Timothy D. Adams
President & CEO
IIF

Kenneth E. Bentsen, Jr.
President & CEO
GFMA

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Mr. Svein Andresen
Secretary General
Financial Stability Board
Centralbahnplatz 2
CH – 4002 Basel
Switzerland

IIF-GFMA Joint Comments

FSB Consultation on Adequacy of loss-absorbing capacity of global systemically important banks in resolution

Dear Mr. Andresen:

Introduction

The Institute of International Finance (IIF) and the Global Financial Markets Association (GFMA) (collectively, the associations)[1] welcome the Financial Stability Board's (FSB) publication of a term sheet (TS) for Total Loss Absorbing Capacity (TLAC) for Global Systemically Important Banks (G-SIBs).[2] The FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions*[3] already provides a sound basis for the resolution of a major cross-border bank. The industry has consistently supported the *Key Attributes* approach to resolution.[4] Assuring that adequate loss-absorbing capacity is available in a resolution of a bank group, along with the FSB's support for consistent treatment of financial contracts

[1] *See* the appendix for a description of each association.
[2] FSB, *Adequacy of loss-absorbing capacity of global systemically important banks in resolution - Consultative Document* (2014), available at: http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.
[3] FSB, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (2014), available at http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf.
[4] *See* IIF / GFMA, *The associations' Submission Re: FSB Consultative Document On Cross-Border Recognition Of Resolution Action, FSB Consultative Document On Guidance On Cooperation And Information Sharing With Host Authorities Of Jurisdictions Not Represented On CMGs Where A G-SIFI Has A Systemic Presence* (2014), available at https://www.iif.com/file/7060/download?token=6h71moTA.

via the International Swaps and Derivatives Association (ISDA) Protocol and cross-border cooperation, mean that the essentials for credible resolution will have been put in place.[5]

The associations appreciate the FSB's decision to launch its TLAC proposal in the form of a public consultation at the term-sheet stage, to be followed by Quantitative Impact Studies (QIS) and a market impact study. While the necessity of assuring sufficient loss-absorbing capacity for the resolution of any major firm is indisputable, getting the details right for a consistent international standard that will work for varied business models across diverse jurisdictions requires further development of many issues. It is essential to make sure that the calibration of the loss-absorbing requirement would cover likely loss scenarios, without being so demanding that it would unnecessarily burden credit capacity or the dynamics of a global economy.

While the associations have extensive comments and suggestions as to how the term sheet ought to be fleshed out, it is important to stress that the TLAC proposal, along with the FSB's concurrent initiatives on financial contracts and cross-border cooperation, are breakthrough developments, essential to completing the G20 financial reform program, and, as such, have the industry's broad support.

I. Executive Summary

1. *Comprehensive Impact Analyses*

    a. The industry applauds the fact that the FSB plans to conduct QIS, macro- and micro-economic impact, and market-impact assessments in order to ensure that the calibration of the minimum TLAC requirements will have a solid economic foundation. The planned review of historical losses and recapitalization needs will be important to the final calibration of TLAC requirements. The industry would appreciate the opportunity to discuss the results prior to their being used to finalize the proposal.

    b. In performing such analyses, the associations encourage the FSB to take into account a broad array of issues, including impacts on different business models and markets, and the overall question of pro-cyclical effects. The industry and its associations stand ready to contribute to such impact assessments in any way possible and look forward to consulting with the FSB about them.

2. *Calibration of the Amount of TLAC Required*

    a. Evidence of history is that 16% of Risk Weighted Assets (RWAs), especially given the existence of capital buffers and G-SIB surcharges, would be ample for G-SIBs as relatively diversified banks with broad international scope. The industry, therefore, believes that calibration should at a maximum be at the lower end of the proposed range of 16-20%.

    b. In conducting the loss assessment, pre-Basel III losses should be considered in light of subsequent capital and liquidity requirements, enhanced risk management and supervision, changes to business models, and risk-reducing improvements in trading and settlement procedures.

[5] *See* IIF / GFMA, *supra* note 4.

3. *Use of the Leverage Ratio*

   a. The transposition of the leverage ratio from Basel III to the TLAC context should not be automatic. The associations are concerned that the leverage ratio as a basis for TLAC calculation will have a disproportionate effect on those banks that have portfolios with low RWAs relative to total assets (for example, a typical mortgage bank or custody bank, or a similar subsidiary of a G-SIB). There is a danger that the leverage ratio requirement, at least without careful recalibration, may be most likely to bite in cases that the TLAC construct is not intended to catch.

   b. Against this backdrop, the associations believe the QIS should examine whether it is in fact necessary to double the leverage ratio for TLAC determination purposes or whether a somewhat lower multiplier, rather than simple doubling, might be more appropriate.

   c. The final TLAC standard should make clear that, as under Basel III, Common Equity Tier 1 (CET1) held toward buffers counts toward the leverage ratio for TLAC purposes.

4. *TLAC Should Be a Separate Analysis Even If Based on Basel Capital Requirements*

   a. The level of the TLAC requirement should not automatically follow any increases or changes in the international leverage ratio or changes in RWA requirements (for example, regarding any revisions of RWAs or the international leverage ratio), either in the current round of reconsideration or in the future, but should be subject to separate analysis.

   b. Similarly, the deduction for holdings of other G-SIBs should be separate from, albeit similar to Basel III, capital deductions. A TLAC deduction should preferably be subject to a separate threshold, or the 10% CET1 threshold for equity holdings in financial institutions should be recalibrated to a percentage of total TLAC, such that debt holdings would not affect existing CET1, Tier 1 and total capital ratios.

5. *"Goldplating"*

   a. The FSB should discourage jurisdictions from resorting to across-the-board "goldplating", which creates the same problems for level playing field and efficient international markets as would a jurisdiction's imposing less-restrictive rules. This should include urging jurisdictions to adhere to the FSB's TLAC principles and requirements, including that internal TLAC should *only* be required for material subsidiaries outside the remit of the same resolution authority.

6. *Additional TLAC Pillar 2 Requirements*

   a. From a resolution perspective, most of the issues that might be considered to justify Pillar 2-type additions are already covered by other regulatory requirements and, especially, the recovery and resolution planning process and resolvability assessments, and G-SIB surcharges. The term sheet does not clearly identify separate criteria that should be used in imposing Pillar 2 requirements. It is also not clear how Pillar 2 for TLAC purposes would relate to any decisions made under Pillar 2 of Basel III. Therefore, the industry suggests reconsidering the premises of a Pillar 2 in this context, but if it is decided that a form of Pillar 2 would be retained, its usage should be made as clearly defined and targeted as possible, and limited to addressing major impediments to resolution until such impediments are corrected.

7. *EME Exception*

   a. The exclusion of certain G-SIBs is contrary to the principle of the international level playing field that the FSB has sought to assure since its founding. Moreover, the rationale behind the

proposed initial exclusion of Emerging Market Economies (EME) G-SIBs is not well understood. If nonetheless an exemption is adopted, criteria should be established for phasing out the exemption over time, or in relation to the foreign and cross-border business conducted by EME G-SIBs. The exemption should also apply to foreign banks competing in such countries, whether through resolution entities or though material subsidiaries in order to satisfy the principles of competitive equity, comparability and national treatment, and to align requirements of Multiple Point of Entry (MPE) and SPE groups. Conversely, subsidiaries of EME banks in major jurisdictions should be subject to TLAC.

8. *Subordination*

   a. The industry supports the objectives of subordination of eligible TLAC to operating liabilities (but not all excluded liabilities), so that it is clear to the holders of eligible TLAC and other bail-inable liabilities that they will absorb all losses before the holders of operating liabilities suffer any losses.

   b. It is important to maintain and develop each of the three means to obtain subordination (contractual, structural, or statutory) to accommodate the different means of achieving this objective in different jurisdictions and different business structures, while ensuring avoidance of competitive distortions. It may be useful to clarify that the TLAC framework would accommodate future statutory changes on subordination.

   c. The associations note the particular difficulties faced by banks that would be subject to both TLAC and the European Union (EU) Bank Recovery and Resolution Directive (BRRD), including that structural subordination is not available to banks that are structured under an operating parent company; contractual subordination is made difficult by the current wording of the BRRD; and statutory subordination as a potential way forward may be considered in some jurisdictions, but would require substantial analysis and time for implementation, which should be taken into account by the FSB in setting the conformance period.

   d. The term sheet definitions of excluded liabilities mix exclusions for reasons of ranking, and exclusions for reasons of practicality of bail-in. This confusion between insolvency ranking and qualification for a ratio creates conflict between the eligibility criteria, and the application of the insolvency or resolution hierarchy.

   e. In practice, if not amended, the current subordination provisions would effectively exclude any reliance on structural subordination because it is difficult to run a holding company that does not have some excluded liabilities.

9. *Determination of Instruments Eligible for Inclusion in External TLAC*

   a. The term sheet requires that "TLAC eligible liabilities may not be *pari passu* or senior to *any* excluded liabilities" [emphasis added]. Interpreted literally, this principle would defeat the purposes of TLAC.

   b. *Holding companies.* As stated above, the current proposal would create unnecessary obstacles to use of structural subordination by holding companies: certain liabilities need to be permitted to be *pari passu* with other liabilities issued out of a holding company. The industry does not believe that it was the intent to undermine the holding company model of bail-in, which provides for good segregation via structural subordination of bail-inable debt to operating liabilities. A means must be found to allow a reasonable amount of liabilities such as taxes, administrators' or vendors' liens, and liabilities related to own-account hedging transactions in a holding company that also issues long-term debt. Allowance for such obligations would not

compromise structural subordination, but is essential to make the structural-subordination approach viable.

c. *Operating-company based groups.* Banks with an operating parent company structure, whose long term senior unsecured debt will often rank *pari passu* with excluded liabilities, including those excluded from bail-in by statute, would be particularly penalized by the proposal in its present form. This could be addressed by legislation to modify existing bail-in hierarchies and insolvency waterfalls to achieve more appropriate forms of statutory subordination, notably in jurisdictions subject to the European BRRD currently in transposition.

d. *Structured notes.* Structured notes should not be arbitrarily excluded from TLAC, as long as they satisfy the key requirements of the final TLAC term sheet (e.g. unsecured status, sufficient maturity, effective subordination to operating liabilities, etc.). Structured note obligations do not differ conceptually from vanilla instruments that are hedged. Both are unsecured claims on the balance sheet that can be converted into equity in resolution.

e. *The 33% debt expectation.* The "expectation" of 33% debt in a bank's TLAC needs to be approached with due regard to the facts and circumstances of specific business models and capital structures. In many instances, cost factors will in any case suggest using a substantial portion of debt, but there should be no unnecessary restrictions on firms' flexibility in deciding on the appropriate funding mix for a given situation.

   i. Certain highly capitalized firms are concerned that the requirement sets up a conflict between prudential policy and resolution policy in that it would create incentives for them to reduce CET1 and increase reliance on debt, a result that seems odd in light of traditional prudential concepts and policies.

   ii. This concern is particularly acute in EMEs with underdeveloped local capital markets, which make it less likely that adequate debt for TLAC purposes could be raised locally.

f. *Remaining maturity.* Qualifying instruments should include debt issued with an original maturity of over one year having a remaining maturity of at least six months. This approach would make TLAC more manageable from a corporate finance point of view and would be congruent with the Net Stable Funding Ratio (NSFR), without sacrificing significant loss absorbency.

g. *Supervisory intervention.* The current requirements to obtain supervisory approval before eligible external TLAC can be redeemed are overly broad. No public policy benefit would be gained if firms must seek regulatory approval for ordinary-course treasury decisions, for example to retire or to exercise a call of the firm's existing debt, unless it would put them in violation of TLAC requirements. Decisions on calls, for example, are highly market-dependent and banks should not be constrained in pursuing favourable market opportunities that come up, as long as they keep TLAC above required levels. For similar reasons, it should be made clear that debt callable at the issuer's option should be eligible (not treated as an excluded derivative).

