

Forging Consensus on TLAC

November 2015



On 9 November 2015, the Financial Stability Board (FSB) published its final standards on total loss-absorbing capacity (TLAC) for global systemically important banks (G-SIBs). The TLAC standards will require the world's 30 largest banks to finance themselves with a minimum amount of capital and, for the first time, of long-term debt, such that the cost of their failure would be borne by investors rather than taxpayers. This is a critical component of post-crisis policymaking designed to ensure that none of these firms remain 'too big to fail', and that the impact of their failure would not result in contagion across the industry and damage to the real economy. These standards build on the Basel III minimum capital requirements, including the capital surcharge for G-SIBs and the capital conservation buffer which, for most banks, are incremental to the minimum TLAC requirements.

In this report, we examine the details of the final standards and discuss what has changed from the initial consultation. We consider the various impacts on banks according to their business model and jurisdiction of operation, and also propose next steps for banks to move towards a compliant and strategically optimised solution in line with the initial 2019 conformance deadline.

Summary of key points

The FSB's announcement of key terms, anchored on an 18% risk-weighted asset (RWA) TLAC minimum and a 6.75% leverage ratio, is the result of a multi-year effort to reach consensus among global regulators. By setting the minimum RWA ratio at the midpoint of the 16–20% range previously announced, the FSB has set a baseline upon which national authorities can then build in stricter conditions.

The Basel Committee on Banking Supervision (BCBS) also released the results of a quantitative impact study that includes a number of case studies for estimating the TLAC shortfall. Excluding the four Chinese banks which have an additional six years to comply, we believe the BCBS shortfall estimate of €422bn (\$456bn)¹ to meet 2022 compliance standards is the most realistic. This case includes an additional assumption that senior bank debt currently considered ineligible due to lack of clear subordination terms could be converted to eligible TLAC.² A number of European authorities are already pursuing statutory subordination of senior debt via specialised legislative amendments to achieve this goal.

TLAC introduces higher funding costs for some banks, as well as a higher compliance burden. The standards will impact each G-SIB to differing extents depending on their business model, choice of resolution strategy, and specific countries of operation. TLAC will likely most increase the cost of funding for deposit-heavy banks which will have to issue more debt than currently required under their business models.

In the long term, TLAC also reinforces an ongoing trend placing downward pressure on banks' ratings at the holding company level, given the near-total removal of the so-called 'too big to fail' subsidy previously asserted by many in the market. While the FSB's phase in of the requirements from 2019 to 2022 allows banks time to comply, some firms are acting now on anticipated TLAC needs to lock in relatively low rates and avoid potentially higher future costs of meeting anticipated shortfalls.

¹ Assumes an exchange rate of 1.08USD to 1EUR.

² *TLAC Quantitative Impact Study Report*, BCBS, November 2015.

Finally, the FSB confirmed an internal TLAC requirement for material subsidiaries which requires a significant proportion of debt issued by a parent G-SIB to be directly invested in them. The internal TLAC needs to account for 75%–90% of the subsidiaries' notional stand-alone external TLAC requirement. This requirement introduces new intra-group funding challenges for banks that are currently pursuing a multiple point of entry (MPE) resolution strategy, and will also impact the intermediate holding companies (IHC) of international banks in the US. Similar domestic rules around internal TLAC in the UK and elsewhere are anticipated to be imposed on the domestic operations of the G-SIBs, thereby further 'ring fencing' material subsidiaries and adding another level of operational complexity for the G-SIBs.

Background

The TLAC standards

The FSB issued its final TLAC standards as a precursor to the G-20 Leaders Summit in Istanbul. These standards comprise a set of high-level principles and a term sheet with the detailed requirements. The main elements of the term sheet are summarised in the table below.

		Key Final Terms
How much?	<p>All G-SIBs will be required to be funded by regulatory capital and other long-term unsecured debt issued to external investors equivalent to at least 18% of their risk-weighted assets (RWAs) or 6.75% of their total (non-risk-adjusted) on- and off-balance sheet exposures, whichever is the higher value.</p> <p>Regulatory capital used to meet the Basel III capital conservation and G-SIB buffers will not count toward the RWA-based TLAC requirement. To maintain consistency with the Basel III framework (which does not impose buffers on the leverage ratio), the FSB clarified that buffers need to be met only in addition to the TLAC RWA minimum and not the leverage ratio minimum. However, G-SIB home authorities may impose buffers on top of the leverage ratio requirement as part of an additional national requirement.</p> <p>This more than doubles the minimum regulatory capital and leverage requirements introduced under Basel III, but allows a broader set of funding instruments to count towards meeting them.</p> <p>Some banks may need to meet even stricter firm-specific requirements if deemed necessary by resolution authorities in order to implement an orderly resolution, minimise financial stability impacts, and ensure the continuity of critical functions.</p>	<ul style="list-style-type: none"> Confirmation of the 18% minimum requirement from within the previously proposed range of 16-20% of RWAs. Confirmation of a 6.75% total leverage ratio.

