

# TLAC term sheet

## Finally finalised

The Financial Stability Board (FSB) and Basel Committee on Banking Supervision released the final term sheet for TLAC (total loss-absorbing capacity) on 9 November ahead of its adoption at the G20 meeting in Ankara, Turkey. This was largely unchanged from a version leaked in August and subsequent pointers. Here, we highlight selected items of interest from the final text.

### TLAC term sheet: Key points of interest

Calibration	<ul style="list-style-type: none"> <li>• Minimum risk-weighted assets (RWA) requirement: set at 16% on 1/1/2019, increasing to 18% by 1/1/2022. Buffers apply on top of these minima</li> <li>• Min. leverage ratio exposure (LRE) requirement: set at 6% on 1/1/2019, increasing to 6.75% in 2022, including buffers (i.e. these are not on top)</li> <li>• These are Pillar 1 minimum requirements. Discretion left to national authorities to “gold plate” requirements, e.g. through firm-specific requirements, if this is required to ensure an orderly resolution strategy</li> </ul>
Effective Date/ Conformance Period	<ul style="list-style-type: none"> <li>• For 2015 G-SIBs remaining G-SIBs until end-2018: 1/1/2019</li> <li>• For new G-SIBs between 2016-end 2018: 2022 min. requirements apply, as of 1/1/2022</li> <li>• For new G-SIBs after periods above: 36 months to comply with 2022 requirements after designation as G-SIB</li> <li>• For EME G-SIBs: 2019 min. requirement apply from 2025, 2022 requirements apply from 2028</li> <li>• Acceleration if EME’s debt capital markets, excl. SSA issuers, exceed 55% of relevant EME country GDP, but same 6 year two-step conformance period applies</li> </ul>
Eligible Regulatory Capital Instruments	<ul style="list-style-type: none"> <li>• CET1 ex amounts allocated to meeting buffers, Additional Tier 1 and subordinated Tier 2 debt</li> <li>• CET1 capital issued by subsidiaries will count in TLAC, subject to minority interest haircuts, at all times</li> <li>• AT1 and Tier 2 issued by subsidiaries, subject to minority interest haircuts, will count in TLAC until 1/1/2022 (s.t. conditions)</li> <li>• Thereafter, AT1 and Tier 2 only issued by the resolution entity(ies) will count towards TLAC</li> <li>• Exception from the above AT1/T2 limitation only for cooperative banks “that have in place an institutional protection scheme or other cooperative mutual solidarity system that protects the solvency and liquidity of the affiliated cooperative banks and institutions”</li> </ul>
Minimum TLAC eligible debt requirement	<ul style="list-style-type: none"> <li>• 33% of minimum TLAC requirement to be fulfilled by (i) AT1 and Tier 2 debt instruments and (ii) other TLAC-eligible debt instruments not included in regulatory capital</li> </ul>
Maturity and Redemption Restrictions	<ul style="list-style-type: none"> <li>• No debt instruments with residual maturity of less than one year can count in the TLAC computation (incl. T2)</li> <li>• Issuer calls subject to regulatory approval if calling the issue would result in breach of TLAC</li> <li>• Investor puts only allowable if time between put announcement and actual redemption &gt; 1 year</li> </ul>

Source: *Crédit Agricole CIB*

### Role of Senior Unsecured Instruments

A list of TLAC-excluded liabilities is included in the FSB TLAC term sheet. It is broad enough to include the liabilities excluded by the local statutory framework, so it should absorb the Bank Recovery & Resolution Directive (BRRD) in the EU. However, liabilities arising from derivatives are explicitly excluded from TLAC, while they can, under certain assumptions, be subject to write-down and conversion powers under Art. 49 of the BRRD.



#### TLAC-Excluded Liabilities

Insured deposits

Sight deposits and short term deposits (deposits with original maturity of less than one year)

Liabilities that are funded directly by the issuer or a related party of the issuer, except where the relevant home and host authorities in the crisis management group (CMG) agree that it is consistent with the resolution strategy to count eligible liabilities issued to a parent of a resolution entity towards external TLAC

Liabilities arising from derivatives or debt instruments with derivative-linked features, such as structured notes

Liabilities arising other than through a contract, such as tax liabilities; liabilities which are preferred to normal senior unsecured creditors under the relevant insolvency law (e.g. covered bonds, other secured borrowings)

Any other liabilities that, under the laws governing the issuing entity, cannot be effectively written down or converted into equity by the relevant resolution authority

Source: Crédit Agricole CIB

Senior unsecured instruments can be included in the TLAC computation under one of the following three alternatives

#### Base Alternatives to Compute Senior Unsecured Instruments under TLAC

Contractual subordination: contractually subordinated to all excluded liabilities on the balance sheet of the resolution entity; OR

