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Total Loss-Absorption Capacity (TLAC): Does It Matter?

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- In anticipation of the forthcoming mid-November G20 summit in Brisbane, the FSB is expected to publish proposals regarding Total Loss-Absorption Capacity (TLAC) norms and standards for the world's 29 Global Systemically Important Banks (G-SIB), 16 of which are headquartered in Europe. TLAC would likely consist of equity and bailinable debt that a banking group would need to hold in preparation for a potential resolution scenario (exact details of the definition will be provided soon by the FSB). Current unofficial reports expect TLAC level requirements of 16%, 20% or even 25% of a group's consolidated risk-weighted assets (RWAs).

  However, as a global normative consensus will have to be reached – thus to include G-SIBs in Asia which on average are more deposit-rich than large European or even US banks -- we expect the required level not to be excessively high. That said, national authorities -- or in the case of large banks in the euro area (EA) the ECB which early next month will become their direct supervisor via the Single Supervisory Mechanism (SSM) -- may call for higher TLAC requirements. In any event, to satisfy market expectations, banks are likely to consider going above regulatory levels with their TLAC reserves.

- Similar to resolution regimes in other parts of the world, the EU's Bank Recovery and Resolution Directive (BRRD) includes senior unsecured debt obligations and large-size deposits in resolvable banks' bailinable liabilities. However, we consider that in order to protect senior unsecured debt (let alone large-size deposits) from the risk of bailin – and thus to preserve the relatively safer risk characteristics of these liability classes – many banks will aim to build TLAC reserves primarily, if not exclusively, with capital instruments (AT1 and Tier 2) and other subordinated debt, in addition to equity.

  Not doing so could possibly make the totality of their bailinable liabilities – notably senior unsecured debt -- more vulnerable to negative market sentiment and thus to disadvantageous pricing risk, potentially harming earnings and even the viability of funding sources. Said otherwise, ceteris paribus senior unsecured debt investors would be more positively disposed towards a bank without senior unsecured debt in its TLAC reserve than towards a bank with TLAC partially including it.

  On the other hand, it is plausible that banks with strong fundamentals may feel confident enough to partially fill the TLAC gap with senior unsecured debt. They may do so considering that the relatively higher cost of issuing large amounts of junior securities could possibly exceed the potential bailin premium of the senior securities which, given their reassuring credit characteristics, could in fact be more modest.

- In previously published research (*"Holding Companies: the right vehicle for European banks' SPE resolution?"*, September 2014, available on www.scoperatings.com), we have suggested that a holding company structure could help the transparency, credibility and functionality of resolution for large banking groups, notably in the case of a Single Point of Entry (SPE) resolution approach. We believe that in these cases the TLAC reserves would end up being held at the holding company level --

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thus distinctly separated from the other group liabilities, notably customer deposits – to satisfy the potential requirements of the home supervisors.

In the case of Multiple Points of Entry (MPE) or hybrid SPE-MPE resolution approaches TLAC reserves may be held also at local intermediate holding company levels – for example in the case of groups with material wholesale and investment banking activities in the US or UK markets – to meet the potential requirements of the respective host supervisors.

- We note however that the holding company structure is far less utilized in the case of large EA and Nordic banking groups, a situation which could potentially blur the clarity and transparency of TLAC liabilities vs. other bailinable group liabilities. When appropriate, a group restructuring to include a parent nonbank holding company could occur in time, but at this time there are few public indications that large European universal banking groups are indeed planning it or that their respective regulatory authorities are pushing in this direction. Developments in this area may emerge in the future, in the EA once there is more clarity on the resolution mechanisms and the new SSM and Single Resolution Mechanism (SRM) set up clear norms.

- In the table below we show the TLAC gaps (not including any senior debt) – for 16%, 20% and 25% of RWA -- of the 16 G-SIB European groups and of 16 other large European banks, based on the latest available public disclosure. Our base case for EA banks is a regulatory requirement of 20% of RWA, with possible higher required levels in other jurisdictions, such as Sweden, Switzerland or the UK. Overall, we believe that, barring another major crisis bursting out, the resolvable banking groups in Europe will be able to reach and likely exceed their TLAC targets, many doing so sooner rather than later.

