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Speech

Total Loss-Absorbing Capacity – the thinking behind the FSB Term Sheet

Speech given by

Andrew Gracie, Executive Director, Resolution, Bank of England

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Today I'd like to talk about total loss-absorbing capacity (TLAC) and the minimum requirement for own funds and eligible liabilities (MREL). But first some context.

Resolution has been central to the financial reform agenda. A repeated lesson from the crisis is that insolvency doesn't work for banks, let alone cross-border global systemically important banks (G-SIBs). We cannot afford a hard stop in the critical economic functions that banks provide. Instead, on failure, we must cover losses and recapitalise firms so that they can be reorganised in an orderly way.

In the crisis, of course, this was achieved via bail-outs, but clearly this is intolerable: gains from finance cannot go to shareholders and highly-paid employees with losses falling to taxpayers. Hence the move towards a new paradigm of resolution and "bail-in" instead of bailouts.

The first necessary ingredient for this new paradigm is a statutory framework for resolution. Progress since the agreement of the Key Attributes[1] as an international standard in 2011 has been impressive. We are on the verge of the EU Bank Recovery and Resolution Directive (BRRD) coming into force and with that, the UK will largely be Key Attribute compliant. We will have a bail-in tool, which will allow us to write down liabilities of a failing bank and/or convert them to equity should its failure pose a risk to financial stability. With these extraordinary powers over property rights will come protections for creditors: we will follow the creditor hierarchy and the circumstances in which we can depart from that will be tightly circumscribed. And whatever happens, the creditor safeguard of "no creditor worse off" (NCWO) will be in place. In other words, the outcome for each shareholder and creditor will be no worse than they would each have received in insolvency.

But while resolution powers make bail-in legally feasible, they do not necessarily ensure that bail-in is possible in practice. And this is where TLAC and MREL come in. We need to make liability structures of G-SIBs compatible with resolution and time-consistent in a cross-border context. TLAC has been designed to do that.

I want to set out the policy thinking behind TLAC across four dimensions: quantity, quality, distributions and holders. And then I will finish on the relationship with MREL.

But first I should stress that the discussion at FSB around TLAC has set out to be neutral in terms of group structure and neutral in terms of resolution strategy. In other words, the TLAC proposal is not a single point of entry (SPE) charter. It should work for both multiple point of entry (MPE) and SPE firms. Similarly it is intended to be policy neutral for G-SIBs with and without holding companies.

[1] http://www.financialstabilityboard.org/wp-content/uploads/r_111104cc.pdf?page_moved=1

Quantity of TLAC

In thinking about the quantity of TLAC, I have already mentioned the FSB's intentions regarding what the resolution transaction is meant to achieve. We need to go from imminent failure of an institution on a Friday night to a Monday where we can reopen the firm on the basis that it can be reauthorised by all the relevant supervisors and regulators, both domestically and internationally. Also important is that the firm can regain market access. It is of no use to us if we bail in a firm to be able to reauthorise it if the subsequent result is going to be an outflow of all liquidity in the firm and we, as public authorities, are left in some way refinancing those liability outflows. So the target of recapitalising a firm to a level where it can regain and maintain market confidence is key.

What does that objective imply for the minimum TLAC requirement? The FSB proposal offers a range of 16-20% of risk-weighted assets (RWAs) or two times the impending Basel leverage requirement. Why those numbers? First, we worked on the assumption that on entry into resolution, all capital was gone. It may be that from an accounting perspective all the losses have not been recognised or crystallised but historic experience suggests to us that we should not operate on an assumption that there is still residual net asset value in the firm. And then from a recapitalisation perspective we assume that, at the very least, the firm needs to be recapitalised to meet the regulatory minimum, hence the 16% RWA lower bound of the minimum TLAC requirement. Under Basel, summing across core equity, Additional Tier 1 and Tier 2, there is an 8% in minimum capital requirements that need to be met and 8% to replace that in resolution. I should say that what we are talking about in the FSB is a pillar 1 minimum. There will still be a process via crisis management groups (CMGs) and the resolution planning process for firms that will evaluate the adequacy of the TLAC requirement on a per firm basis. Based on this, from a pillar 2 perspective, there may be a need to seek a higher level of loss absorbing capacity in addition to the pillar 1 requirement. I should also say that this 16-20% figure is out for consultation now. Subsequent to this, FSB will undertake an impact assessment, including a quantitative impact study (QIS). On evaluation of that, a point within that 16-20% range will be fixed in the final TLAC requirements.