10. *Internal TLAC*

   a. *Ensuring the Availability of TLAC in the Resolution of Cross-Border Groups*

      i. Pre-positioning of internal TLAC in material subsidiaries to support the confidence of both home and host authorities, if necessary to assure orderly resolution and reduce incentives to ring-fence assets, is a highly important policy.

ii. A reasonable amount of internal TLAC will act to improve the alignment of incentives of home and host regulators to cooperate, but it should not be seen as a substitute for broader efforts to increase international regulatory cooperation, the fostering of which should remain a top priority for the FSB. The distribution rules should be kept focused on their purpose, *viz*. to increase trust between home and host authorities, and should be modified or reduced over time as international trust and cooperation improve.

iii. The 33% debt expectation should not apply to internal TLAC.

b. Percentage Requirement

i. From the point of view of home/host balancing and the goals of internal TLAC, many firms have concluded that 65-75% would be a better range within which to fix a requirement, with a presumption toward 65%. A higher requirement, certainly at the 90% level, would seriously constrict the flexibility required to move resources to avoid difficulties that may arise in one market or another (the problem known as *"brittleness").*

ii. The FSB clearly understands the problem that the sum of internal TLAC requirements may easily become greater than 100% of a group's consolidated standalone TLAC requirement. This becomes more likely the higher the percentage that is set. The issue would also be driven by the mix of material subsidiaries in a group: some may have a natural need for external debt instruments, whereas others might have funding surpluses or other issues. These concerns also argue for a lower percentage requirement.

c. Trade-Offs between Assurances to Hosts and Flexibility

i. As much of TLAC resources as possible should be allowed to remain available at the group level (or, as applicable, at the resolution-entity level for MPE banks) for use as determined by the group where most needed.[6]

ii. Recognizing the difficult balancing required to get this point right, the industry is of the view that the current proposal tips the balance too much to the host-country's point of view, at the expense of lessening the resilience of institutions from a whole-group viewpoint. While reassurance to hosts is vital, it needs to be balanced against the interests of the system as a whole in avoiding brittleness (as defined above) and unnecessary ring-fencing, to provide appropriate flexibility in the deployment of resources to assure the resilience of groups, and efficient use of resources in the system. Over the longer term, hosts will benefit from participating in more resilient international groups.

iii. Any internal TLAC that is required should generally be expected, subject to internal determinations as discussed above, to be distributed proportionately in the group, and should relate to the group's resolution strategy and only to operating subsidiaries that have economically significant functions, as well as being deemed material to the group in accordance with the term sheet.

[6] The group TLAC that is not pre-positioned at critical subsidiaries may be invested in securities at the holding company, or may be down-streamed for productive use in group subsidiaries. What is essential is that any such down-streaming is not mandated or restricted in that specific form and use. It can be reallocated as needed, potentially as TLAC into a different entity that needs additional support. This creates the necessary flexibility to manage TLAC that can be redeployed as needed and thereby restore resilience to the group.

iv. Hosts should be discouraged from overriding prudent internal allocations of resources to subsidiaries and should be encouraged to come to agreement with home authorities on such allocations.

v. In doing the QIS and in calibrating internal TLAC requirements, the FSB and Crisis Management Groups (CMGs) need to keep in mind the need for groups to be managed efficiently, to move resources where needed to support the needs of the increasingly integrated world economy, and to use group resources when appropriate to resolve weaknesses that might arise in one part of a group or another.

d. Guarantees

i. Consideration should be given to allowing an appropriate part of the requirement to be met by capital commitments or unconditional, but uncollateralized, guarantees of the parent, with supervisory approval, including assurances from home authorities that such capital commitments or guarantees would be honored insofar as their approval might be required. Especially if a requirement at the higher end of the spectrum is imposed, this would provide the firm with additional beneficial flexibility.

ii. Collateral backing the collateralized portion of guarantees should be allowed to be pooled at the group level (not allocated to specific subsidiaries), and eligible collateral should be defined broadly for TLAC purposes, not limited unnecessarily, for example, to central-bank eligible instruments.

e. Flexibility

i. Firms should be allowed the flexibility to determine the most appropriate mix of allowed approaches to internal TLAC distribution, subject to review by their CMGs, rather than being required to follow an inflexible or predetermined approach that may not be appropriate for the firm's specific funding and capital structure.

11. Limitation of Contagion

a. The reasons for concern about contagion are well understood; however, it is important to balance this concern with the objective of assuring broad, diversified and liquid markets for banks' TLAC-eligible paper. The market must have sufficient size and efficiency to provide the resources needed effectively to end Too Big To Fail (TBTF). It is important that this issue be considered in the market-impact analysis.

b. The deduction for holdings of TLAC of other G-SIBs raises several concerns. Large-exposures limitations should be sufficient to meet the concern about contagion if large amounts of TLAC instruments were held by other G-SIBs. Such requirements would be analogous to the Basel requirements on G-SIBs' holdings of each other's obligations, and would add some flexibility to the development of markets for TLAC-eligible paper, without materially increasing contagion risk.

c. The industry urges that the FSB make an exception to the restrictions on holding TLAC of other firms for *market making and underwriting*, and to include in the QIS an analysis of what the absence of such an exception would mean for the market.

d. In addition, there should be an appropriate, TLAC-specific minimum threshold for a certain amount of other firms' TLAC-eligible instruments, below which the limitation would not apply. This is essential for practical as well as market reasons. A TLAC deduction should preferably be

subject to a separate threshold from that for equity deductions, or the 10% CET1 threshold for equity holdings in financial institutions should be recalibrated to a percentage of total TLAC, such that debt holdings would not affect existing CET1, Tier 1, and total capital ratios.

12. Conformance Period

a. While banks are likely to be pushed by the market to start to meet the requirements well in advance of the official deadline, the official date is still highly important and will have some effect on market expectations. The market-impact study should consider this question and, given the effects of the restructuring of the entire corporate debt market implied, may well conclude that a later starting date would be prudent.

b. Furthermore, the market-impact analysis should at the same time consider the market impact of Domestic Systemically Important Banks' (D-SIBs) anticipating having to comply with similar rules in the future, and the fact that EU banks of all sizes will be preparing for compliance with Minimum Requirement for Own Funds and Eligible Liabilities (MREL). Beyond regulatory requirements, there is the further likelihood that the market will push all banks to meet something like these standards in advance of the deadlines, further compounding market effects.

c. It may also be necessary to allow time for legislative changes where banks will need to rely on statutory or contractual subordination.

13. Transparency

a. The industry supports appropriate transparency of TLAC, standards of which will need to be developed. It will be essential for the market to have a clear understanding of the potential exposures of external TLAC. Achieving full transparency will require each bank and its CMG to reach consensus on the TLAC characteristics of available instruments.

II. General Comments

How to Look at the Suite of Liabilities

Several of the comments in this letter, in effect, reflect the point that, although the term sheet is apparently structured around a binary concept of (i) excluded liabilities and (ii) TLAC, it would be more appropriate to consider that there are analytically four classes of exposures that are relevant to getting the ultimate TLAC requirements right, *viz*.

a. instruments that are clearly TLAC-eligible, i.e. that are bail-in-able and meet the TLAC eligibility criteria;

b. instruments that are not TLAC-eligible because they are not bail-in-able or are excluded as operating liabilities;

c. instruments that are not TLAC-eligible only because they do not meet one or more of the TLAC criteria, but are bail-inable, (Non-TLAC, non-excluded liabilities (NTNE));[7] and

[7] Such liabilities will, if bail-inable, be expected to be bailed in regardless of whether they have TLAC status or not (for example, a liability with 11 months' remaining maturity).

d. other claims, such as certain non-TLAC liabilities, including tax claims or administrators' claims, or vendors' claims while in resolution, that are not bail-in-able but may be *pari passu* with, or superior to, TLAC depending on local law ("Administrative Liabilities").

NTNE claims are generally (but not invariably) bail-in-able, and often (but not invariably) *pari passu* with TLAC. While TLAC should, subject to the comments in this letter, generally be subordinated to operating liabilities, there is no reason why it should be expected to be subordinated to NTNE liabilities. (An example of NTNE would be securities originally issued with maturities over one year, but with less than one year's residual maturity.)

Issues of the priority of the different categories and the scope of subordination will be discussed at several points in this letter.[8] It is important to signal, in particular, that the current term sheet raises a number of significant issues for operating companies and holding companies alike because of the requirement to subordinate TLAC to "any" other liabilities. See the discussion of Question 9, *infra*.

Multiple Point of Entry Groups

MPE groups are concerned that the proposal could be more fully developed in its application to such groups, particularly with respect to the identification of resolution entities, including the need for definition of *de-minimis* thresholds for such designations, and, as discussed further under Questions 4, 5 and 7 herein, with respect to finding ways to address the specific issues of local banks, which are often deposit-funded or highly capitalized, that are members of G-SIB groups.

Tax Considerations

The tax treatment of different types of securities varies from country to country, and, in particular, the use of different subordination techniques may lead to different tax consequences as regards deductibility of interest payments. This may be a particular concern for contractual, as opposed to structural or statutory subordination. Depending on the jurisdiction, loss-absorbing or conversion features may create risk that a given TLAC security could be recharacterized at issuance as an indeterminate hybrid or an equity security for tax purposes. It is certainly important to avoid a situation where similar G-SIBs in different countries are forced to use different structures for their TLAC because of discrepancies in local tax treatment of different subordination methodologies. Among other things, such differences would reduce comparability across groups and impede market discipline. Consequently, the FSB should be prepared to raise, at the intergovernmental level, the importance of ensuring consistent tax rulings or interpretations of instruments used in national implementation of TLAC.

Strategic Review

While the importance of TLAC in the battle to end TBTF is understood, it is not yet clear how the total picture of changes in capital regimes coheres with prudential strategy (especially if elements not in the international framework but strongly influencing banks' capital position and market activities such as the US and European Central Bank (ECB)/European Banking Authority (EBA) stress tests are added in). Therefore, once an appropriate TLAC requirement is in place the associations endorse the importance of a strategic review of the whole prudential apparatus in the longer term. This would be consistent with remarks made by both Governor Carney, and Governor Ingves about the need to assess the huge accomplishments of the FSB, the Basel Committee on Banking Supervision (BCBS), and national governments since the crisis with an eye to adjusting those elements that may need refinement. Such a

[8] *See* responses to Question 6 for discussion on structured notes and responses to Question 9 on the treatment of holding companies.

review would be separate from the impact assessments discussed in the next section, but would build on the assessment work to be done in 2015.

III. Impact of the Proposal on the Financial System and the Real Economy

The Consultative Document very appropriately states that the FSB will undertake, with the BCBS and the Bank for International Settlements (BIS) comprehensive impact assessment studies, comprising a QIS, micro- and macro-economic impact assessments, and a market survey to judge the depth of markets and likely effects on markets of the proposals.

Emerging-market members note that the discussion of TLAC to date, and apparently the impact studies, will be focused on major-market issues, reflecting the focus of the present proposal on G-SIBs as such. This is of significant concern to G-SIBs that are active in emerging markets as well, especially insofar as resolution entities or other subsidiaries may be required to raise funding in local markets. The emerging-market members, however, are also concerned that, if the current proposals are extended to their D-SIBs (or G-SIBs that may be designated in the future), the design of TLAC would not necessarily be appropriate for their markets. Therefore, they request the FSB to watch closely for developments in this area and, if it appears that TLAC will be extended to EME D-SIBs or other banks, it should undertake supplemental micro- and macro-economic and market-impact studies to evaluate impacts and the appropriate calibration of requirements for their markets.

As discussed further in this letter, a review of historical losses and recapitalization needs will also be important to the calibration of TLAC requirements. Such studies are obviously essential, and the associations applaud the breadth of the planned assessments. The FSB is correct to seek a 360-degree view of the impact of the proposals on the industry, the global financial system, and the real economy. The existence of broad, deep, liquid, and diversified markets for TLAC-type paper will be essential to the success of the TLAC concept, and, thus, to ending TBTF.

As discussed further with respect to Question 15, it will be very important for the market-impact assessment to take into account the full range of market issues arising from the imposition of TLAC requirements, including effects on the different investor segments purchasing different types of obligations; competition in the market from D-SIBs that may also be issuing TLAC-type instruments; the interaction of TLAC demand with the simultaneous shift of corporate borrowers to more use of market financing that is widely expected, etc.

The associations and the industry generally stand ready to contribute as best they can to these important studies, and to discuss their outcomes and implications at any time. The associations and their members would appreciate the opportunity to meet with the FSB steering group and, as appropriate, the BCBS and the BIS on all aspects of such studies before finalization.

Once the studies are completed, the associations recommend that the FSB publish them for public comment, including the conclusions drawn for purposes of finalization of TLAC requirements.