Statutory subordination: junior in the statutory creditor hierarchy to all excluded liabilities on the balance sheet of the resolution entity; OR

Structural subordination: issued by a resolution entity which does not have excluded liabilities on its balance sheet (for example, a holding company) and the proceeds are down-streamed from the resolution entity to subsidiaries in a form that subordinates the eligible liabilities to the excluded liabilities of subsidiaries. Therefore there is no need for the TLAC issued from the resolution entity itself to be contractually or statutorily subordinated

Source: Crédit Agricole CIB

The final TLAC Term Sheet includes two waivers for a pari passu ranking of excluded liabilities alongside TLAC-eligible liabilities (i.e. exemptions from the subordination requirement for TLAC-eligible liabilities) (TLAC term sheet Section 11):

- Primarily aimed at resolution entities without structural subordination: Excluded liabilities can rank pari passu with TLAC-eligible liabilities up to a maximum of 2.5% of RWA's where the TLAC min. requirement is set at 16% (increasing to 3.5% of RWA when the RWA min. requirement increases to 18% of RWA in 2022)
- Primarily aimed at resolution entities with structural subordination: Excluded liabilities can rank pari passu with TLAC-eligible liabilities up to a maximum of 5% of the resolution entity's eligible external TLAC (this allows for a minimum amount of tax and derivative liabilities necessary to run the balance sheet of e.g. a non-operational HoldCo)

Only one of the two exemptions may be used. Another constraint is that the usage of one of these exceptions must not give rise to material risk of successful legal challenge or valid compensation claims.

### Points of Interest on the TLAC Needs as per Basel Committee QIS

The following Basel Committee table summarises the aggregate shortfalls (RWA buffers considered) by case, including and excluding emerging market G-SIBs, and the potential impact of the 2.5% exemptions. The shortfalls are calculated as the larger of the RWAs requirement or the 2×3% leverage requirement at each G-SIB level.

- Case 1: only includes TLAC instruments meeting all criteria of the final TLAC term sheet, including the subordination requirement.
- Case 2: same as Case 1, but with additional requirements on Tier 2 capital as per Basel III.
- Case 3: same as Case 1, but includes senior unsecured debt issued by resolution entities.
- Case 4: same as Case 3, plus structured debt and senior unsecured issued by non-resolution entities.

Shortfall (RWA buffers considered)	Case 1	Case 2	Case 3	Case 4
16% RWA or 2×3% leverage	Eu767bn	Eu790bn	Eu526bn	Eu307bn
20% RWA or 2×3% leverage	Eu1,388bn	Eu1,406bn	Eu1,025bn	Eu662bn
16% RWA or 2×3% leverage ex. emerging market G-SIBs	Eu498bn	Eu520bn	Eu260bn	Eu42bn
20% RWA or 2×3% leverage ex. emerging market G-SIBs	Eu949bn	Eu966bn	Eu588bn	Eu227bn
Impact of 2.5% exemptions	Up to Eu137bn			

*Sample size: 30 G-SIBs in Case 1 and 29 G-SIBs in Cases 2 to 4 (one G-SIB excluded from Cases 2 to 4 due to insufficient data).*

*Sources: Basel Committee on Banking Supervision, Crédit Agricole CIB*

- Overall, significant needs identified, providing potential support for German/Italian law style approaches within the Single Supervisory Mechanism (SSM) area.
- However, potentially unlevel playing field for e.g. UK and Swiss banks, which must fill their TLAC buffers through eligible HoldCo issuance.

### NEW ELEMENT: Basel Committee Consultation Paper on TLAC Holdings by Banks

Alongside the final TLAC documentation package, the Basel Committee published a consultative document titled “TLAC Holdings”. The paper is open for consultation until 12 February 2016.

The Basel Committee proposes that banks treat TLAC-eligible debt holdings, (i.e. in addition to qualifying reg. cap. Instruments, other TLAC-eligible instruments, such as potential Tier 3 debt, fully qualifying senior debt (e.g. German bank senior post 2017)) as they currently treat Tier 2 debt holdings, i.e. net (long minus short positions, subject to conditions of Basel III paras. 80 and 84). TLAC holdings are:

- If the investor bank holds less than 10% of the common shares of the bank invested in: below a Basel III threshold, the net TLAC holdings are risk-weighted and any excess above the Basel III threshold is fully deducted against Tier 2 capital;
- If the investor bank holds more than 10% of the common shares of the bank invested in: the net TLAC holdings fully deducted against Tier 2 capital;
- To the extent that Tier 2 capital is insufficient to fully absorb the deductions, any excess deduction is applied first against AT1 capital and then against CET1 capital.

