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Position of the European Financial Congress[1] in relation to the Financial Stability Board's consultative document on Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs ('Internal TLAC')[2]

Methodology for preparing the answers

The answers were prepared in three stages:

Stage 1

A group of experts including several dozen specialists were invited to participate in the survey. They received selected extracts of the consultation document as well as selected consultation questions in Polish. The experts were guaranteed anonymity.

Stage 2

The Gdańsk Institute for Market Economics[3] received 22 opinions from key financial market institutions in Poland and from individual experts. All the responses were collected, anonymised and presented to the experts who took part in the consultations. The experts were asked to mark in the other consultation participants' opinions the passages that should be included in the final position as well as the passages they did not agree with. Experts could also adjust their positions under the influence of arguments presented by other experts that they had not known previously.

Responses were obtained from experts representing:

- universal banks,
- financial conglomerates,
- regulatory and supervision bodies,
- consulting firms and law firms,
- the academia.

Stage 3

On the basis of the responses received, the survey project coordinators from the European Financial Congress prepared the final version of the European Financial Congress's answers presented below.[4]

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[1] European Financial Congress (EFC – www.efcongress.com). The purpose of the regular debates held within the EFC is to ensure the financial security of the European Union and Poland.

[2] http://www.fsb.org/wp-content/uploads/Guiding-Principles-on-the-Internal-Total-Loss-absorbing-Capacity-of-G-SIBs.pdf

[3] Instytut Badań nad Gospodarką Rynkową (IBnGR) – the first independent think tank in Central and Eastern Europe, founded in 1989 by a group of economists associated with the democratic opposition and the "Solidarity" movement.

[4] An individual opinion of one of the experts is presented following the standpoint of the EFC.

Answers of the European Financial Congress to the consultation questions[5]

Question 1:

What factors should the relevant authorities take into account when determining the composition of material sub-groups and the distribution of internal TLAC between the entities that form the material sub-group (guiding principle 2)?

Determining the composition of material sub-groups

The quantitative criteria applied to determine the material sub-groups and proposed in the TLAC Term Sheet (Section 17, letters a-d) are correct. They are simple and easy to use in practice, which is an advantage. However, we would like to make several comments to supplement the material:

1) The criteria presented by FSB in fact apply to credit risk and focus on credit institutions. Those criteria do not sufficiently and properly account for: i) market risks/ liquidity risks which may lead to material losses in a relatively short time should they materialise, ii) a bank's policy with regard to the credit loss absorption through impairment provisions established (the expected credit losses), iii) systemic importance of a bank for a given country (i.e. it might happen that the criteria set out in items a-d in Section 17 have not been met, and yet the local bank from a given group is systemically important for a given (local) market/ country).
2) It may be a problem for the host countries that the criteria proposed account for only one perspective, that is the entity's importance for the group, and disregard the importance of the entity for the local market on which it operates. That is why the list of criteria should be a "minimum list" and it should be the starting point for the process of identifying the material sub-groups. Ultimately, the process itself should be the result of agreements between the resolution authorities in the home country and in the host country. The basic list in Section 17 a-d should definitely account for the essential criterion being the entity's importance from the perspective of the financial system and the economy of the host country. And it should be explicitly stated in Section 17. It would be expedient for the CMG (at the request of the host authority) to identify a sub-group that has at least one domestic Systemically Important Financial Institution, or domestic SIFI, as a material sub-group (domestic SIFI is the EU equivalent of Other Systemically Important Institutions, or OSII). Each host country, in collaboration with the home country, should define hard criteria that determine classification into a material sub-group. The main principle should be the introduction of a rule whereby the risk of a subsidiary of a resolution entity should be assessed according to the same criteria as used for the assessment of the risk of banks in the host country.
3) It is also advisable that additional criteria be added to the list in terms of the efficiency of the resolution process. When identifying the material sub-groups, there is an additional factor that should be taken into account, notably the mutual relations between the entities that are members of the entire group (e.g. material functions exercised by the entity in the entire group). The existence of such relations will affect the choice of the right strategy and of the preferred resolution tools.

[5] The questions were selected from a broader pool of questions provided in the Financial Stability Board's consultation document. The original numbering has been preserved.

