ABI response to the FSB consultation on the adequacy of loss-absorbing capacity of global systemically important banks in resolution

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The Italian Banking Association (ABI) welcomes the opportunity to comment the FSB consultation on the adequacy of loss-absorbing capacity of global systemically important banks in resolution.

ABI does not believe that TLAC requirement is necessary. In Europe, and particularly in the countries of the Euro area, in fact, the FSB “Key Attributes of Effective Resolution Regimes for Financial Institutions” recommendations have been adopted very strictly and accurately, with the creation of a single, supranational resolution fund, precisely in order to guarantee orderly resolution of banks.

The TLAC is therefore too much, perhaps even counter-productive, as it creates further problems of coordination with the MREL requirement and contributes to increasing uncertainty on how much capital banks need, in view of the fact that the first-pillar TLAC is rumoured to be between 16 and 20 percent of the RWA, envisaging, at the same time, further strengthening through second-pillar measures at national discretion.

Furthermore, it is also important to note that the new TLAC requirement would run togheter with Basel 3, which has yet to be fully enforced with respect to the new liquidity and leverage ratio requirements.

The increase in the cost of funding due to the introduction of the new TLAC requirement will be influenced mainly by two variables. The first is undoubtedly the level of calibration which will be adopted, the second refers to the level of adaptability to the various national jurisdictions.

In particular, in order to remove the competitive disadvantage of the 2,5% RWA limit to the recognition of senior unsecured debt for banking groups that are governed by a holding company that also manages commercial bank activities (typically the case with banks on the European continent, including Italy), ABI propose to amendmen of the national (or regional) insolvency law to grant corporate deposits and derivatives a form of preference above senior debt, so as to clarify their ranking in the credit hierarchy, that would remove a significant amount of legal risk for regulators. The FSB term sheet should acknowledge that this kind of subordination qualifies as structural subordination and therefore that for those jurisdictions does not apply.

Finally, it should be noted that despite the fact that the proposal of the FSB envisages the more restrictive requirements not coming into force prior to 2019, with the idea of allowing banks to come into line with the new requirements on a gradual basis, it is felt that the market operators and financial analysts would start seeking compliance from day one. Therefore, in order to avoid potential unwanted quirks in the markets, the minimum requirement of TLAC should be proportional to the G-SIB *buffer*, and not left to the discretion of the individual national supervisor.

1. Calibration of the amount of TLAC required

Question 1: Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement, adequate in the light of experiences from past failures to support the recapitalisation and resolution objectives set out in this proposal? What other factors should be taken into account in calibrating the Pillar 1 Minimum TLAC requirement?

ABI response: Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, ABI believes that its introduction does avoid systemic effects in the resolution, but also creates potential ones in the going-concern. The range of the requirement is such (16-20%) that, in the event of a new persistent crisis in financial markets, it would be very difficult, if not impossible, to comply with TLAC, also given the limited time for re-entry within the limit (12/24 months). In other words, in the final calibration of the requirement and its characteristics, one must take into account that in times of crisis, due to the closure of (equity and fixed income) markets, the need to respect TLAC may generate procyclical effects, given that the alternative for complying with the requirement would in fact be deleveraging.

An effective way to face such concerns would be to recognize the different level of systemic importance among G-SIBs rather than setting a common minimum standard. In particular, the FSB could set the TLAC requirement according with the G-SIBs' five buckets. As an alternative, the TLAC bucketing methodology could be based on the banks' resolution plan, instead of the existing G-SIBs' five buckets.

Question 2: Does the initial exclusion of G-SIBs headquartered in emerging market economies (EMEs) from meeting the Common Pillar 1 Minimum TLAC requirement appropriately reflect the different market conditions affecting those G-SIBs? Under what circumstances should the exclusion end?

ABI response: Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, ABI believes that increasing integration of financial markets offers the opportunity to avoid exclusions for banks operating on international markets, irrespective of the country of residence. Unwanted side effects lie within the potential opportunities for arbitrage and competitive disparity that would be created.

Question 3: What factors or considerations should be taken into account in calibrating any additional Pillar 2 requirements?

