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ALERT MEMORANDUM

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Financial Stability Board Proposes TLAC Requirements for G-SIBs

On November 10, 2014, the Financial Stability Board ("FSB") released a consultative document entitled "Adequacy of loss-absorbing capacity of global systemically important banks in resolution" (the "Proposal"), which seeks comment on proposals to require global systemically important banks ("G-SIBs") to hold regulatory capital and other loss absorbing instruments in an amount sufficient to recapitalize a G-SIB in resolution. The stated objective of the Proposal is to ensure that the G-SIBs maintain sufficient loss absorbing and recapitalization capacity so that, during and after a resolution, "critical functions can be continued without taxpayers' funds (public funds) or financial stability being put at risk."

To achieve this objective, the Proposal recommends requiring all G-SIBs to maintain levels of equity capital and debt as Total Loss Absorbing Capacity ("TLAC") to serve as a going concern and gone concern cushion so that, once the Basel III minimum required capital is eroded, there remains sufficient TLAC that can be written down or converted into equity to recapitalize the G-SIB so that it complies with the Basel III minimum capital standards. In order to accomplish this, the Proposal calls for TLAC in a combination of debt and equity capital at levels that combined are approximately double the level of equity capital under the Basel III minimum capital standards. However, the Proposal excludes the additional regulatory capital buffers, such as the G-SIB surcharge and capital conservation buffer, so that those would apparently remain in place and "sit on top" of the TLAC requirement as additional loss absorbency.

The Proposal sets out a set of principles and a TLAC term sheet and requests comments by February 2, 2015. The FSB has announced that once the comments have been received it will conduct additional analysis, including a quantitative impact study ("QIS") and a market survey, before releasing final standards at the next G-20 Summit in November 2015. Although the FSB does not anticipate global implementation until January 2019, certain jurisdictions, including the United States, may seek to implement the requirements more rapidly.

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Summary of Key Elements

- **Applicability:**
  - The requirements would apply to the thirty G-SIBs identified by the FSB, with the exception of G-SIBs headquartered in developing countries, including China. A full list of all G-SIBs is included at the end of this memorandum.

- **External TLAC Issuer:** Each entity (referred to as a "resolution entity") identified by the G-SIB's crisis management group ("CMG") as being a "point of entry" during resolution would be subject to the external TLAC requirement:
  - In a "Single Point of Entry" G-SIB, only the single entity that would enter resolution would be subject to the external TLAC requirement.
  - In a "Multiple Point of Entry" G-SIB, each point-of-entry entity would be subject to the external TLAC requirement.

- **Amount of External TLAC:** The minimum TLAC requirement would be set by reference to the consolidated balance sheet of each resolution group. A "resolution group" is the resolution entity and any direct or indirect subsidiaries that are not themselves resolution entities.
  - The Pillar 1 common minimum TLAC requirement would be 16% – 20% of the "resolution group's" risk-weighted assets ("RWAs"), **AND**
  - At least double the amount of capital required to meet the relevant Tier 1 leverage ratio.
  - Regulators would be able to establish firm-specific, "Pillar 2" enhancements to these requirements based on the risk profile of the bank.

- **Interaction with Regulatory Capital:** Regulatory capital instruments could be applied towards the external TLAC requirement, but debt instruments would need to constitute 33% of external TLAC.
  - Instruments satisfying capital buffer requirements, including the capital conservation buffer, countercyclical buffer and G-SIB surcharge buffer, are not counted towards meeting the external TLAC requirement.
  - Accordingly, depending on the applicable G-SIB surcharge, G-SIBs would be required to maintain a combination of TLAC-eligible instruments and regulatory capital instruments equal to between 19.5% and 27% of RWAs (16% – 20% TLAC, plus a G-SIB surcharge of between 1% and 4.5%, plus the 2.5% capital conservation buffer), assuming no countercyclical buffer.

- **Instruments Eligible for External TLAC:** To be eligible as TLAC, instruments would need to be unsecured, issued by the resolution entity, have a remaining maturity of more than one year and be subordinated (structurally, contractually or

statutorily) to those liabilities defined as excluded liabilities ("Eligible Instruments").

- Eligible Instruments would also need to be subject to the law of the issuing entity's jurisdiction of incorporation or, if subject to another law, include legally enforceable contractual provisions recognizing the application of the resolution tools of the issuing entity's jurisdiction of incorporation, unless there is an equivalent binding statutory provision for cross-border resolution.
- Credible ex-ante commitments to recapitalize a G-SIB in resolution from the authorities may also count towards minimum external TLAC. The Proposal requires that these commitments be pre-funded by industry contributions and cannot fulfill the entire TLAC requirement.

- **Excluded Liabilities:** Eligible Instruments cannot include the following liabilities ("Excluded Liabilities"):
  - Insured deposits;
  - Liabilities callable on demand without supervisory approval;
  - Liabilities funded directly by the issuer or a related party of the issuer (except where the CMG agrees that liabilities issued to a resolution entity's parent may be counted);
  - Liabilities arising from derivatives or debt instruments with derivative-linked features (e.g. structured notes);
  - Liabilities arising other than through a contract (e.g. tax liabilities);
  - Liabilities that are preferred to normal senior unsecured obligations under the applicable insolvency regime;
  - Any other liabilities that, under the law governing the issuing entity, cannot be written down or converted into equity by the applicable resolution authority.