		Key Final Terms
Of what?	<p>There are three potential ways to meet TLAC requirements:</p> <ul style="list-style-type: none"> Regulatory capital – excluding Common Equity Tier 1 capital that counts towards the Basel III combined capital buffer. Long-term unsecured debt instruments – that are fully paid-up, not subject to set off or netting rights, have a remaining effective maturity of at least one year and are effectively and transparently subordinated to other (senior) liabilities in the creditor hierarchy (e.g. via the US clean holding company rules). Industry pre-funded recapitalisation commitments – which may count towards up to 3.5% of RWAs if they can be shown to be credible. <p>Debt instruments (including subordinated debt that counts as regulatory capital) are expected to comprise at least one-third of the minimum TLAC requirement to ensure that some additional loss-absorbing capacity is available in the event that a bank enters resolution after a significant depletion in the amount of equity left to absorb losses has already occurred.</p>	<ul style="list-style-type: none"> Broader recognition of loss-absorbing instruments, including long-term unsecured debt as TLAC. Structured notes will not count as TLAC due to concerns about the difficulty of valuing instruments containing embedded derivatives in resolution.
Located where?	<p>Most TLAC is likely to be issued externally by the top operating company or parent holding company of a G-SIB group. Where the group has material subsidiary operations (typically representing at least 5% of group income, RWAs or exposures) the TLAC standards include a requirement to ensure that the external TLAC is appropriately distributed within the group to give confidence to relevant resolution authorities (often on a cross-border basis) that each material entity has sufficient loss-absorbing capacity.</p> <p>Each of these subsidiaries (or sub-groups thereof) must be funded by internal TLAC equal to at least 75%-90% of the external TLAC they would be required to have individually if they were not part of a wider group. This internal TLAC must be in the form of eligible TLAC instruments that can absorb losses at the point of non-viability (i.e. before resolution) or, potentially, collateralised guarantees.</p>	<ul style="list-style-type: none"> Confirmation that the minimum internal TLAC requirement will be set by individual resolution authorities within the range of 75%-90%. Allowance for different resolution authorities – often in different jurisdictions – to agree to TLAC adjustments for MPE banks so they are not disadvantaged relative to Single Point of Entry (SPE) banks due to group consolidation effects.
By when?	<p>G-SIBs will need to meet the TLAC standards in full by 2022, with the notable exception of banks located in emerging markets. This deadline follows a three-year transition period beginning in 2019 when the G-SIBs will need to meet the transitional requirements of the greater of 16% of RWAs and 6% of total leverage exposures.</p> <p>The four Chinese G-SIBs have until 2025 to conform to the higher of 16% RWAs and 6% leverage exposure, and until 2028 to meet the higher of 18% RWAs and 6.75% leverage exposure.</p>	<ul style="list-style-type: none"> Introduction of a transition period to give banks more time to meet requirements.

National implementation

The TLAC standards are minimum requirements. Resolution authorities may choose to go above and beyond them in the same way that some supervisors have when implementing Basel III in their jurisdictions. Enhancements may take the form of bank-specific add-ons (as envisaged within the standards) or simply higher expectations on specific terms. In fact, some notable jurisdictions, such as Switzerland and the US, have already announced domestic plans which incorporate stricter TLAC regimes.

In addition, it is likely that banks will choose to build in an internal management buffer on top of the minimum requirement to provide a cushion against breaching that requirement. The FSB estimates that the average expected internal buffer will be 1.8% of RWAs, equal to 10% headroom above the minimum RWA-based requirements.

The United States

Last month, the US Federal Reserve (Fed) announced its proposal on TLAC provisions, which largely mirrored the FSB proposal on RWA minima but contained a notably higher 9.75% leverage requirement as well as a separate requirement for holding a minimum amount of long-term debt. The separate long-term debt standard involves a calculation such that approximately 50% of the TLAC eligible instruments must be in the form of debt, depending on the bank, versus the 33% Basel minimum expectation.