Of note, also TLAC liabilities ranking pari passu with Excluded Liabilities are included in the Tier 2 deduction (when original maturity > 1 year). The Basel Committee proposes this approach in order to create a level-playing field between G-SIBs (who will have TLAC liabilities other than reg. cap. Instruments) and non-G-SIBs (who are unlikely to have TLAC liabilities other than reg. cap. Instruments). Thus, the usual correspondence approach for deductions (e.g. Tier 2 vs. Tier 2) is abandoned.

### Impact on Trading and Liquidity

In its proposal, the Basel Committee states that “one of the aims of the Basel III deduction threshold is to permit a limited level of activity, such as market-making, to occur without banks being subject to a deduction”. Thus, the Basel Committee appears potentially cognizant of the negative impacts that the proposed Tier 2 deduction approach could have on secondary trading levels and market liquidity. Hence, as part of the consultation process, the Basel Committee is seeking feedback on “whether any adjustment to the existing threshold, set at 10% of a bank’s own common equity, is warranted”.

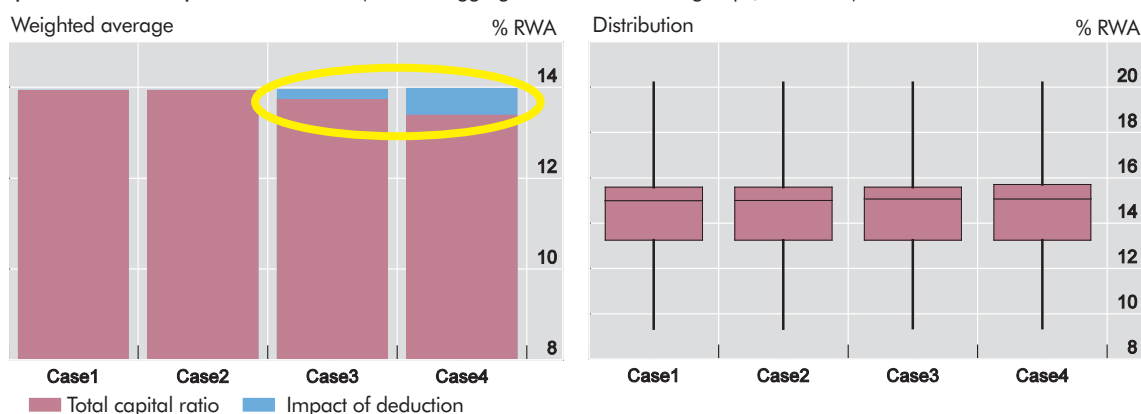
We anticipate banks with market-making operations and other debt market stakeholders to focus significantly on this issue in the coming months.

### Basel Committee Consultation Paper on TLAC Holdings – Quantitative Impact

Below is a summary of the essential impacts found by the Basel Committee on the proposed Tier 2 deduction approach. We note that this Basel Committee QIS seems to ignore existing deductions against Tier 2, which is a drawback of the analysis, in our view.

Impact on G-SIBs (ex EME G-SIBs), with relevant cases highlighted

Total capital ratios and impacts of deduction (SPE and aggregated MPE resolution groups, % of RWA)

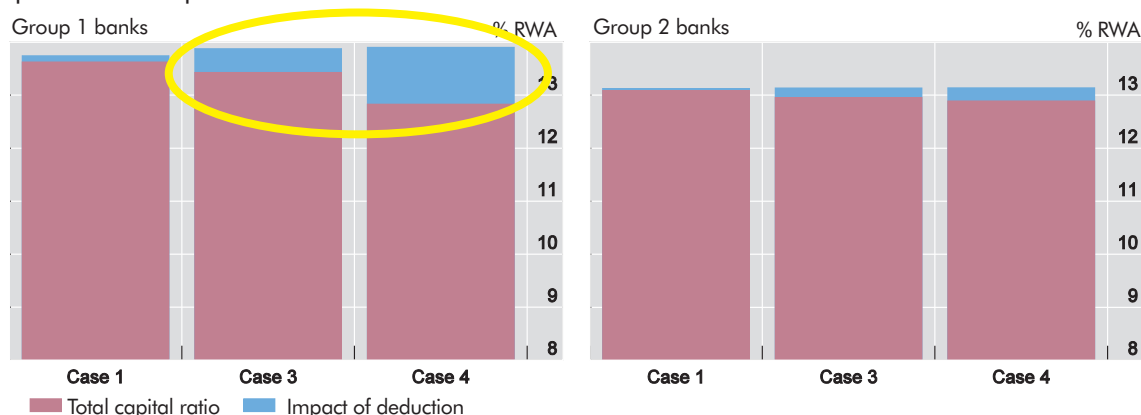


Sample size: 26 G-SIBs

Sources: Basel Committee on Banking Supervision, Crédit Agricole CIB

Impact on non-G-SIBs, with relevant cases highlighted

Total capital ratios and impacts of deduction



Sample size: Group 1: Case 1 = 44, Case 3 = 43, Case 4 = 44;  
Group 2: Case 1/3/4 = 72.

