatory capital), will be greater than a third of the overall Minimum Pillar 1 TLAC requirement.

[2] See our "*Regulatory Capital Library – Publications*" on Basel III and various final standards supplementing Basel III, available at: http://www.shearman.com/en/services/practices/basel-iii-regulatory-capital.

[3] Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0059&from=EN.

TLAC in Addition to Basel Capital Requirements



External vs. Internal TLAC

In terms of the location of TLAC within a group, TLAC debt is broken down into "**External TLAC**" and "**Internal TLAC**."

- External TLAC is TLAC that is issued to third parties and is applicable to each resolution entity within the G-SIB group. Depending on the resolution strategy that is applied, a resolution entity could be the parent of a subsidiary operating company or the ultimate or intermediate holding company. Resolution strategies can focus on resolving a whole group through the parent holding company ("**single-point of entry**", or "**SPOE**") or resolving the whole group by compartmentalizing it by regulated entity or subgroup ("**multiple-point-of-entry**", or "**MPOE**") which would be subject to the resolution framework of the jurisdiction in which the resolution entity is incorporated.
- Outside of each resolution entity, there is a further Internal TLAC requirement applicable to each material subsidiary of a resolution entity that is incorporated in a jurisdiction other than that of the resolution entity. The idea is that such subsidiaries can be re-capitalized through Internal TLAC instruments held by parent resolution entities without requiring statutory resolution tools to be applied to such subsidiaries.
- A subsidiary is identified as material if it meets one of the following criteria:
  - has more than 5% of the consolidated RWAs of the G-SIB group; or
  - generates more than 5% of the consolidated revenues of the G-SIB group; or
  - has a total leverage exposure larger than 5% of the G-SIB group's total leverage exposure; or
  - has been identified by the firm's Crisis Management Group ("**CMG**") as material to the exercise of the firm's critical functions.

The amount of Internal TLAC to be held by each material subsidiary is set at 75-90% of the minimum that would apply if the subsidiary was a resolution entity itself. This is to be calculated by the subsidiary's regulator if it is incorporated outside the jurisdiction of its parent resolution entity. If the Internal TLAC is not pre-positioned, *i.e.*, already on the subsidiary's balance sheet, it needs to be nonetheless readily available to recapitalize the subsidiary in a resolution scenario.

Eligible TLAC Instruments

Eligible TLAC instruments include debt and equity instruments that count as Tier 1 or Tier 2 regulatory capital as well as other debt instruments that meet each of the following criteria:

- must be unsecured;
- must have a minimum remaining maturity of at least one year;
- must absorb losses prior to "excluded liabilities" in insolvency or in resolution without giving rise to material risk of successful legal challenge or compensation claims;
- must be subordinated to excluded liabilities that are on the balance sheet of the resolution entity;
- may be ranked as senior to capital instruments, including Tier 2 subordinated debt, in the creditor hierarchy or junior to all "excluded liabilities";
- may be issued by a resolution entity which does not have excluded liabilities on its balance sheet (for example, a holding company). In such a case, there is no need for the TLAC issued from such a resolution entity itself to be contractually or statutorily subordinated;
- must be held by third parties that would satisfy minimum External TLAC requirements and have a contractual trigger or other statutory mechanism that allows regulatory authorities to write-down/write-off or convert into equity; and
- instruments eligible for the External TLAC requirement may not be hedged or netted in a way that would reduce their ability to absorb losses in resolution.

Credible *ex-ante* commitments from authorities that contribute to resolution funding costs, or other temporary resolution funding, may count towards the Pillar 1 Minimum TLAC requirement subject to the agreement of relevant supervisory authorities. However, these commitments must be pre-funded by industry contributions and can only account for up to 2.5% of RWAs, which could be higher if the minimum Pillar 1 TLAC requirement exceeds 16% of RWAs.

Eligibility criteria for Internal TLAC are the same as the core criteria for eligible External TLAC (except for the issuing entity and permitted holders). Home and relevant host authorities in CMGs may jointly agree to substitute on-balance sheet Internal TLAC with Internal TLAC in the form of collateralized guarantees, subject to certain conditions.

