

Ten key points from the FSB's TLAC ratio

On November 10th, the Financial Stability Board (FSB) issued a long-awaited consultative document that defined a global standard for minimum amounts of Total Loss Absorbency Capacity (TLAC) to be held by Global Systemically Important Banks (G-SIBs). TLAC is meant to ensure that G-SIBs have the loss absorbing and recapitalization capacity so that, in and immediately following resolution, critical functions can continue without requiring taxpayer support or threatening financial stability.

The FSB's document requires a G-SIB to hold a minimum amount of regulatory capital (Tier 1 and Tier 2) plus long term unsecured debt that together are at least 16-20%¹ of its risk weighted assets (RWA), i.e., at least twice the minimum Basel III total regulatory capital ratio of 8%. In addition, the amount of a firm's regulatory capital and unsecured long term debt cannot be less than 6% of its leverage exposure, i.e., at least twice the Basel III leverage ratio. In addition to this "Pillar 1" requirement, TLAC would also include a subjective component (called "Pillar 2") to be assessed for each firm individually, based on qualitative firm-specific risks that take into account the firm's recovery and resolution plans, systemic footprint, risk profile, and other factors.

- 1. TLAC is manageable but will be costly for some G-SIBs:** The measure appears challenging but manageable for most G-SIBs who will have until 2019 to meet the minimum Pillar 1 requirements. Industry analysts have suggested that the range of shortfall at individual US firms is between \$0 and \$25 billion, based on a 16% TLAC requirement. Such shortfalls can be addressed through a combination of additional senior and Tier 2 debt issuances, and by RWA reductions. However, a TLAC requirement at the higher end of the proposed range (i.e., 20%), will impose significantly greater cost, and require changes in balance sheet management, for firms that use relatively lower levels of long term unsecured debt as part of their strategy. Countries with banks that have excess deposits relative to loans are likely to be forced to issue more TLAC debt as a percentage of current outstanding. For example, some US G-SIBs would face a greater TLAC challenge than their European peers, who already use more debt in their funding model.
- 2. TLAC's 33% debt requirement will be expensive:** The requirement that TLAC be composed of at least 33% long term (greater than one year) unsecured debt is meant to ensure that eligible debt instruments are available to absorb losses prior to all other liabilities (especially deposits). To be effective, such debt must be bailed-in without serious risk of legal challenge, so a contractual trigger or statutory mechanism would be needed. In our view, contractual triggers will likely be more effective than statutory mechanisms as they will provide investors with greater certainty and will facilitate improved credit ratings for banks with a great deal of TLAC.

¹ The range is expected to be narrowed down to a single number based on an FSB upcoming quantitative impact study.

3. US implementation is likely to be more severe than other jurisdictions': We expect next year's US proposal implementing TLAC to be more severe than the FSB's document, given recent comments by Federal Reserve Governor Dan Tarullo.² The US proposal will likely require a higher percentage of TLAC to be composed of long term unsecured debt (perhaps as high as 50% versus the FSB's proposed 33%) due to the US view that most, if not all, equity would be wiped out in resolution. More broadly, on top of TLAC we expect in the next few weeks a US proposal to implement Basel's G-SIB capital buffer which will assign an additional CET1 surcharge of 1 to 2.5%³ depending on the G-SIB's systemic risk level, and add another 1 to 1.5% CET1 surcharge depending on the G-SIB's reliance on short term wholesale funding. In addition, US implementation of Basel's capital conservation buffer will go into effect in 2016, which will require an additional 0.65% of CET1, rising to 2.5% by 2019. CET1 in excess of the required minimum of 4.5% would have to be attributed to both of these buffers – but not to TLAC. See the **Appendix** for a graphic that depicts the layering of these US requirements.

4. Deposit taking and “traditional banking” get penalized: By placing an emphasis on issuing unsecured long term debt, TLAC penalizes firms that rely mostly on deposits for their funding such as retail and commercial banks. Although deposits are treated nearly as favorably in Basel's recently finalized Net Stable Funding Ratio,⁴ firms get no credit for accepting deposits as part of traditional banking activities under TLAC. Thus, firms are essentially being required to pay similarly high premiums on their life insurance policies, despite differing probabilities of entering resolution. This approach perhaps makes more sense in Europe, where banks are generally less reliant on deposit funding and regulators need firms to have larger cushions to avoid the risk of needing government support, which due to their smaller economies they simply cannot afford.

² In Europe, the challenge will be to align the Minimum Requirement for Own Funds and Eligible Liabilities (“MREL”) within the Bank Recovery and Resolution Directive (“BRRD”) with TLAC. The EBA is expected to issue a paper on MREL in the next few days.

³ While the range-topping “bucket” under Basel's G-SIB buffer is currently at 2.5%, this range is subject to annual assessment and can be further extended in increments of 1% if deemed insufficient to address a G-SIB's systemic risk.

