Financial Services Management

Internal TLAC

Cite

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Impact Assessment

- Capital and liquidity would be increasingly trapped in GSIB subsidiaries, making it difficult to allocate to address changing business circumstances or to move capital efficiently in response to changing markets and to a troubled subsidiary without undermining overall TLAC compliance.
- Host countries will be better assured that failure of a GSIB material subsidiary in another jurisdiction is unlikely to threaten operations within its borders. However, instances in which a host regulator triggers internal TLAC in opposition to home-authority wishes could exacerbate stress at the parent GSIB.
- GSIBs may need to maintain more home-country TLAC to satisfy demanding regulators depending upon how much host-country TLAC is required and the extent to which home countries believe it will be trapped under stress.
- Treatment of non-bank subsidiaries (e.g., insurance companies, asset management, brokers) will vary by national practice, creating uncertainties about non-bank affiliate stability and the extent to which their assets would be marshalled for parent-company or affiliated-bank support.
- Internal TLAC amounts remain as finalized, meaning that large amounts of capital could be ring-fenced unless the FSB reduces it in the final standards.
- Host countries could force GSIBs within their borders to make significant, costly structural changes.

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Overview

Continuing its work to build out the global total loss absorbing capacity (TLAC) regime, the FSB has added to its basic framework[1] a proposed approach to "internal TLAC" – that is, the total loss-absorbing resources GSIBs would have to commit to material subsidiaries so that subsidiary banks and possibly other entities in the parent group housed in a particular country that are not themselves subject to TLAC would not fail even if their parent companies falter. Building on the prior FSB decision that there should be internal TLAC for material sub-groups that could pose systemic risk, this consultation does not on its own reopen FSB's prior decision in favor of internal TLAC but instead addresses the operational infrastructure of internal TLAC in areas such as how it is to be allocated between the parent, when it is triggered, and how differences between home and host regulators – critical questions – are to be resolved. Reflecting how controversial these issues have proven, the FSB lays out only high-level guiding principles, not specific standards that would be more binding. Because the thrust of this approach assigns most decision-making authority to host-country regulators, national interests are preserved at the possible expense of an efficient international-financial system and the profits and resilience of GSIBs.

Impact

TLAC is an instrument demanded by the Group of Twenty heads of state[2] as one of the resolution tools needed to ensure that systemically-important financial institutions (SIFIs) can fail without negative externalities or taxpayer rescue. To date, the global TLAC framework governs only global systemically-important banks (GSIBs), with nothing mandated for investment companies and a higher loss absorbency rule for systemic insurers[3] combining features of TLAC with those of the GSIB capital surcharge.[4]

Because this regime directly addresses only GSIBs, the treatment of non-banking entities in their operations is among the most controversial surrounding internal TLAC. The consultation generally suggests that non-banks be excluded from these requirements but also recognizes that many host authorities will be unwilling to do so. An approach to allocating internal TLAC at non-banking entities is thus proposed. It could well be interpreted as requiring these entities to sacrifice their own interests – policy-holders – in favor of a banking affiliate in the host country or even that of ensuring a successful single-point-of-entry resolution of the parent GSIB. Allocating risk

1 See **TLAC4**, *Financial Services Management*, November 24, 2015.

2 See Client Reports in the **SUMMIT** Series.

3 See **INSURANCE50**, *Financial Services Management*, October 20, 2015.

4 See **GSIB7**, *Financial Services Management*, July 23, 2015.

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and resolution responsibility across a diversified GSIB will thus remain a highly-controversial issue, especially in the U.S.

Internal TLAC is designed to reassure host-country regulators that large financial institutions in their borders that are GSIB subsidiaries will not be sacrificed to support the home-country parent.

It is a particularly thorny problem because it requires careful coordination between host country authorities (given most of the authority in this consultation) and the home authority of the parent group that would need to approve the ring-fencing of capital and/or liquidity in any subsidiaries designated by the host for TLAC purposes. Because host authorities could demand the pre-positioned TLAC, disputes over whether a sub-group (i.e., a subsidiary) in a host country is material to the parent would generally be resolved by the authority of a host regulator to mandate pre-positioned TLAC. In such cases, the parent would either have to provide it or face termination of its activities in that nation. Notably, pre-positioned TLAC will make offshore operations more expensive to the parent, possibly leading some GSIBs to consolidate global operations at cost to host countries that rely on subsidiary banks for a significant percentage of host-country financial services.