- **Internal TLAC:** Each material subsidiary of a G-SIB that is not a resolution entity would be required to maintain a minimum amount of internal TLAC of 75% – 90% of the external Pillar 1 TLAC requirement that would apply if this subsidiary were a resolution entity.
  - Internal TLAC instrument requirements are similar to those for external TLAC, but would be held by the resolution-entity parent.
  - The resolution entity should maintain at least as much external TLAC as the sum of internal TLAC.

- **Conformance Period:** The conformance period will be informed by the FSB's QIS, but will not be before January 1, 2019.

Facilitating New Resolution Strategies

The Proposal is another step in the international project to end Too Big To Fail by developing a supervisory, regulatory, insolvency and operational framework to allow the resolution of G-SIBs without either creating systemic destabilization or imposing losses on taxpayers. Other components of this initiative include heightened capital and liquidity requirements as well as regulatory and supervisory restrictions on risk-taking designed to reduce the risk of failure. The FSB's "Key Attributes of Effective Resolution Regimes for Financial Institutions," which specified a suite of resolution powers that should be incorporated into national law, have increasingly become law in key jurisdictions.[1] These changes, particularly the new powers under resolution regimes, have allowed resolution authorities, particularly in the U.S. and in Europe, to pursue new strategies to resolve G-SIBs.

The Proposal recognizes that there are several strategies that may be successful in resolving a G-SIB. The Proposal focuses on requiring sufficient TLAC at the right locations within a G-SIB's group structure to permit effective loss-absorption and recapitalization. As a result, the Proposal requires the regulatory authorities to identify the preferred resolution strategy for a particular G-SIB and, based on that preferred strategy, define the entity or entities within the group which should be required to maintain the minimum levels of TLAC.

The resolution strategy that has been favored for U.S. and many other G-SIBs is the Single Point of Entry ("SPE") strategy. Under the SPE strategy, only the top-level holding or operating company of a financial group would be resolved, and recapitalized. The goal is to focus the resolution on the top-level owner of the operating subsidiaries so that those subsidiaries conducting the systemically important functions of the group would be able to remain open and operating.[2] The SPE strategy can be implemented through several different approaches to resolution. The common feature for the SPE

[1] Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions," October 15, 2014, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf (while the Key Attributes were adopted in October 2011, the FSB has published a new document that includes guidance to the Key Attributes on specific sectors and issues, but does not change the original 2011 Key Attributes).

[2] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013); Swiss Financial Market Supervisory Authority, "Resolution of Global Systemically Important Banks," August 7, 2012, *available at* http://www.finma.ch/e/finma/publikationen/Documents/pos-sanierung-abwicklung-20130807-e.pdf; Bank of England & Federal Deposit Insurance Corporation, "Resolving Globally Active, Systemically Important, Financial Institutions," December 10, 2012, *available at* https://www.fdic.gov/about/srac/2012/gsifi.pdf.

approach is that all external TLAC would be issued by the top-level holding or operating company.

In the U.S., the SPE approach developed by the Federal Deposit Insurance Corporation ("FDIC") under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), with input from other regulators and the industry, calls for placing the G-SIB's holding company into insolvency proceedings and transferring the holding company's ownership of the operating subsidiaries to a temporary government-controlled bridge holding company. The operating subsidiaries would remain open. Once stabilized, the bridge holding company could be recapitalized by converting pre-failure debt into new equity. In this way, losses are absorbed by equity and creditors at the holding company.

In Europe (including the U.K. and Switzerland), the SPE strategy is expected to rely more heavily on the use of bail-in authority to allow recapitalization either with or without the initiation of formal insolvency proceedings. In these approaches, the bail-in authority would be used to recapitalize the top-level company by writing down existing equity and converting certain debt obligations into new equity. This open institution approach has been favored by many in Europe because the top-level company for many of the European G-SIBs are themselves operating companies and there is concern that putting these operating companies into insolvency proceedings, even if for a moment, could lead to greater disruptions to their operations. In contrast, the top-level companies for U.S. G-SIBs are holding companies with virtually no operating businesses.

Some G-SIBs are structured around separate subsidiary operations in different countries. In many of these subsidiarized G-SIBs, external debt has been issued from a number of different subsidiaries. In these cases, the focus has been on developing effective Multiple Points of Entry ("MPE") resolution strategies. These strategies draw on the same approaches described above, but would be executed on a regional basis through multiple "resolution entities" based in different countries. An MPE approach may provide for resolution of multiple companies in different countries or geographic regions. The MPE approach frequently results in "de-grouping," where the resolved entities are no longer affiliated because of transfers of operations to unaffiliated acquirers or creditors becoming the new owners of subsidiaries as a result of resolution.

The Proposal is aimed at facilitating these new resolution strategies for G-SIBs by providing the essential cushion of loss absorbing common equity and debt to make possible the recapitalization of the G-SIB or its key operating entities after the original base of Basel III minimum regulatory capital has been eroded.

Key Implications

A Focus on SPE Strategies and Non-operating Holding Company Structures

The Proposal has clear implications for which entities will be issuers of debt. While the Proposal accommodates MPE strategies by allowing for multiple "resolution entities" that must hold TLAC and can issue external TLAC, the original discussions around TLAC were driven primarily by the need for a resource of debt that could be written down to recapitalize a parent entity under an SPE strategy. As a result, the logic of the Proposal implies that all external TLAC debt will be issued preferably by one or, at least, by a very limited number of resolution entities.