IV. Responses to FSB Enumerated Questions

Calibration of the Amount of TLAC Required

1. **Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement, adequate in the light of experiences from past failures to support the recapitalisation and resolution objectives set out in this proposal? What other factors should be taken into account in calibrating the Pillar 1 Minimum TLAC requirement?**

Loss Experience

The evidence of history is that 16% of RWAs, especially given the existence of capital buffers and G-SIB surcharges, would be ample for G-SIBs, as banks with broad international scope, which are relatively diversified, even under adverse macroeconomic scenarios more severe than those since the Great Depression, including 2008. Provided regulators act reasonably decisively when the point of non-viability is reached, 16% disregarding capital buffers and G-SIB surcharges should be more than sufficient to cover all resolution needs, and consideration should be given to setting a lower percentage if justified on the basis of the information to be acquired via the QIS.

The only losses during the global financial crisis that were exceptional from this point of view were of narrowly focused, undiversified banks such as Anglo-Irish. Any bank would certainly face constraints on such business models under post-crisis regulations if it attempted the same strategies today.

As discussed further below, the industry, therefore, believes that calibration should at a maximum be at the lower end of the proposed range of 16-20%, excluding capital buffers and G-SIB surcharges (i.e., not more than 16%), and that such level would be shown appropriate on a proper analysis of losses.

In conducting the QIS and impact studies, the FSB should take note of an important caveat: many prior reports focused only on gross losses[9]; for purposes of the planned loss analysis, the FSB should look at net losses all-in (i.e., the draw-down of bank capital including bail-outs). Such loss analysis further needs to take into account the following:

- Pre-reform losses need to be evaluated in light of subsequently tightened capital and liquidity requirements of firms, as well as enhanced risk management and supervision, rather than taking pre-reform losses without correction as indicative of what might occur in the post-reform environment. While it is true that losses in the crisis were mitigated by unprecedented governmental support given the systemic nature of the crisis, the extensive changes made by the regulatory reform program and banks' own business changes, including the introduction of TLAC requirements, should make such extraordinary support of any bank a thing of the past.

- Prudential improvements since the crisis will greatly affect most sources of historical losses: margin requirements, ISDA protocol, central clearing, and Basel III, including G-SIB surcharges (which would substantially have modified the example of the Lehman experience), etc., would all have mitigated or avoided much damage.

[9] *See* e.g. Independent Commission on Banking, *Final Report Recommendations*, September 2011, available at: http://webarchive.nationalarchives.gov.uk/20131003105424/https:/hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/ICB%2520Final%2520Report%5B1%5D.pdf.

- Rapid change of business models since the crisis and in response to regulatory requirements and incentives also substantially reduces the precedential value of the losses suffered in the recent crisis.

- Furthermore, the overall impact of the full Basel II/III requirements (including excluded buffers and G-SIB surcharges, and related matters) needs to be considered when calibrating Pillar 1 level and internal TLAC requirements. If the TLAC Pillar 2 is maintained, the extent of its likely use should also be taken into account in the calibration exercise.

- It must also be borne in mind that banks will generally add on top of any minimum external or internal TLAC requirement an additional management buffer to mitigate the risk of a momentary or inadvertent violation; thus the actual amount will be greater than whatever the minimum requirements are stated to be.

- The TLAC requirement should be applied on the basis of the Basel III internationally determined capital standards. Many jurisdictions have applied super-equivalent Basel Pillar 1 requirements. Such super-equivalencies should be removed before applying the TLAC requirements to prevent banks in such jurisdictions from facing duplicative measures to address the same issues. There is no reason analytically why TLAC should automatically follow specific local super-equivalent capital requirements; in fact, such requirements argue for less, not more TLAC.

Sufficiency for Recapitalisation

As noted in Principle 4, resolution action will probably be taken at a point when the group is likely to have some remaining equity value. The G-SIB and conservation buffers make it even more unlikely that a firm would burn through all its capital before significant action is taken. Accordingly, an assumption that the bank will have zero capital at the point of resolution is very conservative because in practice some capital should remain. The reference to needing to take account of risk weightings that turn out to be overly optimistic should be mitigated to a substantial extent by pending private-sector and Basel revisions on the use of internal models for RWAs. Furthermore, residual risks of overly optimistic risk weightings should be adequately addressed by the leverage ratio element of the minimum Pillar 1 requirement, even if adjusted as suggested below.

The degree of recapitalisation envisioned should be focused on facilitating the group resolution plan. As noted in Principle 5 of the Consultative Document, resolution seeks to ensure the continuation of critical functions. The resolution plan may not imply that the entire group would be recapitalised in the same form in which it enters resolution. Resolution plans may involve discontinuing or winding down some non-critical functions or business lines rather than continuing the entire business. While a conservative assumption for many firms would be that broad recapitalization would be necessary to manage short-term issues at the time of resolution and to preserve the franchise, it would also be the case that a firm in such a situation would not undertake certain transactions that it would have done in normal times (e.g. a large leveraged-buyout transaction) and, thus, some parts of the business may naturally shrink, regardless of other considerations. This would require fewer resources for recapitalisation to implement the group resolution plan and ensure the continuity of critical functions. In other words, it would be reasonable to assume that the denominator will be smaller, which should affect requirements for the numerator. The EBA draft Regulatory Technical Standards (RTS) on MREL[10] supports the need to consider this issue.

[10] *See* EBA, EBA/CP/2014/41, *Draft Regulatory Technical Standards On Criteria For Determining The Minimum Requirement For Own Funds And Eligible Liabilities Under Directive 2014/59/EU* (2014), available at http://www.eba.europa.eu/documents/10180/911034/EBA+CP+2014+41+%28CP+on+draft+RTS+on+MREL%29.pdf.

In conclusion, for the above reasons, the proposed minimum Pillar 1 requirement of 16-20% RWAs or double the Basel minimum leverage ratio plus buffers is, particularly at the upper end of the range, significantly higher than is likely to be necessary to achieve the stated objective.

See also the discussion of Question 10, below.

Use of the Leverage Ratio

The use of the leverage ratio in the determination of TLAC should be reconsidered as part of the QIS.

Although the analogy to the reasons for including the leverage ratio in Basel III is understood, its transposition to the TLAC context should not be automatic.

As part of the QIS and calibration exercise, the FSB and BCBS should take into account the interplay between the two bases of calculation, the calibration at which they are to be applied, and market impacts, with an eye to making sure that the final requirement does not penalize any particular business model, or banks' ability to find the best possible equilibrium between the two ratios.

The leverage ratio as a basis for TLAC calculation will have a disproportionate effect on those banks that have portfolios with low RWAs relative to total assets (for example, a typical mortgage bank or custody bank). Other specific business models may also prove to be prone to leverage ratio issues, without in fact coming near the pre-resolution conditions that TLAC is intended to address. There is a danger that the leverage ratio requirement, at least without careful recalibration, may be most likely to bite in cases that the TLAC construct is not intended to catch.

The use of the leverage ratio, without careful recalibration specifically for TLAC purposes, runs the risk of making the leverage ratio more likely to be the effective binding constraint, contrary to the BCBS's intent that the leverage ratio be a back-stop measure.

Setting an appropriate multiplier. The QIS should examine whether it is in fact necessary to double the leverage ratio for TLAC determination purposes or whether a somewhat lower multiplier, rather than simple doubling, might be more appropriate and avoid distortions in the context of specific business models.

Reconsideration of the basis on which the leverage ratio is to be applied would be one means of mitigating potentially disproportionate effects on certain business models, or unintended outcomes.

Reconsideration of the leverage ratio along these lines would also be consistent with Principle 4 of the Consultative Document, which makes the point that the *Key Attributes* require resolution action to be taken at a sufficiently early point that losses should be moderated and some positive net asset value at entry into resolution may be present.

A more moderate multiplier of the Basel leverage ratio would alleviate the risk that the leverage ratio calculation would throw an essentially sound bank (including a bank with a major subsidiary with a low-RWA portfolio) into TLAC violation, with all its consequences.

Group issues. G-SIB groups may have subsidiaries structured like standalone mortgage banks (discussed above) or similar institutions that might be disproportionately and needlessly vulnerable to the leverage ratio calculation of TLAC, while at the same time having other subsidiaries with counterbalancing structures. It would seem odd for such subsidiaries to be considered for the leverage ratio calculation. At the same time, it is hard to see how the group or resolution-entity

consolidated TLAC can be adjusted to take account of this anomaly with respect to such subsidiaries. This is a conundrum that needs attention in finalization of TLAC requirements.

TLAC Calculation Should Be a Separate Analysis Even If Based on Basel Capital Requirements

The TLAC leverage ratio component should be set by reference to the international leverage ratio as it exists at the time the TLAC term sheet was proposed (not the local leverage ratio if higher[11] and not necessarily any subsequent increase of the Basel leverage ratio). Where local details of the leverage ratio differ from the Basel standard, the Basel standard should be applied for determination of TLAC, to promote international consistency.

Important aspects of Basel III are still subject to review and possibly significant change. RWAs and RWA density may trend upward given Basel's and the industry's work on reducing RWA variance.[12] Similarly, the leverage ratio will be reviewed by the BCBS and possibly raised.

TLAC should not *automatically* follow any increases or changes in the international leverage ratio or changes in RWA requirements, either in the current round of reconsideration or in the future, but should be subject to separate analysis to make sure that TLAC requirements remain appropriately calibrated to historical loss experience and actual resolution requirements, as opposed to other regulatory or prudential concerns.

Analysis of the impact of any such potential increases or changes in the leverage ratio or RWA requirements (as well as the impact of the current levels) should be included in the methodology for the TLAC QIS and market-impact studies.

If it is not planned to do a separate TLAC analysis to determine whether to carry any increase in RWAs or the leverage ratio should be carried over to TLAC, that is another reason for fixing the Pillar 1 requirement at the bottom end of the proposed range, anticipating possible increases.

Similarly, as discussed further with respect to Question 12, the deduction of holdings of other G-SIBs should be separate from, albeit similar to, Basel III capital deductions. A TLAC deduction should preferably be subject to a separate threshold, or the 10% CET1 threshold for equity holdings in financial institutions should be recalibrated to a percentage of total TLAC, such that debt holdings would not impact existing CET1, Tier 1, and total capital ratios.

One Global Standard

There should be one, global Pillar 1 minimum, not a range. It would be confusing to the market not to have a fixed Pillar 1 target; further flexibility at the level of the international standard would be counterproductive; subject to the comments below, the remaining national autonomy to establish requirements above the minimum provides ample flexibility.

The FSB should discourage (even if it cannot prevent) jurisdictions from resorting to across-the-board "goldplating". One standard, without "goldplating", would be in the interest of the level playing field and efficient international markets. The effects of "goldplating" TLAC would compound the

[11] The industry's analysis is that the incremental portion of the supplemental leverage ratio over the Basel requirement that is applicable to certain very large banks and bank holding companies in the US would be considered a buffer and, in accordance with the term sheet as written, not be taken into account in establishing TLAC. This should be confirmed.

[12] *See* BCBS, *Discussion Paper - The Regulatory Framework: Balancing Risk Sensitivity, Simplicity And Comparability* (2013), available at http://www.bis.org/publ/bcbs258.pdf; see also, IIF / ISDA, *Re: BCBS Discussion Paper – The Regulatory Framework: Balancing Risk Sensitivity, Simplicity and Comparability* (2013), available at https://www.iif.com/file/4323/download?token=MOGZJk4g.

existing "goldplating" of Basel III in some jurisdictions. Further cumulative requirements would amount to buying additional insurance against a risk that is, in principle, already insured.
The industry has reservations about the open-ended Pillar 2 process that is envisioned (see the response to Question 3 below); however, if the current approach to Pillar 2 is maintained, that is a further argument for setting the Pillar 1 requirement at the bottom end of the spectrum, or less than 16% depending on assumptions as to the extent of use of Pillar 2.

"Other" Factors

The second sentence of Question 1 asks about "other" factors to be taken into account in setting minimum Pillar 1 TLAC. Among the considerations that should be taken up are the following:

- *Proportionality*. Pillar 1 should be proportionate to the overall loss experience of G-SIBs as a group, not driven by one or two cases of outliers that appear highly unlikely to recur given post-crisis reforms (see above).

- *Riskiness*. Remaining impediments to resolution should not be used to calibrate Pillar 1, given that current impediments are likely to be managed down over time and are in any case mandatorily addressed by recovery and resolution planning.[13]

- *Effects of market-structure changes*. Movement of substantial amounts of transactions to Central Counterparties (CCPs) substantially changes the dynamics of "interconnectedness" in the system. This should be taken into account in designing TLAC requirements.

