

Total Loss-absorbing Capacity

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Total loss-absorbing capacity (TLAC) is a key part of the G20's regulatory reform agenda to address the problems associated with financial institutions that are 'too big to fail'. By strengthening the loss-absorbing and recapitalisation capacity of global systemically important banks (G-SIBs), the TLAC standard is intended to help ensure that these large, interconnected and complex financial institutions can be resolved in an orderly manner if they fail, without the need for financial support using public funds.

Introduction

In November 2015, the G20 Leaders endorsed a new Financial Stability Board (FSB) standard for TLAC for G-SIBs, which, as currently identified by the FSB (2015b), include 30 of the world's largest banks.¹ The finalisation of the TLAC standard is a significant milestone in the international policy reform agenda to address the problem of 'too big to fail', where the threatened failure of a systemically important financial institution (SIFI) leaves authorities with no alternative but to recapitalise it using public funds (that is to 'bail-out'). SIFIs may not only be 'too big to fail', but also too interconnected, too irreplaceable (as a market participant or as a service provider), or too complex to be wound up under normal insolvency proceedings without significant disruption to the wider financial system and economic activity.²

The premise of the TLAC standard is that G-SIBs should have sufficient resources to absorb losses and be recapitalised if they fail. The availability of these resources is intended to allow an orderly 'resolution' of a G-SIB where financial stability is maintained and the risk of exposing taxpayers to loss is minimised. 'Resolution' in this context means the restructuring

of a failed G-SIB so as to allow its critical functions to continue while potentially winding down other parts of its business. This is achieved by establishing a minimum requirement for financial instruments held on the balance sheet that are readily available to absorb losses and, in the event that a G-SIB fails, enable it to be recapitalised through the writedown and/or conversion of the principal of these instruments to equity ('bail-in'). Financial instruments that count towards a G-SIB's TLAC requirements (TLAC instruments) are a mix of regulatory capital and qualifying uninsured liabilities.

Key Features of the TLAC Standard

The TLAC standard builds on a significant body of international regulatory reform already undertaken by the FSB to improve resolution frameworks for G-SIBs. In particular, it builds on the *Key Attributes of Effective Resolution Regimes for Financial Institutions* (the *Key Attributes*) which specifies that FSB jurisdictions should have in place legally enforceable mechanisms to implement a bail-in and adequate cross-border cooperation arrangements between regulators in the jurisdictions where G-SIBs operate (see 'Box A: Addressing 'Too Big to Fail)'). This cooperation has been facilitated through the establishment of crisis management groups (CMGs) for individual G-SIBs.

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1 No G-SIBs are headquartered in Australia.

2 For information on identifying global systemically important financial institutions (G-SIFIs), including banks, see Yuksel (2014).

TOTAL LOSS-ABSORBING CAPACITY

The TLAC standard itself comprises a set of guiding principles that reflect earlier FSB work and the terms of the minimum requirement, including its size and the characteristics of financial instruments that can be counted towards the requirement (FSB 2015a).

Size of the minimum requirement

For G-SIBs that are headquartered in advanced economies, the FSB's common minimum TLAC requirement has been set as follows:

- from 1 January 2019, resolution entities must hold TLAC instruments at least equivalent in value to 16 per cent of the resolution group's RWAs and 6 per cent of unweighted exposures; and
- from 1 January 2022, resolution entities must hold TLAC instruments of at least 18 per cent of the resolution group's RWAs and 6.75 per cent of unweighted exposures.

G-SIBs headquartered in emerging market economies will be allowed to conform to a delayed timetable, meeting the lower requirement by 1 January 2025 and the higher requirement by 1 January 2028. This is because capital markets may be less well developed in these jurisdictions. The conformance period will be accelerated if corporate debt markets in these economies reach 55 per cent of gross domestic product within the next five years.

The FSB's minimum TLAC requirement is set with reference to both risk-weighted assets (RWAs) and unweighted balance sheet assets, as defined by the Basel III leverage ratio exposure measure.³ The leverage ratio exposure measure is used in addition to RWAs because unweighted exposures are more relevant than RWAs for valuing assets in the case of insolvency and because there could be uncertainties about the reliability of risk weights once a firm has entered resolution.

The minimum TLAC requirement is also set at the level of the 'resolution entity', rather than for the

whole banking group. Resolution entities are the legal entities that will be 'resolved' if a G-SIB fails and are identified by each G-SIB's CMG. Where it is intended that a G-SIB would be broken up into separate groups upon resolution (for example, along national lines), there would be more than one resolution entity (see 'Box A: Addressing 'Too Big to Fail)').