Similarly, since the Proposal was developed in the context of an SPE strategy designed to maintain systemically important operations in subsidiaries, it favors holding companies with no or very limited operations. While this is the structure used by the U.S. G-SIBs and some others, there are a considerable number of G-SIBs, particularly in Europe and Asia, that have operating banks as the topmost parent. Similarly, while U.S. G-SIB holding companies tend to issue both equity and significant amounts of long-term unsecured debt, the same is not true for many of the other G-SIBs with holding-company structures who tend to issue such debt out of their operating subsidiaries. The potential implications of the Proposal for corporate structure as well as the financing of operations for G-SIBs raise significant issues. In combination with requirements for recovery and resolution planning in many countries, the TLAC requirement could potentially contribute to greater homogenization in G-SIB corporate structures and financing. While the SPE strategy offers some significant advantages when applied to G-SIBs built around holding companies with operations conducted through subsidiaries, other G-SIBs built around top-level operating companies or relatively independent subsidiaries may be better suited to the MPE strategy. If the TLAC requirement is interpreted by regulators as implying a need for the reorientation of G-SIB organizations towards a U.S.-style holding company model, it would have significant consequences on the diversity of available business models and the flexibility previously allowed in financing business operations.

The structural issues faced by some G-SIBs outside the United States are compounded by uncertainty regarding the manner in which a resolution process would be implemented. Many of these G-SIBs conduct banking activities and raise funding in multiple entities, and they rely on market funding rather than deposits to finance banking activities to a much greater extent than their U.S. counterparts. To raise this funding at the lowest cost they need to provide investors with certainty regarding the hierarchy of their various debt instruments in resolution, which in turn depends on their resolution plans. Because the final form and potential implementation of resolution plans remains a work in progress, the practical ability of G-SIBs to provide investors with certainty is limited. While this issue may be resolved over time as the terms of resolution plans

become more clear, the question is whether the requisite level of certainty will be available in time to allow G-SIBs to implement the necessary structural changes—and to explain them to investors—before the TLAC deadline.

Internal TLAC – Rigidity and Scaling

The requirement of internal TLAC for material subsidiaries located outside the home country raises significant questions. While such an approach "pre-positions" recapitalization resources in host countries, it also creates a risk of trapping those resources in multiple host country silos. This could limit the ability of G-SIBs to redeploy resources to threatened subsidiaries by reducing the available and easily deployable resources to head off failure, which, on a global scale, raises concerns about systemic stability in future crises. The need for flexibility must be balanced against the interest in providing comfort to host countries to reduce the likelihood that they will take pre-emptive ring-fencing actions to manage their domestic risks in a crisis.

The Proposal reflects this tension by limiting the internal TLAC requirement for a material subsidiary that is not a resolution entity to 75% – 90% of the external TLAC requirement that would apply if it was a material entity. However, the cumulative size and potential consequences of such internal TLAC requirements must be carefully calibrated during the QIS to prevent this requirement from creating less resilient G-SIBs. Further, requiring a "bottoms up" approach to determining internal TLAC could increase the total amount of TLAC required for an institution (i.e., where the sum of the internal TLAC requirements for material subsidiaries exceeds what is required of the parent based on consolidated RWAs). An alternative approach would be to require that a specified percentage of external TLAC be downstreamed to material subsidiaries.

New Relationship Between Equity Capital and Debt

If adopted as proposed, the Proposal would impose more specific requirements on the composition of G-SIB balance sheets by mandating specific minimum proportions of instruments that are Tier 1 or Tier 2 capital instruments in the form of debt plus other eligible TLAC that is not regulatory capital. In essence, the Proposal represents an historic realignment of the traditional relationship between equity capital and debt. Traditionally, common equity capital (often referred to as Tier 1 common) has served as a shock absorber for unanticipated losses to prevent insolvency. In that role, it provides going-concern loss absorbency. Debt issued by a banking institution has been conceived as providing a more secure investment for a more limited return. Generally, unless subordinated by contract, debt has had the same priority in insolvency as most other general liabilities of financial institutions. While the Proposal maintains the relative priorities between common equity and debt, it requires TLAC-eligible debt to be subordinated to most general liabilities—particularly those that serve as short-term funding or operational liabilities. Other requirements, such as a minimum remaining

term of one year, further distinguish Eligible Instruments from operating liabilities and help prevent disruption of critical functions or giving rise to a material risk of a successful legal challenge. Under the Proposal, Eligible Instruments constitute an intermediate category between common equity capital and operational liabilities to absorb losses while hopefully having a more limited impact on funding and operations. The Proposal thus segregates common equity capital and TLAC-eligible debt as resources to absorb going-concern losses before insolvency (the role of equity capital) and to provide a reservoir of liabilities that can be converted into new common equity capital to recapitalize the failed G-SIB (the role of TLAC-eligible debt).

This relationship between equity capital and debt is reflected in the Proposal's recommendation of a Pillar 1 minimum external TLAC requirement that is double the Basel III minimum capital standard as a percentage of RWAs, while requiring that at least 33% of the TLAC must be in Tier 1 or Tier 2 capital instruments in the form of debt plus other eligible TLAC that is not regulatory capital. This approach is designed to provide assurance that there will be a sufficient buffer of loss absorbing equity and debt to permit recapitalization after regulatory capital has absorbed losses prior to insolvency. This relationship assumes that resolution occurs while sufficient TLAC remains to recapitalize the G-SIB. Under the Proposal, this action can occur either before or after initiation of insolvency proceedings. In either event, while the Proposal does not address this question, it is essential that action must be taken before the exhaustion of the Basel III minimum capital requirement so that the remaining TLAC can serve to recapitalize the G-SIB. While the Proposal does not count the additional Basel III capital buffers as part of TLAC, this additional cushion would still serve to absorb losses before the TLAC cushion.

