FSB FINANCIAL STABILITY BOARD

9 November 2015

Overview of the post-consultation revisions to the TLAC Principles and Term Sheet

On 10 November 2014, the FSB published a consultative document with policy proposals developed at the request of G-20 leaders to enhance the loss-absorbing capacity of global systemically important banks (G-SIBs) in resolution. The consultation document consisted of a set of Principles on loss-absorbing and recapitalisation capacity of G-SIBs in resolution and a concrete proposal in the form of a Term Sheet for implementing these Principles (Term sheet on Total Loss-Absorbing Capacity (TLAC)).

The FSB received 62 comment letters from financial institutions (24), industry associations (21), public authorities (5), think tanks (5), individuals (6) and one rating agency.[1] Most of the respondents (including G-SIBs) expressed overall support for the proposal's objective of ensuring that sufficient loss-absorbing and recapitalisation capacity is available for G-SIBs in resolution. A TLAC requirement is viewed as an important step towards ending "too-big-to-fail" (TBTF) and promoting confidence in orderly resolution.

This note summarises the main comments to the public consultation and sets out the main changes to the Principles and Term sheet (TS) that seek to address them. The final standard retains the format and overall structure of the consultation document. The FSB sought to limit substantive changes to those necessary to address comments to the public consultation or reflect findings from the impact assessment studies.[2] It is however expected that technical issues and questions will arise in the course of implementation. These will need to be reviewed in Crisis Management Groups (CMGs) and discussed in the relevant committees and working groups, and within the FSB. The FSB will play a coordinating role, and will conduct a review of the technical implementation of the Term Sheet by end-2019.

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1 The letters have been published on the FSB website, with the exception of those that requested otherwise.

2 The findings of the impact assessment studies are published alongside the final TLAC Principles and Term Sheet.

1. Minimum External TLAC

Minimum external TLAC requirement for MPE G-SIBs (TS Section 3)

Several respondents to the public consultation commented that the TLAC framework should set out how Minimum TLAC will be calculated for G-SIBs that are subject to a multiple point of entry resolution strategy ("MPE G-SIBs") and expressed level playing field concerns about the differential treatment of G-SIBs composed of two or more resolution groups as compared to G-SIBs that form a single resolution group. TS Section 3 clarifies that, for MPE G-SIBs, the sub-consolidated balance sheet risk weighted assets (RWAs) of each resolution group (denominator) is to be calculated inclusive of exposures to other resolution groups of the same G-SIB. Where such exposures correspond to instruments or liabilities eligible for TLAC they should be deducted from TLAC resources (numerator) and therefore from the measures of leverage ratio exposure and risk-weighted assets (denominator).

TS Section 3 addresses level playing field concerns with two allowances, which remain consistent with the Basel III rules on deductions and the underlying objectives of an MPE resolution strategy:

- First, TS Section 3 introduces some flexibility with respect to the location of deductions of eligible TLAC, so that the deduction of surplus TLAC could be made at the level of the subsidiary resolution entity instead of the parent. However, in all cases, the deduction at the parent must be no lower than the parent's exposure to the subsidiary's TLAC, less the amount of TLAC above the subsidiary's TLAC requirement ('surplus TLAC') that is attributable to the parent (that is, excluding surplus TLAC attributable to third party investors). The calculation of this surplus should take into account any adjustment that has been agreed pursuant to the second allowance below. The part of the TLAC surplus that arises from a surplus of regulatory capital should be considered "attributable to the parent" in a proportion equal to the share of the parent in the regulatory capital of the subsidiary. The part of the TLAC surplus that arises from a surplus of TLAC liabilities that the subsidiary has issued to the parent, should be fully attributable to the parent. If there were legal restrictions for the subsidiary to repay these TLAC liabilities at its discretion, then the surplus "attributable to the parent" would be the share of the parent in these TLAC instruments multiplied by the surplus.
- Second, in cases where the sum of Minimum TLAC requirements for MPE resolution entities is greater than the (hypothetical) SPE Minimum TLAC requirement, an adjustment may be made to minimise or eliminate the difference. This adjustment can be made in respect of differences in the calculation of risk weighted assets between home and host jurisdictions, but not for differences arising from exposures between resolution groups, as this would be inconsistent with the objectives of an MPE resolution strategy.