2. **Does the initial exclusion of G-SIBs headquartered in emerging market economies (EMEs) from meeting the Common Pillar 1 Minimum TLAC requirement appropriately reflect the different market conditions affecting those G-SIBs? Under what circumstances should the exclusion end?**

The exclusion of certain G-SIBs is, from the international perspective, contrary to the international level playing field that the FSB has sought to assure since its founding. The rationale behind the proposed initial exclusion of EME G-SIBs is not well understood, and a fuller explanation would be helpful.

Better-articulated criteria for application or disapplication of the exemption would be very helpful in creating market confidence in the determination and appropriateness of the exemption.

This is especially important as EMEs, and hence their banks, are growing much more rapidly than the rest of the world. While growth is overall positive, it may create risks for rapidly growing banks, and such banks' role in the global market can be expected to grow and change rapidly. In addition, of course, the proposed exclusion would affect the competitiveness of other G-SIBs that are subject to TLAC in international markets.

Application of the exemption to EME banks that become G-SIBs while the initial exclusion is still in place should not be automatic.

For G-SIBs initially benefitting from the exemption, growth of financial resources should indicate a diminishing need for any exemption and, conversely, growth of the kind of systemic, international interconnections that the TLAC regime is supposed to address should suggest removal of the exemption.

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[13] *See* FSB, *Cross-border recognition of resolution action – Consultative Document* (2014), available at http://www.financialstabilityboard.org/wp-content/uploads/c_140929.pdf; see also, IIF/GFMA, *supra* note 4, at 4.

The "initial" exclusion should be phased out under conditions and pursuant to principles that are understood in advance. A simple phase-out schedule would be the easiest to manage and create the most predictability for investors and competitors in the market.

If a fixed timeline for phase-out is not adopted, other criteria could be considered, for example, the percentage of an EME G-SIB's balance sheet reflecting assets and liabilities outside its home market or other cross-jurisdictional activity would be a powerful indicator of (a) the lack of full applicability of whatever home-market conditions justify the exemption, (b) the possibility of risks to host markets and the international financial system, and (c) increase of concern about level playing field issues.

Consideration could be given to phasing in the TLAC requirement in relationship to the non-home business of a G-SIB group.

To the extent that the exemption continues to be available, it should also apply to foreign banks competing in such countries, whether through resolution entities or through material subsidiaries, in order to satisfy the principles of competitive equity, comparability and national treatment by adjusting the external requirements for resolution entities and pre-positioning requirements for material subsidiaries. Resolution entities of MPE banks operating in such EMEs should be exempt from external TLAC requirements. Likewise, material subsidiaries of SPE banks operating in such EMEs should be exempt from internal TLAC requirements. This approach would meet the principles of competitive equity and comparability, as well as national treatment. It would also align the requirements made of MPE and SPE banks operating in such EMEs.

Conversely, MPE subsidiaries of EME banks should be subject to TLAC for subsidiaries in major jurisdictions on the same terms as subsidiaries of other G-SIBs.

3. What factors or considerations should be taken into account in calibrating any additional Pillar 2 requirements?

The rationale for additional Pillar 2 TLAC requirements needs further debate. Given that G-SIBs must meet Basel III capital and liquidity requirements (including the original Pillar 2); capital conservation buffers; possible countercyclical buffers; G-SIB surcharges; and now TLAC, the need for and role of a specific Pillar 2 for TLAC is questionable. The TLAC Pillar 2 should, if retained, be used only in exceptional circumstances, and clearly targeted at any firm-specific resolvability issues that are not adequately dealt with by all these other measures.

Given the different structure and purposes of TLAC and Basel II/III, it is not clear that a Pillar 2 requirement can be justified merely by analogy to Basel II/III. Under Basel II/III, Pillar 2 is intended to cover bank-specific risks that are not captured by Pillar 1. From a resolution perspective, however, most of the issues that might be considered to justify Pillar 2-type additions are already covered by Basel Pillar 2 requirements, G-SIB surcharges, supervisory stress testing, resolvability assessments, the TLAC analysis, or the Basel capital requirements and buffers, and the interrelationship of TLAC with those requirements.

A TLAC Pillar 2, at least as currently described in the term sheet, would sow confusion in the market because investors could not predict the Pillar 2 requirement that might be imposed, either as to its size or composition.

A significant aim of TLAC, as is clear from the FSB's introductory discussion, is to create confidence in the market that TBTF has indeed been ended. For this purpose, it is important to have set a standard that has the endorsement of the international community. Provision for open-ended Pillar 2 requirements that are not clearly distinguishable from other requirements could create the

appearance of a lack of confidence that all the layers of prudential protections, to which TLAC is now being added, are sufficient, thus undermining one of the main aims of defining TLAC.

Furthermore, extensive and open-ended use of Pillar 2 requirements would make the planned QIS and market-impact studies more speculative and difficult to evaluate; in turn, this would make it even more difficult than is anyway the case to estimate increased funding costs, and, therefore, impacts on real-economy activity.

As clarity and consistency are essential to market acceptance of TLAC, and for banks to plan their funding needs in a coherent and transparent way, the open-endedness of Pillar 2 as proposed needs careful attention, even if a Pillar 2 requirement is retained.

If Pillar 2 is Retained, a Number of Considerations Suggest Themselves:

TS Section 6 is problematic because the "principles" for Pillar 2 seem to be essentially a restatement of the rationale for TLAC overall, not principles that would guide proportionate and relatively consistent usage of Pillar 2 for specifically supplementary Pillar 2 purposes.[14]

More-specific principles should be drafted to guide authorities in the execution of Pillar 2, aimed at increased clarity and predictability, and keeping Pillar 2 interventions targeted at specific problems that may be encountered. Such principles would also be of some assistance to the market in understanding the new Pillar 2.

If the purpose of Pillar 2 is to remedy defects in resolvability assessments, (a) guidance should be provided as to the special needs or extraordinary weaknesses that would justify additional Pillar 2 TLAC, (b) Pillar 2 should be reserved for exceptional, one-off resolvability issues, not jurisdiction-wide gold-plating, and (c) the purposes of Pillar 2 should be stated in such a way that Pillar 2 can be applied in a reasonably consistent way across jurisdictions. For example, a Pillar 2 requirement might be related to unique and very serious impediments to resolution or particular issues that would make assets hard to value.

FSB guidance to help inform and channel Pillar 2 decisions by CMGs, keeping them to appropriate purposes and without excess, will be important to avoid misperceptions that may arise in the public and the press. Given the importance of TLAC for the credibility of the FSB's solution to TBTF, the kind of *supervisory* variances that have contributed to the perceived problem of variance of RWAs should be avoided.[15]

There should be a clearer understanding of how Pillar 2 requirements could affect the triggering of resolution (or how failure to meet Pillar 2 requirements would affect a bank short of resolution). It should also be clarified how the Pillar 2 process would mesh with the existing resolvability assessment process and resulting requirements under the resolution regime.

Application of Pillar 2 by an authority should not radically vary the international standard; extensive or highly divergent use of Pillar 2 would undermine the predictability of TLAC, thereby making pricing more difficult and raising costs for TLAC instruments in the market.

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[14] For a discussion of international consistency: s*ee* Mark Carney, *2014 Monetary Authority of Singapore Lecture: The Future of Financial Reform* at 16, 20 (Nov, 2014), available at http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech775.pdf, which affirms that "[t]rust can be sustained only if all countries (…) implement standards consistently, fully and in a timely way" and that "[c]onsistent, full and timely implementation of global standards is necessary to continue to build the cross-border trust on which an integrated system can be founded."

[15] *See* BCBS, *supra* note 12, ¶ 69.

The industry agrees with the first sentence of TS Section 6 that, if Pillar 2 is retained, any Pillar 2 requirement should be set by the home authority. Except for certain MPE resolution entities, there should be no Pillar 2 at the subsidiary level and there is concern that the second sentence of TS Section 6 could be read to invite multiple Pillar 2 requirements at the subsidiary level, which would contradict the goal of not increasing overall requirements on cross-border groups. Host interests would of course be taken into account through the CMG process in any discussion of Pillar 2, if it is retained.

For banks with an MPE strategy, the home authority setting any Pillar 2 requirement should be the home authority of the relevant resolution group; otherwise, the home authority setting the Pillar 2 requirement, if any, should be that of the group as a whole.

Ensuring the Availability of TLAC for Loss Absorption and Recapitalization in the Resolution of Cross-Border Groups

4. **Should TLAC generally be distributed from the resolution entity to material subsidiaries in proportion to the size and risk of their exposures? Is this an appropriate means of supporting resolution under different resolution strategies? Which subsidiaries should be regarded as material for this purpose?**

Purpose and focus. Reasonable amounts of internal TLAC will improve alignment of incentives among home and host authorities but should not be seen as a substitute for international regulatory cooperation, the fostering of which should remain a top priority for the FSB.

The distribution rules should be kept focused on their purpose, *viz*. to address the potential for lack of trust between home and host authorities. Excessive or unnecessary distribution of TLAC would be contrary to the goals of the FSB as stated in the general comments on the TLAC proposal.[16] It would undermine the viability of SPE resolution strategies to trap unnecessary capital in multiple jurisdictions and entities, and unnecessarily add rigidity and inefficiency to MPE strategies as much as to SPE strategies. In either case, distribution of capital within the group should be driven by business decisions, except to the extent judged necessary to meet the problem of developing mutual trust.

In doing the QIS and in calibrating internal TLAC requirements, the FSB and CMGs need to keep in mind the need for groups to be managed efficiently, to have the flexibility to move resources where needed to support the needs of the increasingly integrated world economy, to maximize profitability, and to use group resources when appropriate to resolve weaknesses that might arise in one part of a group or another.

There is no need for the composition of internal TLAC to be limited (e.g. by the 33% debt requirement). This point may be implied by TS Section 20, but it should be made clear. By the same token, eligible TLAC should be able to be down-streamed from the relevant resolution entity as senior debt.

Additionally, the proposal should be clarified to provide that any entity within a group (including a special-purpose financing entity), whether or not it is a resolution entity, is allowed to hold internal TLAC for the benefit of a resolution entity so long as losses of the group are ultimately transferred to, and absorbed by, the holders of external TLAC.

[16] *See*, e.g., *supra* Comment 10(a)(i) and accompanying text, and *infra* responses to Question 5 for discussion regarding the importance of avoiding ring-fencing.

General Approach

Subject to the comments above about the purposes and focus of such requirements, any internal TLAC that is required should generally be expected, all other things being equal, to be distributed proportionately in the group, and should relate to the group's resolution strategy. While the FSB does not have legal powers, it should make it clear as a policy matter that authorities in specific jurisdictions should not seek to command more than a proportionate share of the required internal TLAC.

There is a need for strong guidance (led by the FSB and home regulators via CMGs) to avoid local fragmentation, and parcellation of resources contrary to the intent of the FSB and to the healthy growth of the global economy.[17] While this applies particularly to SPE groups, somewhat the same efficiency concerns apply to MPE groups as well.

The tests for the application of material-subsidiary requirements set out in TS Section 21 are incomplete or overly broad in that they only look at the subsidiary's role in the group. To avoid unnecessary requirements and complexity, internal TLAC should be required only for operating subsidiaries under other resolution authorities that are material pursuant to the tests set out in TS Section 21 *and* perform economically significant functions in a given jurisdiction. Meeting the requirements of TS Section 21 should not in itself indicate the need for an internal TLAC requirement.

TS Section 21 limits its definition of material subsidiaries to those incorporated in a national jurisdiction other than that in which the relevant resolution entity is located. This is appropriate because it focuses on the cross-border problem, which internal TLAC is intended to solve; however, use of place of incorporation as the test may sometimes miss the point. It would be better to refocus the definition to make clear that internal TLAC should not be required for subsidiaries where the same authority is both the home and the host resolution authority. This would assure that the focus on establishing trust among authorities potentially involved in a cross-border resolution is maintained.

TS Section 21(d) should be clarified by a small, but significant correction: whereas the present text says, "has been identified by the firm's CMG as *material to the exercise of* the firm's critical functions", it would be more appropriate for it to read, "identified … *as performing* critical functions." This change would correct the implication that entities with support functions rather than those actually delivering critical functions would be caught. Much of the apparatus of internal TLAC would not be appropriate or feasible for such support functions. Importantly, many are not set up to, and would normally not need to, hold the funding required.

There is concern that the penultimate paragraph of TS Section 20 and the final paragraph of TS Section 21 indicate that hosts can impose internal TLAC on non-material subsidiaries or designate non-material subsidiaries as material. While it is true that hosts' discretion on such matters cannot be limited legally, it would be helpful to have directive language from the FSB indicating that hosts should refrain from taking such actions, in the interest of coherent resolution planning through the CMGs and the avoidance of additional TLAC that would contribute to groups' brittleness (as defined in the response to Question 5).