In effect, the Proposal recommends a significant extension of the current regulatory capital framework. For certain banking organizations, such as the U.S.-headquartered G-SIBs, the TLAC requirements would not require changes to which entities principally issue equity and debt. In addition, many U.S.-headquartered G-SIBs appear currently to have sufficient equity and debt outstanding to meet the requirements. However, even for these G-SIBs, the specific requirements of the proposal will impose constraints on their flexibility to determine which instruments to issue and in what quantity irrespective of market conditions and they may be subject to additional requirements under as yet unissued final standards and rules. For some G-SIBs, the TLAC Proposal may require material modifications to the terms of debt instruments they have already issued and could require these banking organizations to issue significantly more debt, at both the parent level and the level of each material subsidiary. Without question, the new relationship between equity and TLAC-eligible debt, as well as the required volume of capital instruments that must be issued, implies new considerations for issuing G-SIBs and investors.

<u>Interplay with Resolution Regimes</u>

As discussed above, although certain aspects of the Proposal, such as the concept of "resolution entities," appear designed to accommodate MPE resolution, the Proposal as a whole still generally presumes an SPE-resolution approach and contains provisions that may not be consistent with the corporate and debt structures of many G-SIBs headquartered outside the United States. For instance, many self-funded operating companies finance themselves with senior unsecured debt that sits *pari passu* with Excluded Liabilities. Under the EU Bank Recovery and Resolution Directive (the "<u>BRRD</u>"), the resolution authority may request to exclude some of these Excluded Liabilities from write down. However, under the Proposal, G-SIBs subject to the BRRD would only be able to count instruments that sit *pari passu* with Excluded Liabilities up to 2.5% of RWAs. Accordingly, the FSB may need to reconsider its definition of Eligible Instruments to permit firms with different corporate and debt structures to compete with their foreign counterparts on a level playing field. Alternatively, some European jurisdictions may need to change their laws regarding priority so that senior unsecured debt is subordinated to the Excluded Liabilities.

Other elements of the Proposal may also frustrate fair competition between G-SIBs. For instance, the blanket exemption for G-SIBs from developing countries may make it very difficult for firms with headquarters in developed nations to compete in developing countries where local banking organizations would not have to bear the costs of meeting the TLAC requirements. Likewise, the provision allowing G-SIBs with uncapped resolution funds to count those funds towards 2.5% of RWAs fails to account for the fact that firms in other countries also contribute to resolution funds. While this provision may have been a political compromise, it creates a potential mismatch in TLAC requirements that could impose differential costs on G-SIBs competing in the same markets and for the same customers. This mismatch could distort competition and create unintended consequences both in good times and in more stressed periods. At a minimum, it would increase the costs of financing in some jurisdictions compared to others.

<u>Calibration of the Total TLAC Requirement</u>

The projected calibration of the Pillar 1 external TLAC requirement at 16% – 20% of RWAs also raises some questions. Although this range represents approximately twice the Basel III regulatory capital requirements, it is not clear that this is the appropriate figure. Some officials have suggested that requiring G-SIBs to hold TLAC equal to twice the Basel III was based on the "capital refill" theory. Under this theory, a banking organization must have enough TLAC so that, following resolution, it will not only be solvent, but have sufficient capital to meet applicable regulatory capital requirements. Mandating that banks hold TLAC equal to twice the Basel III capital requirements meets this end, officials have suggested, by ensuring that, once the firm's

equity is depleted, there will be loss-absorbency equal precisely to the amount of regulatory capital required to bring the banking organization back into conformance with Basel III.

This approach, however, presumes that regulatory capital would be depleted in its entirety before resolution occurs. However, if regulators apply prompt corrective action strategies and seek resolution before capital insolvency, or if the company cannot access market-based funding and becomes illiquid before capital insolvency (as happened during the recent financial crisis), resolution should occur before capital insolvency. If so, TLAC calibrated around double the Basel III regulatory capital requirements (while excluding regulatory capital buffers) may impose higher total TLAC requirements than necessary. A careful assessment of prior crises and loss scenarios may indicate that assuming complete depletion of regulatory capital is inconsistent with historical examples and therefore unnecessary.

Consequences for Breaching TLAC Minimums

It is unclear from the Proposal how regulators are expected to treat a G-SIB that falls below the TLAC requirement. The Proposal suggests that such a firm will be treated as one that breaches its regulatory capital requirements and therefore subjected to capital-style supervisory remediation actions. Presumably, this should initiate supervisory actions aimed at restoring TLAC to the required minimums. And regulators close to the TLAC negotiations have confirmed that the expectation is not that a breach of TLAC minimums would alone be grounds for initiating resolution. Such a quick trigger could result in far more resolutions and may be less efficient than allowing the firm to remediate as appropriate given then-existing market conditions. However, substantial and sustained depletion of TLAC could logically serve as an indicator of resolution. This implies that there should be gradations of TLAC adequacy, much the same as there are gradations of compliance with regulatory capital requirements.

Triggers

Greater clarity is likely necessary with respect to the triggers applicable to TLAC-Eligible Instruments. The Proposal provides that Eligible Instruments would need to “contain a contractual trigger or be subject to a statutory mechanism” that permits the resolution authority to expose the instrument to losses in resolution. Investors, however, will likely need greater certainty as to when this trigger event is likely to occur, i.e. what standards regulators will use to determine when a G-SIB has reached the “point of non-viability.”

