

Global Regulatory Network

Executive Briefing

January 2016

Global

Tom Huertas
thuertas@uk.ey.com

Americas

Ted Price
ted.price@ey.com

Marc Saidenberg
marc.saidenberg@ey.com

Rick Small
rick_small@ey.com

Scott Waterhouse
scott.waterhouse@ey.com

Asia-Pacific

Keith Pogson
keith.pogson@hk.ey.com

Philip Rodd
philip.rodd@hk.ey.com

David Scott
david.scott@hk.ey.com

Judy Vas
judy.vas@hk.ey.com

EMEIA

Mario Delgado
Mario.DelgadoAlfaro@es.ey.com

Marie-Hélène Fortesa
marie.helene.fortesa@fr.ey.com

Patricia Jackson
pjackson@uk.ey.com

John Liver
jliver1@uk.ey.com

Shane O'Neill
SO'Neill2@uk.ey.com

Japan

Hidekatsu Koishihara
koishihara-hdtkts@shinnihon.or.jp

Responding to the Financial Stability Board's Total Loss Absorbing Capacity standard

The recent total loss absorbing capacity (TLAC) standard published by the Financial Stability Board (FSB) will help end “too big to fail” by assuring that global systemic banks (G-SIBs) have “reserve capital” in place that can be bailed in if the bank enters resolution. This, in turn, will have significant implications for bank funding, bank management and bank disclosure. Much, however, will depend on whether banking groups can convince home and host authorities to accept the resolution strategy that the bank wishes to employ.

What is TLAC?

TLAC consists of investor obligations that are subordinated to operating liabilities such as deposits, and includes common equity Tier 1 (CET1), Additional Tier 1 (AT1) and Tier 2 (T2) capital as well as qualifying “intermediate” debt senior to subordinated debt but junior to deposits and other operating liabilities. Note, however, that CET1 capital held to meet buffers will not count toward TLAC.

According to the FSB standard, from 1 January 2019, TLAC should meet two tests: 16% of the bank's risk-weighted assets; and 6% of the bank's assets as defined for the purposes of the leverage ratios (LRAs). From 1 January 2022, these tests become stricter: 18% of RWAs and 6.75% of LRAs. At least one-third of the total TLAC requirement must be in the form of debt so that there is something available to be bailed in, should losses exhaust CET1 capital. This debt should be subject to write-down or conversion into CET1 capital, if the bank enters resolution. It should also have a remaining maturity of at least one year.

Banking organizations must meet TLAC requirements at each “resolution entity” so that the bank in resolution can be recapitalized and continue to perform critical economic functions. Where the operating bank is the top-level company within the group, this entity will issue instruments qualifying as TLAC directly to third-party investors. Where the bank is a subsidiary of a parent holding company, the bank may issue TLAC instruments either to



its parent holding company or to third-party investors, depending on the resolution strategy applicable to the group. Under the single point of entry strategy, the subsidiary issues instruments to its parent holding company, which in turn will issue TLAC instruments to third-party investors. Under the multiple point of entry strategy, the subsidiary bank may issue some of the TLAC instruments to third-party investors. If the bank subsidiary enters resolution and TLAC instruments held by third-party investors are converted into CET1 capital, control over the bank subsidiary could pass to the third-party investors. If so, this could result in the deconsolidation of the failed bank subsidiary from its original banking group.

As with all FSB standards, implementation may vary from one jurisdiction to another. It should be noted that the FSB standard sets a minimum: jurisdictions may impose higher requirements, constrain certain choices and/or adapt the definition to conform to concepts contained in local legislation. For example, according to the Note of Proposed Rulemaking (NPR) published on 30 October 2015 by the Federal Reserve, the US will apply the TLAC requirement to bank holding companies, including the intermediate holding companies to be formed by foreign banking organizations.

In Europe, the authorities will have to reconcile TLAC and minimum own funds and required eligible (for bail-in) liabilities (MREL), the similar but not identical concept contained in the Bank Recovery and Resolution Directive (BRRD), a very relevant difference being that TLAC applies only to G-SIBs whereas in Europe MREL applies to all entities.

What should banks be doing in response to TLAC?

TLAC is part and parcel of the overall response to regulatory reform. Where possible, banks should embed TLAC implementation into existing projects. These would include measures to:

- ▶ Develop recovery and resolution plans. As outlined above, implementation of TLAC will depend on the resolution strategy applicable to the banking organization. This is ultimately up to the authorities and should be determined by the banking organization's crisis management group.