⁴ See PwC's *First take: Basel's final NSFR* (November 5, 2014).

5. Does TLAC favor certain business models over others?: There is wide disparity between firms with respect to their activities and sources of funding. Our review of US banks' size relative to their holding companies shows that US G-SIBs' banking assets range from about 30% to 90% of the assets of their US holding companies. To make up for the higher cost of issuing long term unsecured debt, some firms that have traditionally favored cheaper funding sources may decide to engage in riskier activities. We do not expect the calibration of TLAC that the FSB document calls for to greatly improve the situation. Although TLAC tries to strike a balance in its treatment of investment, commercial, and custody banking activities – by establishing minimum requirements based on both RWA and leverage exposure – it is an imprecise art to get the numerical balance right. The binding constraint will vary depending on business model (e.g., investment and custody banks will likely be more impacted by the leverage ratio, and commercial banks by the RWA measure). This balancing challenge is evidenced by the practical, but somewhat arbitrary, approach the FSB took of essentially doubling currently required regulatory capital and leverage ratios in order to arrive at TLAC minimums.

6. The TLAC solution may solve the wrong problem: As noted in the FSB document, the objective of TLAC is to facilitate the recapitalization of a failed firm and promote market confidence during and after resolution. This statement is the crux of the argument for setting TLAC levels; however, TLAC levels are based on current G-SIB profiles and do not seem to account for recovery plans developed by firms that would result in asset sales and be triggered well in advance of resolution (except in the extraordinary case of an immediate need for resolution of a large firm).⁵ Furthermore, TLAC is focused on the consolidated size of the firm as opposed to the subset of “critical functions” that are identified in resolution plans and would need to be saved. Given this, TLAC looks much more like an additional penalty for scale rather than a tool focused on facilitating resolution.

7. Pre-positioning of TLAC at foreign subsidiaries challenges global banking: The TLAC document envisions that foreign subsidiaries of G-SIBs that are deemed material (and are not resolution entities themselves) will need to have local TLAC available to them (called “internal TLAC” in the FSB document). Internal TLAC will

⁵ See PwC's *Regulatory Brief, Recovery planning: Until the last gasp* (October 2014).

need to be pre-positioned on the subsidiary's balance sheet and will be similar in form to TLAC at the holding company, except the amount to be held will be 75% to 90% of the amount that the subsidiary would have had to hold if it were a resolution entity itself. A major challenge will be whether jurisdictions can reach agreement as to which subsidiaries are "material" and therefore subject to holding internal TLAC.⁶ The FSB document is consistent with the emerging global trend to require more local capital (as evidenced by the US requirement for large foreign banks to establish Intermediate Holding Companies in the US⁷ or the trend in Europe to use subsidiaries rather than branches), largely due to lack of complete confidence that foreign parent companies (and home country governments) would have the capacity to fully support foreign operations. Furthermore, the document allows for host authorities to impose additional TLAC requirements on material foreign subsidiaries beyond 90%, which reflects the difficulties regulators face in establishing an effective global cross-border resolution regime. The long term trend will likely be toward fewer G-SIBs, and other firms having limited capability to support the needs of global customers.

- 8. Pillar 2 requirements are too imprecise to be meaningful now:** The FSB document provides no specific guidance on Pillar 2 requirements, which would be determined for each G-SIB individually based on qualitative criteria such as the firms' recovery and resolution plans, systemic footprint, risk profile and other factors. Besides a lack of criteria around factors used to determine the size of a firm's Pillar 2 TLAC requirement, the document states that this requirement should be established through discussion among both home and host jurisdiction regulators (e.g., the G-SIB's Crisis Management Group). Given the need for more effective global coordination in this area, including substantive progress on cross-border resolution regimes, we expect that it will take a very long time for concrete Pillar 2 requirements to come into effect.

- 9. Banking sector risk will be pushed to other sectors:** The FSB document requires that a G-SIB that holds an amount of TLAC debt issued by other G-SIBs deduct that amount from its own TLAC. Given the amount of unsecured senior G-SIB debt currently held by other G-SIBs, and the additional amount that will need to be raised to meet TLAC requirements, the pool of buyers for TLAC-eligible debt will be limited. Therefore, other potentially systemically important firms (e.g., insurance companies, asset managers, and hedge funds) will likely become TLAC debt holders and assume the risk of bank failures. Although this risk spreading may reduce contagion in the banking sector, it may produce the unintended effect of increasing broader systemic risk.