Cost-Benefit Analysis

This is, in some ways, the ultimate question that is inherent within the preceding issues. What are the costs and benefits to economic development and financial resiliency of a defined level of TLAC for G-SIBs? The FSB directly poses this question in the Proposal. The FSB notes that "the added funding costs associated with a TLAC requirement will lead to a reduction of the implicit public subsidy for G-SIBs." However, in assessing this effect, it presumptively adopts a relatively simple binary understanding of the potential relationships by concluding that "G-SIBs may pass on a share of their higher funding costs to their clients, prompting a shift of banking activities to other banks without necessarily reducing the amount of activity." While this may be true for many activities, it appears to assume the answer and, at least, presents some questions about whether it is inevitably true about certain financial functions performed by G-SIBS, such as global capital formation, funding and certain more complex derivatives activities.

Detailed Analysis of the Elements of the Proposal

Entities Subject to External TLAC Requirements

Under the Proposal, the minimum external TLAC requirement would apply to each "resolution entity" within a G-SIB. A resolution entity is an entity to which resolution tools would be applied in accordance with the resolution strategy determined for the G-SIB by its CMG. Depending on a firm's structure and its jurisdiction's special resolution regime ("SRR"), the resolution entity might be a parent or one or more subsidiaries within a firm. For instance, in the case of a U.S. G-SIB with a non-operating parent holding company, the parent would likely be the resolution entity subject to TLAC, based on the FDIC's description of an SPE resolution strategy as the likely choice for such groups under the Orderly Liquidation Authority.[3] By contrast, for G-SIBs pursuing MPE strategies, each "point of entry" would be a resolution entity subject to the minimum external TLAC requirement.

The size of the TLAC requirement would be based on the consolidated balance sheet of each "resolution group." The Proposal defines the resolution group as the resolution entity and any direct or indirect subsidiaries that are not resolution entities themselves or subsidiaries of other resolution entities.

Under the Proposal, G-SIBs headquartered in emerging markets, including China, would not initially be subject to the TLAC requirement.

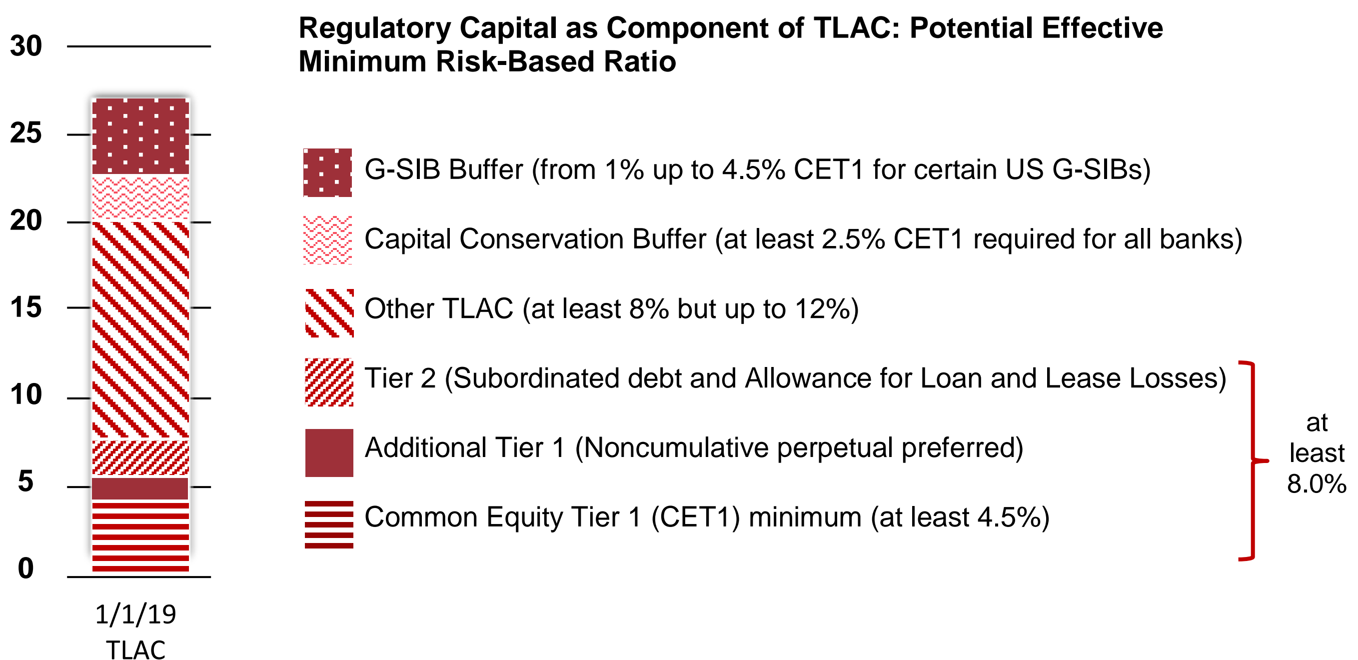
Quantum of External TLAC and Relation to Regulatory Capital

Under the Proposal, G-SIBs would be required to meet a new requirement for minimum external TLAC. This requirement would consist of a Pillar 1 and a Pillar 2 component. Pillar 1 would provide a common floor, applicable to all G-SIBs, while Pillar 2 would be designed to set firm-specific requirements.