However, banks should not simply wait for the authorities to make a decision. Banks should make the case for the resolution strategy they prefer. This creates a "preferred path" for the resolution authorities to follow and can serve as a basis for disclosure to investors (see below). Such a preferred path will also help the bank demonstrate its resolvability. That in turn reduces the likelihood that regulators will order changes to the bank's structure and/or strategy (as they could do if they were to find the bank to be irresolvable) and increases the likelihood that the bank's strategy will succeed.

- ▶ Develop the capability to manage and report on a legal vehicle basis as well as a group and line of business basis. This is especially important for banking organizations that wish to have a multiple point of entry resolution strategy, but will in any event be required in connection with structural reforms such as the introduction of the intermediate holding company in the US and the ring-fenced bank in the UK.
- ▶ Develop overall capital and funding plans. TLAC is an additional capital requirement, but many elements of TLAC can "do double duty" and be used to meet capital requirements and/or absorb losses under a stress test scenario. Understanding this interaction will be helpful to rating agencies and investors in determining how to rate and whether to invest in TLAC instruments.

Factors unique to TLAC

- ▶ Determining whether existing issuance meets TLAC requirements. The requirements are quite extensive. For example, to qualify as TLAC, "intermediate" debt has to be unsecured, subordinated to operating liabilities, have a remaining maturity of at least one year and meet a number of other conditions.
- ▶ Designing instruments that do meet TLAC requirements. In particular, banks should explore whether TLAC instruments should take the write-down or conversion form. In addition to the subordination, enforceability



and maturity requirements listed in the term sheet, banks should take tax considerations into account. Jurisdictions may differ in how they treat the conversion event and/or the write-down event for tax purposes.

- ▶ Assuring that parent holding companies are “clean” (i.e., do nothing other than hold investments and issue debt and equity liabilities). In particular, banking groups will need to move away from cross-guarantees and cross-default. Bank subsidiaries can no longer guarantee the obligations of their parent holding companies. And default by a parent holding company can no longer be classified as an event of default for the subsidiary bank.
- ▶ Assuring appropriate disclosure to investors. From an investor perspective, the introduction of TLAC underlines the fact that they will be at risk if the bank fails. Bail-in, not bailout, will be the rule. Investors will therefore wish to understand very clearly (and banks should therefore disclose):
 - ▶ Which legal vehicle the investor has a claim on
 - ▶ Where the investor’s claim stands in the creditor hierarchy of that vehicle
 - ▶ What rights, if any, the investor has as creditor during the resolution process either individually or as a class

Although these concerns most directly affect investors in TLAC instruments that will be subject to write-down or conversion, they will also apply to other unsecured creditors, such as uninsured depositors, as there is no guarantee that bail-in will stop at instruments qualifying as TLAC. If losses are high enough, bail-in will continue straight up the creditor hierarchy. At a minimum, banks should underline to depositors that uninsured deposits are at risk. If uninsured deposits are subordinated to insured, banks should state this clearly as well.

Dr. Thomas F. Huertas | Partner, FS Risk and Chair, EY Global Regulatory Network

For additional information

Americas
Marc R. Saidenberg
Principal, Financial Services
Ernst & Young LLP
marc.saidenberg@ey.com

Asia-Pacific
David C. Scott
Partner, Financial Services
Ernst & Young Advisory Services
Limited
david.scott@hk.ey.com

EMEIA
Dr. Thomas F. Huertas
Partner, FS Risk and Chair, EY
Global Regulatory Network
Ernst & Young LLP
thuertas@uk.ey.com

▶ [Find solutions to your regulatory challenges. Visit EY’s Global Regulatory Network >](#)

EY Global Regulatory Network Executive Team Previous appointments

Mario Delgado: FROB (Spanish Banking Resolution Authority) Head of International Coordination and EBA and FSB representative; Spanish Ministry of Economy: Director of Office of the Secretary of State for the Economy in the Economic Affairs; Head of the Spanish Delegation in the Paris Club; Deputy Head of relations with the IMF

Marie-Hélène Fortésa: Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority); Association Française des Banques (French Banking Association); and French National Institute for Statistics and Economic Studies. She has also held senior roles at a global investment bank