So to summarise, we make this assumption that all capital is gone on entry into resolution and that TLAC should be set so as to meet the regulatory minimum, but we may need more.

Buffers sit on top of this TLAC and are separate. The logic there is that we want the buffers to be useable to serve the purpose that they were intended for in Basel 3. But we also want this minimum TLAC requirement to be hard; we want it to have the same rigour as capital requirements under Basel 3. So we could not subsume the buffer within the minimum TLAC requirement, because then, with a unit of loss, we would immediately have to go to a bank to ask it to replace the TLAC and so the buffer wouldn't work. So the buffers had to be kept separate from the TLAC requirement.

Quality of TLAC

Let me now turn to what counts towards TLAC in terms of quality.

The first obvious point from the FSB proposal is that the resolution authority's powers over TLAC need to be legally enforceable. So where TLAC has been issued under foreign law in foreign jurisdictions, there needs to be an adequate legal opinion to demonstrate that the relevant resolution authority can impose their resolution powers and bail-in those liabilities if they're to be counted as TLAC. The second point is that we need the TLAC to be there when we get to a resolution and we also don't want to count short-dated liabilities as TLAC. This would just set-up an incentive for liabilities to run and to precipitate failures. Therefore we have a minimum residual maturity requirement of TLAC of a year. But again the term structure of the TLAC within the bank would need to be investigated as part of the resolution planning process; we would not want cliff edges in terms of maturity structure in the liabilities being held as TLAC.

But perhaps the most significant of the requirements regarding the quality of TLAC relates to subordination. This comes down to the question of credibility of bail-in. Through the crisis, we could have, at various points, imposed losses on long-term debt sitting in the senior class. Generally we did not. One of the main reasons for that is that we were concerned that, should we do so, we would instantly introduce contagion to other debt-holders, transmitting a problem across banks. And there is a concern about NCWO. Generally, senior debt (e.g. senior bonds or securities), in a senior class, is a very small proportion of the class. And a lot of the other liabilities in that class are either difficult to bail in or cannot be bailed in without impairing critical functions. If we are relying on senior debt but not these other senior liabilities to absorb loss, then we would have to depart from the principle of equal treatment of equally ranking liabilities, and we might well quickly hit an NCWO constraint given that, in insolvency, losses would be spread across the class as a whole.

And so, in the interest of ensuring maximum adherence to the insolvency creditor hierarchy in resolution and of making resolution credible, the TLAC proposal places an emphasis on the subordination of TLAC liabilities to what are described in the term sheet as 'excluded liabilities.' These are liabilities of the sort that would be difficult to bail in from a financial stability perspective: sight deposits, derivatives, trade creditors, etc. The term sheet sets out several routes through which subordination could be achieved. It could be achieved on a statutory, structural or contractual basis. Statutory subordination could be achieved were a jurisdiction to rewrite its insolvency creditor hierarchy in a way that TLAC liabilities were subordinated in insolvency to the exempted liabilities that I have just described. It could be structurally subordinated, where the resolution entity's claims on its material subsidiaries are in the form of internal TLAC instruments and these instruments are junior to the senior liabilities of the subsidiaries. For example, debt issuance from a holding company could count as TLAC if the proceeds were down-streamed into a subsidiary as intragroup debt subordinated to senior liabilities in the subsidiary.

If losses were realised at the subsidiary, then they would be applied to the liabilities of the subsidiary in an order that follows the creditor hierarchy. Common equity Tier 1 holders of the subsidiary (including minority shareholders) would experience losses first; then the subsidiary's other Tier 1 capital holders and then its Tier 2 capital holders. After those liabilities had been exhausted, other TLAC-eligible liabilities, and any liabilities which rank alongside them (for example TLAC liabilities whose residual maturity had fallen to less than a year) would be exposed to loss.