The US approach to a higher long-term debt requirement reflects the Federal Deposit Insurance Corporation's (FDIC) strongly held position that a bank's capital position may be difficult to value prior to resolution and that sufficient unsecured debt needs to be available after the intervention of a resolution authority. We would expect the Fed to finalise the US TLAC proposal in early 2016, leaving in place a phased-in implementation schedule that parallels the FSB's requirement.

Europe

In Europe, 13 out of 15 of the G-SIBs (excluding two Swiss-headquartered banks) will have to manage the additional complexity of complying with the conceptually similar but technically different minimum requirements for funds and eligible liabilities (MREL) in accordance with the EU Bank Recovery and Resolution Directive (BRRD). Definitional differences between TLAC and MREL, and the application of the latter on a solo (i.e. individual entity) as well as a consolidated (i.e. group-wide) basis, will create potentially significant operational challenges.

European authorities are also already beginning to adopt different approaches to achieving effective subordination of TLAC (and MREL) eligible liabilities. Germany is pursuing statutory subordination of certain types of senior unsecured debt. Italy is planning to give preference to all depositors relative to other senior debt claims. The UK is keen on structural subordination achieved by liability issuance from a holding company that sits above the operating company in the legal entity structure. These varying approaches create a compliance and reporting headache for banks operating in multiple jurisdictions, and a pricing and risk management challenge for investors trying to understand where they stand in the line of contingent loss-absorbency providers.

Switzerland, which is not in scope of the EU's Directive, pre-empted the FSB's announcement by requiring its two largest banks to meet TLAC requirements calibrated as 28.6% of RWAs or 10% of total exposures by 2019. This super-equivalence is driven by the scale of these institutions relative to the Swiss economy.

Asia

In Asia, Japanese and Chinese regulators are unlikely to move at a pace faster than their global counterparts. For their part, Asia's regulators have not focused on TLAC to the same extent as their Western peers. This is particularly true for the Chinese banks that have been afforded six additional years, as the FSB announced that G-SIBs headquartered in emerging market economies will be required to meet the 16% RWA and 6% leverage ratio minimum requirement no later than 2025, and the 18% RWA and 6.75% leverage ratio minimum requirement no later than 2028.³

What is the size of the shortfall?

The BCBS also released an impact study this week that includes a number of case studies used to estimate the TLAC shortfall related to 2019 and 2022 requirements. As a base case, the BCBS provided an aggregate TLAC shortfall relative to 2022 requirements for all G-SIBs of €1,110bn (\$1,199bn). However, this estimate likely overstates the actual shortfall by excluding existing senior debt which could be converted to TLAC eligible instruments. As noted above, this process of achieving statutory subordination is already underway in a number of European jurisdictions and will substantially decrease the estimated shortfall. The FSB's higher estimate also includes the shortfall estimate of four Chinese banks which have an additional six years to comply.

Excluding the Chinese G-SIBs, we believe the BCBS's best estimate is a shortfall of €422bn (\$456bn) relative to 2022 requirements, and €260 (\$281bn) to reach 2019 compliance. This includes the assumption that existing senior bank debt will be converted to eligible TLAC instruments.

Notably, the US Fed recently estimated the 2022 compliance shortfall for the eight US G-SIBs at \$120bn, and some private sector analysts have placed the total European bank shortfall at less than \$200bn. We would expect most G-SIBs to address their TLAC needs through a combination of new issuances and the refinancing of maturing debt, at the operating company level, with debt from the holding company.

In Europe, we expect the 6.75% Basel leverage minimum to serve as the binding constraint for some banks as opposed to the minimum RWA requirements. In the US, the binding constraint for most banks is the combination of RWA minima with a separate long-term debt threshold.

³ This conformance period will be accelerated if, in the next five years, corporate debt markets in these economies reach 55% of the emerging market economy's GDP.

How much will this cost G-SIBs and the real economy?

Achieving the public policy objective of reducing risks to the taxpayers through a higher capital and debt requirement places further costs on the G-SIBs, which will likely feed through to higher lending rates. Assuming a constant G-SIB return on equity, an FSB-linked research group estimates that the increased costs to the real economy will translate into increases in lending rates for the average borrower that range from 2.2 to 3.2 basis points, while the median long-run annual output costs are estimated at 2 to 2.8 basis points of GDP.⁴

TLAC's longer term impact on funding costs for all G-SIBs will depend on multiple external market factors including changes in the perception of risk at individual banks and the development of global debt markets for instruments qualifying as TLAC. Certain features of TLAC debt, such as restrictions on holding by other G-SIBs, will limit the scope of the investor base and may ultimately drive up funding costs. Pricing differentials haven't really emerged yet, but the low-rate environment has aided firms' ability to roll over existing obligations with TLAC eligible debt.