Dr. Tom Huertas: UK Financial Services Authority's Executive Committee; Alternate Chair of the European Banking Authority, Basel Committee on Banking Supervision; and Financial Stability Board Resolution Steering Committee

Patricia Jackson: Basel Committee Member; Basel II lead; Global Quantitative Impact Studies Committee Chair; Basel II Calibration Subgroup chair; Head of the Financial Industry and Regulation Division of the Bank of England

Hidekatsu Koishihara: Chief inspector and inspection administrator for the Japan Financial Services Agency, Ministry of Finance (MOF) of Japan; Japan's former financial regulator as financial inspector at the Bank Bureau of MOF and Financial Inspection Division; and Minister's Secretariat of MOF

John Liver: Divisional Compliance Lead at Barclays; Head of Department, Investment Firm Supervision, and prior roles in enforcement and supervision of investment management, life insurance and pensions at the UK Financial Services Authority and its predecessors. Current EY/UK Financial Conduct Authority relationship lead

Keith Pogson: Immediate Past President of the Hong Kong Institute of Certified Public Accountants; more than 20 years of experience advising governments and regulators across Asia-Pacific on acquisitions, market entry strategy and due diligence across banking, asset management and securities

Ted Price: Deputy Superintendent and Head of Supervision at the Office of the Superintendent of Financial Institutions, Canada, serving on the Senior Supervisors' Group and the Financial Stability Board Supervisory Intensity and Effectiveness Working Group. Prior to OSFI, Ted held senior roles at a global investment bank

Philip Rodd has more than 23 years of experience in accounting and risk management, including 13 years in the Asia-Pacific region. His areas of expertise include assisting clients in assessing the impact of regulatory change, implementing compliance initiatives, and responding to regulatory findings

Marc Saldenberg: Senior Vice President and Director of Supervisory Policy at Federal Reserve Bank of New York; Basel Committee Member and Liquidity Working Group Co-chair; involved in the development of supervisory expectations for capital planning, liquidity risk management and resolution planning

David Scott is involved in addressing emerging regulatory and legislative initiatives and engaging in dialogue with regulators and supervisors on emerging issues. He has worked with a number of large global institutions, most recently on the implementation of the global financial regulatory reform agenda

Rick Small: Deputy Assistant Director, Federal Reserve System, Enforcement and Investigations, and Policy Leader for anti-money laundering and sanctions; executive leadership positions overseeing global financial crimes risk and compliance functions at American Express, Citigroup and GE Money; former federal prosecutor

Judy Vas: Currently sits on the Hong Kong Takeovers Panel, Takeovers Appeals Committee and the Hong Kong Securities & Investment Institute Examination Committee. Former managing director, Head of Regulatory Affairs and Head of Compliance for Asia (excluding Japan), Goldman Sachs

Scott Waterhouse was capital markets lead expert for large banks at the Office of the Comptroller of the Currency (OCC) and Examiner-in-Charge of the OCC's London Office. He coordinated the supervision of trading, treasury and capital markets activities including Dodd-Frank implementation and Basel Committee requirements

Shane O'Neill has 20 years' experience in banking, capital markets, asset finance and prudential regulation in CFO, COO, strategy and regulatory roles. As Head of Banking Supervision at the Central Bank of Ireland he influenced restructuring and recapitalization and executed numerous stress tests and asset quality reviews

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

About the EY Global Regulatory Network
EY's Global Regulatory Network helps our clients find solutions to their regulatory challenges, providing extensive experience, leadership and strategic insights on financial regulation. Led by Dr. Tom Huertas, former Alternate Chair of the European Banking Authority, the network comprises more than 100 former regulators throughout the Americas, Asia and Europe, many with senior regulatory experience, including membership in the Basel Committee, the Financial Stability Board, the European Banking Authority, the Federal Reserve Bank of New York and the Japanese Financial Services Agency. The network enables our clients to understand and adapt to the impact of the changing regulatory landscape, advising on such topics as:

- ▶ Capital and liquidity
- ▶ Recovery and resolution
- ▶ Governance
- ▶ Risk culture and controls
- ▶ Structure
- ▶ Conduct

Learn more at

<http://ey.com/globalregulatorynetwork>

© 2016 EYGM Limited.
All Rights Reserved.

EYG no. EK0412
BSC No. 601-1805299
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com