Sources: Basel Committee on Banking Supervision, Crédit Agricole CIB

- The overall impact of TLAC deductions against Tier 2 for G-SIBs appears limited
- However, the Basel Committee states that the impact can be significant for some individual G-SIBs
- The impact is much more pronounced on non-G-SIB banks
- The relevant Group is Group 1, i.e. internationally active banks with CET1 of more than Eu3bn
- As a result of a shortage of Tier 2 to absorb the required deductions, around one-third of the Group 1 banks, ie 44 banks, have to deduct part of their TLAC liabilities from AT1 and almost half of the 44 banks have to deduct part of them from AT1 and CET1 in Case 4 – the CET1 ratio is reduced on average by 1 percentage point.

PROPOSED TLAC DEDUCTION APPROACH: AREAS OF CONCERN

The proposed deduction approach applies to “internationally active banks” – the scope of application of the proposed regime must be clarified. Will the proposed application also extend to DSIBs and hence to MREL-eligible liabilities in the EU?

Considerations on likely impact

- As per Basel Committee QIS, the proposed approach seems to result in significant deductions only for a minority of G-SIBs and comparable banks, though it can't be ignored
- Thus, the risk weightings below the 10% threshold appear to be the binding constraint (though a bank must look at all its senior unsecured bank exposures, incl. look-through approach on index exposure when determining whether it is above 10% of own funds)
- In this context, the proposed revisions to the risk weighting of senior unsecured and subordinated debt bank exposure appear key. The impact must be looked at on an aggregated basis across the banking and the trading book

**Proposed Banking Book Risk-Weighting Approach**

Proposed Standardised Approach for risk-weighting non-TLAC senior unsecured bank exposure with External Credit Rating					
Counterparty Rating	External Credit Risk Assessment Approach				
	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
"Base" RW	20%	50%	50%	100%	150%
Short Term RW	20%	20%	20%	50%	150%
Effective RW assuming a 70% floor					
Counterparty Rating	External Credit Risk Assessment Approach				
	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Below B-
"Base" RW	14%	35%	35%	70%	105%
Short Term RW	14%	14%	14%	35%	105%

Grey denotes metrics applicable to majority of EU banks Sources: BCBS, Crédit Agricole CIB

- Even assuming a softening of the proposed approach and application of a generous floor for IRB risk weights based on 70% of SA risk weights, the impact may be such that in certain jurisdictions the applied risk weights for senior bank debt exposure increase significantly
- Moreover, subordinated debt is proposed to be risk-weighted at 150% across the board
- Given the new role of senior unsecured debt to specifically fulfill MREL/TLAC purposes in certain jurisdictions, it cannot be excluded that the Basel Committee may in time define new harsher risk weights for lower-ranked senior unsecured debt in the future

**Proposed Revision to Trading Book exposure through the Fundamental Review of the Trading Book (FRTB)**

More clarity on the potential impact of the FRTB should come from the anticipated publication of a nearly final paper by BCBS on the subject in the coming weeks.

The impact on the trading book may result in higher risk weights due to two reasons:

**Value at Risk (VaR) and Stressed VaR (SVaR):**

- Horizon extension to 10 days: potentially higher risk weights due to the lengthening of the horizon for the VaR/SVaR calculation
- Bail-in-able senior debt should exhibit ceteris paribus higher volatility than non-bail-inable senior debt -> VaR/SVaR should be higher, thus higher risk weights

**Non-modellable risk factors (NMRF)**

- Whilst point of non-viability (PONV), although not a precisely defined event, can be modelled on proxy parameters such as CET1 ratio with a good degree of confidence, the decision of the resolution authority to bail in senior unsecured debt may be a NMRF. In the latest QIS on FRTB, NMRFs were one of the biggest contributors to higher risk weights

**Central Bank Eligibility of bail-in-able/lower-ranked senior unsecured debt**

The jury as to whether lower-ranked senior unsecured debt (relative to Excluded Liabilities) is Central Bank-eligible is still out and can be answered ultimately only by the Central Banks. Technical factors such as structured senior unsecured debt being higher-ranked, e.g. in the German law, may influence the decision towards exclusion of Central Bank repo eligibility. Central Bank repo eligibility is a key factor in the private repo market: without Central Bank repo eligibility, private market repo eligibility may severely decline. This may further reduce liquidity and tradability of the product.

**Bringing it all together...**

- Potentially higher risk weights across banking and trading book and loss of repo eligibility are potential factors common to all banks and may restrict the ability of banks to invest in the product (with the exception of specific bank sectors benefiting from more lenient risk weight treatment).
- Higher risk weights may also impact insurers as another key constituent of the investor community.
- Secondary trading of the product may become hampered to a degree that is not commensurate with the size of the asset class and the liquidity it needs.