ABI response: ABI maintains that the Pillar 2 requirement is not necessary if the FSB adopt the Pillar 1 bucketing methodology.

Should the FSB introduce the additional Pillar 2 requirements, the objectives of increasing banks' capacity to absorb losses, if they were to meet such difficulties that would make it necessary their resolution, while at the same time preserving their critically important functions, avoiding the use of public money and avoiding jeopardizing financial stability, have already been achieved with the legislation that the various jurisdictions enacted to implement the "Key Attributes of Effective Resolution Regimes for Financial Institutions" issued specifically by the FSB.

The European Union has already embraced these goals in its recent EU legislation on banking recovery and resolution , as a precursor to TLAC, requires banks to hold additional capital buffers but with greater attention to the specific characteristics of the European banking system. The FSB should take account of that fact when calibrating the requested level of TLAC.

Lastly, because the local authorities have other tools to ensure an adequate loss absorption capacity through combined buffer requirement and the requirements of *Pillar* 2, it is felt that the minimum requirement of TLAC should be proportional to the G-SIB buffer, and not left to the discretion of the individual national sopervisor.

2. Ensuring the availability of TLAC for loss absorption and recapitalization in the resolution of cross-border groups

Question 4: Should TLAC generally be distributed from the resolution entity to material subsidiaries in proportion to the size and risk of their exposures? Is this an appropriate means of supporting resolution under different resolution strategies? Which subsidiaries should be regarded as material for this purpose?

ABI response: Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, ABI agrees with the objective of considering, for purposes of the TLAC, only major subsidiaries ("material") so as the make the (Group) resolution strategy more credible and increase the relationship of trust between host and home authorities, but believes it would be more efficient - and more in line with the standards already issued by the FSB itself - to use the guidelines for identification of the Domestic SIB (D-SIB), rather than adopting a linear threshold of 5% in terms of consolidated RWA.

Question 5: To what extent would pre-positioning of internal TLAC in material subsidiaries support the confidence of both home and host authorities that a G-SIB can be resolved in an orderly manner and diminish incentives to ring-fence assets? Is a requirement to preposition internal TLAC in the range of 75 - 90% of the TLAC requirement that would be applicable on a stand-alone basis, as set out in the term sheet (Section 22), appropriate to satisfy the goals of the proposal and ensure that TLAC is readily and reliably available to recapitalize subsidiaries as necessary to support resolution? Can this pre-positioning be achieved through other means such as collateralized guarantees?

ABI response:

Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, ABI believes that alternative instruments such as collateralized guarantees would be sufficient to ensure that the (Group) resolution strategy is credible and capable of increasing the relationship of trust between home and host authorities.

In any case, the internal TLAC proposal seems to be counterintuitive vis-à-vis the SPE (Single Point of Entry) model that the consultation paper seems to promote as it does not enable all TLAC eligible capital to be held at the highest consolidated level of a group.

3. Determination of instruments eligible for inclusion in external TLAC

Question 6: Are the eligibility criteria for TLAC as set out in the term sheet (Sections 8-17) appropriate?

ABI response: In section 13 a proposal is made to allow the TLAC requirement to be covered by up to a maximum of 2.5 per cent of the RWAs with unsecured but non-subordinate debt instruments (such as unsecured bank bonds that are not subordinate since they are not issued by a holding company) provided that the authorities ensure that the possibility of excluding certain liabilities from bail-in in exceptional cases does not give rise to potential litigation.

ABI believes that if the authorities are able to provide such an assurance, then the motive itself of exclusion is no longer valid and consequently the ceiling of 2.5 per cent of RWAs does not appear reasonable, and should therefore be abolished.

Question 7: What considerations bear on the desirability of an expectation that a certain proportion of the common minimum Pillar 1 TLAC requirement consists of (i) tier 1 and tier 2 capital instruments in the form of debt plus (ii) other eligible TLAC that is not regulatory capital?

ABI response: Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, ABI believes that allowing coverage of the new requirement with alternative instruments to regulatory capital certainly helps to cool the effects on the cost of bank funding. In order not to disperse the benefits that derive from the possibility of covering 33% of TLAC with “debt” instruments, a clear legal or accounting definition of the term "debt" is required, that can define these instruments through a simple application criterion (e.g. IAS/IFRS).