[17] *See*, Carney, *supra* note 14, at 15 (stating that "[f]ragmentation will reduce the efficiency with which savings are allocated to investments, and potentially lead to misallocation of capital on a global scale. All economies would be harmed by this, whether advanced, emerging or developing").

Identification of Resolution Entities

TS Section 21 describes a resolution entity in general terms as an entity "to which resolution tools will be applied in accordance with the resolution strategy for the G-SIB", but it does not specify how resolution entities would be designated. While the flexibility of the definition is appropriate, designations of resolution entities should be made by agreement of home and host resolution authorities, preferably acting through the CMG. The risk is that uncoordinated designations by hosts could disrupt resolution planning or the efficiency and effectiveness of actual resolution strategies.

TS Section 21 refers to "a regulated operating entity" that is not a resolution entity. This language may be too broad: it would be more accurate to make clear that such an entity would need to be a prudentially regulated entity such as a bank or securities company.

As noted in part II of this document, MPE groups are concerned that the proposal could be more fully developed in describing its application to such groups, particularly with respect to the identification of resolution entities. It would be appropriate to define *de-minimis* thresholds for such designations.

5. **To what extent would pre-positioning of internal TLAC in material subsidiaries support the confidence of both home and host authorities that a G-SIB can be resolved in an orderly manner and diminish incentives to ring-fence assets? Is a requirement to pre-position internal TLAC in the range of 75 – 90% of the TLAC requirement that would be applicable on a stand-alone basis, as set out in the term sheet (Section 22), appropriate to satisfy the goals of the proposal and ensure that TLAC is readily and reliably available to recapitalize subsidiaries as necessary to support resolution? Can this pre-positioning be achieved through other means such as collateralized guarantees?**

Trade-Offs between Assurances and Flexibility

Pre-positioning of internal TLAC in material subsidiaries where necessary to support the confidence of *both* home and host authorities to assure orderly resolution and reduce incentives to ring-fence assets is a highly important policy.

The policy should be established, however, that internal TLAC requirements would be managed downward over time as understanding of each group and its resolution strategy, and trust between authorities increases, and as legislative changes take place.

In other words, as feasible, higher priority should be given to reducing inefficiencies in the allocation of TLAC within groups, whether ex-ante or when a resolution situation develops. Decisions about the allocation of corporate resources should be determined flexibly at the group level (or, as applicable, at the resolution-entity level for MPE banks) for use where most needed.[18] Hosts should be discouraged from overriding prudent internal allocations of resources to subsidiaries and should be encouraged to come to agreement with home authorities on such allocations.

The Consultative Document's introductory discussion of internal TLAC appropriately calls for an amount that would provide "*sufficient* comfort for host authorities that sufficient resources are available to absorb losses in material subsidiaries but provide some *flexibility* to deploy non-prepositioned internal TLAC as necessary across the group in resolution." [Emphasis added.]

[18] As noted in the executive summary, group TLAC that is not pre-positioned at critical subsidiaries may be invested in securities at the holding company, or may be down-streamed for productive use in group subsidiaries. What is essential is that any such down-streaming is not mandated or restricted in that specific form and use. It can be reallocated as needed, potentially as TLAC into a different entity that needs additional support. This creates the necessary flexibility to manage TLAC that can be redeployed as needed and thereby restore resilience to the group.

However, the industry is concerned that the current proposal is excessively rigid in terms of the amounts of internal TLAC contemplated. Recognizing the difficult balancing required to get this point right, the associations are nonetheless of the view that the current proposal arguably tips the balance too much to the host-country point of view, at the expense of lessening the resilience of institutions from a whole-group viewpoint.

While the reassurance of hosts is vital, it needs to be balanced against the interests of home countries, and the system as a whole, in avoiding brittleness and unnecessary ring-fencing, to provide appropriate flexibility in the deployment of resources to assure the resilience of groups and the efficient use of resources in the system. The flexibility to deploy resources where they are most needed is particularly important in times of stress. Host countries ultimately benefit from such increased resiliency.

Both home and host regulators have an interest in having enough resources in the local subsidiary that the host country can assume it will never be in the interests of the group – or of the home supervisor – to allow the subsidiary to fail and be liquidated (except of course where the resolution plan of a group with an MPE strategy contemplates that possibility). From that point of view, it would be hard to see why more than 65-75% would be necessary to establish such "skin in the game" (in addition, of course, to the firm's interest in the franchise value of the local business itself).

The associations consider that the starting point for the assessment of internal TLAC should be requirements for external TLAC. It should then be agreed by the group with its home and host authorities how, and to what extent, external TLAC should be distributed within the group in accordance with the group resolution plan (as discussed in response to the preceding question).

In its last paragraph on double-gearing restrictions, Section 22 implicitly recognizes the risk that the sum of internal TLAC could become super-equivalent to external TLAC. These restrictions put the onus of this problem on the group (and by implication the home authority), but do permit one important mitigant, *viz.*, that external TLAC may be lower "if and to the extent this is due to consolidation effects only." This clarification would seem to remove accounting effects that could lead to super-equivalence and brittleness, which is an important enhancement. However, there are a number of other factors that arise between internal and external TLAC that could still create major obstacles.[19]

The industry remains concerned that the implications of the internal TLAC structure, when these requirements are combined at the group level, could overwhelm the design of external TLAC in a way that seems unintended. A broader policy statement about consolidation and other group effects would help resolve this issue, and restore internal TLAC to its correct role as a purely internal feature that supports the overall structure. An emphasis on proportional downstreaming that recognized more explicitly retention of appropriate allocable resources at the group level would be helpful in this respect.

Furthermore, consideration should be given to excluding the obligations of its parent and other affiliates from a material subsidiary's calculation of its required internal TLAC. Thus, in finalizing the rules on internal TLAC, consideration should be given to excluding RWAs of a material subsidiary that consist of obligations of its parent or affiliates. Including them would have potential effect in

[19] Other issues that could lead to a divergence between "the sum of the parts" of internal TLAC and external TLAC include issues such as divergence between local RWA requirements and consolidated methods, "greater of" effects between leverage and RWA constraints at the subsidiary level, the possible application of the 33% expectation of term TLAC at the subsidiary level, and other factors. The associations believe the "33% expectation" in particular is unnecessary for internal TLAC and should be dropped outright, but the other issues need to be addressed as well for a holistic solution.

many cases of causing the aggregate of a G-SIB resolution entity's holdings of internal TLAC to exceed the amount of its own external TLAC.

Target Range

From the point of view of home/host balancing and the goals of internal TLAC, many firms have concluded that 65-75% would be a better range within which to consider fixing a requirement, with a presumption toward 65%. The internal analysis being done on this question is, of course, subject to objective, industry-wide analysis via the pending QIS. Firms believe that, for the most part, a requirement in the 65-75% range would allow for sufficient recapitalization resources to replenish going-concern requirements for relevant subsidiaries, while leaving meaningful TLAC resources at the group level for deployment where needed, and reducing the risk that adding up a group's internal TLAC would produce a greater figure than would be set on a group basis.[20]

A higher requirement, certainly at the 90% level, would seriously constrict the flexibility required to move resources to avoid difficulties that may arise in one market or another (the problem known as *"brittleness").* Brittleness creates the risk that – even if the firm overall remains fundamentally strong – one or more entities within a group could become distressed or even trigger the failure of the group in extreme cases. By contrast, a more moderate requirement would give greater assurances of the wider flexibility of the global system. The importance of this flexibility is recognized in the discussion of internal TLAC in the overview section of the consultative document, but the proposal is too conservative in the limits that it applies.[21]

The FSB clearly understands the problem that the sum of internal TLAC requirements may easily become greater than 100% of a group's consolidated standalone TLAC requirement. This becomes more likely the higher the percentage that is set. The issue would also be driven by the mix of material subsidiaries in a group: some may have a natural need for external debt instruments, whereas others might have funding surpluses or other issues. These concerns also argue for a lower percentage requirement.

It would be preferable to set a single target percentage (e.g. 65% or 75%) rather than stating the requirement as a range. Given that, per TS Section 20, internal TLAC is a minimum that can in any case be increased by hosts, setting a moderate standard percentage would help establish clarity and predictability.

A clear international target percentage would increase the transparency and comprehensibility of the internal TLAC requirements for the market; conversely, if internal TLAC requirements were set as a range, and, as a result, varied substantially between groups, the resulting complexity would make it harder for investors to understand and compare cross-border groups or to comprehend the international resolution solution overall. Given that internal TLAC is in part intended to avoid potential tensions between home and host authorities, it would make sense for there to be a clear international benchmark to work from, lest banks be caught in the middle.

[20] The group TLAC that is not pre-positioned at critical subsidiaries may be invested in securities at the holding company, or may be down-streamed for productive use in group subsidiaries. What is essential is that any such down-streaming is not mandated or restricted in that specific form and use. It can be reallocated as needed, potentially as TLAC into a different entity that needs additional support. This creates the necessary flexibility to manage TLAC that can be redeployed as needed and thereby restore resilience to the group.

[21] A further issue, applicable to a limited, but significant number of situations, is that an internal TLAC requirement requires firms to place investments in countries where the rule of law has not been historically reliable. It would be better to keep such resources insofar as possible in GSIB treasuries in their home counties, to reduce the risk of expropriation. Conversely, a high requirement might dissuade banks from building up the affiliates in such countries, to the detriment of competition and market development in such countries. Banks have long-standing experience in operating in international markets in the face of political risk and, with their home supervisors, seek to manage such risks without taking undue exposures, and without weakening their risk controls.

Group Issues

Regardless of what target percentage is set, but especially if the concept of a range is retained, it should be made clear that the target percentage of internal TLAC should be uniform within each group. Having different target percentages for different entities within a group would be incoherent from a regulatory point of view; would increase capital and liability management complexity for firms; and would tend to incite jurisdictions to ratchet up TLAC requirements, and thereby increase the risk of brittleness.

In addition, the final TLAC requirements should take into account the need to avoid doubling-up or double-counting requirements in ways not related to the attainment of TLAC goals.

See the discussion of TS Section 2 in the response to Question 17 regarding the role of certain internal funding vehicles.

In addition, there may be instances where funding is pre-positioned with material entities via an intermediate entity which has standalone capital requirements. Depending on the form of funding that is passed on to the material subsidiary, the intermediate legal entity will attract solo capital charges on its funding exposures to its material entities. Capital charges may be in the form of RWAs (large exposures and leverage would also be a consideration) or in the form of capital deductions depending on the instrument features.

The associations ask the FSB to consider how the internal TLAC rules will be integrated with applicable capital regulations and whether a waiver from intra-group capital requirements, large exposure rules and leverage ratio requirements would be appropriate for such internal TLAC exposures.

Certain jurisdictions have limits on related-party exposures. The interaction between such limits and the proposed internal TLAC requirements need to be considered, as they may limit the ability of banks to achieve the internal TLAC required under certain circumstances.

Guarantees

The option to use guarantees (including capital commitments) for part of the requirement is important to afford firms appropriate flexibility in their corporate-finance strategies, and to make provisions for different responses to different market conditions. TS Section 23 sets out generally appropriate, conservative criteria for collateralized guarantees, although, as discussed further below, the apparent requirement of collateral segregation guarantee-by-guarantee is unnecessarily conservative and would increase brittleness. Collateral backing the collateralized portion of guarantees should be allowed to be pooled at the group level (not allocated to specific subsidiaries), and eligible collateral should be defined broadly for TLAC purposes, not limited unnecessarily, for example, to central-bank eligible instruments.

The possible requirement (the text is ambiguous) that collateral be segregated for each collateralized guarantee for the benefit of a material subsidiary would, if confirmed, be unduly restrictive. G-SIBs should be permitted to hold collateral used to secure guarantee agreements in a single collateral pool. Requiring separate pools for each such agreement would be inefficient, and unnecessarily increase the brittleness resulting from prepositioning of internal TLAC, as further discussed in Question 5.

The last bullet of TS Section 23 suggests that collateral would be held at the parent level, but greater clarity that there are no restrictions as to how, or where, the collateral can be held would be helpful.

The effects of the immobilization of collateral backing such guarantees, which would apparently be excluded from High Quality Liquid Assets (HQLA) for liquidity purposes, need full analysis in the QIS.