- As mentioned above, we expect European banks' TLAC gaps to be largely filled with capital instruments and subordinated debt. While AT1 issuance will likely resume – potentially starting as soon as the immediate aftermath of the ECB's Comprehensive Assessment's results publication – our belief is that for the medium term Tier 2 securities may be the issuance instrument of choice, both in parallel with AT1 issuance and also once the AT1 regulatory limits (18.75% of the initial total capital requirement of 8% of RWA in the EU) would have been filled. There is indeed significant unused Tier 2 issuance capacity. In a subsequent stage, once the regulatory limits for Tier 2 (25% of the initial total capital requirement of 8% of RWA in the EU) would have also been reached, banks still needing to build TLAC reserves could continue to issue other forms of subordinated debt, even if they would not count as regulatory capital. In this context, we expect that surviving grandfathered junior securities may be also used as a fill-in.

  At the same time, retaining or even moderately issuing more equity in the future is also likely, especially taking into account the forthcoming regulatory requirements for additional buffers.

- Overall, we believe that once the new TLAC norms are firmed out the market – investors, analysts, rating agencies – will increasingly consider TLAC coverage as a key risk-protection metric for banks, alongside CET1 or leverage ratios. In this respect, the tighter the international normative consensus on TLAC will be following the G20 summit the more market participants will be able to assess global banks in a truly comparative context.

- ***Importance for bank ratings:*** *We view the future TLAC coverage of a bank, as well as the other elements related to its resolvability, as important credit considerations in the fundamental assessment underpinning our Issuer Credit-Strength Rating (ICSR). In this respect Scope considers that a resolvable bank's TLAC will matter considerably in the future, and our research will reflect that.*

Bank [1]	Issuer Credit Strength Rating (ICSR)	Outlook	TLAC [3] (% of RWAs)	Shortfall to 16% [4] (EUR mn)	Shortfall to 20% [4] (EUR mn)	Shortfall to 25% [4] (EUR mn)
Swedbank	NR [2]	NR	31.0%			
Svenska Handelsbanken	NR	NR	29.5%			
Lloyds Banking Group	A	Stable	27.4%			
UBS (2013Y)*	A	Stable	26.7%			
SEB	NR	NR	25.7%			
Rabobank	A+	Stable	23.3%			3,605
Nordea*	NR	NR	23.3%			2,603
Credit Suisse*	A+	Negative	22.6%			5,652
Danske Bank	NR	NR	22.2%			3,335
Credit Mutuel (2013Y)	A	Stable	22.0%			6,213
RBS* [5]	BBB+	Stable	21.7%			16,085
Credit Agricole*	A	Positive	21.4%			17,903
Intesa (2013Y)	BBB+	Positive	21.0%			10,976
Deutsche Bank*	A-	Positive	20.9%			16,251
KBC	A-	Stable	20.8%			3,950
Standard Chartered*	NR	NR	20.8%			10,907
CaixaBank	NR	NR	20.7%			6,224
HSBC*	AA-	Stable	19.4%		5,123	50,734
ABN AMRO Group	NR	NR	19.0%		1,096	6,844
Barclays*	A	Stable	18.8%		6,034	31,716
Commerzbank	BBB+	Positive	18.3%		3,797	14,647
DNB	NR	NR	17.9%		2,379	8,181
Unicredit (2013Y)*	BBB	Positive	17.5%		9,679	28,916
Société Générale*	A	Stable	17.5%		8,941	26,476
BBVA*	A	Stable	17.4%		8,700	25,529
ING Bank (2013Y)*	A	Stable	17.2%		8,016	22,141
Santander*	A	Stable	16.9%		17,558	45,503
Erste Bank	NR	NR	16.3%		3,641	8,543
BPCE*	A+	Stable	16.2%		15,171	35,371
BNP Paribas*	A+	Negative	15.9%	658	25,458	56,458
Bankia	NR	NR	14.6%	1,249	4,941	9,555
RZB	NR	NR	11.9%	3,662	7,226	11,682

Notes: [1] Banks with * are considered G-SIB. [2] NR = Not rated by Scope. [3] Data is from H1 2014 unless mentioned otherwise.
[4] Not including any senior debt. [5] Rating includes one notch up for UK government majority ownership.

Source: SNL and Scope Ratings

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