Question 8: Are the conditions specified in the term sheet (Section 8) under which pre-funded commitments from industry-financed resolution funds to provide resolution funding contribute to TLAC appropriate?

ABI response: The FSB seems to be open to the possibility of considering the "existence" of a resolution fund as eligible in TLAC with a weight of up to a maximum of 2.5%. It seems, however, in the way the proposal is written, that this possibility does not apply for the Single Resolution Fund that is being set up, since there must not be any limits set by law (in Europe the BRRD and the SRM provided for a ceiling of 5 percent). Even if one agrees with the principle that the resolution funds must be eligible in TLAC, it would, nevertheless, be appropriate to amend the exclusion criteria which should be proportional to the capacity for intervention (e.g. relationship between the endowment of the fund and the RWAs of potential beneficiaries). Exclusion on the basis of the existence of intervention limits could benefit the funds with an endowment lower than the EU one (1% of guaranteed deposits) that might, however, not be sufficient at the moment of use (ultimately, the endowment would need to be equal to the total unsecured debt of the adherents to the fund in order to make the absence of intervention limits realistic).

Question 9: Is the manner in which subordination of TLAC-eligible instruments to excluded liabilities is defined in the term sheet (Section 13) sufficient to provide certainty regarding the order in which creditors bear loss in resolution, and to avoid potentially successful legal challenges or compensation claims? Where there is scope for liabilities which are not subordinated to excluded liabilities to qualify for TLAC, are the transparency and disclosure requirements set out in section 13 and 24 sufficient to ensure that holders of these instruments would be aware of the risk that they will absorb losses prior to other equally ranking but excluded liabilities? If not, what additional requirements should be adopted?

ABI response: The subordination requirement envisaged by the FSB proposal provides a precise list of the excluded liabilities that would seem to create problems with the possible classification of senior unsecured exposures among those TLAC-*eligible* ones, because in some cases these could contribute pari passu towards the liabilities excluded from the TLAC, and thus miss the subordination requirement.

For those jurisdictions such as the European one, which allow the competent authorities to exclude certain liabilities from the bail-in in exceptional circumstances, the ability also to qualify senior unsecured liabilities in terms of TLAC is recognized up to the equivalent of 2.5% of RWAs (if the overall required TLAC is equal to 16% of RWAs) or more (if the overall required TLAC is higher than 16% of RWAs).

Despite considering this limited recognition, since the FSB acknowledges the requirement of subordination in structural terms to all liabilities, there would be a significant competitive distortion in favour of banking groups that are governed by a “pure” holding company (typically the case with US, British and Swiss banks) and to the total disadvantage of banking groups that are governed by a holding company that also manages commercial bank activities (typically the case with banks on the European continent, including Italy).

Changing the governance structure of a banking group in order to be compliant with the proposal of the FSB is not a simple task since it requires the agreement of the shareholders to remove the commercial bank activities from the parent company (or the creation of a new “pure” holding company); this operation could also have important consequences in terms of rating.

An effective solution would be to make the senior debt eligible for TLAC subordinated enough to excluded liabilities to lower the risk of legal challenge for resolution authorities.

Since the two major asset classes that rank pari-passu with senior debt are corporate deposits and derivatives, through an amendment of the national (or regional – for the EU Member States) insolvency law it is possible to grant them a form of preference above senior debt, so as to clarify their ranking in the credit hierarchy, that would remove a significant amount of legal risk for regulators.

The FSB term sheet should acknowledge that this kind of subordination qualifies as structural subordination and therefore that for those jurisdictions the 2,5% RWA limit to the recognition of senior unsecured debt does not apply.

4. Interaction with regulatory capital requirements and consequence of breaches of TLAC

Question 10: Do you agree that the TLAC requirement for G-SIBs should be integrated with Basel III such that the minimum TLAC requirement should be met first, and only after TLAC is met should any surplus common equity tier 1 (CET1) be available to meet the Basel III buffers?