Consideration should be given to allowing an appropriate part of the requirement to be met by capital commitments or unconditional, but uncollateralized, guarantees of the parent, with supervisory approval, including assurances from home authorities that such capital commitments or guarantees would be honored insofar as their approval might be required. Such guarantees, used in a reasonable proportion, and in conjunction with funded internal TLAC, can reduce brittleness while still supporting the key objectives of internal TLAC. Such instruments provide a clear mechanism for upstreaming losses and downstreaming capital, in line with entity governance requirements. This technique can also provide transparency and legal clarity to potentially nervous hosts about the home country's intentions. Lastly, it would provide a useful explanation to oversight bodies for the actions of a home supervisor; in some cases a home supervisor may be challenged for supporting offshore entities of a group, even if in the economic interest of the group. This problem can be much reduced by the presence of ex-ante legal commitments.

Particularly if a requirement at the higher end of the spectrum is imposed, an allowance for a portion of uncollateralized guarantees would provide the firm with additional beneficial flexibility.

As discussed in the first part of the response to this question, it may be that groups and their CMGs move toward such greater flexibility over time as more experience is gained through the process, and confidence is built in resolution planning and in coordination among the CMG participants.

Determination of Instruments Eligible for Inclusion in External TLAC

6. Are the eligibility criteria for TLAC as set out in the term sheet (Sections 8-17) appropriate?

Structured Notes

Structured notes should not be arbitrarily excluded from TLAC, as long as they satisfy all the requirements otherwise applicable to eligible TLAC instruments in the final framework; such as, unsecured status, minimum remaining maturity and effective subordination to operating liabilities, plus certain additional conditions designed to ensure that sufficient operational preparations have been made to make it feasible to write them down or convert them into equity at the point of entry into resolution.

Structured notes comprise an important source of unsecured funding for many G-SIBs, and can provide an additional source of loss-absorbing capacity. We estimate that G-SIBs currently have more than $500 billion in outstanding structured notes, based on a review of public sources.[22] Including structured notes in TLAC can add diversity and depth to the TLAC investor base beyond traditional equity and debt capital markets. Indeed, the market for structured notes can often provide access to unsecured term funding when issuance in benchmark debt capital markets is unattractive (or difficult to access). Including structured notes in eligible TLAC, will help ensure sufficient demand for TLAC.

Structured note obligations do not differ conceptually for resolution purposes from plain vanilla instruments that are hedged, such as fixed rate bonds swapped to a floating rate. Issuers of structured notes similarly use swaps to hedge their exposures on the structured notes. In both cases, unsecured claims on the notes can be converted into equity in resolution. The balance sheet impact

[22] This estimate is based on public disclosure by major G-SIB issuers, and analysis by Credit Suisse.

of bailing-in both types of obligations can be ascertained, especially if the additional conditions outlined below are satisfied.

Additional Conditions:

- Appropriate preparations, such as developing a system for determining the aggregate and individual amounts of claims under structured notes, should provide resolution authorities with the information they need to make a bail-in of structured notes just as effective and efficient as plain vanilla notes.

- In order to determine the amount of bail-in-able claims under structured notes in a timely manner for direct or bridge bail-in, G-SIBs must have a crisis-resistant system in place that can:

    - periodically produce a list of outstanding structured notes, including those treated as eligible TLAC,[23]

    - on a daily basis determine what the aggregate and individual amounts of claims would be against the issuer under the structured notes, including those treated as eligible TLAC, and how much capital would be generated by writing down such claims or converting them to equity, and

    - on a daily basis determine the net hedging positions on derivatives used to hedge the issuer's liabilities, including swaps against both vanilla notes and structured notes, so that any rebalancing after resolution can be accomplished easily and quickly.

- The amounts determined by this system will be the amounts used to calculate the amount of loss-absorbing capacity of structured notes included in TLAC.

    - In the case of principal protected structured notes, this amount would be the greater of (i) the fair value of the notes, adjusted for any issuer-specific credit value adjustment reflected in the fair value on the issuer's balance sheet, or (ii) any stated minimum amount payable upon early termination or entry into resolution.

    - In the case of structured notes that are not principal protected upon early termination or entry into resolution, this amount would be the fair value of the notes, adjusted for any issuer-specific credit value adjustment reflected in the fair value on the issuer's balance sheet.

- In order to ensure that it is operationally feasible to notify the holders of structured notes that their claims have been written down or converted into equity, how and when the amount of any equity to be delivered to them in satisfaction of their claims will be determined and delivered in a direct or bridge bail-in, and to actually deliver any such equity in a direct or bridge bail-in, structured notes included in TLAC must be held through a securities settlement system.

Supervisory Intervention

The requirement of TS Section 15 that firms obtain supervisory approval before eligible external TLAC can be redeemed is overly broad. The requirement that firms receive supervisory approval

[23] A resolution authority will want to know the total resources available to it at the point of non-viability, which will include both structured notes that are eligible TLAC and other structured notes that might no longer qualify, such as long-term structured notes that have remaining maturity of less than one year (or six months).

when redeeming eligible external TLAC (except when replacing eligible TLAC with liabilities of the same or better quality, and when the replacement is done at conditions which are sustainable for the income capacity of the bank) gives rise to a concern that institutions may be put in the position of constantly having to seek regulatory approval for ordinary course events (general retirements, calls, tender), even in relation to plain-vanilla debt.

Firms will not exercise an option to call debt if it brings them below required TLAC levels without regulatory consultation, and should not require supervisory approval if they would remain in compliance with TLAC requirements. Also, the decision to call debt is often highly market-dependent, and, therefore, not suitable to a supervisory approval process, which may last longer than the opportunity for a favorable call presents itself. The result could undermine prudent treasury-management techniques that support efficient and prudent funding structures.

The requirement that institutions have to maintain a specified amount of TLAC, coupled with the required terms of TLAC instruments, normal supervision already existing under national standards, and penalties for breach, should be sufficient to ensure that institutions are compliant with TLAC requirements, without adding an additional level of supervisory intervention.

In sum, the implication of the term sheet is extensive new requirements for supervisory approvals that would require regulators and resolution authorities, in effect, to establish shadow treasuries for each bank, and take on control and responsibility for firm balance sheets on a real-time basis that is unprecedented outside of conservatorship.

Maturity Requirements

In general, maturity restrictions should be very carefully conceived because they could create discontinuities in funding markets. While that problem can be addressed in part by the general statement in TS Section 11 covering oversight of the whole maturity profile, nevertheless, the effect of the current proposal would appear to incentivize banks to redeem funding with a residual maturity of less than one year. The effects thereof should be considered in connection with the market-impact analysis.

The associations suggest expanding the scope of qualifying instruments to debt issued with an original maturity of over one year having a remaining maturity of at least six months. This approach would make TLAC more manageable from a corporate finance point of view and would be congruent with the NSFR, without sacrificing significant loss absorbency.

Treatment of Tier 2 Instruments

Tier 2 capital is amortized in its last five years of existence – thus a tier 2 instrument with a face value of 100 and two years' residual maturity will contribute 40 to capital. However, the instrument would fully qualify as TLAC with a value of 100. It is important to be able to identify how such an instrument would contribute to meeting the overall TLAC requirement. In the associations' view, the appropriate treatment would be to provide that to the extent an instrument qualifies for capital, it should contribute to capital, and where any remainder qualifies for TLAC, it should be recognized as such.

Clarification for Redeemable Debt

The associations also ask the FSB to confirm their understanding that senior and subordinated debt that is redeemable at the issuer's option is included in eligible external TLAC and that the issuer's redemption right is not considered a "derivative-linked" feature that precludes inclusion under TS Section 12 (d).

7. **What considerations bear on the desirability of an expectation that a certain proportion of the common minimum Pillar 1 TLAC requirement consists of (i) tier 1 and tier 2 capital instruments in the form of debt plus (ii) other eligible TLAC that is not regulatory capital?**

The basic approach to TLAC, using going- and gone-concern resources, makes sense as a broad matter. It would, however, be helpful for the industry and the market to have a clearer exposition of the FSB's thinking of how the TLAC proposal combines going- and gone-concern resources functionally.

The "expectation" of 33% debt for external TLAC needs to be approached with due regard to the facts and circumstances of specific business models and capital structures. In the most usual situation, cost factors will in any case suggest using a substantial portion of debt in many structures, but this may not always be the case, so there should be no unnecessary restrictions on firms' flexibility in deciding on the appropriate funding mix for a given situation. It should be confirmed that the "expectation" is not to be considered a fixed-calibration requirement, but rather a point of reference for the authorities.

The implication of TS Section 7 that the 33% debt expectation would apply only at the consolidated group level, and not for internal TLAC (see the penultimate indent of TS Section 7) should be confirmed. Applying the 33% expectation at a subsidiary level would complicate corporate finance in groups unduly, and would lack some of the justification for such an expectation as part of external TLAC because it would not provide the monitoring benefit and market discipline that external debt would provide. There is also the risk that including the expectation for internal TLAC could increase the risk that it would become an unintended binding constraint that would not be appropriate or feasible in certain markets and circumstances.

Technical accounting distinctions of debt and equity should not be dispositive of the status of an instrument; rather, the analysis should be an independent TLAC analysis of how instruments would perform in a resolution.

High-Capital Firms

Certain highly capitalized firms are concerned that, as currently stated, the requirement sets up a conflict between prudential and resolution policies in that it would create incentives for them to reduce CET1 and increase reliance on debt, a result that seems odd in light of traditional prudential concepts and policies. This concern is particularly acute in EMEs with underdeveloped local capital markets, which make it less likely that adequate debt for TLAC purposes could be raised locally.

Similarly, for MPE entities and material subsidiaries, there will be cases where, for various business or regulatory reasons, it makes sense to maintain the entity on a highly capitalized basis rather than resorting to debt. This is the case, for example, for deposit-funded subsidiaries, often located in EMEs.

In such cases, or in cases where a firm can demonstrate that the TLAC principles are met (especially Principle 1 regarding sufficient loss absorbing and recapitalization), a 33% debt requirement would not be necessary and, again, it needs to be clear that the "expectation" would not need to be met in such cases.

It may be possible to design a means of meeting the loss-absorbency concerns behind the debt "expectation" by other means that would be workable for highly capitalized firms.[24] As with any resolution strategy, any such alternative would have to be discussed with the firm's CMG, and approved by the relevant regulators. In accordance with Principle 4, a high proportion of equity in the mix would be taken into account in deciding when to take action on recovery or resolution.

In any case where a materially different approach from the 33% expectation were to apply, there should of course be appropriate disclosure to the market about it, to be consistent with the intent of TS Section 24. In effect, this would be a "comply or explain" requirement, given that the generally agreed goal would be achieved, but by somewhat different means dictated by the facts and circumstances.

8. Are the conditions specified in the term sheet (Section 8) under which pre-funded commitments from industry-financed resolution funds to provide resolution funding contribute to TLAC appropriate?

Members directly affected consider the conditions stated for use of pre-funded, industry-financed resolution funds for resolution, including recapitalization as envisioned in the term sheet, generally appropriate.

FSB peer review should be designed to assure that the structures and mechanisms of such funds are designed to prevent moral hazard, and to maintain adequate resources for reasonably anticipated potential resolution needs.

A more explicit discussion of the rationale and limitations of the use of such funds (including the 2.5% cap) would assist both market understanding and future peer reviews.

It should be made clear that the term sheet does not advocate the extension of pre-funded resolution funds to additional countries. Many in the industry would consider extension of such funds in their countries counterproductive.

[24] As an example (and subject to further elaboration), an appropriate model might be for supervisors of a highly-capitalized firm to allow it to designate notional "buckets" of CET1, such that the second "bucket" would be available on the same basis as bail-in capital after conversion, after the first "bucket" is depleted to a given level. Before reaching that level, of course, supervisors would be able to observe the state of the firm's buffers and take any early-intervention action that would be required. If that level were reached, the consequences of a breach of Minimum TLAC requirements would kick in per TS Section 7 (presumably including change of management, restrictions on distribution, etc.) and, if dictated by the circumstances, full resolution might be initiated. The second "bucket" of capital would be present at the same amount as if debt had been converted pursuant to bail-in. This approach should be a matter of specific application in given circumstances; the issue for the final version of the TLAC proposal would simply be to make sure such solutions are not foreclosed. This approach would have much the same result as the basic bail-in approach (in fact, it would be easier because it would obviate "no-creditor-worse-off-than-in-liquidation" (NCWOL) and *pari-passu* issues), but would allow firms to choose a high-equity strategy for a given resolution entity, if it seemed appropriate for whatever business or regulatory purposes.