The TS makes clear that changes in both the location of the deduction and the TLAC requirement should be consistent with the G-SIB's resolution strategy and be discussed and agreed within the CMG.

2. Relationship with Capital Requirements

Treatment of buffers (TS Section 4)

The consultation document led some respondents to assume that buffers also apply to the leverage ratio exposure requirement. To maintain consistency with the Basel III framework (which does not impose buffers on the leverage ratio), TS Section 4 clarifies that buffers need to be met only in addition to the TLAC RWA Minimum. However, G-SIB home authorities may impose buffers on top of the leverage ratio requirement as part of an additional national requirement.

Consistency with Basel III (TS Sections 6, 8 and 19)

The TS makes clear that Minimum TLAC is an additional requirement to minimum regulatory capital. Instruments that count towards satisfying minimum regulatory requirements may also count towards satisfying Minimum TLAC, subject to certain conditions as set out in TS Section 6. However, there remains a potential inconsistency between Basel III and the TLAC criteria in respect of the actual availability of resources in resolution, e.g. in respect of instruments with an insufficiently long maturity and/or instruments not issued out of the resolution entity. To ensure that instruments recognised as TLAC are available in resolution when and where needed, TS Section 7 provides that all TLAC-eligible instruments must meet the core features and eligibility criteria for TLAC set out in the Term Sheet. A phase-out would apply to certain regulatory capital instruments that do not comply with all of the TLAC Term Sheet criteria. As such, regulatory capital instruments that are not directly issued from the resolution entity and do not meet the other TLAC eligibility criteria could no longer be used to meet Minimum TLAC after 31 December 2021. An exception would apply for (i) CET1 regulatory capital issued from subsidiaries forming part of the resolution entity's resolution group to the extent that this is recognised as CET1 for the consolidated resolution entity under the rules set out in paragraph 62 of the Basel III framework; and for (ii) regulatory capital instruments issued by cooperative banks or financial institutions affiliated to them that have in place an institutional protection scheme or other cooperative mutual solidarity system that protects the solvency and liquidity of the affiliated cooperative banks and institutions. In both cases the conditions set out in TS Section 6 a. to e. must continue to be met.

3. Additional firm-specific external TLAC instead of Pillar II

Addition firm-specific external TLAC (TS Section 5)

Several respondents to the consultation expressed concern about the opacity of the proposed Pillar 2 regime for external TLAC and consistency of its application across jurisdictions. The specific reference to 'Pillar 2' has therefore been removed. Instead, the TS provides that home authorities should apply additional firm-specific requirements in consultation with the CMG and subject to review through the Resolvability Assessment Process (RAP) if they determine that this is necessary to achieve resolution objectives.

4. Instruments and debt liabilities eligible for external TLAC

Long-term debt expectation (TS Section 6)

The consultation document raised the question of whether the expectation that 33% of the Minimum TLAC be met in the form of long-term debt should become a mandatory requirement. Several respondents to the public consultation objected to the introduction of a mandatory long-term debt requirement. The TS therefore leaves the long-term debt expectation unchanged. However, consistent with TS Section 4, this does not limit authorities' to set a domestic long-term debt requirement as part of a TLAC requirement.

Loss-absorption beyond TLAC (TS Section 7)

The final standard makes clear that instruments and liabilities that are not TLAC remain subject to potential exposure to loss in resolution, in accordance with the applicable resolution law and the resolution strategy for the G-SIB. The standard does not seek to limit any powers authorities may have under applicable resolution law to expose any liability to loss in resolution through bail-in or the application of other resolution tools, though some of these liabilities may not count as eligible TLAC.

