10 November 2014

Total Loss-Absorbing Capacity (TLAC) Emerges as Key Prudential Metric

- About two weeks ago Scope Ratings published a comment titled “TLAC: does it matter?” (available at www.scoperatings.com). This morning’s FSB consultative document titled “Adequacy of loss-absorbing capacity of global systemically important banks in resolution” emphatically answers in the affirmative. We anticipate that TLAC will become a new and powerful key prudential metric used by international and national bank regulators to assess banks’ safety and also used by investors and analysts to monitor the banks they follow. This is so because before tampering with regulatory capital adequacy norms or future leverage levels, a global bank may in fact fall short on its future TLAC requirement, which based on the FSB’s proposals is likely to be relatively severe. The consultative document explicitly states that if a bank “has breached or is likely to breach its minimum TLAC requirement, authorities should require the firm to take prompt action to address the breach or likely breach”.

- Based on a forthcoming Quantitative Impact Study and cost benefit analysis, the Pillar 1 common Minimum TLAC requirement for G-SIBs will be between 16% and 20% of consolidated risk weighted assets (RWAs). However, home supervisory authorities can decide on a Pillar 2 component of TLAC in addition to the minimum requirements. The consultative document states that “in calibrating the individual requirement for specific firms, authorities will take into account the recovery and resolution plans of individual G-SIBs, their systemic footprint, business model, risk profile and organizational structure”. We believe that TLAC requirement may end up being more demanding in the case of groups with riskier and more complex business models, a more difficult legacy from the crisis years, or a predominance of financial risks (trading and investment banking) compared to more traditional economic risks (commercial and retail lending).

- The FSB document makes it clear that regulatory capital buffers should not be included in the Minimum TLAC, and that they must be usable without the firm entering resolution. In our view this is an important point made by the regulators, which in effect could be the difference between point of non-viability and resolution.

- Furthermore, the FSB’s document states that “the added funding costs associated with a TLAC requirement will lead to a reduction of the implicit public subsidy for G-SIBs. […] 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. Alternatively, G-SIB dividends and other distributions, such as employee remuneration, might fall”. This statement is a clear evidence of regulatory authorities’ goal of nudging the global financial system away from the current heavy reliance on a smaller group of mega-financial institutions, to the extent that their market advantage has been in the past -- including during the crisis years --

Contact :

Sam Theodore
s.theodore@scoperatings.com

Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Scope Ratings

The Gridiron Building
One Pancras Square
London N1C 4AG, UK

Phone +44 (0)203 714 4982

based on the market perception of timely public support (expressed also by rating agencies providing rating uplifts based on sovereign support).

- The FSB cautions that when losses in resolution exceed the TLAC, "liabilities that are not eligible as TLAC or that are not included in a G-SIB's TLAC remain subject to potential exposure to loss in resolution, in accordance with the applicable resolution law". This is a clear regulatory warning to larger categories of investors (such as senior unsecured creditors) that the scope of bail-in under a resolution regime goes beyond TLAC liabilities – which represent only the front-line defense cushion.
- Regulatory authorities aim to discourage excessive TLAC buildup on equity (which can be insufficient to absorb losses in resolution), which is why the consultative document states that at least one third of TLAC should consist of debt – both qualifying as regulatory capital (AT1 or Tier 2) or other eligible debt that is not regulatory capital. The latter may include senior unsecured debt. We believe that to the extent possible TLAC will consist of junior securities (AT1, Tier 2 and junior debt not qualifying as regulatory capital), to offer senior unsecured creditors better protection. Alternatively, senior unsecured debt may be issued as TLAC, especially if this can be done via holding companies (specialized resolution entities) to segregate from operational liabilities (the funding of the operating bank's general activities). That said, as a possible hedge, the document adds to the list of liabilities excluded from TLAC eligibility those which "under the laws governing the issuing entity cannot be effectively written down or converted into equity by the relevant resolution authority".

- The FSB notes that a G-SIB could consist of one resolution group, or of at least two resolution groups, with a corresponding number of resolution entities. In this way the regulators seem to include both groups with a Single Point of Entry (SPE) and Multiple Points of Entry (MPE) resolution strategies, thus helping clarify the uncertainties related to the difference between the two resolution avenues.

