

## Ten key points from the Fed's TLAC proposal

The Fed proposed its long-awaited Total Loss-Absorbing Capacity (TLAC) requirements on October 30th. As expected, the Fed's proposal came out tougher than the Financial Stability Board's (FSB) TLAC standard proposed last year,<sup>1</sup> including limitations on capital distributions and bonus payments, and will likely be tougher than the FSB's final standard expected next week. In an unusual move, the US issued its proposal before the FSB, suggesting that a consensus could not be reached in line with US regulators' desire for more stringency.

However, the Fed did not go as far in its quantitative TLAC requirements as some feared it would. The proposal requires that the eight US global systemically important banks (GSIBs) hold TLAC at the holding company level in an amount greater than (a) 18% of their consolidated risk-weighted assets (RWA)<sup>2</sup> which is consistent with the FSB's proposal (and lower than the Fed had been suggesting) and (b) 9.5% of the GSIB's consolidated *leverage exposure* (as calculated under the Fed's Supplementary Leverage Ratio<sup>3</sup>) which is a tougher requirement than the FSB's proposed 6%.

TLAC must be composed of CET1, additional Tier 1 capital, and most importantly debt with maturity over one year that is unsecured and unstructured (LTD). The amount of required LTD must be greater than (a) 7% to 10.5% of consolidated RWA, depending on the firm's systemic importance and reliance on short-term wholesale funding (as calculated under the Fed's GSIB capital surcharge<sup>4</sup>) and (b) 4.5% of the GSIB's consolidated *leverage exposure*. Notably, a firm subject to the 10.5% LTD requirement must therefore hold well over half of its 18% required TLAC in the form of LTD, which is significantly higher than the FSB proposal's 33% and even higher than the 50% level that had been rumored for the US proposal.

- 1. How high is the TLAC mountain?** We believe the TLAC requirements are manageable for US GSIBs, based on the Fed's aggregate shortfall estimate of \$102 billion in TLAC and \$90 billion in LTD (even with the proposal's 50% discount for LTD maturing between one and two years). The proposal introduces new expenses, but firms will have over three years before the proposal begins taking effect in 2019 (during which time several firms will need to refinance their operating subsidiaries' LTD at the holding company). Beyond the numbers, the proposal raises three key considerations for US GSIBs. First, given the backdrop of impending rising interest rates, firms will likely want to address TLAC shortfalls sooner rather than later. Second, with the proposal's explicit bail-in feature of LTD, firms may have to review the risk appetite of their investors as they issue LTD. Third, the proposal introduces yet another set of regulatory ratios that will require ongoing measuring, monitoring, and reporting as part of the capital planning and asset-liability management processes.

- 2. Is the mountain higher than it appears?** US GSIBs will need to maintain a “TLAC buffer” on top of required TLAC which must be comprised solely of CET1. If this buffer is breached, GSIBs would face limitations on their capital distribution plans (including dividends to shareholders) and on discretionary employee bonuses. The TLAC buffer sits on top of the proposal’s 18% RWA requirement and ranges from 3.5% - 5.0% of RWA, depending on the GSIB’s systemic importance as calculated under “method one” of the Fed’s final GSIB capital surcharge rule.<sup>5</sup> Despite essentially raising the RWA requirement from 18% to a range of 21.5% - 23.0%, the TLAC buffer is likely manageable because CET1 applied to meeting the GSIB’s separate capital surcharge and conservation buffer may also be applied to the TLAC buffer.<sup>6</sup> Furthermore, the proposal’s language indicates that the TLAC buffer only sits on top of the 18% RWA requirement, so it would not be in addition to the 9.5% leverage-exposure requirement.
- 3. Is the climb higher for non-US GSIBs?** Although the Fed proposal is likely to be tougher than the final FSB global standard, US GSIBs are nonetheless probably in better shape than their global counterparts. This advantage largely emanates from the current bank holding company structure employed by US GSIBs (which is far less prominent globally) and the fact that US GSIBs’ LTD issuances are already centered at the parent company level. In addition, US firms hold higher amounts of capital, largely due to US capital stress testing which has been underway for several years.
- 4. Is the climb higher for foreign firms’ US operations?** Another concern for non-US GSIBs is the proposal’s application of the TLAC regime to their intermediate holding companies (IHC) in the US and required public disclosure of IHCs’ “internal” LTD and TLAC.<sup>7</sup> Under the proposal, IHCs must hold “internal LTD” in an amount greater than 7% of RWAs, 3% of total leverage exposure, and 4% of consolidated assets.<sup>8</sup> IHCs must also meet “internal TLAC” requirements, which will depend on whether the IHC will be resolved when its parent fails, according to the IHC’s resolution plan (i.e., IHCs that are not expected to enter resolution with the parent will have lower internal TLAC requirements than those that are<sup>9</sup>). Furthermore, the IHC must hold a TLAC buffer like US GSIBs, but it would only be 2.5%.<sup>10</sup>
- 5. What obstacles lie on the path?** One of the proposal’s most important questions for public comment pertains to “domestic internal TLAC.” Under the Single Point of Entry resolution strategy, it is assumed that losses will be passed up from subsidiaries to the GSIB parent (or IHC) and that these losses will then be passed on to either the external TLAC holders (in the case of US GSIBs) or a foreign parent entity (in the case of IHCs). However, the Fed admits that a sufficient mechanism does not exist for passing losses from the subsidiary to the holding company. Therefore, the Fed proposes identifying material operating subsidiaries that would be subject to a domestic internal TLAC requirement based on the subsidiary’s RWA or total leverage exposure. This internal TLAC would be divided into two categories: (a) “contributable resources” (largely liquid assets as defined under the Liquidity Coverage Ratio<sup>11</sup>) held at the parent level and (b) “prepositioned resources” (debt of the operating subsidiary and equity) held at the subsidiary level. These additional requirements could create new challenges for US GSIBs to manage. For example, depending on the calibration of internal TLAC required for subsidiaries, and existing double leverage levels, firms may need to position substantially more resources at domestic subsidiaries.
- 6. Is quantitative TLAC the summit?** The TLAC proposal also significantly raises the bar by specifying requirements for a “clean holding company” for US GSIBs and IHCs. Under this requirement, holding companies may no longer issue short-term debt, qualified financial contracts such as derivatives, or certain guarantees of subsidiary liabilities (and the subsidiary may not guarantee liabilities of the parent). Furthermore, certain liabilities of the holding company will be capped at 5% of the GSIB’s TLAC. These requirements call on firms to closely scrutinize the obligations of the parent company to ensure compliance.
- 7. Is the climb steeper for “traditional banks”?** By placing an emphasis on issuing LTD, TLAC arguably penalizes firms that rely mostly on deposits for their funding such as retail and commercial banks. Although certain deposits are treated favorably in Basel’s Net Stable Funding Ratio as steady sources of funding,<sup>12</sup> firms get little credit for accepting stable deposits as part of more traditional funding and banking activities under TLAC. The proposal only somewhat addresses this conundrum by incorporating the Fed’s GSIB capital surcharge (i.e., “method two” and its focus on short-term wholesale financing) into the LTD requirement.<sup>13</sup>

