German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on the Financial Stability Board's Consultation Paper "Adequacy of loss-absorbing capacity of global systemically important banks in resolution"

Register of Interest Representatives
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Berlin, 2015-02-02

The **German Banking Industry Committee** is the joint committee established by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks; the Bundesverband deutscher Banken (BdB), for the private commercial banks; the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks; the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group; and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Comments on the FSB TLAC

I. General comments

The German Banking Industry Committee (GBIC) shares the Financial Stability Board's goal of increasing financial stability. Stable financial markets are in the interests of the banking industry.

However, governments and regulators have already responded with a wide range of initiatives: among other things, they have

- increased the capital requirements and the requirements for risk management;
- imposed standards for compliance with a leverage ratio that must already be reported to the supervisors;
- extended the remit of the supervisory authorities; and
- in our opinion, adequately addressed the "too big to fail" problem in the European Union by introducing the Bank Recovery and Resolution Directive (BRRD) and the single resolution mechanism (SRM) in the EU.

The regulatory approaches enshrined in the BRRD and SRM examine at the level of the individual entity if the recovery or resolution of the institution or the group would be possible within the existing structure, whether structural impediments have to be removed and whether there is a need to further enhance the loss-absorbing capacity. The European regulatory framework (BRRD and SRM) provides for a bail-in tool for certain capital instruments and/or liabilities that is similar in substance to the FSB's TLAC proposals. Based on this regulatory framework, institution-specific minimum requirements for eligible liabilities – meaning regulatory capital plus mainly subordinated liabilities – will be defined in Germany starting in 2015 (and EU-wide starting in 2016).

In contrast to the FSB's proposals, the requirements in the BRRD governing the minimum requirements for own funds and eligible liabilities (MREL) are not oriented on risk-weighted assets, but rather on total assets and are based on the institution's individual loss-absorbing capacity needed in the event of resolution. In our opinion, the requirements would be comparable with the FSB's TLAC proposals both in terms of the amount involved and the way they function. The EBA also sees a considerable degree of consistency between TLAC and MREL (see also EBA CP/2014/41).

This regulatory framework is to be supplemented by banking structural reform in the EU with the aim of either banning risky transactions, especially by large banks, or of separating them into a separate trading entity. Here, too, the primary objective is to minimise the impact of any financial stress at large institutions on financial stability in general.

We therefore strongly urge awaiting and analysing the effects on G-SIBs of the aforementioned EU regulatory requirements, which have only recently entered into force. In our view the fundamental concern of the FSB, to establish loss-absorbing capital in systemic institutions, has already been addressed by the new resolution regime (MREL) according to BRRD, which has just come into effect. Therefore we strongly urge, that the FSB acknowledges the European resolution regime and considers the rules within their proposals.

The FSB itself acknowledges that the TLAC requirements will have far-reaching consequences for institutions' funding structures in particular. It should be borne in mind in this context that the requirements contained in the Consultation Paper relating to the subordination of TLAC-eligible liabilities,

in combination with the quantitative requirements, could lead to bottlenecks and market distortions because the market for these instruments is insufficiently deep and broad. In addition, we are very concerned that the subordination requirement could result in considerable competitive disadvantages for European banks because, as a rule, the way these entities are organised means that they are barred from using more cost-effective funding options involving structural subordination.

We therefore welcome the fact that the FSB will take into account the findings of an impact study in the final calibration of the TLAC requirements. We reject the potential extension of the requirements to domestic or other systemically important institutions because we believe that the MREL requirements that are currently the subject of an EBA consultation ensure that institutions have an adequate loss-absorbing capacity in the event of resolution.

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II. Specific comments

Calibration of the amount of TLAC required

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?

The primary objective of the TLAC requirement is to ensure sufficient funds in the event of the resolution of an institution, and in doing so both to avoid the use of public funds (taxpayers' money) and to strengthen financial stability. Appropriate measurement of the quantitative TLAC requirement should not depend on the current operating activities of the institution or group before the start of the resolution process. Such an approach would exceed the minimum TLAC requirement because the institution that is suffering a crisis will already have implemented measures under its recovery plan before the resolution event that will have contributed to a reduction in the size of the institution and will have resulted in a significant drop in its risk-weighted assets, among other things. In addition, the quantum of TLAC required should consider the fact that, in the recent banking crises, an eight per cent bail-in was almost always sufficient to recapitalise the bank and resolve it without recourse to taxpayers' money.

For this reason, our position is that the minimum TLAC requirement should be oriented as a maximum on the recapitalisation funds needed to maintain the critical functions of the resolution entity in question and should take into account the "shrinkage" of balance sheet assets that has already occurred. The recovery and resolution planning should define the functions deemed to be "critical" and hence worth preserving, and those that are not – and that can therefore be discontinued. We therefore advocate defining the minimum TLAC requirement as a maximum of 16% of risk-weighted assets (RWAs) including capital conservation buffers. It should also be considered in this context that additional (systemic and countercyclical) capital buffer requirements under Basel III will ultimately lead to the institution having an even greater loss-absorbing capacity, because they will have to be met in addition to the TLAC requirements.