Distribution of internal TLAC

The availability of funding during the resolution process is a key factor on which the success of the entire exercise is dependent. Therefore, efforts should be made that each institution should, on its own, maintain the highest TLAC possible (relative to its needs) in the form of instruments directly issued by that institution that allow for quick recapitalisation, if any. An adequate distribution of funds within internal TLAC, e.g. the taking up of the issue by the parent company , is of particular importance for host countries with less developed capital markets, and consequently less possibility to organise an issuance of debt instruments on their own to increase the institution's TLAC.

Question 3:

Do you agree with the roles of home and host authorities in relation to the host authority's determination of the size of the internal TLAC requirement, as set out in guiding principles 5 and 6? What additional factors, if any, should the host authority take into account when setting the internal TLAC requirement?

The division of roles between the home and host authorities as proposed in guiding principle 5 is right. The home authorities should have a coordinating function in terms of determining the TLAC level for the subsidiaries and for the entire group. At the same time, the domestic authorities (the host authorities) should have the final say on the internal TLAC requirement determined for an entity within their jurisdiction.

The level of internal TLAC should not be limited to the level of the external TLAC determined for the parent company. There should be a rule that the internal TLAC expressed as a percentage of RWA may be higher than the external TLAC level on a consolidated basis.

The FSB strategy which envisages that a certain amount of external TLAC at the parent company level should be retained so as to offer that parent company some flexibility when allocating internal TLAC should be supported by guarantees or other arrangements between the parent company and the subsidiaries acceptable to the resolution authorities within their jurisdictions.

When determining the level of internal TLAC, it is also worth taking into consideration criteria other than the ones set out in guiding principle 5, including those proposed in the EU regulations. Additional factors may include:

- the resolution strategy in the group – SPE/ MPE
- the degree of the development of the domestic capital market and access of the domestic institutions to foreign capital markets;
- the ability to use the funds accumulated in the deposit guarantee scheme;
- the negative influence that the institution's bankruptcy may have on financial stability.

The guidelines do not include any rules regarding further redistribution of the loss absorption capacity for individual entities within the material sub-group.

Question 5:

What are your views on the composition of internal TLAC, as set out in guiding principle 8? In particular, should there be an expectation of the inclusion within the internal TLAC of debt liabilities accounting for an amount equal to, or greater than, 33% of the material sub-group's internal TLAC?

Maintaining a part of TLAC in the form of debt is right in terms of the efficiency of the resolution process. If the bank meets the requirements for the purpose of capital ratios and for the resolution purposes mainly in the form of core tier 1 capital (CET1), then the capital may be used for covering losses on an ongoing basis. It cannot be excluded that a major part of that capital will already have been used up by the time the resolution procedure is started. Where the equity structure is dominated by core tier 1 capital, the trigger for the commencement of the resolution is also delayed and the ability to write down or convert the instrument into equity within the resolution process is frequently limited to (i) a part of core tier 1 capital left after the losses have been covered and (ii) deposits not covered by guarantees. Where equity also comprises debt instruments (that is, AT1 capital), the resolution authority has broader possibilities to write down or convert capital instruments once the resolution procedure is started.

However, the fact that the debt liabilities included in TLAC should account for an amount equal to, or greater than 33%, gives rise to certain doubts. The 33% level should be given only as a point of reference. Consideration should also be given to the fact that the degree of development of the domestic capital markets and access of the institutions to foreign markets vary greatly, and it may be impossible to meet the requirement if it is too high. The detailed structure of internal TLAC should remain at the discretion of the resolution authority in the host country in each case.

The use of TLAC in the form of collateralized guarantees should not be permitted. The point of non-viability (PONV) is reached when the holding entity already failed to meet its investor-related obligations towards a subsidiary and the competent supervisory authority, and refused to recapitalise an entity during the early intervention stage. In the case of groups located in the EU member states, this is also likely to mean that the holding entity failed to properly meet its obligations under the intragroup financial support arrangements. If there is a threat, the fulfilment of a guarantee obligations may be jeopardised, despite the collateral.

Question 6:

What are your views on the potential benefits or drawbacks of different approaches to the issuance of internal TLAC instruments as set out in guiding principle 10, and what steps could be taken to mitigate the drawbacks that you have identified?

The principles contained in the consultative document should not exclude any internal TLAC allocation option in the subsidiaries – whether direct or indirect ("daisy chain"). The approach as such (direct or indirect) is of secondary importance; what is more important is to subordinate the internal TLAC properly, to have the ability to recapitalise the subsidiary without starting the resolution procedure against it and to ensure that the instruments issued by the subsidiary are governed by the law of the issuer's country.