In a set-up where TLAC requirements were met via structural subordination, TLAC-eligible liabilities of a subsidiary will be held by the holding company[2]. Writing these down would pass the losses from subsidiary to parent. This may be sufficient to put the holding company into resolution, especially in the case of a material subsidiary. External liability holders would then suffer losses in priority order according to the creditor hierarchy in the holding company: common equity Tier 1 holders first; then other Tier 1 capital holders; then Tier 2 capital holders; and then other liability holders if losses exceeded capital resources issued by the holding company.

In a holding company group structure, only if the capital resources and other TLAC-eligible liabilities issued by the subsidiary were insufficient to meet losses and recapitalisation needs, would there then be a need to look at bailing in senior liabilities in the subsidiary.

And then the third route is simply to issue the TLAC out of the operating company itself but for it to be contractually subordinated. Now that doesn't necessarily mean Tier 2 capital. Again, it could be positioned above Tier 2 but below the operating liabilities. And to re-emphasise my previous point that the proposals are neutral in terms of group structure and resolution strategy, the economic effect should be the same, whether TLAC is structurally subordinated out of a holding company or contractually subordinated out of an operating company.

So those are the provisions in the term sheet broadly in relation to quality. But let me move on now to the question of distribution. In other words, where does the TLAC sit within the group?

<u>Distribution of TLAC</u>

It is worth noting that the resolution strategy governs TLAC, not the other way round. In an SPE firm, TLAC would sit at the top of the group so that the ownership of the group does not change after a bail-in. In an MPE firm, where the expectation is that the group would break into separate sub-groups at the resolution weekend, TLAC should sit at each point of entry, or legal entity that would need to be subjected to resolution powers.

[2] A holding company in this example though in principle the parent resolution entity could be an operating bank.

Now that explains where external TLAC needs to sit within a group. Let me say a few more words about internal TLAC, the corollary of this external TLAC. The FSB proposal takes a new step here relative to previous Basel proposals, in that it goes into the distribution of the loss absorbency within the group. The proposal says that for major operating subsidiaries of resolution entities there needs to be pre-positioning of internal TLAC that corresponds to 75-90% of what would be the TLAC requirement for that entity if it were a resolution entity. What is the logic for that figure? The first point to observe is that, assuming 16% RWA as the pillar 1 minimum, 8% points of that is made-up of capital, so we are talking about an additional 8% points that will be gone concern loss absorbing capacity. Thus in effect 75-90% of TLAC translates into an additional 50-80% of the consolidated requirements of the major operating entities within a group being prepositioned. This 50-80% strikes a balance between the interests of the home authority and host authority, especially in an SPE resolution. Home authorities for SPE firms are essentially sellers of those SPE strategies. And to convince host authorities to agree to SPE, we need to provide them with assurance that in the event of losses occurring in the operating companies that they are responsible for, that they will not end up being on the hook to bail them out. This on balance sheet pre-positioning provides them with that assurance.

The expectation in SPE as well is that we do not actually put these operating companies into resolution at all. But rather that this internal debt is down-streamed in the form of a "coco" which would convert at the point that the operating company would otherwise need to go into resolution. So the host authority looks at the capital position within the operating company that it is responsible for, reaches the determination that it is close to the point of non-viability (PONV) and says to the home authority that they wish to convert the internal debt to recapitalise the operating company. If the home agrees (and if home and host have negotiated this resolution strategy in a CMG there should be no reason why it should not agree), then there is a recapitalisation and the operating company can continue. If the home disagrees (despite an agreement in a CMG, we still have to allow for the possibility that the home decides in the event not to honour the agreement), then because the debt is pre-positioned on the balance sheet of the operating subsidiary, the host authority can still put the subsidiary into resolution and bail-in the internal TLAC using its own resolution powers. And so what we think we have created is an alignment between home and host incentives that avoids disorderly ring-fencing at the time of stress and brings some time consistency to the resolution process.

So that is what is in the term sheet in terms of distribution. Let me make a quick observation on a couple of points that have come up in relation to that. The 75-90% TLAC requirement for internal TLAC is an expected level. It is not a minimum and it is not a maximum. It is the expected level to ensure that home/host interests are balanced. What we want to achieve with this FSB proposal is to lean against, or even reverse, the trend that we are seeing with capital requirements where there is a fragmentation of the international banking system, with more and more requirements in local jurisdictions pushing up overall capital levels. The rationale for that in the absence of a workable resolution regime has been understandable. But what we want to do with TLAC is to lean against that so that we do not have this unnecessary tying up of capital and loss-absorbency, with excessive capital and loss-absorbency trapped in different parts of groups.