The following are excluded liabilities and do not count towards the external TLAC requirement:

- insured deposits;
- liabilities that may be callable on demand without supervisory approval;
- liabilities that are funded directly by the issuer or a related party of the issuer, except where the relevant home and host authorities in the CMG agree that it is consistent with the resolution strategy to count eligible liabilities issued to a parent of a resolution entity towards external TLAC;
- liabilities arising from derivatives or debt instruments with derivative linked features, such as structured notes;

- liabilities arising other than through a contract, such as tax liabilities;
- liabilities which are preferred to normal senior unsecured creditors under relevant insolvency laws; and
- any other liabilities that, under the laws governing the issuing entity, cannot be effectively written-down or converted into equity.

Notwithstanding the exclusion of these liabilities, they may still be subject to bail-in under national recovery or resolution regimes.

Disclosure

G SIBs must disclose the amount, maturity, and composition of TLAC maintained by each resolution entity and at each material subsidiary. G SIBs must also disclose, at a minimum, the amount, nature and maturity of any liabilities of each resolution entity which in the relevant creditor hierarchy rank *pari passu* or junior to liabilities which qualify for inclusion as Minimum TLAC. For material subsidiaries that are not themselves resolution entities, any liabilities which rank *pari passu* with or junior to Internal TLAC will need to be disclosed. The FSB will work with the Basel Committee to carry out further work to specify the disclosure requirements.

Timeline

The FSB will hold a QIS over the next year and is expected to finalize the rules by the next G-20 Summit in 2015. The effective date would be no earlier than January 2019. The final calibration of the Pillar 1 Minimum TLAC requirement will take account of the results of this consultation and the QIS and market survey. Any likely final implementation standard must be seen in the context of various other national initiatives directed at achieving more stable capital structures and liability profiles for systemically important banks.

Impact on Bank Balance Sheets

It is uncertain how the TLAC proposal will work in practice. The type of additional unsecured debt that will be eligible for TLAC purposes is effectively a new species of bank debt, and further stratifies the liability side of bank balance sheets. The relationship between this structural constraint on bank balance sheets and other constraints, for instance the minimum requirement for eligible liabilities (or "**MREL**") that applies to EU G-SIBs, is yet to be fully worked out. The MREL requirement applies to large EU banks and broker-dealers and requires a minimum amount of bail-in-able debt relative to total liabilities.

A further complexity arises from complex G-SIB structures and the tension between SPOE and MPOE modes of resolution. Satisfying the TLAC requirement at the ultimate holding company level may in many circumstances be the most effective means of ensuring all the operating subsidiaries can continue to function smoothly. It avoids the tricky position of ensuring TLAC debt is sufficiently distinct from normal operating liabilities so as to avoid any market concerns over the ramifications of TLAC bail-in. However, many G-SIBs, particularly EU G-SIBs, do not operate under a single holding company structure and would have to undergo a significant and costly corporate reorganization for such purpose. That said, given the long lead-in time before the TLAC proposals become effective, it is possible that banks may have undergone extensive restructuring by that time.

Impact on Markets

There is significant weight placed on the willingness of host regulators (supervising local operating subsidiaries) to rely on the parent to absorb losses, albeit much of the loss-absorbing capital would be "pre-positioned" on-balance sheet. More broadly, it is uncertain whether the market would be able to absorb large volumes of TLAC issuances which could run into the hundreds of billions of dollars.

In terms of pricing, and drawing on the experience of bail-in debt eligible for Additional Tier 1 or Tier 2 treatment, it is unclear how the market will be able accurately to account for and price conversion or write-down risk. Current secondary market pricing for bail-in debt arguably does not take into account the risk of conversion or write-down but merely reflects a risk of restructuring of the debt. The fallout from any conversion or write-down of TLAC debt and the effect on investor appetite for "bail-in" debt generally would likely impact the market for TLAC-eligible debt. In this context, clarity around the mechanics and timing of the conversion/write-down trigger will be crucial.

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