An example of how complex this can quickly become is in the U.S. The U.S. TLAC standards do not now include internal TLAC for domestic GSIBs, in part because U.S. BHCs owe a duty to serve as a source of support to subsidiary insured depositories that would downstream TLAC to any offshore operation covered by the FDIC. Further, U.S. living wills[5] require advance planning for pre-positioned TLAC at material sub-groups outside of the United States, albeit not with the restrictions host regulators believe necessary to secure their interests against any demands by U.S. regulators under stress. However, the intermediate holding company (IHC) subsidiaries of any foreign bank designated as a GSIB or found by the FRB to be one would have to isolate TLAC in their U.S. operation. The FSB principles permit a host authority to mandate IHCs and even stipulate, as described below, that host-country regulations may supersede its approach. However, it also urges home-host cooperation to ensure that internal TLAC at a material sub-group is not more than the home-country regulator thinks necessary in the context of the parent. This is unlikely to be the case for the FRB's requirements because they are so stringent and come in concert with other IHC requirements[6] to which home regulators often strongly object.

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[5] See Client Reports in the **LIVINGWILL** series.

[6] See **FBO3**, *Financial Services Management*, February 25, 2014.

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This dispute is contributing to an increasing effort by other regulators – most notably now the EU[7] – to ring-fence subsidiaries and require IHC formation. This enhances resolvability but significantly undermines the capital and liquidity efficiency of a large, complex bank and, as noted, also could contribute to decisions to reduce or discontinue certain operations in host countries where TLAC requirements are deemed excessive. Indirect effects of pre-positioned TLAC will contribute to these concerns. To the extent a GSIB must pre-position capital and/or liquidity at subsidiaries, these funds become less accessible to the parent and could contribute to problems in efficiently deploying resources across the banking organization.

Host countries with tax or other operational impediments to repatriation of pre-positioned TLAC will exacerbate these concerns, as well as possibly increase rating-agency worries. To the extent parent companies are downgraded due to pre-positioned TLAC, overall funding costs could rise with adverse strategic or even resolution consequences.

Aspects of internal TLAC could, depending upon how implemented, force considerable restructuring of the global banking system. Not only could significant amounts of capital or liquidity be ring-fenced from the parent company, but host authorities could also stipulate restructuring within their own borders to ensure TLAC is sufficient not only for entities generally recognized as material to the GSIB, but also all other GSIB operations in the host country. Although host countries have long had authority to stipulate banking structures within their borders (e.g., branch versus subsidiary operations), this provision and the chance to ensure pre-positioned resolution resources that protect the host country could well lead more host countries to redesign the way in which GSIBs may do business.

What's Next

This consultation was issued on December 16, with comments due by February 10. After it is finalized, the FSB will monitor for compliance and continue its overall review of the global resolution regime (now slated for completion by year-end 2019).

Analysis

A. TLAC Structure

Under the FSB's overall TLAC term sheet, GSIBs are to pre-position internal TLAC equal to 75-90 percent of what would be required of each material sub-group if it were itself a resolution entity. Commenters on the initial TLAC term sheet requested that this amount be significantly reduced, but this

[7] See *Client Report* **REFORM132**, November 23, 2016.

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consultation does not do so. The actual amount of internal TLAC would be set by the host regulator in consultation with the home one. The host authority would trigger internal TLAC subject to home-authority consent where required. During this process, the internal sub-group would not fail even though its non-viability led to the TLAC trigger.

B. Guiding Principles

These address:

- Material Sub-Group Identification: Although the host authority identifies material sub-groups subject to internal TLAC in consultation with the home authority and crisis management group (CMG), the home authority would begin the process of identifying these entities. The principles lay out how host authorities would request that the parent pre-position TLAC, how disputes would be resolved, and how sub-groups would cease to be deemed material for TLAC purposes. Any sub-group designation determined to be critical to the GSIB's operations would need to be approved by the CMG. Even if a sub-group is no longer subject to TLAC under terms of the FSB term sheet, the principles preserve the ability of host regulators to do so by regulation, doubtless a nod to the FRB's rules.
- Material Sub-Group Composition: Host authorities would assess the sub-group to identify where TLAC is held and how to ensure it is properly pre-positioned. Composition should generally be assessed by regulatory or accounting consolidation. Composition options include host mandates for IHCs, allowing a network of "sister subsidiaries" within the sub-group, requiring TLAC to be pre-positioned at a parent subsidiary and/or its sub-groups, or at a single material subsidiary (with each of these options described in a detailed annex to the consultation). Host authorities are to explain to the host entity and the CMB how these arrangements will work. Host authorities are to ensure that these sub-group compositions make sense and are not mandated solely for TLAC purposes.
- Multi-Jurisdictional Material Sub-Groups: This should occur only where a single resolution governs these subsidiaries (i.e., in the EU) or a "high degree" of cooperation between home and host authorities. This option would only be authorized in exceptional circumstances due to the challenges of operationalizing it in failure.
- Regulated and Unregulated Non-Bank Entities: These are to be included in material sub-groups only when this is necessary to ensure resolvability or continuation of critical services. TLAC mandates these entities are to be the exception and only be included after alternative arrangements (e.g., informal agreements) are considered. Sector-specific tools (e.g., those for insurance) should also be considered prior to mandating TLAC. The guiding principles lay out a methodology for how to calculate internal

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TLAC for the non-bank entities despite its general opposition to having host authorities do so.