In addition to the common minimum, each G-SIB's CMG is required to set a firm-specific minimum TLAC requirement that is at least equal to the FSB's common minimum. This minimum should take into account the recovery and resolution plans of individual G-SIBs, their systemic footprint, business models, risk profiles and organisational structures. The intent is that this firm-specific minimum should be large enough to absorb losses and recapitalise the critical functions of a failing G-SIB to a level where market confidence and access is restored. The FSB has determined that, in practice, this means that the resolved G-SIB will need to meet the minimum conditions for authorisation to use financial infrastructures, such as payments systems, and comply with its Basel III regulatory capital requirements.

Regulatory capital and relationship with Basel III

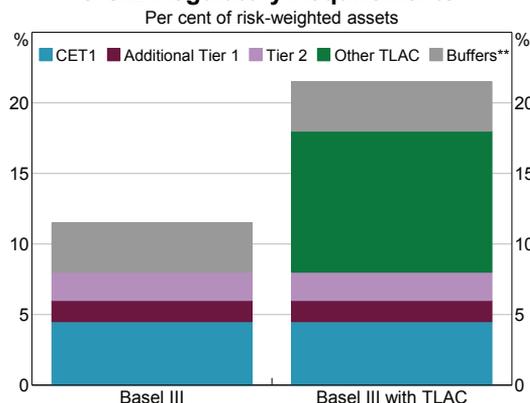
The TLAC minimum requirement is additional and complementary to the existing Basel III capital framework that, from 1 January 2019, requires banks to hold a minimum of 8 per cent of RWA in regulatory capital.⁴ In general, instruments that count towards satisfying Basel III capital requirements also count towards a G-SIB's TLAC requirement. However, common equity Tier 1 (CET1) capital that is used to satisfy regulatory capital buffers – capital conservation, countercyclical and G-SIB surcharge

3 For information on the leverage ratio, see BCBS (2014).

4 This is to be made up of 4½ per cent of RWAs in CET1, 1½ per cent of RWAs in Additional Tier 1 and 2 per cent of RWAs in Tier 2 instruments. A capital conservation buffer equal to 2½ per cent of RWAs and a countercyclical buffer set between 0–2½ per cent of RWAs dependent on credit growth will apply on top of this. G-SIBs are also subject to a capital surcharge equal to 1–3½ of RWAs. All buffers must be met with CET1 capital.

– does not count towards TLAC.⁵ Hence a G-SIB with a standard 2½ per cent capital conservation buffer and, for example, a 1 per cent G-SIB surcharge would effectively be required to meet a minimum of 19½ per cent of RWA from 1 January 2019 and 21½ per cent of RWA from 1 January 2022 (Graph 1). The decision to exclude regulatory capital buffers was based on the principle that these buffers exist, above the minimum, to be drawn down in periods of stress and should continue to function as intended.

Graph 1
G-SIB Regulatory Requirements*
Per cent of risk-weighted assets



* Examples assume fully phased-in Basel III applies

** Examples assume the standard buffer of 2.5% RWAs and a 1% RWAs G-SIB surcharge is applied; buffers must be met with CET1

Sources: BIS; FSB; RBA

Other eligible liabilities

There is an expectation that at least one-third of the minimum TLAC requirement will be met with eligible debt liabilities. This could comprise of Additional Tier 1 (AT1) and Tier 2 (T2) regulatory capital instruments as well as other eligible liabilities. The eligibility criteria for these liabilities are intended to reflect the feasibility and credibility of bailing them in. In particular, the use of these instruments to cover losses should be legally enforceable and should not give rise to systemic risk or the disruption of critical functions. Particular concerns are that the

⁵ Common equity Tier 1 capital is capital with the greatest ability to absorb loss. It includes common shares and retained earnings. Tier 1 capital comprises common equity and Tier 1 hybrids. Tier 2 capital is a lower quality form of regulatory capital, and includes Tier 2 hybrids, which are similar to subordinated debt.

application of bail-in powers should not lead to contagion to the broader financial system so as to threaten financial stability, or give rise to a material risk of a successful legal challenge or compensation costs under the principle of ‘no creditor worse off than in liquidation’ set out in the *Key Attributes*.⁶

The identification of TLAC instruments other than regulatory capital is primarily achieved by recognising what instruments are not eligible.

- Insured deposits are protected from bail-in and so cannot count towards TLAC. There are several reasons why authorities seek to provide greater protection to depositors, including that deposits facilitate economic transactions in a way that wholesale debt does not and are a primary form of saving for many individuals, who may be unable to protect themselves against the risk of loss (Turner 2011).
- Liabilities arising from derivative instruments are excluded because they would be difficult to value in a crisis and because their bail-in has the potential to lead to contagion and disrupt the functioning of financial markets.
- Operational liabilities such as wages, pension and tax liabilities are excluded because their bail-in could impair the failed G-SIB’s ability to perform critical functions.