9. **Is the manner in which subordination of TLAC-eligible instruments to excluded liabilities is defined in the term sheet (Section 13) sufficient to provide certainty regarding the order in which creditors bear loss in resolution, and to avoid potentially successful legal challenges or compensation claims? Where there is scope for liabilities which are not subordinated to excluded liabilities to qualify for TLAC, are the transparency and disclosure requirements set out in section 13 and 24 sufficient to ensure that holders of these instruments would be aware of the risk that they will absorb losses prior to other equally ranking but excluded liabilities? If not, what additional requirements should be adopted?**

The associations agree with the aim of ensuring that TLAC in G-SIB groups will be credibly loss absorbing without causing financial instability. To that end, it is important to maintain and develop each of the three means to obtain subordination (contractual, structural, or statutory) where necessary,[25] to accommodate the different means of achieving this objective in different jurisdictions.

Non-Holding Company Structures

Significant issues of achieving subordination. The associations draw the attention of the FSB to the difficulties faced by banks that would be subject to both TLAC and to the European BRRD.

It needs to be borne in mind that, owing to existing group structures, meeting subordination requirements will have a significantly greater transitional impact on banks that do not currently have holding companies; moreover, there are significant legal and financial obstacles to putting in place new holding companies in several jurisdictions (and which vary by jurisdiction), including requirements to cash-out non-consenting shareholders or the like, which are sufficiently difficult that many banks consider a change of structure impossible or potentially destructive financially if attempted.

Structural subordination is, therefore, not currently available to the numerous European banks that are structured with an operating parent company, and those that do have holding companies have generally not issued significant amounts of debt from such structures.

Holding company structures are not a universal panacea for TLAC, and the possibility of replicating the same advantages as "clean" holding companies via special-purpose vehicle issuances should be specifically provided for in the TLAC standard. Certain firms in the US already use special-purpose funding vehicles to do some funding and some EU banks are also exploring how to use such means to achieve effective subordination, while satisfying legal concerns over priority and NCWOL, while also providing investors with appropriate transparency about the exposures of their investments. That avenue appears, however, to be blocked by the requirements of the current term sheet that issuance be out of resolution entities. In order for the industry to explore the possibilities of this approach, the impediments of the current draft must first be addressed. See also the discussion of TS Section 2 under Question 17.

Contractual subordination for European banks is also made particularly difficult by the wording of the BRRD, which defines contractual bail-in debt as being subordinated in insolvency to "eligible liabilities", which include some existing subordinated debt and legacy capital instruments. Many European banks also have covenants on their Tier 2 debt that prevent them from issuing any less-subordinated debt that would meet TLAC requirements.

[25] *See supra* responses to Question 6 with regard to not overstating the extent of subordination and to the discussion of structured notes.

Senior unsecured debt can, as the TLAC proposal stands, meet only a limited proportion of the overall requirement; many European banks will have access only to capital instruments as contractually qualifying TLAC liabilities (see the discussion of the allowance of non-subordinated liabilities below).

Statutory subordination is a potential way forward for European banks (and perhaps banks in other jurisdictions), which, given the difficulty of access to structural or contractual subordination, may need the authorities to consider such a solution for non-operating liabilities with original maturity of over one year. This would require a legal mechanism either at the EU level, via an amendment to the BRRD, or through national legislation, the feasibility of which is not fully established at this juncture. In-depth legal analysis and political commitment are definite pre-requisites.

In the current form of the TLAC wording, European banks, in general, consider that they are placed at a significant competitive disadvantage because few of the different avenues of subordination offered by the term sheet are open to them, or would be open only at considerable cost and difficulty in the current state of other legislation to which they are subject (notably the BRRD, European corporate law, and US and other listing rules). The timeframe for opening these avenues may not be compatible with the tentative implementation date for TLAC included in the term sheet. If efforts are not made to open avenues of subordination for European banks, including statutory subordination, there is a danger that European banks, notably those based on an operating company, may struggle to meet their TLAC requirements, particularly if the leverage ratio constraint were to be based on a possible increase of the Basel leverage ratio as discussed above.

Although these legal constraints are of course not results of the FSB's term sheet, the difficulties faced in the banking region that includes the greatest number of G-SIBs worldwide should be taken into account. The same issues come up in other jurisdictions, including some with mainly D-SIB banks, as well. The FSB should seek to work with the European authorities and other affected jurisdictions to find ways in which subordination can be more readily made available within the TLAC timeline as finally agreed.

When finalized, the points reflected in TS Section 13 should be drafted so as to remove any doubt that statutory subordination (including of some senior debt) provided by subsequent regulatory changes that allow firms to meet the test for eligible external TLAC to "absorb losses prior to excluded liabilities in insolvency or in resolution without giving rise to material risk of successful legal challenge or compensation claims" would be recognized as meeting the requirements. The current drafting has left some doubt as to whether subordination legislation or regulation subsequently adopted would satisfy the requirements.

Statutory subordination should be approached as a functional matter – "does it deliver the desired loss-absorbency?" – rather than imposing the currently stated terms as a rigid test.

As discussed further with respect to Question 13, the extent of the need for legal changes to assure statutory subordination where it would be the most significant means of achieving TLAC goals should be taken into account in defining the conformance period. The FSB should also do what it can to encourage those member jurisdictions that intend to implement TLAC using a statutory approach, to provide clarity on their intention to do so in a timely way to help mitigate the "announcement effect" of the final TLAC term sheet and principles.

Allowance of non-subordinated liabilities. The rationale for the 2.5% allowance of non-subordinated liabilities is not stated, but that limitation should be tested as part of the QIS process, examining both the legal and the economic requirements stated in TS Section 13. Whether 2.5% is an appropriate level for an allowance will depend in part on the amount of non-TLAC, but bail-inable obligations among a firm's liabilities. What liabilities are excluded is a matter that is generally an

important focus of a group's resolution plan, which would presumably assess the effective loss-absorbing capacity of the firm's liability structure, and the application of such limitations should be consistent with the resolution plan.

If an appropriate mix of bail-inable, TLAC-eligible, and non-bail-inable obligations is maintained, and the relevant resolution authority determines that the stated conditions are met, the most important legal risk, *viz.* claims resulting from failure to meet the NCWOL test, will have been obviated because losses would have to be spread among sufficient bail-inable liabilities, including TLAC, so that the chances of failing the NCWOL test (which is generally remote in any case) would be minimal.

Conversely, certain provisions, such as the 2.5% allowance for non-subordinated liabilities in TS Section 13 will not be available to foreign banks in the affected countries. Such differential impacts should be considered in the QIS and impact studies, and taken into account in establishing the final compliance timeline, and in calibrating the final TLAC requirements, including internal TLAC requirements as relevant.

Holding Companies

A significant technical issue exists for the intended use of structural subordination via holding companies because of failure to allow for normal functional liabilities that any company must have.

The definition of excluded liabilities in TS Section 12 includes liabilities that are funded directly by the issuer or a related party; swap liabilities; tax liabilities; and any other liabilities that cannot be effectively written down. TS Section 13 requires that "TLAC eligible liabilities [may not be] *pari passu* or senior to *any* excluded liabilities" [emphasis added]. In practice, if not amended, this would effectively preclude any reliance on structural subordination because it is impossible to run a holding company that does not have some excluded liabilities, for example:

Any typical holding company would be subject to tax liabilities or liens, which generally rank as senior liabilities, but would often be preferred or *pari passu* in liquidation. In some countries, administrators' or vendors' claims in resolution may also be preferred.

The current version would prohibit normal internal hedging transactions for a holding company's own debt, including internal swaps. Market making in a holding company's own equity or debt would be prevented (because such liabilities would be funded by a related party subsidiary).[26] While there is a legitimate concern about reduction of bail-in capacity this could be handled by a system of limits or internal TLAC offsets.

The stark language of "any other liabilities that cannot be effectively written down" raises a question – are there other liabilities that would be caught, and how would that be determined? Could this relate to contingent liabilities, litigation claims, etc.? The answers may be variable and unpredictable across jurisdictions.

Toward a Better Approach for Holding Companies

The associations do not believe that it was the intent to undermine the holding company model of bail-in, which provides for good segregation via structural subordination of bail-inable debt to operating liabilities. Rather, the goals were to ensure that bail-in liabilities are externally held so that a write-down of holding company liabilities provides effective recapitalization or resolution

[26] *See infra* responses to Question 12 for a more detailed discussion on market-making.

resources, and would not erode the resources of, for example, a subsidiary holding such assets; ensure that operating liabilities, such as demand deposits or supporting critical functions are not disrupted to any material extent; to avoid NCWOL issues or exposing the resolution calculation to extensive setoff or priority problems; and to avoid the prospect that resolution might encourage the acceleration of claims.

The associations believe that procedures can be established to assure that a holding company can deliver structural subordination of major financing liabilities while functioning in a normal manner. The goal would be to remove the "poison pill" effect of the current version, which would invalidate TLAC if even a penny (or cent) of *pari-passu* obligations existed.

A simple solution could be to forbid major critical customer functions from being housed in the holding company (which would be in line with general practice in any case), but to allow a reasonable, modest amount of *pari-passu* liabilities as follows, subject to a materiality constraint. External lending to non-group third-parties out of the holding company should be strictly limited (to ensure no set-off issues, (assuming that internal TLAC would not be subject to set-off issues because to count as TLAC the instrument must contain a waiver of set-off rights (TS Section 14)).

For example swaps hedging the firm's own debt should be allowed to be entered into or guaranteed by a holding company *pari passu* with its external TLAC, unlike large dealer-type swap books.[27]

Internal derivatives (i.e. not street facing) should also be allowed to enable a holding company to hedge its interest rate and currency risk from debt issuance via appropriate subsidiaries, without needing to face the market itself.

Any tax liability and open-ended "other liability items" should be dropped from the list of exclusions, as long as these did not become so large as to create an NCWOL issue.

Intra-company holdings of TLAC should not be excluded, but should be deducted from external TLAC, with an exemption for a reasonable amount of market-making positions by a subsidiary. External issuances via funding vehicles should also be permitted.

Rules along the lines of the foregoing would allow appropriate management of a reasonably "clean" operating company, without creating unmanageable expectations or creating serious NCWOL risk.

A simpler alternative for holding companies would be to define a safe harbor that would allow for a reasonable *de-minimis* allowance of NTNE and "Administrative Liabilities" as defined for purposes of part II of this response. Presumably the safe harbour would be subject to home-country agency, CMG, and supervisory review and testing against the general loss-absorbency standard. If need be, an overall cap of, say 10% of liabilities could be defined as part of the TLAC standard, although, *a priori*, leaving the administration of the safe harbor to the home country and the CMG might be preferable to assure that the results are appropriate in all cases.

As the question suggests, where the "exceptional circumstances" to include liabilities that are not subordinated exist, there should be sufficient disclosure, consistent with general disclosure principles, for investors to understand how TLAC is being determined for the relevant institution.

[27] Derivatives that a holding company enters into or guarantees as an end user to hedge the interest rate, currency, and other risks arising out of its activities should be allowed to be *pari passu* with external TLAC. Such derivatives are significantly less likely than derivatives held in dealer books to result in a large-scale, disorderly termination that would impair the financial stability of the company or the broader financial markets, particularly in light of post-crisis reforms such as enhanced margin requirements and mandatory clearing of most swaps through CCPs.

Interaction with Regulatory Capital Requirements and Consequence of Breaches of TLAC

10. Do you agree that the TLAC requirement for G-SIBs should be integrated with Basel III such that the minimum TLAC requirement should be met first, and only after TLAC is met should any surplus common equity tier 1 (CET1) be available to meet the Basel III buffers?

The associations would appreciate confirmation of how Basel III and TLAC requirements work together. The interpretation of TS Section 4 is that the Minimum TLAC requirement would be calculated including in such calculation, RWAs under Basel III requirements, but excluding from the calculation applicable regulatory capital buffers, whether imposed by Basel III or otherwise.[28] Buffers are said to "sit on top of" TLAC, meaning that a bank would have to maintain TLAC at all times, but usage of buffers would not cause a violation of TLAC requirements.

Subject to the comments above regarding the leverage ratio and possible future changes of both the leverage ratio and RWAs for capital purposes, the general approach taken appears appropriate (if confirmed as stated above). It makes sense that buffers ought to be able to be used without risk of a TLAC violation, which could itself have dramatic market consequences, especially as TS Section 7 says that breach must be treated "as seriously as a breach, or likely breach, of minimum regulatory capital requirements."