- Internal-TLAC Size: As noted, host authorities are to set the TLAC amount in consultation with the home authority and CMG. Internal-TLAC amounts are to be sufficient to cover loss absorption and recapitalization and to support the parent entity resolution strategy. Home and host authorities are to consult on this last issue. Host-country criteria are detailed.
- Home-Country Role: Home authorities are to advise host authorities of how they treat relevant material sub-groups and pre-position TLAC at the parent when a host authority does not require it or if internal TLAC amounts are deemed insufficient. Home authorities are also to help the host assess parent TLAC and risks to the sub-group.
- Surplus TLAC: This is parent TLAC not contributed to the sub-groups above and beyond that needed for the parent resolution entity. Surplus TLAC should be readily available to support direct and indirect subsidiaries as determined by the home authority. The home authority is also to ensure that surplus TLAC is in a form that can be readily distributed to material sub-groups given that internal TLAC is, as noted, not the full allocation needed to ensure resolvability.
- Internal TLAC Composition: This is to be determined by the host in consultation with the home authority. Hosts could decide that internal TLAC could include debt equal to or greater than one-third of the total buffer.
- Collateralized Guarantees: Home and host authorities on relevant CMGs may jointly agree to substitute balance-sheet TLAC with a collateralized guarantee from the parent subject to conditions designed to ensure that funding will in fact be available under stress. Host authorities would retain control over matters such as changes to the terms of the guarantee instrument and eligible collateral.
- TLAC Instruments: Any TLAC instrument (e.g., non-common equity) that does not promote resolvability should be barred by host authorities. "Daisy chain" or direct issuance issues are also to be addressed based on the corporate structure of the parent resolution entity, with approaches proposed to prevent double-counting. Future FSB work will address deduction issues to ensure that TLAC that is in the form of capital and must be deducted under the external TLAC rules is also deducted for internal TLAC.
- Governing Law: Internal TLAC should generally be subject to the jurisdiction where it is relevant unless law or irrevocable contracts permit issuance under another jurisdiction with sufficient assurance of use in the sub-group domicile.
- Obstacles: Host authorities and GSIBs are to identify legal, regulatory, or operational impediments to TLAC activation. Possible obstacles and solutions to them are detailed.
- Contractual Triggers: Contractual triggers should be explicit and binding. The trigger should be the point at which the material sub-group reaches the point of non-viability as determined by the host authority. Any consent

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to a trigger demanded by the home authority is to be reflected in the agreement and considered by the host authority. Sample language is provided.

- Point of Non-Viability: Any limits on an authority's ability to declare a point of non-viability or trigger TLAC should be addressed in the TLAC instrument. Only the subsidiary's non-viability should trigger internal TLAC, not other factors such as other resolutions in the GSIB. The consultation includes the information the host authority is to give the home one if internal TLAC is triggered.
- Home and Host Communications: How TLAC is to be handled in advance and under stress is detailed.
- Options to Restore Viability: Internal TLAC is to be triggered only as a last resort, with home and host authorities instructed to explore other options (e.g., sale of assets parent-company capital injections).
- Home-Authority Consent: If this is required, the host authority should give it in a timely fashion (e.g., 48 hours) and the host authority should provide the information needed to provide informed consent. If home consent is not provided, then the host may trigger bail-ins or take other actions to ensure viability despite the risks of a disorderly resolution in the absence of coordinated action.
- Material Sub-Group Recapitalization: Host authorities would determine the capital shortfall to be offset by internal TLAC, although again the host should work with the home. In general, recapitalization should refill both minimum and buffer requirements, taking into account the operational costs of recapitalization.
- Write-Down and Equity Conversion: Triggering TLAC should not change the control of the material sub-group inconsistent with the resolution strategy unless barred by applicable law or subject to meaningful challenge under it. A December 31, 2021 deadline is set for disqualifying TLAC instruments that pose these risks.

C. Request for Comment

Views are specifically solicited on:

- key internal TLAC factors;
- the treatment of regulated and unregulated non-bank entities and how internal TLAC would be calculated for them if this were done;
- the relative powers of home and host authorities;
- how surplus TLAC at the parent should be maintained to ensure availability;
- the composition of internal TLAC, with comment sought in particular on requiring debt to be at least one-third of internal TLAC;
- issuance of TLAC;

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- the need for a deduction mechanism;
- obstacles to internal TLAC;
- contractual triggers, with particular focus on the use of regulatory-capital instruments;
- triggers, particularly the home-authority's timeframe as proposed; and
- other actions necessary to make internal TLAC viable.

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