In addition, TLAC liabilities must meet certain eligibility criteria.

- To safeguard the availability of TLAC, eligible instruments must be unsecured and have a minimum maturity of at least one year. Financial instruments with a shorter maturity could be prone to be sold-off by investors in times of stress, limiting their availability to be exposed to losses and potentially leading to contagion.
- TLAC liabilities must also be subordinated to financial instruments that are explicitly excluded from TLAC. The subordination requirement

⁶ In particular the principle is a safeguard that ‘creditors should have a right to compensation where they do not receive at a minimum what they would have received in a liquidation of the firm under the applicable insolvency regime’. (*Key Attribute 5.2*; FSB 2014).

ensures that TLAC instruments will bear losses before any excluded liabilities in an order consistent with each jurisdiction's statutory hierarchy of claims in liquidation. This is intended to reduce the likelihood of a successful legal challenge.⁷ Under the principle of 'no creditor worse off than in liquidation', creditors could be entitled to compensation if they were to receive less in resolution than they would have received if a G-SIB were placed into liquidation.

Consequences of falling below the minimum TLAC requirement

If a G-SIB's TLAC were to fall below its minimum requirement, this would not in itself trigger resolution. Rather, consistent with the current regulatory capital framework, authorities would be expected to require the firm to take prompt action to address any breach or likely breach of the minimum. If, however, authorities determined that a G-SIB was failing or was likely to fail with no reasonable prospect of recovery, it would be placed into resolution and bail-in could occur.

Implications

G-SIBs' creditors

The application of the TLAC standard implies that TLAC instruments will be at greater risk of being exposed to loss. At the same time, G-SIBs' excluded liabilities, such as short-term senior debt, arguably have become safer.

Insured deposits are protected from bail-in under various national deposit insurance schemes and do not count towards TLAC. In certain jurisdictions, such as in Japan, deposits do not specifically rank ahead of other unsecured liabilities in the creditor hierarchy (Davis 2015). Such deposits could potentially be exposed to loss if they are uninsured and have a maturity that is greater than one year. However, in

jurisdictions with 'depositor preference', such as Australia, China, Switzerland or the United States, most uninsured deposits would also be excluded from TLAC due to the subordination requirements discussed above and are less likely to be bailed-in in resolution.

Households could invest in TLAC instruments issued by G-SIBs, including indirectly through pension or other investment funds. To ensure that market participants make investment decisions based on an informed understanding of the associated risks, G-SIBs will be required to disclose the amount, maturity and composition of all TLAC instruments, as well as the amount, nature and maturity of liabilities that rank equal to, or are subordinated to, TLAC instruments in the creditor hierarchy. The extent to which households will actively make investment decisions based on this information is not yet known.

Banks could also invest in TLAC instruments issued by other financial institutions, potentially creating a channel of contagion in the event that TLAC was bailed-in. The FSB has sought to limit this potential. G-SIBs must deduct TLAC instruments issued by other G-SIBs from their own TLAC or regulatory capital exposures. The Basel Committee on Banking Supervision released a consultative document in November 2015 on this provision as well as standards for how prudential authorities might treat non-G-SIBs' TLAC holdings, which include the use of deductions (BCBS 2015a). How regulators choose to regulate TLAC holdings could have implications for G-SIBs' ability to issue TLAC, the market liquidity for such products and therefore the cost of such issuance.

Results of the quantitative impact studies

In setting the minimum TLAC requirement, FSB members sought to balance the need to set a minimum that was high enough to engender market confidence against the effect the TLAC standard might have on raising G-SIBs' funding costs. The concern was that increased funding costs would be passed on to G-SIBs' customers in the form of higher

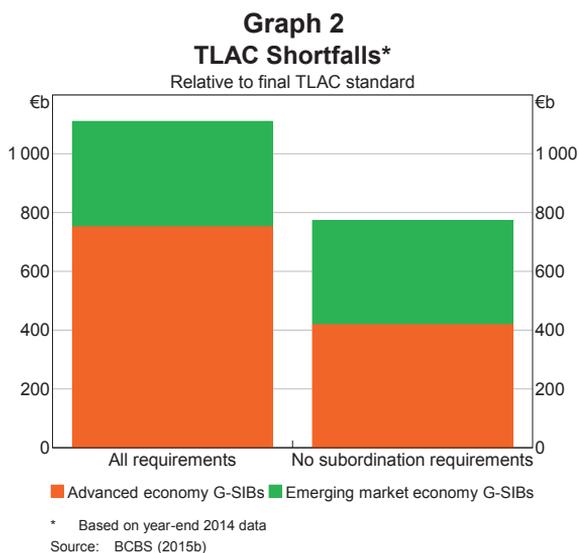
⁷ Subordination can be achieved via contract, statute or by issuance out of a parent company that does not have excluded liabilities on its balance sheet (structural subordination). G-SIBs can claim some limited exemptions from the subordination rule.