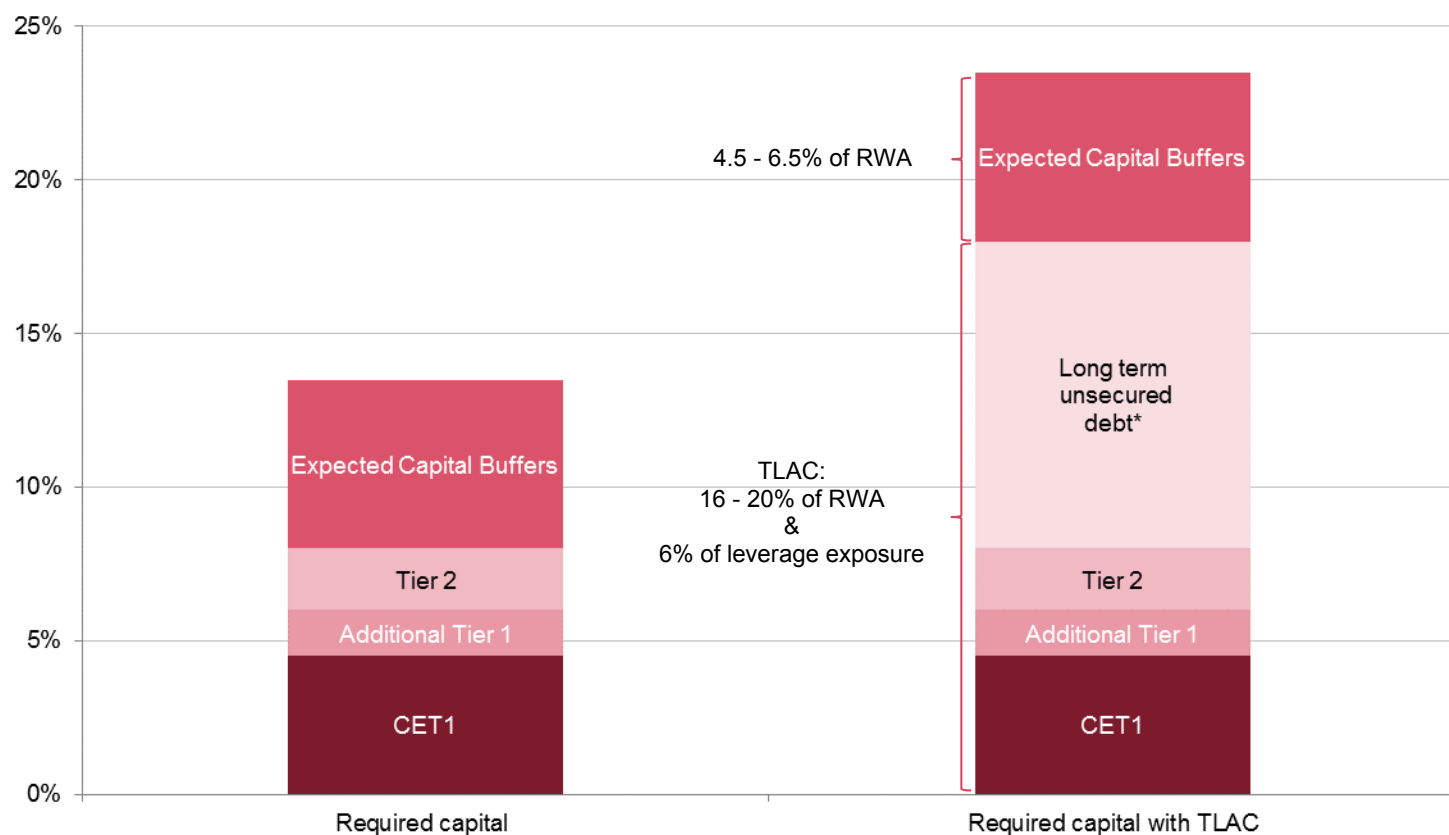
- 10. A long road ahead before ending the TBTF perception:** Despite inconclusive evidence in last summer's report by the US Government Accountability Office that the "Too Big to Fail" (TBTF) subsidy continues to exist, the TBTF debate will remain a major topic among policy makers. With the announcement of the TLAC proposal, global regulators claimed significant progress in addressing TBTF and avoiding taxpayer bailouts of G-SIBs (an assertion made eight times in the document). However, the fine print of the FSB document itself indicates several issues that would need to be addressed before declaring victory. These include the completion of legislative reforms to implement the FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions" (which was issued in 2011); enhanced cross-border information sharing and the removal of cross-border obstacles; and the prevention of large-scale early termination of financial contracts in resolution. Addressing these complex issues and settling on a final TLAC will be very challenging to say the least.

⁶ The FSB document provides the following quantitative criteria as determinants of "material" subsidiaries: A material subsidiary is one that (a) has more than 5% of the G-SIB's consolidated risk-weighted assets, (b) generates more than 5% of the G-SIB's consolidated revenues, or (c) has total leverage exposure that is more than 5% of the G-SIB's total leverage exposure.

⁷ See PwC's *Regulatory Brief, Foreign Banks: US admission price rising* (July 2014).

Appendix

Increased burden for US firms under Pillar 1 TLAC



* The depicted long term unsecured debt component may be reduced by excess Tier 2 or Additional Tier 1 capital, but it must make up at least 33% of TLAC.

Additional information

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