ABI response: Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, ABI agrees that the new capital buffers introduced by Basel 3 – though with the ability to absorb losses - should be taken as additional to TLAC, so as to allow banks to be able to use the buffers without, for this reason, suffering any supervisory actions or entering into a resolution procedure; this, however, must lead to a rethink about the calibration of TLAC, since for a G-SIB bank of the bucket

1, the new total, post-buffer, capital requirement would be positioned in the 19.5% to 23.5% range, which is particularly high.

5. Transparency

Question 11: What disclosures (in particular in terms of the amount, nature and maturity of liabilities within each rank of the insolvency creditor hierarchy) should be required by resolution entities and material subsidiaries to ensure that the order and quantum of loss absorption in insolvency and resolution is clear to investors and other market participants?

ABI response: Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, with specific reference to the European Union context, it is felt that the disclosure provided under existing Community legislation on banking crisis management is already widely sufficient to guarantee an appropriate level of disclosure to investors.

FSB should therefore refrain from imposing additional compliance burdens on banks, unless justified by an impact assessment on costs and benefits.

6. Limitation of contagion

Question 12: What restrictions on the holdings of TLAC are appropriate to avoid the risk of contagion should those liabilities be exposed to loss in resolution?

ABI response: In order to avoid the crisis of a G-SIB creating a contagion effect, FSB proposes to discourage or even prohibit the underwriting of TLAC liabilities by banks operating internationally or by other G-SIBs.

Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, ABI believes that this proposal, whilst acceptable in its intentions, should nevertheless be looked at in greater depth in order to avoid undesired drying-out of the reference markets and, consequently, an unjustified increase in the cost of funding for the G-SIB banks.

7. Conformance period

Question 13: Should G-SIBs be required to conform with these requirements from 1 January 2019? Why or why not? What, within the range of 12 to 36 months following the identification as a G-SIB, should be the conformance period for banks identified as GSIBs at a future date?

ABI response: It should be noted that despite the fact that the proposal of the FSB envisages the more restrictive requirements not coming into force prior to 2019, with the idea of allowing banks to come into line with the new requirements on a gradual basis, it is felt that the market operators and financial analysts would start seeking compliance from day one. Therefore, in order to avoid potential unwanted quirks in the markets, the minimum requirement of TLAC should be proportional to the G-SIB *buffer*, and not left to the discretion of the individual national supervisor.

8. Market impact and other aspects

Question 14: How far is the TLAC proposal, if implemented as proposed, likely to achieve the objective of providing sufficient loss-absorbing and recapitalization capacity to promote the orderly resolution of G-SIBs?

ABI response: Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, the ABI believes that, to be effective, the TLAC proposal should be made sufficiently flexible to the extent that it can be credibly adapted to the peculiarities of the various jurisdictions.

Question 15: What will be the impact on G-SIB's overall funding costs of the adoption of a Pillar 1 Minimum TLAC requirement?

ABI response: ABI maintains that the potential increase in the cost of funding will be influenced mainly by two variables. The first is undoubtedly the level of calibration which will be adopted, the second refers to the level of adaptability to the various national jurisdictions.

TLAC should therefore not be a substitute to the Pillar II instruments and consequently it should be calibrated in accordance with the buckets, and not left to the discretion of the individual national regulator. In addition, all the liabilities that are eligible for the purposes of the European requirement (MREL) should therefore be recognized as qualifying in terms of TLAC, since they are subordinate by law.

Lastly, it will be necessary to determine the anti-contagion measures in an appropriate manner so as to avoid undesired drying-out of the reference markets and, consequently, an unjustified increase in the cost of funding for the G-SIB banks.

Question 16: What will be the impact on the financial system and its ability to provide financing to the real economy?

ABI response: It is absolutely clear that the new TLAC requirement would increase the cost of funding and may negatively affect the ability of banks to support the real economy and, if not properly calibrated, may encourage unwanted effects of deleveraging.

This would therefore contradict the efforts of the ECB and European policy makers to promote growth and jobs by stimulating lending to the real economy.

Question 17: Do you have any comments on any other aspects of the proposals?

ABI response: Taking into account the opposition to introduction of the TLAC for the reasons indicated in the introduction, ABI believes that the consultation examined all aspects deemed crucial.