Under the Proposal, each G-SIB would be required to maintain Pillar 1 TLAC in an amount equal to 16% – 20% of the resolution group's RWAs. As discussed further below, instruments that count towards satisfying regulatory capital requirements would generally count towards the calculation of Pillar 1 TLAC. However, instruments

[3] Title II of the Dodd-Frank Act created a special insolvency regime known as the "Orderly Liquidation Authority" ("OLA") to address the failure of systemically significant nonbank financial companies, including financial holding companies. Under OLA, a failing financial company the insolvency of which would have serious adverse effects on the U.S. economy would be placed into receivership administered by the FDIC. As receiver, the FDIC would have the power to, among other things, repudiate executory contracts and selectively transfer the financial company's assets.

satisfying capital buffer requirements, including the capital conservation buffer, countercyclical buffer and G-SIB surcharge buffer, may not be applied to the external TLAC requirement. As a consequence, G-SIBs would be required to hold regulatory capital sufficient to satisfy capital buffers *in addition to* the external Pillar 1 TLAC requirement. For example, a G-SIB with a 1% G-SIB surcharge would need to maintain a combination of TLAC-eligible instruments and regulatory capital instruments equal to 19.5% – 23.5% of RWAs (16% – 20% TLAC, plus the 1% G-SIB surcharge, plus the 2.5% capital conservation buffer), assuming no countercyclical buffer.[4] Under the Proposal, at least 33% of TLAC would need to consist of debt, which may include debt instruments that count as regulatory capital.[5]



[4] On December 9, 2014, the Federal Reserve Board proposed to establish "super-equivalent" G-SIB surcharges for U.S. G-SIBs that are expected to range from 1% to 4.5%, as compared to 1% to 2.5% under the Basel G-SIB framework. See Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies *available at* http://federalreserve.gov/aboutthefed/files/bcreg20141209a1.pdf

[5] Interestingly, the FSB Proposal does not specifically provide that 33% of TLAC would need to consist of debt. It says, rather, that this is "an expectation" in view of TLAC's purpose of ensuring that a failed G-SIB has sufficient long-term debt to absorb losses and effect a recapitalization. Accordingly, this may be more of an estimate than a proposed requirement.

The Proposal also provides that a firm's Pillar 1 TLAC would need to be at least equal to two times the quantum of regulatory capital needed to satisfy the relevant Tier 1 leverage ratio requirement.[6] Accordingly, one can understand the Proposal as requiring the satisfaction of two required ratios: (1) a risk-weighted TLAC ratio akin to the standard regulatory capital ratio, with TLAC in the numerator and RWAs in the denominator and (2) a TLAC leverage ratio akin to the leverage ratio, with TLAC in the numerator and total leverage exposure in the denominator.

Key Ratios

Risk-Weighted TLAC Ratio:

$$\frac{\text{TLAC}}{\text{Risk Weighted Assets}} = 16 - 20\%$$

TLAC Leverage Ratio:

$$\frac{\text{TLAC}}{\text{Total Leverage Exposure}} = 2 \times \text{Leverage ratio}$$

Each G-SIB's home regulators, in consultation with its CMG, would determine the G-SIB's Pillar 2 component. The FSB has provided minimal guidance as to the size or range of the Pillar 2 component or the criteria that authorities would use to determine the component. Nor has it specified what instruments would count towards meeting the Pillar 2 component. Accordingly, it remains unclear whether common equity Tier 1 capital held to meet capital buffer requirements could be applied towards the Pillar 2 TLAC component.

In calculating their external TLAC, resolution entities would need to deduct exposures to TLAC liabilities issued by other G-SIBs, just as Basel III requires the deduction from regulatory capital of certain investments in the regulatory capital of other financial institutions.[7]

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[6] The TLAC proposal does not explicitly provide that the relevant Tier 1 leverage requirement would be the Basel III leverage ratio, which was finalized in January 2014 by the Basel Committee on Banking Supervision as 3% Tier 1 capital to total leverage exposure (a measure that includes all on-balance sheet assets and certain off-balance sheet items). In the United States, G-SIBs are also subject to a separate leverage ratio requirement of 4% Tier 1 capital to average on-balance sheet assets.

[7] As presently drafted, this requirement could effectively prohibit G-SIBs from making a market in other G-SIBs' debt securities. This may not have been the FSB's intent, but, as with the Volcker Rule, it may prove difficult to delineate when a firm holds securities for market-making, as opposed to proprietary, purposes.

TLAC Eligible Instruments

The Proposal details in substantial depth the instruments that would count as TLAC Eligible Instruments. In order to be eligible for TLAC, an instrument would generally need to be unsecured, issued by the resolution entity, have a minimum remaining maturity of at least one year and be subordinated to Excluded Liabilities.

Criteria for TLAC-Eligible Instruments

- Unsecured
- Issued by resolution entity
- Minimum remaining maturity ≥ 1 year
- Recognizes application of resolution entity's resolution regime
- Convertible to equity in insolvency
- Subordinated to Excluded Liabilities

Eligible Instruments would also need to be subject to the home-country jurisdiction's resolution regime. To satisfy this requirement, instruments could either be governed by the law of the home-country jurisdiction or include contractual provisions recognizing and consenting to the application of the home-country jurisdiction's resolution regime.[8] The instruments would also need to contain a trigger or be subject to a statutory mechanism permitting the relevant resolution authority to expose the instrument to loss or convert it into equity in the event of resolution. Further, the instruments would need to not be subject to set-off or netting rights that would frustrate their loss-absorbing capacity.