Nonetheless, in the future, an increase in debt issuances from G-SIBs may test the absorption capacity of the market and lead to an increase in spreads. The impact will likely be concentrated on G-SIBs with larger shortfalls which may be required to issue into a more saturated investor base.

Credit rating agencies will also continue to play a role in defining the TLAC funding environment. We have already seen some rating agencies take action, such as S&P's decision to place US G-SIB holding company ratings on review for a potential credit downgrade following the release of the US TLAC proposal. Under the FSB's terms, G-SIBs must disclose the amount, maturity and composition of external and internal TLAC that is maintained, respectively, by each resolution entity, and at each legal entity that forms part of a material sub-group and issues internal TLAC.

Business model challenges

Funding structure

Generally, banks that use customer deposits more heavily in their funding models, such as large retail banks, will face more challenges in meeting the new TLAC standard. Many of these banks have little long-term debt outstanding and so will need to increase their issuance, in some cases substantially. Adding new long-term debt will push up these banks' funding costs given the higher cost of long-term debt relative to deposit funding. This new issuance will also lead to higher overall leverage at these firms, unless offset by the issuance of even more expensive new equity.

⁴ Assessing the economic costs and benefits of TLAC implementation, report submitted to the FSB by an Experts Group chaired by Kostas Tsatsaronis (BIS), 9 November 2015. Notably, this estimate is based on the BCBS's base case which excludes assumptions related to senior debt conversion.

As TLAC eligible debt also excludes short-term wholesale funding,⁵ it will affect more than just large retail banks. Universal banks will also likely have TLAC to raise to varying degrees based on their specific funding models. The two G-SIBs which have investment banking as their primary businesses and which rely on both short-term wholesale funding and long-term debt, however, are not expected to have TLAC shortfalls. They should therefore expect to have only a marginal increase to their cost of funding, if any.

Legal entity structures

Banks with existing holding companies with few or no international operations and with fewer material subsidiaries, will see less of an impact. TLAC requirements will impact intra-group financing arrangements depending on each bank's choice of resolution strategy. Those pursuing a SPE resolution strategy will be less impacted by the internal TLAC requirements than MPE banks. The latter will have to liaise extensively with a number of resolution authorities on an ongoing basis to agree to the amount and form of internal TLAC required of individual entities and the group. To demonstrate compliance with these internal TLAC requirements they will have less flexibility in their intra-group financing arrangements than their SPE peers.

Internal TLAC challenges

We see certain significant challenges around internal TLAC. The requirement to pre-position a significant proportion of external TLAC on the balance sheet of material subsidiaries will reduce the options available to banking groups to allocate financial resources flexibly around the group, including the ability to move loss-absorbing capacity to the source of losses as they materialise. This effectively results in a requirement for material subsidiaries to all but meet TLAC requirements on an individual basis, in addition to the external TLAC requirement of the consolidated banking group. While this may have less of an impact on European banks that need to meet MREL on a solo basis, for US banks with material domestic subsidiaries in Europe, this could represent a significant change to their current funding model.

The proposed US TLAC rule also imposes internal TLAC requirements upon the US IHCs of foreign G-SIBs, and there is some concern that foreign regulators may respond with similar requirements on US G-SIB operations in their own countries. This outcome, by which domestic regulatory authorities are effectively 'ring fencing' material subsidies, would increase managerial complexity and could indicate that regulators are themselves sceptical regarding the expected degree of cross-border cooperation in the event of a G-SIB failure.

⁵ Short-term funding is defined as debt with remaining maturity of less than one year.

Key considerations

There are a number of actions for G-SIBs to consider now that the TLAC standards have been finalised.