Moreover, the context of additional Pillar 2 requirements should also be taken into account. If the FSB eventually opts for this form of calibration, this would argue even more strongly in favour of a minimum requirement of no more than 16%, as some degree of supervisory readjustment should be expected. We wish to draw attention here primarily to the proposals contained in the EBA's consultation paper on the minimum requirements for own funds and eligible liabilities (MREL – EBA/CP/2014/41). If a Pillar 2 requirement is imposed, we also think it is important for it to be based on clear, predefined criteria.

We also believe that the second requirement for calculating the TLAC in the same way as the Basel III leverage ratio is appropriate in principle for determining the level of the TLAC. However, the ratio should be set at a fixed percentage, e.g. 6%. This would avoid a situation where the ratio would change disproportionately if the Basel III leverage ratio is set at a level other than 3%. Additionally it should be made clear, that the Leverage Ratio requirements of

currently 6 % does not imply an additional TLAC-requirement amounting to the capital buffers. . The leverage ratio concept does not contain any capital buffers, so it is not appropriate to include them when measuring resolvability in this context. In addition, using capital buffers that systematically depict going concern loss-absorbing potential would breach the TLAC requirement in this context.

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?

We believe that exemptions for certain G-SIBs would be counterproductive because they would distort competition. Exemptions of this nature would encourage undesirable relocation tendencies, which should be prevented. We are therefore not in favour of exemptions and advocate ensuring a level playing field.

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

As a matter of principle, we have doubts about the need for any additional Pillar 2 requirements, because these would make the TLAC requirement more complex and adversely affect its transparency. The relationship to the Pillar 2 requirements of Basel III is also unclear. However, if the FSB really decides to implement a Pillar 2 component for the TLAC requirement, it will have to be factored into the calibration of the minimum TLAC requirement. We believe that the combination of a minimum 16% requirement plus a Pillar 2 component is inappropriate. If however the FSB introduced a Pillar 2 requirement, the minimum Pillar 1 requirements should be set at a maximum of 16 %. Furthermore, any dimension of the Pillar-2 requirements should be determined via pre-defined and comprehensible criteria.

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

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?

We would like to refer again to the European context here and are therefore of the opinion that there is no need for pre-positioning within an established resolution regime such as the one being implemented under the BRRD. The requirement to pre-position TLAC in material subsidiaries would ultimately be interpreted as a lack of confidence in the proper functioning of the European resolution mechanism. If a distribution of TLAC is effectively deemed to be indispensable, the quantum should be defined by the resolution authority to reflect the resolution plan. However, this should be the exception and apply in special cases only.

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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 pre-position 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?

As already explained above, we do not see any need to pre-position TLAC as a matter of principle. However, if a need for internal loss absorbing capacity does arise in justified scenarios, we would advocate limiting the requirement to a maximum of 75% so as not to overly limit the flexibility to use eligible liabilities within groups. We also suggest examining whether the distribution of TLAC can be assured by means of collateralised guarantees. However, it must be ensured in such cases that the collateral is counted towards the high-quality liquid assets (HQLA, within the meaning of the Liquidity Coverage Ratio (LCR) requirements).

Determination of instruments eligible for inclusion in external TLAC

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

The criteria set out in sections 8–17 should be modified in terms of both their content and their wording in order to align them with the EU BRRD criteria governing bail-in liabilities and the MREL; alternatively the latter should supplement the TLAC eligibility criteria. This would counter future legal uncertainties and ensure that subordinated liabilities eligible for MREL are also eligible in full for TLAC purposes. We do not see any reason why liabilities that are already deemed to be eligible for bail-ins under the BRRD should additionally have to be subordinated in order to make them eligible for TLAC.

In any event, we reject the criteria defined in the FSB's term sheet because they unilaterally disadvantage European corporate banking structures. The FSB definitions allow banks that are organised in a holding company structure to originate their TLAC-eligible liabilities in the form of senior unsecured debt because subordination is achieved through the corporate structure. By contrast, German banks, which normally have operating companies at the top tier of their group, are forced to contractually ensure the subordination of the liabilities, which will lead to considerably higher funding costs. We believe that this represents an unwarranted competitive disadvantage for German banks.

We also believe it is remarkable that the FSB notes in section 13 that senior debt can contribute up to 2.5% of RWAs for the TLAC requirement if certain conditions are met. If this means that it is possible to make senior debt TLAC-eligible by defining requirements, we do not see any reason for stipulating a 2.5% ceiling here.

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Finally, we are concerned about the blanket exclusion of structured notes from TLAC eligibility. In principle, structured notes can also be written down and converted. We therefore advocate a more differentiated approach here when assessing TLAC eligibility.