Under the Proposal, certain liabilities would be excluded from counting towards TLAC. These Excluded Liabilities include insured deposits, liabilities callable upon demand without supervisory approval, liabilities arising from derivatives or debt instruments with derivative-linked features (e.g. structured notes), non-contractual liabilities (e.g. tax liabilities), liabilities that are preferred to normal senior unsecured creditors under the relevant insolvency law and any other liabilities that the resolution authority is not permitted to write down or convert into equity. Liabilities funded directly by the issuer or a related party would generally also be considered Excluded Liabilities; however, otherwise eligible liabilities issued to a resolution entity's parent might count as external TLAC if the firm's home authorities and the G-SIB's CMG agreed that such eligibility is consistent with the resolution strategy of the resolution entity.

In order to be eligible for TLAC, an instrument would need to absorb losses prior to Excluded Liabilities without giving rise to a material risk of successful legal challenge

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8 The Proposal provides that Eligible Instruments may alternatively be subject to a binding statutory provision that provides for recognition of the home-country resolution regime, but it is unclear what this requirement actually means. Treaties requiring unconditional recognition of another regime's exercise of resolution powers are generally thought to be unlikely, and presumably permissive recognition powers, such as those required under the BRRD, would not be sufficient.

or compensation claims. In order to ensure this subordination exists, the Eligible Instrument would need to be:

a) contractually subordinated to all Excluded Liabilities on the resolution entity's balance sheet;
b) junior in the statutory creditor hierarchy to all Excluded Liabilities on the resolution entity's balance sheet; or
c) issued by a resolution entity that does not have Excluded Liabilities on its balance sheet (i.e. structurally subordinated).

Certain exceptions to this subordination requirement would apply for jurisdictions that limit the use of Excluded Liabilities in bail-in proceedings. In those jurisdictions that statutorily prohibit the write down or conversion into equity of Excluded Liabilities in bail-in proceedings, resolution entities would be able to count instruments that otherwise meet the eligibility criteria as TLAC, even if they are not contractually, statutorily or structurally subordinated. In those jurisdictions in which the resolution authority may, under exceptional circumstances, exclude from bail-in Excluded Liabilities, the relevant authorities could permit instruments that otherwise meet the eligibility criteria to contribute up to 2.5% of RWAs (or more if the final Pillar 1 component ends up being greater than 16% of RWAs). In either case, authorities would need to ensure that the exclusion of Excluded Liabilities would not give rise to a material risk of successful legal challenge or valid compensation claims.

As described above, regulatory capital instruments issued by the resolution entity would be eligible to count as TLAC. Similarly, regulatory capital instruments issued by other entities within a resolution group and held by persons outside of the G-SIB would also count towards the resolution entity's external TLAC to the extent the resolution entity were permitted to recognize them as Tier 1 or Tier 2 capital instruments. Home and host authorities would need to agree, however, that such instruments could be exposed to loss upon the subsidiary's non-viability without requiring the use of resolution tools and that the conversion of capital issued by subsidiaries would not result in a change of the subsidiary's control that would be inconsistent with the agreed resolution strategy.

The Proposal provides that a resolution entity would be able to count towards its external TLAC its authorities' ex-ante commitment to recapitalize it in resolution, provided certain conditions were met. The relevant authorities would need to consent to the counting and there would need to be no legal impediments to the authorities' use of funds, such as a requirement that senior creditors be exposed to loss or a limitation on the amount of funds the authorities may use. Further, the commitments would need to be prefunded by industry contributions. If these conditions are met, a resolution entity would be permitted to count the commitment in an amount equivalent to 2.5% of RWAs (or more if the final Pillar 1 component ends up being greater than 16% of RWAs).

Internal TLAC

In addition to requiring that each resolution entity maintain a certain level of external TLAC, the Proposal contains provisions regarding the distribution of TLAC to foreign subsidiaries. Specifically, the Proposal would require that G-SIBs ensure that each "material subsidiary" has "internal TLAC" in an amount equal to 75 – 90% of the amount of external TLAC the subsidiary would need to hold on a stand-alone basis. The Proposal defines "material subsidiary" as an entity incorporated in a national jurisdiction other than that of the resolution entity that (a) has more than 5% of the consolidated RWAs of the G-SIB group; (b) generates more than 5% of the consolidated revenue of the G-SIB group; (c) has a total leverage exposure measure larger than 5% of the G-SIB group's total leverage exposure measure; or (d) has been identified by the firm's CMG as material to the operation of a critical function of the G-SIB (as identified in the firm's resolution plan). Neither a resolution entity nor a branch would be considered a material subsidiary.

Internal TLAC Overview

- Requirement would apply to each foreign material subsidiary
  - Subsidiary that holds ≥ 5% of G-SIB's RWAs, generates ≥ 5% of G-SIB's revenue, has total leverage exposure measure ≥ 5% of G-SIB's measure or is deemed material by CMG
  - Cannot be a resolution entity or a branch
- Would need to hold internal TLAC equal to 75% – 90% of what would be required on a stand-alone basis
- Eligibility criteria the same as external TLAC, but would not need to be issued outside G-SIB
- Internal TLAC would need to be subject to write-down/conversion into equity by host authority outside of resolution
- Regulators would be able to count collateralized guarantees as internal TLAC under certain circumstances