There seems to be one very important advantage of internal TLAC issuance relying on the daisy chain approach in terms of resolution purposes. Only that form of the internal TLAC issuance

warrants the maintenance of the existing structure of the entire group, and consequently the continued exercise of its critical functions. Daisy chain issuances also seem to meet the expectations of the regulators. Upon the write-down or the conversion of the debt into equity, the institution remains under the supervision of the same entity and may continue its existing activity as a going concern. If the ownership structure changes, it might be the case that the new owners will want to change the company's business profile (especially in view of experience with crisis), which may affect the exercise of the critical functions by the entire group. This has an impact on the proper relations between the domestic regulators and increasing effectiveness of the activities during crisis.

However, the final choice regarding the setup of an internal TLAC issuance should combine the expectations of the resolution and supervisory authorities, as well as the needs of the group itself and its preferences regarding TLAC (while taking into consideration the potential costs and benefits of the individual solutions).

Question 8:

Do you agree with the obstacles to the implementation of internal TLAC mechanisms set out in guiding principle 12? How should G-SIBs and authorities address those obstacles and what additional obstacles, if any, might arise?

The list of potential obstacles relating to the implementation of the internal TLAC mechanism, as identified by FSB, is correct. Tax treatment and the upstream of losses mechanism may be considered the most important ones. The list is not exhaustive and the following obstacles may be added thereto:

- the rights and regulations protecting minority shareholders which may be violated if the TLAC components are converted to equity,
- asymmetrical treatment of the regulatory minimum values of capital requirements effective in different jurisdictions under the respective banking laws, which may be, and actually is, applied by local banking supervisory authorities as part of the applicable provisions/ regulations giving such rights to the local banking regulator.
- the issue of valuing the internal TLAC instruments (it will be difficult to indicate a good benchmark for their valuation which may be a temptation for the holding companies to use internal TLAC for draining on the profits of the subsidiaries and may lead to potential disputes between the home and host authorities),
- a conflict between the TLAC requirement and the concentration limits (if TLAC instruments are issued by a subsidiary to the parent company).

It seems that more examples may become available during the implementation process itself, which will identify barriers that are typical of a given country and that relate to specific legal conditions or to the cooperation among the resolution authorities on the international scene (e.g. resolution boards in the EU).

As for addressing the obstacles, this is a circumstance-specific issue which should be resolved by CMG on a case-by-case basis, upon accounting for the circumstances of the specific case, including in particular the specific nature of the legal frameworks in the home and host countries.

Question 9:

Do you agree with the key features of contractual trigger language for internal TLAC, as set out in guiding principle 13 and in Annex 2? Should authorities consider the use of contractual triggers for internal TLAC in the form of regulatory capital instruments, including in cases where statutory point of non-viability powers exist in relation to such instruments?

The essence of the SPE strategy is to empower the resolution authorities to write down or convert internal TLAC (or other qualifying liabilities) into equity without initiating a resolution procedure towards the subsidiary. If such an empowerment does not arise by law, it must be ensured by contractual provisions. The shape of those clauses should be adjusted to the law that governs the contract.

Including, in the issuance terms and conditions, contractual provisions that will specify the conditions under which a write-down or conversion into equity is expected to take place would increase the investors' awareness of possible consequences relating to the acquisition of a given financial instrument. The moment for taking such actions should be indicated as precisely as possible from the operating point of view, and in particular in order to account for the interests of the minority shareholders.

Nevertheless, any attempts at quantifying PONV should be approached with great caution due to, for example, the fact that different approaches may be adopted to value an entity's assets under regulatory reporting (the going concern assumption) and for the resolution purposes (the approximate liquidation value). In view of the above, the resolution authorities (or the supervisory authorities) should have the freedom, and the decision should be based on certain triggers which should – at least to some extent – be qualitative.

If we assume that it is the holding entities that will invest into such instruments, then there is no need to take efforts to ensure high transparency level of the mechanism which would be necessary in the case of retail clients. In any case, the fulfilment of the resolution premises set out in the law should be the ultimate trigger for the write-down or conversion of internal TLAC into equity.

To conclude, the rules could be split into "hard" ones and "soft" ones, where the hard ones determine automatic bail-in and the soft ones require a justification for the lack of bail-in (consultations at the home-host level).