- In the consultative document, the FSB clarifies the concept of external vs. internal TLAC. Specifically, while external TLAC is to be issued by the resolution entity of the resolution group (be it a top parent bank, holding company, or other specialized entity), internal TLAC is to be issued by each material subsidiary up to at least 75%-90% of the Pillar 1 TLAC requirement that would have applied if the material subsidiary were a resolution entity itself. The internal TLAC is to be pre-positioned on-balance sheet to be available for the group's host supervisors (which are the home supervisors of the material subsidiary) in a cross-border resolution strategy for the group. Within a G-SIB, a material subsidiary is any operating entity which is not a resolution entity itself, which is incorporated in a national jurisdiction other than that of the resolution entity, and is a material presence (within the consolidated group represents at least 5% of assets, revenues or leverage exposure). Supervisory Crisis Management Groups (CMGs) are to decide on material subsidiaries annually.

- The document highlights that to avoid "double gearing" a resolution entity should maintain at least as much external TLAC as the sum of internal TLAC including the TLAC that the resolution entity itself holds for its own balance sheet.

- We believe that investors in external TLAC debt will wish to know in detail the amount, nature and issuer of internal TLAC to get reassurance about their own investment – as they would be able to gauge the risks of the various subsidiaries of the group and their relationship with the local supervisors.

- We also point out that the document states that CMGs may agree to substitute on-balance sheet internal TLAC with internal TLAC in the form of collateralized guarantees (as long as these are properly haircut, fully cover the guaranteed internal TLAC amount, are unencumbered and also have matching maturities). Again, investors in a group's external TLAC may wish to compare the safety of on-balance sheet internal TLAC with the collateralized guarantees equivalent.

- We also note that at this time emerging-market G-SIBs – specifically the three largest global banks headquartered in China – will not be subject to the Pillar 1 TLAC requirement. We believe that this exception may give such banks a relative competitive advantage in global markets, but on the other hand we note the significant degree of implicit public support that exists for "national champions" in some emerging-market banking systems.

- With respect to banks in the European Union, we expect that under the Bank Recovery and Resolution Directive (BRRD) regulatory authorities will next year clarify the Minimum Requirement for own funds and Eligible Liabilities (MREL). It is possible that MREL may in fact mirror to some extent the features of TLAC, as EU authorities will be keen not to allow material distortions in competitiveness among large banks (G-SIBs vs. other large groups). On the other hand, taking into account the specific track record of national regulators across the EU, it is possible that some banks will be subject to MREL requirements higher than the EU minimum.

- Based on these considerations, we anticipate significant debt issuance by large European banks – both the G-SIB and other relevant institutions – during the next years to build up TLAC or MREL reserves. We continue to believe that, in addition to topping up their AT1 and Tier 2 regulatory capital allocations (18.75% and 25%, respectively, of the initial total capital requirement of 8% of RWA), EU banks will also aim to issue subordinated debt not qualifying as regulatory capital and which would rank below senior unsecured debt. This would be so especially for large banks without a holding company structure – thus a majority of banks in the euro area and the Nordic region.

- ***Importance for bank ratings:*** *We again highlight that we view the future TLAC or MREL coverage of a bank, as well as the other elements related to its resolvability, as important credit considerations in the assessment underpinning our bank ratings. Our rating analysis will address this topic in the future, especially as regulatory rules are further clarified and banks adjust their disclosure.*

Scope's Bank Rating Team

Lead Analysts
Jacques-Henri Gaulard
j-h.gaulard@scoperatings.com

Pauline Lambert
p.lambert@scoperatings.com

Marco Troiano
m.troiano@scoperatings.com

Associate Analysts
Juan Villalobos
j.villalobos@scoperatings.com

Chiara Romano
c.romano@scoperatings.com

Associate
Thue Sondergaard
t.sondergaard@scoperatings.com

Team Leader
Sam Theodore
s.theodore@scoperatings.com

Disclaimer