lending rates that could dampen economic activity. This was balanced against the potential benefits that accrue from a reduced likelihood and lower cost of systemic crises (BIS 2015).

To help assess these potential costs and benefits, the FSB in conjunction with the BCBS undertook: a quantitative impact study (QIS) that focused on G-SIBs' current ability to meet the minimum requirements; an economic impact analysis that considered the cost and benefits of the TLAC framework; a market survey to understand market capacity to invest in TLAC instruments; and a historical loss and recapitalisation study to gather information on the scale of previous failures (FSB 2015b).

The QIS found that, excluding emerging market economy G-SIBs, around three-quarters of the remaining G-SIBs have insufficient TLAC instruments to meet the 16 per cent risk-weighted minimum that will apply from 1 January 2019.⁸ The total shortfall for these 20 G-SIBs was estimated to be around €500 billion. A further €250 billion is required for G-SIBs to comply with the final 18 per cent minimum requirement in force from 1 January 2022. This implies a total current shortfall of around €750 billion. The QIS suggests that roughly half of this shortfall could potentially be met by the replacement of maturing existing debt, which would otherwise have been TLAC eligible if not for its failure to comply with the TLAC subordination requirement. If the shortfalls of emerging market economy G-SIBs are included, the total estimated G-SIB shortfall increases significantly to €1 110 billion (Graph 2). The large shortfalls of emerging market economy G-SIBs largely reflect their greater use of deposit based funding (BCBS 2015b).

Nevertheless, the market survey suggests that the aggregate shortfalls faced by G-SIBs are small relative to the total size of unsecured securities debt markets (at €1 110 billion, total shortfalls are approximately 1½ per cent of the estimated €80 trillion global



debt securities market). Though this implies that, in aggregate, markets for TLAC instruments may be sufficiently deep for G-SIBs to meet their TLAC requirements, some G-SIBs could be faced with impediments that make compliance more difficult. This includes that some G-SIBs have relatively large shortfalls as well as factors that limit the investor base for their TLAC instruments, such as potentially restrictive investor mandates and segmented markets.

The historical loss and recapitalisation study found that the size of the minimum TLAC requirement is likely to have been sufficient to meet the loss absorption and recapitalisation needs of most, though not all, systemically important global banks that failed in recent crises. The minimum requirement was set with an appreciation of post-crisis regulatory improvements, that the burden of adjustment across jurisdictions will be uneven, and that the minimum standard will be supplemented by supervisory efforts.

Overall, the economic impact analysis study concluded that the benefits from the reduced likelihood and severity of financial crises outweighed the estimated costs that might arise from higher bank funding costs that lead to lower economic activity (BIS 2015).

⁸ These findings do not include emerging market economy G-SIBs and do not account for the impact of any possible exclusions to the eligibility rules that are permitted.

Implications for Australia

No Australian-headquartered banks are currently identified as G-SIBs, so none are required to conform to the TLAC standard. Nevertheless, the framework does have implications for the Australian financial system. Subsidiaries and branches of G-SIBs operate in Australia, and Australian households and financial entities will potentially invest in TLAC instruments issued by G-SIBs. As noted, such instruments are now potentially at greater risk of being exposed to loss. At the same time excluded G-SIB liabilities, such as short-term senior debt, arguably have become relatively safer. More prospectively, a

recommendation of the 2014 Financial System Inquiry (FSI) was for the Australian Prudential Regulation Authority (APRA) to implement a framework for minimum loss-absorbing and recapitalisation capacity in line with emerging international practice (FSI 2014, p 67). The Government endorsed this recommendation in its October 2015 response to the FSI and asked APRA to ensure Australian authorised deposit-taking institutions (ADIs) have appropriate total loss-absorbing capacity (Australian Government 2015, pp 5). The timeframe for the implementation of this recommendation was beyond 2016. ✕

Box A

Addressing ‘Too Big to Fail’

The TLAC standard represents an important milestone in the international policy agenda to improve the resolvability of SIFIs. It is intended to help promote the full implementation of the *Key Attributes*, which was endorsed by the G20 as an internationally agreed standard in November 2011 (FSB 2014). This standard specifies a comprehensive range of powers and options that authorities should have in order ‘to make feasible the resolution of financial institutions without severe systemic disruption and without exposing taxpayers to loss’ (FSB 2014).