Internal TLAC would have largely the same definition and eligibility criteria as external TLAC, except that the instruments would not need to be issued to parties outside the G-SIB. In addition, regulatory capital instruments issued externally by the material subsidiary would count towards internal TLAC, provided they were recognized as Tier 1 or Tier 2 capital instruments for the purpose of the resolution entity's capital requirements and home and host authorities agreed that the quantum of externally issued regulatory capital did not pose a "change of control" risk that would be inconsistent with the agreed resolution strategy, meaning that if the subsidiary were bailed-in by converting the instruments into equity, the parent company would still retain control. However, unlike external TLAC, all internal TLAC instruments would need to be subject to write-down and/or conversion into equity by the subsidiary's host authority at

the point of non-viability without applying resolution tools to the subsidiary. The Proposal further states that any such write down or conversion would be subject to the consent of the resolution entity's home authority, except where Basel III provided that such consent was not necessary. However, it provides little additional elaboration on this requirement. Such elaboration will be vital to provide sufficient clarity to creditors and ensuring home and host authority coordination.

The Proposal provides that internal TLAC would need to be pre-positioned on the balance sheet of material subsidiaries to allow host authorities to recapitalize the subsidiary. Likewise, the non-pre-positioned TLAC at the resolution entity would need to be available to recapitalize subsidiaries in different jurisdictions as necessary in resolution.

The Proposal provides that home and host authorities could agree to substitute collateralized guarantees for on-balance sheet instruments in calculating internal TLAC, provided certain conditions were met. Specifically, the guarantee would need to be provided for at least the equivalent value as the internal TLAC, the collateral backing the guarantee would need to be sufficient to cover the amount guaranteed, the guarantee would need to be drafted in a way that would not affect the ability of the subsidiary's other capital instruments to absorb losses, the collateral backing the guarantee would need to be unencumbered, the collateral would need to have an effective maturity that fulfills the same maturity condition as that for external TLAC and there would need to be no barriers to the transfer of the collateral to the subsidiary.

Notwithstanding the requirement of internal TLAC, the Proposal also states that host regulators could impose external TLAC requirements on material and non-material subsidiaries within their jurisdictions.

Disclosure

Under the Proposal, G-SIBs would be required to disclose the amount, maturity and composition of TLAC maintained by each resolution entity and each material subsidiary. G-SIBs would also need to disclose the amount, nature and maturity of any liabilities of a resolution entity or material subsidiary which, in the relevant jurisdiction, rank *pari passu* or junior to external or internal TLAC.

Timing

The FSB has not determined when G-SIBs would be required to comply with the TLAC requirements, but has clarified that the standards would not go into effect until after January 1, 2019. However, firms could need to disclose and monitor their TLAC

before that date. Further, local regulators will likely impose TLAC requirements before that date.

Under the Proposal, firms that become G-SIBs after the issuance of the standard would have 12 – 36 months to comply with the TLAC requirements. G-SIBs that enter resolution or recapitalize outside of resolution would have 12 – 24 months to return to compliance, provided the firm is still a G-SIB.

Consultation

The FSB has stated that it is receiving comments on the Proposal until February 2, 2015; comments should be sent to fsb@bis.org and will be published on the FSB's website unless the respondent requests otherwise. The FSB has asked for comments on numerous questions about all aspects of the Proposal. In particular, they have requested comment as to:

- Are the Pillar 1 requirements, i.e. the risk-weighted TLAC ratio and TLAC leverage ratio, sufficient to facilitate an orderly resolution and recapitalization that neither disrupts core functions nor exposes public resources? Are there other factors the FSB should consider in calibrating the Pillar 1 requirement?

- What factors should the FSB consider in calibrating any Pillar 2 requirements?

- Is the internal TLAC method of distributing TLAC from the resolution entity to material subsidiaries and the 75 – 90% figure an effective method of facilitating resolution and preventing ring-fencing?

- Are the eligibility criteria for TLAC appropriate?

- Are the requirements regarding subordination of Eligible Instruments to Excluded Liabilities sufficient to provide certainty as to priority and avoid successful legal challenges or compensation claims?

- Should firms be permitted to count capital buffers in the calculation of TLAC?

- What disclosures should resolution entities and material subsidiaries provide to investors?

- Should G-SIBs be permitted to hold each other's TLAC-eligible instruments?

- How long should G-SIBs, both present and future, be given to come into compliance with the TLAC requirements?

- How would the TLAC requirements impact G-SIBs' funding costs and their ability to provide funding to the real economy?

*   *   *

If you have any questions, please feel free to contact

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You may also contact our partners and counsel listed under "Banking and Financial Institutions" located in the "Practices" section of our website at http://www.cgsh.com/.

List of G-SIBs

Below are the financial groups included on the FSB's 2014 list of G-SIBs:[9]

- Agricultural Bank of China
- Bank of America
- Bank of China
- Bank of New York Mellon
- Barclays
- BBVA
- BNP Paribas
- Citigroup
- Credit Suisse
- Deutsche Bank
- Goldman Sachs
- Group Crédit Agricole
- Groupe BPCE
- HSBC
- Industrial and Commercial Bank of China Limited
- ING Bank
- JP Morgan Chase
- Mitsubishi UFJ FG
- Mizuho FG
- Morgan Stanley
- Nordea
- Royal Bank of Scotland
- Santander
- Société Générale
- Standard Chartered
- State Street
- Sumitomo Mitsui FG
- UBS
- Unicredit Group
- Wells Fargo

[9] Financial Stability Board, "2014 update of list of global systemically important banks (G-SIBs)," November 6, 2014, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141106b.pdf.

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