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- 8. Does TLAC encourage risk-taking?** The TLAC regime adds yet another setback to firms' sustained profitability. For firms facing LTD shortfalls, the shifting of funding sources to higher costing LTD will place yet another tax on already compressed margins. Firms may therefore seek to expand riskier investment/lending activities to bolster profitability. Alternatively, the TLAC regime may entice yet another round of deleveraging in the industry through reduction of institutions' size.
- 9. Is this the only mountain in the range?** With the Fed's imposition of an internal TLAC requirement upon the US IHCs of foreign GSIBs, it would seem likely that foreign regulators will respond with similar requirements on US GSIBs' operations in their countries. Most foreign regulators have not yet implemented an IHC-like requirement within their jurisdictions, so the extent to which they will require prepositioned assets is not clear. Either way, such foreign requirements are unlikely to be consistent across jurisdictions, which will challenge US GSIBs even further.
- 10. Can we address the TBTF perception?** The proposal is an important step toward ending the market perception that US GSIBs are too big to fail (TBTF), as evidenced by Standard & Poor's decision today to place the eight firms under review for a credit downgrade. The other element for addressing TBTF is the GSIBs' resolution plans. The last time the regulators weighed in on these plans' credibility (in 2014), the FDIC deemed them all not credible while the Fed reserved judgment.<sup>14</sup> Therefore, firms and the market have been left in suspense with respect to the status of TBTF. This story's next chapter will take place by early next year when regulators provide feedback on the latest plan iterations.<sup>15</sup>

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## Endnotes

1. See PwC's *First take, Ten key points from the FSB's TLAC ratio* (November 2014).
2. The proposal takes effect on January 1, 2019 requiring only 16% TLAC (compared to RWA), ramping up to 18% TLAC on January 1, 2022.
3. See PwC's *First take, Ten key points from the final US supplementary leverage ratio* (September 2014).
4. See PwC's *First take, Key points from the Fed's final G-SIB surcharge* (July 2015).
5. See the *First take* cited in the prior note for details on calculating the GSIB capital surcharge. Additionally, the buffer could increase to as high as 7.5%, on occasions where the counter cyclical capital buffer has been implemented by the Fed.
6. See PwC's *Regulatory brief, G-SIB capital: A look to 2015* (December 2014) for a detailed explanation of the interplay between the G-SIB capital surcharge and the capital conversation buffer.
7. See PwC's *Regulatory brief, Foreign banks: US admission price rising* (July 2014).
8. Internal LTD has similar characteristics to LTD generally; however, internal LTD must also be issued by the IHC to its foreign parent and be subject to a Fed order to convert it into equity (under specified conditions).
9. For IHCs that are not expected to enter resolution in the event of failure of the parent, the amount of TLAC required is 16% of RWAs, 6% of leverage exposure, and 8% of consolidated assets. For IHCs that are expected to enter resolution in the event of failure of the parent, the amount of TLAC required is 18% of RWAs, 6.75% of leverage exposure, and 9% of consolidated assets.
10. The buffer could increase to as high as 5%, where the counter cyclical capital buffer has been implemented by the Fed.
11. See PwC's *First take, Ten key points from the final US liquidity coverage ratio* (September 2014).
12. See PwC's *First take, Ten key points from Basel's final NSFR* (November 2014).
13. As discussed in this paper's introduction, the amount of LTD a GSIB must hold is at least 7% to 10.5% of RWA, depending on the GSIB's reliance on short-term wholesale funding as calculated under the Fed's GSIB capital surcharge rule.
14. See PwC's *First take, Ten key points from regulators' feedback to Wave 1 resolution plan filers* (August 2014).
15. See PwC's *Regulatory brief, Single point of entry strategy ascends* (July 2015) for an analysis of the public sections of these latest plans.

## *Additional information*

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