Near-term priorities

- **Legal entity and liability structure review** – banks will need to understand how their existing group structures will be impacted by the TLAC standards, what instruments and liabilities qualify for TLAC, and the extent to which they will need to take action in order to achieve compliance with the minimum TLAC requirements. This should form part of a broader resolvability assessment work programme.
- **Investor relations** – banks will need to engage proactively with investors to minimise the cost impact of establishing TLAC-compliant debt structures by aligning them as closely as possible with investor preferences for instrument types and subordination. This will need to be combined with transparent disclosure of liability structures so investors can clearly see where they sit in the creditor hierarchy and price their funding accordingly. Some investors may also benefit from a reminder of how the new regulatory environment has significantly changed the landscape (i.e. the risk and return profile) for investing in banks.
- **Resolution authority relations** – banks should engage with resolution authorities in the countries in which they operate to understand how the TLAC standards will be applied in each jurisdiction and what flexibility may be available to make use of the various discretions that rely on resolution authority approval. In the EU, the authorities' view of quality of the banks' resolvability will inform their determination of any additional TLAC requirements. This also means that weaknesses in resolution plans could prove costly.

Longer term challenge

- **TLAC compliance and optimisation** – on the basis of the actions above, banks will need to identify and implement a strategically optimal response to achieving compliance with the TLAC standards. This may need to be aligned with organisational and procedural changes to create an effective framework for TLAC planning and monitoring, potentially as an extension of an existing regulatory capital and stress-testing framework. TLAC represents another new component of an already highly complex regulatory regime to which banks need to adhere while also remaining competitive.

G-SIBs by Region									
	Bank	TLAC Minimum			Capital Conservation Buffer ⁷	FSB G-SIB Surcharge (% of RWAs)			
		2019 Minimum	2022 Minimum	2022 Domestic Standard ⁶					
US									
1	JP Morgan Chase	Higher of 16% of RWAs and 6% of leverage exposure	Higher of 18% of RWAs and 6.75% of leverage exposure	Higher of 18% of RWAs and 9.5% of leverage exposure	2.5% of RWAs	2.5			
2	Citigroup					2			
3	Bank of America					1.5			
4	Goldman Sachs					1.5			
5	Morgan Stanley					1.5			
6	Wells Fargo					1			
7	State Street					1			
8	Bank of New York Mellon					1			
Europe									
9	HSBC	Higher of 16% of RWAs and 6% of leverage exposure	Higher of 18% of RWAs and 6.75% of leverage exposure	N/A	2.5% of RWAs	2.5			
10	Barclays					2			
11	BNP Paribas					2			
12	Deutsche Bank					2			
13	Royal Bank of Scotland					1			
14	Groupe BPCE					1			
15	Group Credit Agricole					1			
16	ING Bank					1			
17	Nordea					1			
18	Santander					1			
19	Societe Generale					1			
20	Standard Chartered					1			
21	Unicredit Group					1			
22	Credit Suisse			Higher of 28.6% of RWAs and 10% of leverage exposure		1.5			
23	UBS					1			
Asia									
24	Mitsubishi UFJ FG	Higher of 16% of RWAs and 6% of leverage exposure	Higher of 18% of RWAs and 6.75% of leverage exposure	N/A	2.5% of RWAs	1.5			
25	Mizuho FG					1			
26	Sumitomo Mitsui FG								
27	Agricultural Bank of China	Chinese G-SIBs have until 2025 to conform to the higher of 16% of RWAs and 6% of leverage exposure, and until 2028 to meet the higher of 18% of RWAs and 6.75% of leverage exposure.							
28	Bank of China								
29	Industrial and Commercial Bank of China Limited								
30	Chinese Construction Bank								

⁶ US and Swiss authorities have both issued domestic guidance prior to the FSB's announcement. For a more detailed discussion of the US proposal please see PwC *First Take: Ten Key Points from the Fed's TLAC Proposal*, 3 November 2015.

⁷ In effect as of 2019.

Contacts

Lance Auer

PwC US
lance.auer@us.pwc.com
+1 646 471 0301

Adam Gilbert

PwC US
adam.gilbert@us.pwc.com
+1 646 471 5086

Brian Polk

PwC UK
brian.polk@uk.pwc.com
+44 20 7804 8020

Agatha Pontiki

PwC UK
agatha.pontiki@uk.pwc.com
+44 (0) 20 7213 3484

Michael Snapes

PwC UK
michael.j.snapes@uk.pwc.com
+44 (0) 20 7212 3166

This memo was prepared with the research assistance of Alistair Moore, PwC US.

www.pwc.com/financialservices

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, advisory and tax services. Find out more and tell us what matters to you by visiting us at www.pwc.com.

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in this publication, and, to the extent permitted by law, PwC does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2015 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details.