5. Phase-out of the issuance of external TLAC by entities other than resolution entities

Issuance of external TLAC indirectly out of funding vehicles (TS Section 8)

To accommodate G-SIBs in jurisdictions where there are legal or practical obstacles to issuing TLAC out of the resolution entity, TS Section 8 permits issuance of external TLAC indirectly through a wholly and directly owned funding entity of the resolution entity during a transitional period but only provided that (i) the debt liabilities are issued prior to 1 January 2022; (ii) that the issuance is consistent with the rules set out in paragraph 65 of the Basel III framework, including that the assets of the funding entity must meet or exceed the eligibility criteria (Section 9) for TLAC instruments; (iii) that there is substantial legal certainty that the issued TLAC will absorb losses at the resolution entity upon its entry into resolution; and (iv) that home and host authorities agree upon the issuance through the wholly owned funding entity in the CMG.

Issuance of external TLAC out of subsidiaries (TS Section 8)

TS Section 8 retains the principle that TLAC-eligible instruments must be issued by the resolution entity and therefore provides for a phase-out by 31 December 2021 of regulatory capital instruments issued out of a subsidiary of a resolution group and held by third parties. This is subject to the aforementioned exemption for CET1 regulatory capital issued from subsidiaries forming part of the resolution entity's resolution group to the extent that this is recognised as CET1 for the consolidated resolution entity, and for regulatory capital instruments issued by cooperative banks or financial institutions affiliated to them (see also above 2.)

6. TLAC eligibility and excluded liabilities

TLAC eligible liabilities and liabilities excluded from TLAC (TS Sections 9 and 10)

Several respondents to the public consultation commented that the structure of the consultation document which defined TLAC-eligible and excluded liabilities was unclear, in particular in relation to the subordination requirement. The relevant TS Sections have therefore been restructured:

- TS Section 9 sets out the eligibility criteria for TLAC and clarifies that eligible TLAC must be paid in (9 a.); may be perpetual (9 d.); and must not be redeemable by the holder prior to maturity (9 e., with a footnote clarification).

- TS Section 10 sets out the list of liabilities that are excluded from TLAC-eligibility. This list remained unchanged.

Liabilities that are not excluded liabilities and that do not meet one or more of the eligibility criteria for TLAC set out in TS Section 9, e.g. liabilities with a maturity of less than one year, may rank pari passu with TLAC eligible liabilities as it is assumed that such liabilities may be, to the extent permitted in law, subject to write-down and/or conversion in resolution (even though they may not provide a stable source of loss-absorbing and recapitalisation capacity). By contrast, liabilities excluded from TLAC pursuant to TS Section 10 must in principle (and subject to certain exemptions set out in the TS) rank senior to TLAC-eligible instruments and liabilities.

Exclusion of structured notes (TS Section 10)

Many industry respondents to the public consultation raised questions regarding the classification of structured notes as excluded liabilities in the proposal. However, the ability to effectively expose structured notes to loss in resolution may not be certain as it depends on a range of factors, including a jurisdiction's preferred resolution tools, the timeline for valuation of liabilities and claim allowance, and the ability of resolution entities to reliably provide the necessary valuation information. For these reasons, TS Section 10 excludes structured notes from TLAC.

7. Priority

De minimis allowance for TLAC eligible instruments to rank pari passu with a limited amount of excluded liabilities (TS Section 11)

A number of respondents to the public consultation were of the view that that a de minimis exemption to the subordination requirement would be necessary for firms pursuing structural subordination, given the unavoidable presence of certain liabilities in holding company structures which rank pari passu with TLAC, e.g., utilities, rent, fees for services, obligations to employees and tax liabilities. However, given that a de minimis allowance could favour G-SIBs with non-operational holding company structures that rely on structural subordination, TS Section 11 provides for a de minimis exception to the subordination requirement that is generally applicable and available if: (i) the amount of excluded liabilities that rank pari passu or are junior to TLAC eligible liabilities on the resolution entity's balance sheet does not exceed 5% of that resolution entity's external TLAC; (ii) the resolution authority of the G-SIB has the authority to differentiate among pari passu creditors in resolution; (iii) differentiation in resolution in favour of such excluded liabilities would not give rise to material risk of successful legal challenge or valid compensation claims; and (iv) that this does not have a material adverse impact on resolvability.