As for contractual provisions, providing the relevant authorities with the ability to write down or convert instruments into equity by law should be the preferred approach; the contractual solutions should only be an additional safeguard. Therefore, it is essential that adequate statutory solutions are implemented in the legal systems of the host countries and that the instrument issuance is governed by the law of the issuers (or the law of another Member State in the EU).

Principle 13 and the subsequent ones which imply that the possible need for obtaining the home authority's consent to a write-down or conversion into equity of instruments issued by a subsidiary are assessed negatively.

General comment:

The TLAC regime is addressed to multi-jurisdictional G-SIBs operating in countries with very different legal systems and different levels of advancement at the financial markets. What is more, the TLAC

Term Sheet and the FSB Key Attributes are a form of recommendation, rather than a binding law. Therefore, the solutions proposed in the TLAC Term Sheet should properly secure the interests of all stakeholder countries, including in particular the host countries because it seems to be the only reliable way to avoid ring fencing.

FSB's approach to the identification of material sub-groups does not meet the demands indicated hereinabove. As such, it does not provide adequate incentives for the host countries not to take individual actions; consequently, it does not ensure credibility of the SPE strategy which requires joint action of all resolution authorities concerned.

In keeping with Section 17 of the TLAC Term Sheet, an entity is or a group of entities are considered material if they are material for the group, rather than for the financial and economic stability of the countries in which they operate. It is easy to imagine a situation where subsidiaries from the Baltic countries, for example, do not meet the FSB criteria, even though they are systemically important for those countries. With such an approach, countries with less developed banking sectors will be left out of the strategies agreed in the CMG, and their resolution authorities will take individual actions towards group entities within their jurisdictions which is contrary to the basic assumptions of the SPE strategy.

An individual opinion of one of the experts

Questions 3,5,6,8:

TLAC level and quality

It needs to be pointed out that the TLAC requirements are restrictive both in quantitative and qualitative terms. In quantitative terms, as of 2019, TLAC is to represent 16% of RWA and 6% of the total exposure for resolution entities (ultimately, it will be 18% of RWA and 6.75% of the total exposure). It should be mentioned that the capital buffers (which typically range from 2.5% to 6.0% of RWA) are not added to the TLAC requirement. Therefore, in practice only the CET1 capital may be included in TLAC when it comes to equity.

Even though, consistently with Principle 18, the value of internal TLAC is reduced to 75%-90% of the Minimum TLAC that would apply to the material subsidiary if it were a resolution group, it should be concluded that the amount of the minimum internal TLAC will exceed the standard minimum MREL requirements which are currently being introduced.

Qualitative requirements applicable to debt instruments included in TLAC are also quite restrictive: such instruments should be subordinate to securities that are not included in TLAC. In practice, AT1 securities (the so-called Contingent Convertibles), T2 instruments and subordinated debt instruments meet those requirements. As for including certain senior debt securities into TLAC requirements, in order to comply with the domestic regulations (in particular with the pari-passu principle), such bonds should be subordinated: a) in contractual terms or b) in structural terms, or c) in regulatory terms. The Polish supervisory and resolution authorities will play a special role if a SPoE, or single point of entry, resolution model is adopted. In such a case, a foreign G-SIB that recapitalises and absorbs the losses of material subsidiaries operating in Poland will be a resolution entity. As part of this arrangement, the Polish supervisory and resolution authorities that will be the

host authorities should keep in mind that the sum of internal TLACs should not be higher than the sum of external TLAC.

In addition, efforts should be made to ensure that the internal TLAC requirement is fulfilled as much as possible in the form of CET1 capital rather than subordinated debt, which is extremely costly; it may also happen that it will be an instrument used for transferring funds to the holding entity (a kind of bonus charged by the resolution entity from the subsidiaries in exchange for being ready to absorb their losses and fulfil the recapitalisation needs).

Question 9:

TLAC write-down or conversion

As for the triggers for internal TLAC, the PONV, or point of non-viability, should be clearly set as a hard trigger. It is important because under the SPoE resolution model, the host authority should obtain the home authority's consent to commencing the write-down or conversion into equity of instruments included in internal TLAC. Under such circumstances, the diverging interests of the two institutions will probably become visible since the process means that the resolution burden for the subsidiaries will be shifted to the resolution entity (G-SIB) supervised by the home authorities.