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?

The FSB's proposals may effectively force institutions to issue subordinated liabilities, regardless of whatever valid capitalisation they may already have. We interpret this requirement to mean that institutions that hold high levels of CET1 instruments may also count them without limitation towards eligible TLAC under the above minimum TLAC requirement. A condition is that they relate to CET1 that is held by the institution over and above the Basel III minimum requirements (including all buffer requirements). This clarification should be added to the final wording of the TLAC requirements. We cannot imagine that the FSB wishes to encourage banks with a significantly above-average capitalisation to increase their debt in order to meet the TLAC requirement.

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?

No comments.

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?

In our view, the requirements of section 13 (priority) in particular should be reconsidered. The requirements contained in this section addressing the creditor hierarchy in the event of resolution should also be anchored in statutory requirements for reasons of legal certainty and uniform international application. The implementation of the bail-in requirements of the BRRD is a good example of this (see Article 59ff. of the BRRD). A creditor hierarchy that becomes effective in the event of resolution and is understandable for all parties was implemented at statutory level in the BRRD. Based on the statutory requirements, the bail-in itself – in other words writing down the capital instrument or liability, or the alternative method of converting liabilities into CET1 – can also be enforced by the resolution authority by means of a sovereign act. There is thus no need to inform the investor concerned separately. This also ensures that existing capital instruments can be included in the BRRD bail-in tool without any problems. This approach is helpful for all parties involved (banks, supervisors and investors) because it contributes both to legal certainty and to improved predictability.

We also wish to draw attention a second time to the fact, already addressed in point 6, that continental EUbanks are being put at a disadvantage versus US, British or Swiss banks. The structural handicap of continental EU banks will result in additional costs that will negatively impact their competitiveness. We therefore believe that it is vital for senior unsecured debt to also be classified as TLAC-eligible.

Interaction with regulatory capital requirements and consequence of breaches of TLAC

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?

In our view, such an approach is not appropriate. CET1 must be used first to meet the Basel III minimum requirements (regulatory capital). Our understanding is that the minimum TLAC requirement should be met either by CET1 or by Additional Tier 1, Tier 2 or "other eligible liabilities" that meet the TLAC requirements. The outstanding portion would have to be met by CET1 only in cases where the institution does not have sufficient Additional Tier 1, Tier 2 or other eligible liabilities that are eligible for recognition as TLAC. Apart from that, the items of CET1 that exceed the Basel III regulatory capital should be included in full in the capital buffer requirements. This should be clarified in the second sentence of section 7.

In our opinion, non-compliance with the minimum TLAC requirement cannot be compared with a breach of the regulatory minimum capital requirements under Basel III. Breaches of the minimum TLAC requirement should be assessed by the competent authority as part of the supervisory review and evaluation process (SREP), and countermeasures should be imposed as appropriate.

Transparency

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?

A high level of transparency has already been ensured by the statutory establishment of a creditor hierarchy (see comments on question 9). The disclosure requirements currently contained in the Consultation Paper could therefore be trimmed back. We are advocating the removal of the disclosure requirements in the second sentence of section 24. However, if the FSB decides to retain disclosure requirements, they should only relate to the top-tier parent of the group.

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Limitation of contagion

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?

From our perspective, the existing large exposure rules, and in particular the reduction of the large exposure limits for exposures between G-SIBs to only 15 % are sufficient to counter any risk of contagion. We would also like to point out again in this context that, despite all the justified concerns about the risk of contagion, the initial hurdle is to find enough investors who are willing to buy TLAC-eligible instruments. If all the requirements currently being proposed take effect, this is an ambitious prospect, to say the least.

Conformance period

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 G-SIBs at a future date?

The findings of the impact study should first be awaited before setting a final date for the entry into force of the minimum TLAC requirement for G-SIBs.

When defining the timing for future G-SIBs, the relevant market environment (macroeconomic position) should be reflected in the decision.

Market impact and other aspects

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?

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

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

<u>Response to questions 14–16:</u>
Overall, we expect funding costs to rise for the G-SIBs affected. If the application of TLAC as an instrument were to be expanded, it is highly questionable whether sufficient subordinated liabilities and investors would actually be available on the market. In our opinion, it is highly probable that the market would quickly become saturated.

In this context, we wish to draw attention to the problem of the regulatory gap between the USA and Europe that will have to be addressed: in the USA, foreign banks have to maintain capital reserves in holding companies that can be accessed exclusively within the USA. This approach represents a form of ring-fencing that frustrates any cross-border initiative.

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Ultimately, the effects of the TLAC requirements should be scrutinised on the basis of the findings of a comprehensive impact study.

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

The current proposals are designed solely for G-SIBs. The experiences gained with the existing regulatory regimes (in particular the BRRD/SRM) should be awaited. The expected impacts should also be fundamentally and comprehensively analysed in advance.