Neither exemption can be used if the capacity to exclude or partially exclude liabilities from bail-in would give rise to a material risk of successful legal challenge or valid compensation claims. To address concerns about the impact of an exemption on resolvability Section 11 requires discussion in the CMG and review through the RAP of (i) the means of subordination (i.e., whether statutory, contractual or structural); (ii) the risk of successful legal challenge or valid compensation claims (in respect to each creditor class); and (iii) the transparency of the order in which creditors can expect to bear losses in insolvency or in resolution**.**

2.5% RWA allowance for liabilities that otherwise count as external TLAC but are pari passu to excluded liabilities (TS Section 11)

The consultation document provided an allowance for jurisdictions where the resolution authority has the capacity, in exceptional circumstances specified in the applicable resolution law, to exclude or partially exclude liabilities from bail-in without giving rise to material risk of successful legal challenge or valid compensation claims. In such cases, the allowance enables liabilities that would otherwise be eligible as external TLAC but that are pari passu to excluded liabilities to contribute a quantum equivalent to up to 2.5% RWA or more if the final calibration of the Minimum TLAC requirement exceeds 16% RWA. TS Section 11 provides that the 2.5% RWA allowance will increase to up to 3.5% RWA when Minimum TLAC increases to 18% RWA. TS Section 11 also makes clear that a G-SIB that uses this exemption may not also invoke the de minimis allowance described above.

An allowance of the same size applies to credible ex-ante commitments to recapitalise a G-SIB that may, subject to the conditions set out in the term sheet, count toward a resolution entity's Minimum TLAC requirement (see TS Section 7). Such commitments may account for an amount equivalent to 2.5% RWA toward the resolution entity's Minimum TLAC when the TLAC RWA Minimum is 16% and for an amount equivalent to 3.5% RWA when the TLAC RWA Minimum is 18%.

8. Redemption restrictions

Supervisory approval only required for a redemption likely to lead to a breach (TS Section 12)

The final standard makes clear that supervisory approval is *only* required for a redemption of eligible TLAC which would lead to a breach of the minimum TLAC requirement, to address several requests for clarification.

9. Governing law (TS Section 13)

TS Section 13 makes clear that liabilities eligible for TLAC may be issued under or be otherwise subject to the laws of another jurisdiction if the application of resolution tools by the relevant resolution authority is effective and enforceable in respect of those liabilities.

10. Internal TLAC

Introduction of the concept of a "material sub-group" (TS Sections 16 and 17)

The consultation document used the concept of a material subsidiary in relation to internal TLAC requirements. However, this definition does not capture the scenario where critical functions are carried out through two or more subsidiaries that may be consolidated under an intermediate or sub-holding company. The results from the impact assessment studies also indicated that G-SIBs identified few material subsidiaries, with some G-SIBs reporting none.

To address this concern, TS Sections 16 and 17 introduce the more flexible concept of a "material sub-group". Each material sub-group is subject to an internal TLAC requirement, which would be calculated on the basis of the sub-consolidated balance sheet of the material sub-group (consistent with the approach set out in TS Section 3).

Determination of the composition of the material sub-group and distribution of internal TLAC (TS Section 16)

TS Section 16 makes clear that the composition of the material sub-group and the distribution of its internal TLAC are determined by the host authority, in consultation with the home authority and the CMG. This provides authorities with greater flexibility in determining the distribution of loss-absorbing and recapitalisation capacity to support resolvability.

Powers to impose additional requirements on subsidiaries (TS Section 16)

TS Section 16 also makes clear that the minimum internal TLAC requirement does not limit a host authority's legal powers to impose additional firm-specific external or internal TLAC requirements and that home authorities of a resolution entity may decide to apply internal TLAC requirements to domestic subsidiaries or sub-groups.

Size of the internal TLAC requirement (TS Section 18)

A number of respondents to the public consultation commented on the 75-90% range of the internal TLAC requirement, and a range of views were expressed with some noting that a requirement at the high end could lead to trapped loss-absorbing and recapitalisation capacity, which would make it more difficult to deploy resources to parts of the group that may be experiencing stress. They also noted that internal TLAC should not be seen as a substitute for international regulatory cooperation. TS Section 18 maintains the 75-90% range and specifies that the requirement within that range should be determined by the host authority of the material sub-group in consultation with the home authority.