The second point I want to make clear is the relationship between external capital instruments in operating companies and structurally subordinated debt in holding companies. This is where the Basel Annex on the PONV really is important. Under this annex, non-equity capital instruments would be written down at PONV. And under the BRRD in Europe, we have statutory powers outside resolution so that at PONV we can do that. This is important because we do not want to deliver an outcome for structurally subordinated debt that results in it being ‘super-subordinated’ to non-equity capital instruments in the operating companies. If the only way that non-equity capital instruments in operating companies can absorb loss, is by putting it through a resolution process, then that invalidates what we are trying to achieve via an SPE strategy.

Now we have that statutory PONV power in the BRRD in Europe. But it begs the question about non-equity capital instruments that are being issued in SPE groups from material subsidiaries outside the EU. And that is one of many barriers to resolvability that should be addressed as part of the resolution planning process for individual firms.

Now let me turn to the final element of the FSB proposal and that is in respect of who holds TLAC.

<u>Holders of TLAC</u>

There is an explicit restriction already in the term sheet that says that G-SIBs can’t hold one another’s TLAC. The reasoning for that is obvious. There may need to be discussions regarding market making, in the same way that there are market-making concessions for capital instruments, but the base principle is clear. And the Basel Committee will look at, whether for international banks more generally, there ought to be any restrictions on those banks holding TLAC. But beyond that the FSB view is that there is no need to restrict who may hold TLAC. Of course, conduct regulators will want to ensure suitability rules are enforced in terms of who TLAC is sold to. But in terms of long-term savings institutions and asset managers, whatever limits currently exist, concentrations to either individual names or sectorally should be, in principle, adequate to manage holdings of TLAC that apply to exposures to other sorts of corporates.

But for this to work, for the buy-side to invest in these instruments, there needs to be disclosure. So another key part of the FSB proposal is that there should be a lot more disclosure. This would include disclosure as to individual creditor hierarchies at the legal entity level to some degree. This inevitably implies that we also need to have a discussion around disclosure of resolution strategies to some degree – as it should in any case be possible to infer from the liabilities structures the broad outline of a resolution strategy. To be able to price the risk to which they are exposed, investors would need to understand whether they are investing in an MPE or SPE group and the relevant risks involved.

So that is the FSB proposal. But it is also important that I say something about the relationship between TLAC and MREL.

TLAC and MREL

When you listen to some rhetoric, it feels as if the two are in conflict and not compatible. Our view is that there is no question about their compatibility.

MREL applies to all credit institutions within Europe, large or small, which in the event of failure would be resolved using the resolution tools of the BRRD. And it is expected to be set on a case-by-case basis for individual firms, according to their resolution strategies. So it is understandable that MREL is much looser, and less prescriptive, when it comes to both the quantity and quality of the eligible liabilities that are allowed to be counted towards MREL. It is worth noting that, under the BRRD, the European Banking Authority (EBA) has produced a draft technical standard further specifying the criteria for determining MREL on a case by case basis, which is currently out for consultation[3] . The RTS has been designed to ensure that EU authorities for G-SIB entities can determine the MREL requirement for those entities in way which is consistent with the FSB's proposed TLAC.

The BRRD is set up so that the approach to MREL will be reviewed by the EBA in October 2016 and potentially subject after that to additional legislation by the European Commission aimed at harmonising the requirement across the EEA. But at this point, in our view, there's no tension between the two. And we would expect during the course of next year, as the Bank, to consult as to how we will regulate MREL, taking account of the EBA RTS. And in that, we may likely say that, for firms that are G-SIBs or part of G-SIB groups operating in the UK, a 'TLAC' type of MREL could well apply. But we will need to work through this in more detail.

So to finish, the FSB proposal is out for consultation[4]. Due date for responses is in early February[5]. The EBA consultation closes later in that month[6]. We are very much looking forward to the responses that we are going to receive from that consultation process.

[3] http://www.eba.europa.eu/documents/10180/911034/EBA+CP+2014+41+%28CP+on+draft+RTS+on+MREL%29.pdf
[4] http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf
[5] Deadline is 2 February 2015
[6] Deadline is 27 February 2015