Bail-in

The *Key Attributes* states that resolution authorities should have statutory powers to ‘bail-in’ shareholders as well as unsecured and uninsured creditors of a failing financial institution. This should be achieved through powers to write down the value of such claims and/or convert liabilities into equity stakes in the firm. This should occur in a manner that respects

the order in which creditors would normally be paid out in liquidation (the statutory hierarchy of claims). By increasing the likelihood that shareholders and creditors will be exposed to loss if a SIFI fails (rather than being bailed out using public funds), an effective resolution regime should increase investors’ incentives to monitor the risk of their investments and, in theory, impose greater market discipline on the management of financial institutions.¹

The TLAC standard seeks to operationalise bail-in by ensuring that a sufficient layer of liabilities is readily identified and available to absorb losses and recapitalise G-SIBs in resolution. It is predicated on the assumption that *Key Attributes*-compliant bail-in

¹ Note that the *Key Attributes* does not prohibit public solvency support in resolution (i.e. using public funds). Rather, resolution frameworks (and individual SIFIs’ resolution plans) should not rely on public support and not create an expectation that such support will be available. Where public funding is required to accomplish orderly resolution, it should be temporary and include provisions to recover any losses incurred from shareholders and unsecured creditors or, if necessary, from the wider financial system (*Key Attribute 6*, FSB 2014).

frameworks are in place in the key home and host jurisdictions where G-SIBs operate.

Resolution Strategies

For global systemically important financial institutions (G-SIFIs), which include G-SIBs, the *Key Attributes* sets out a detailed framework for cross-border cooperation. This includes the establishment of CMGs for each G-SIFI. Members of the CMGs include key regulators – such as supervisory and resolution authorities, central banks and finance ministries – from jurisdictions that are assessed to be material to the resolution of a G-SIFI if it were to fail. These groups are responsible for overseeing recovery and resolution plans for each G-SIFI and for regularly undertaking assessments that evaluate the feasibility of these plans. Where impediments to the resolvability of these firms are identified, measures to address these impediments should be taken. Such measures could include changes to a firm's business practices, structure or organisation.

Because G-SIBs are highly complex financial institutions that typically perform a wide range of functions across multiple countries, the resolution plans that are being developed in their CMGs vary considerably. However, they broadly fall into two categories: 'single point of entry' (SPE) strategies, where resolution powers and tools are applied to one legal entity in a group structure by its home resolution authority; and 'multiple points of entry' (MPE) strategies, where resolution tools are applied to different parts of the group, by two or more resolution authorities which the FSB expects to act in a coordinated way (FSB 2013).

The legal entities to which resolution powers are applied are called 'resolution entities' in the TLAC standard. The groups of subsidiaries that sit below these entities, together with the resolution entity, are referred to as 'resolution groups'. A banking group can have multiple resolution

entities and groups. Depending on the G-SIB's resolution strategy, a resolution entity could be a parent company, an intermediate or ultimate holding company, or an operating subsidiary.

- For SPE strategies, the intent is to keep the G-SIB group together as a single entity after resolution. This strategy tends to be appropriate where there are significant operational interdependencies across the subsidiaries of the G-SIB group, so that resolving them separately is not feasible.² The intent is that bail-in powers would be applied only to equity or eligible unsecured liabilities and debt issued by the resolution entity. If necessary, the resulting funds would be passed down to subsidiaries within the banking group to absorb losses and recapitalise them. As long as there is sufficient TLAC issued by the resolution entity, operating subsidiaries should, in principle, be able to continue as going concerns owned by a single parent company without themselves entering resolution.
- For MPE strategies, the G-SIB is intended to be broken up into separate parts upon resolution, typically along national lines. This strategy tends to be more appropriate where the structure of the G-SIB is more modular with few operational interdependencies between resolution groups. Bail-in powers would be applied to equity and unsecured debt issued by each resolution entity in the group (most likely in different jurisdictions). For example, where a resolution entity is a subsidiary, the parent's equity in the subsidiary resolution entity could be written down to zero. Creditors of this subsidiary who had their claims converted to equity would become owners of the resolution group.

² Neither SPE or MPE resolution strategies preclude the possibility that some subsidiaries might not perform critical functions that are material to the survival of the G-SIB group. Resolution plans could include provisions for such subsidiaries to be sold off or wound up in resolution.

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