Core Features of eligible internal TLAC (TS Section 19)

TS Section 19 provides that the core features of eligible internal TLAC are the same as those for eligible external TLAC (except with regard to the issuing entity and permitted holders). Consistent with the phase-out discussed under 2. above, the eligibility as internal TLAC of regulatory capital other than Common Equity Tier 1 (CET1) issued externally out of a subsidiary belonging to a material sub-group and held by third parties would be phased out.

11. Public disclosure (TS Section 20)

The disclosure requirements of TLAC have been modified to reflect the introduction of material sub-groups. In particular, entities that are part of a material sub-group and issue internal TLAC to a resolution entity are required to disclose any liabilities which rank pari passu with or junior to internal TLAC issued to the resolution entity.

TS Section 21 sets out that, for G-SIBs designated before the end of 2015, TLAC positions should be disclosed and monitored as from 1 January 2019. For such G-SIBs headquartered in emerging market economies (EMEs) disclosure and monitoring should begin with the start of the conformance period for such G-SIBs (see below).

12. Calibration and conformance period (TS Sections 4 and 21)

G-SIBs designated before the end of 2015

The consultation document proposed that the common Minimum TLAC requirement would be set within the range of 16 – 20% of RWAs and at least twice any Basel 3 Tier 1 leverage ratio requirement. Views differed between those favouring a lower and those favouring a higher calibration. FSB Members agreed to provide for a two-stage phase-in of the TLAC standard:

- Firms that have been designated by the FSB as G-SIBs before the end of 2015 and continue to be designated thereafter, with the exception of such firms headquartered in EMEs, must comply with the TLAC standard and meet from 1 January 2019 Minimum TLAC requirements, as set out in Section 4, of at least 16% RWA and 6% of the Basel III leverage ratio denominator with the allowances in Sections 7 and 11 of the Term Sheet set at 2.5% RWA.
- From 1 January 2022, such firms must meet Minimum TLAC requirements of at least 18% RWA and 6.75% of the Basel III leverage ratio denominator, with the allowances in Sections 7 and 11 of the Term Sheet rising to 3.5% RWA.

G-SIBs headquartered in EMEs

A majority of respondents to the public consultation questioned the proposed initial exemption from the Minimum TLAC requirement for G-SIBs that are headquartered in EMEs ("EME exemption"), on the grounds of level playing field concerns, regulatory arbitrage and stability risks. These commenters suggested that if an EME exemption were granted, there should be clear and transparent conditions for its phase-out. To provide for a phase-out over a fixed timeline to provide certainty to market participants, TS Section 21 provides that firms that are currently headquartered in an emerging market economy and designated by the FSB as G-SIBs by the end of 2015 and continue to be designated thereafter will comply with the Minimum TLAC requirement: by 1 January 2025 for the 16% RWA/6% of the Basel III leverage ratio denominator Minimum TLAC requirement; and by 1 January 2028 for the 18% RWA / 6.75% of the Basel III leverage ratio denominator Minimum TLAC requirement.

In addition, the TS provides that this conformance period will accelerate if, in the five years after the publication of the Term Sheet, the aggregate amount of the EME's financial and non-financial corporate debt securities or bonds outstanding (as measured using BIS statistics, excluding issuance by policy banks) exceeds 55% of the EME's GDP (as reported by the relevant national authorities). If the threshold is met, the relevant authorities in the EME would have three years from the start of the following year to require their G-SIBs to comply with the 16% RWA / 6% of the Basel III leverage ratio denominator Minimum TLAC requirement, and a further three years to require them to comply with the 18% RWA / 6.75% of the Basel III leverage ratio denominator Minimum TLAC requirement. The appropriateness of the threshold will be subject to review in 2019.

Firms designated as G-SIBs in 2016 or later

Firms not headquartered in an EME that are newly designated as G-SIBs between 2016 and before the end of 2018 and continue to be designated thereafter must meet Minimum TLAC requirements of at least 18% RWA and 6.75% of the Basel III leverage ratio denominator by 1 January 2022. Firms that are designated as G-SIBs thereafter must meet Minimum TLAC requirements of at least that amount within 36 months from their date of designation.