Triggers

The statement in TS Section 7 that "a breach, or likely breach, of the Minimum TLAC requirement should ordinarily be treated by supervisory and resolution authorities as seriously as a breach, or likely breach, of minimum regulatory capital requirements" needs further explanation. On its own, the statement carries an implication of severity that the associations believe is beyond the FSB's intention. This apparently strict standard and its relationship to Principle 10 need to be clarified.

In order to analyze the impact of the proposal it is necessary to be able to understand the interaction between a breach of TLAC and Point of Non-Viability (PONV) accurately. Could a solvent bank with lots of capital be thrown into resolution because of a formal failure to meet the TLAC requirement (including the 33% debt component)?

Given that a breach of the TLAC requirements could occur well in advance of actual insolvency, especially as such a breach under some circumstances could be simply a technical misalignment, and not a sign of fundamental problems, it is appropriate that the TLAC proposal does not set an automatic trigger for recovery or resolution action. Conversely, the industry needs to understand better the intent of the FSB as to what happens when TLAC is breached, especially at a point where a firm is still substantially solvent, and not at or near the point of non-viability, even if the TLAC requirements are not met.

More guidance should be provided to indicate that regulators would work with the affected firm to resolve the issue, including by pre-resolution reorganization or recapitalization, and that only if the firm appeared unable to be recapitalized outside of resolution should additional actions be considered (which, of course, would be affected by the speed of events, and market conditions).

The buy-side will surely want more predictability on these issues, to understand more clearly the circumstances under which contractual or statutory conversion or write-off clauses would be triggered by the resolution authorities.

[28] Although this seems to be the most likely interpretation, TS Section 4, third indent uses the phrase "TLAC, including combined capital buffers", whereas the second indent says "This does not include any applicable regulatory capital buffers."

Triggers in Instruments

Contractual or statutory triggers of the write-down or write-off of TLAC instruments are to be determined by the relevant resolution authority. The goal is to permit the resolution authority to expose TLAC to loss or to convert to equity *in resolution*. However, as discussed above, under certain circumstances, a firm could be in technical violation of TLAC without necessarily being at or near the point of non-viability. The associations agree with the wisdom of avoiding "hard TLAC triggers" of resolution. More explanation and guidance for authorities will be essential to help the market understand and deem credible the new requirements, and to price instruments subject to write-down or conversion as TLAC, as discussed with respect to TS Section 7 above.

Clarification

The language would be clearer if TS Section 7 read, "only CET1 in excess of 1) that which is required to satisfy minimum regulatory requirements and 2) that, if any, which an institution must allocate to TLAC in order to meet is Minimum TLAC requirement, may count toward regulatory capital buffers."

This would remove a potential ambiguity in the present wording "only CET1 in excess of that required to satisfy minimum capital requirements and Minimum TLAC requirements may count towards regulatory capital buffers", which many have found confusing as to how the buffer requirements fit in. This is intended to clarify the intended relationship between TLAC and buffers, or that any erosion of CET1 would be allocated to buffers first.

Transparency

11. What disclosures (in particular in terms of the amount, nature and maturity of liabilities within each rank of the insolvency creditor hierarchy) should be required by resolution entities and material subsidiaries to ensure that the order and quantum of loss absorption in insolvency and resolution is clear to investors and other market participants?

The associations support appropriate transparency of TLAC, with standards to be developed as indicated in TS Section 24. It will be essential for the market to have a clear understanding of the potential exposures of investors in external TLAC instruments.

The industry is working hard to continue to improve its disclosures generally, and substantial progress has already been made, both by individual banks' efforts and through implementation of the Enhanced Disclosure Task Force (EDTF) recommendations. A number of significant changes of disclosure requirements are in the offing, notably related to phases 1 and 2 of the revision of Basel Pillar 3, and to the revision of disclosure requirements by the accounting standard setters, both IASB (International Accounting Standards Board) and FASB (Financial Accounting Standards Board).

While the term sheet indicates the intent to work with the BCBS on TLAC-specific disclosures, which is good, it is important to keep in mind the significant amount of disclosures that banks are, and will be required to, make, and to assure that any additional TLAC disclosure requirements are well integrated with the overall suite of disclosures that banks make. Additional stove-piped disclosures are likely to contribute more to complexity than to clarity. If additional requirements are required (TLAC is likely to be required to be disclosed under existing requirements), every effort should be made to integrate such disclosure with existing requirements.

Except where sub-group resolution entities or material subsidiaries are themselves public issuers of securities, it is not obvious why they should be required to make separate disclosures of internal TLAC issues, as the last two indents of TS Section 24 seem to indicate.

In fleshing out the disclosure requirements of TS Section 24, the BCBS should avoid multiplying disclosures unnecessarily. For example, where the issuance documents of a given TLAC instrument describe subordination, and other TLAC-related features for the benefit of investors, additional disclosures are unlikely to be required. Consideration should be given to working with the EDTF to develop recommendations based on input from all stakeholders.

A further point of concern for banks is that, taken too far, the language in TS Section 24 could imply disclosure of more detail on "living wills" than is otherwise required to be disclosed. TLAC disclosures should not be allowed to modify the existing disclosure requirements for recovery and resolution planning, many aspects of which are sensitive, and appropriately kept confidential for commercial and prudential reasons.

Achieving full transparency will require banks and CMGs to reach consensus on the TLAC characteristics and bail-in-ability of available instruments. Ambiguities or extra conservatism added by Pillar 2, for example, may complicate banks' disclosure, and, more importantly, the market's understanding of, and interest in, TLAC instruments.

If, at the time of bail-in, the specific instruments written down or converted by the resolution authority differ materially from those previously disclosed as TLAC, the market will be surprised, and the reaction may affect both the specific resolution and the market as a whole unpredictably, increasing market stress. While resolution authorities need appropriate flexibility to respond do specific situations, every effort should be made to ensure that a consensus is reached on TLAC qualification of a group's funding instruments ex-ante, and this should be reflected in appropriate disclosures.

Limitation of Contagion

12. What restrictions on the holdings of TLAC are appropriate to avoid the risk of contagion should those liabilities be exposed to loss in resolution?

While the reasons for restrictions of cross-holdings among G-SIBs are understood, concerns about risks of contagion need to be balanced against the need to develop and maintain broad, deep, and diversified markets for TLAC instruments. For this reason, care should be taken not to restrict the ownership of TLAC instruments any more than is strictly necessary for systemic-risk concerns. For example, a D-SIB's holding of a well-balanced book of G-SIB TLAC paper within normal prudential and risk limits should not be of great concern: this is not implicated by the term sheet in its present form, but the point is that a broad and deep market is essential.

Current industry estimates indicate that the volume of instruments in the market that will be subject to the TLAC requirements amount to around US$ 4 trillion in total. Given the extent of the existing and new issuance that will be affected, making sure that broad, diverse, deep and liquid markets will not be impeded by the design of TLAC is essential.

A large-exposures solution? Looking at the problem as between G-SIBs broadly, there is an obvious question of why existing large-exposures limitations should not be sufficient to meet the concern about contagion that would arise if large amounts of TLAC instruments were held by other G-SIBs.[29] Consideration could also be given to the allowance of some holdings subject to requirements of geographic dispersion (to avoid excessive cross-holdings in a given country), or to differentiating

[29] The final standard on large exposures issued by the BCBS in April 2014 while imposing a general 25% limit on a bank's exposures to a single counterparty or group of connected counterparties, imposes a much tougher limit of 15% on a G-SIB's exposures to another G-SIB. *See* BCBS, *Supervisory Framework For Measuring And Controlling Large Exposures*, ¶ 16 (2014), available at http://www.bis.org/publ/bcbs283.pdf.

requirements for D-SIBs to allow them more leeway than G-SIBs. Such requirements would add some flexibility to the development of markets for TLAC-eligible paper, without materially increasing contagion risk.

Market-making and underwriting. TS Section 18 by its terms would require banks to deduct inventory held for market-making, as opposed to investment. It further makes no explicit allowance for underwriting TLAC instruments, unlike Basel III, which does have an exemption for underwriting.[30] The associations urge that the FSB provide an exception for market-making and underwriting, and include in the QIS an analysis of what the absence of such an exception would mean for the market. If, as is likely, such a deduction made it uneconomical for dealers to underwrite or make a market in TLAC instruments (indicating that such debt, therefore, could not trade efficiently after issuance), the costs and difficulty of issuance could rise significantly. Of equal significance would be the likely further reduction of liquidity in many markets, which is at least in part related to new bank capital, leverage, liquidity, and structural requirements, as noted in several official-sector statements.[31] This issue should definitely be part of the market-impact assessment that is planned.

While the definition of market-making has been vexing for US Dodd-Frank purposes and the EU is likely to face the same definitional issue in 2015, the industry's urgent concern about the need for vibrant market-making and underwriting is nonetheless valid. It is possible that a market-making and underwriting exception for TLAC purposes could refer to such regulations created for other purposes.

Purchases as agent, asset manager or custodian for clients. In many instances G-SIBs or their custodial, trust, or asset-management affiliates hold extensive portfolios of securities on behalf of other entities, asset-management companies, and other third parties under terms and conditions whereby the G-SIB does not take beneficial ownership (or the equivalent under local law) over the assets so held on behalf of others. Such assets may be held in a number of ways, often through multi-tiered custody arrangements. Because beneficial ownership is retained by third parties, the purposes of the restriction are not implicated. In addition, such custodial and asset-management arrangements are vital to the efficient functioning of markets. The associations assume that it was not the FSB's intent that such holdings should be affected by the proposed restrictions on holding of TLAC but it would be helpful to confirm the point expressly.

Very short holdings. By analogy to Paragraph 84 of the Basel III framework,[32] it would be appropriate to exempt a position held for five days or less, whether for underwriting or day-to-day trading purposes (to the extent permissible under local proprietary-trading or other such regulations). A true market-making exemption should not be limited to five days' holding, but a market-making exemption could be built on top of a five-day exemption, with a requirement to demonstrate that inventory of TLAC instruments held over five days reflected market conditions and legitimate market-making intent.

A de-minimis threshold. The term sheet requires G-SIBs to deduct from their own TLAC exposures to external TLAC liabilities of other groups, which is parallel to the similar financial institutions deduction requirement in Basel III.[33] The associations recommend that the FSB establish a deduction

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[30] Compare FSB, *supra* note 2 at 18 with BCBS, *BASEL III: A Global Regulatory Framework For More Resilient Banks And Banking Systems* ¶¶ 80, 84 (rev. ed. 2011), available at http://www.bis.org/publ/bcbs189.pdf.

[31] *See*, e.g., Mark Carney, *supra* note 14; Guy Debelle, "Volatility and Market Pricing", Speech at Citi's Sixth Annual Australian and New Zealand Investment Conference, Sydney, October 1, 2014; Committee on the Global Financial System, *"Market Making and Proprietary Trading: Industry Trends, Drivers and Policy Implications"*, at 1 (November 2014).

[32] *See* BCBS, *supra* note 30, ¶ 84.

[33] *See* BCBS, *supra* note 30, ¶¶ 80-88.

for G-SIB TLAC liabilities, that would be similar to, but operationally distinct from, the existing Basel III deduction, to ensure that debt holdings do not affect existing capital ratios.

In line with Basel III, the FSB should establish a threshold for TLAC deductions; however, debt holdings should preferably be subject to a separate threshold from that for equity deductions, or if aggregated with capital instruments of financial institutions, the threshold should be recalibrated as a percentage of total TLAC. The Basel III financial institutions deductions, including the calibration of the ten percent CET1 thresholds, are the result of a comment process that did not contemplate the potential inclusion of unsecured debt or corollary impacts on debt capital markets. If TLAC liabilities were simply added to existing non-significant holdings in other financial institutions, the corresponding deduction approach would enable an incremental euro of debt to cause a deduction from a bank's common equity ratio. A separate, specifically tailored deduction, and threshold calibration for TLAC purposes is warranted.

Impact Analysis

The FSB's market-impact analysis and QIS should gather data regarding the impact of limitations of holdings of TLAC instruments on the overall market for TLAC instruments; taking into account the fact that G-SIB TLAC instruments will be competing with each other, with instruments of other financial institutions, and with instruments of other large debt issuers. Such analysis should also cover the lack of a market-making and underwriting exemption, unless that problem is corrected.

Conformance Period

13. Should G-SIBs be required to conform with these requirements from 1 January 2019? Why or why not? What, within the range of 12 to 36 months following the identification as a G-SIB, should be the conformance period for banks identified as G-SIBs at a future date?

While banks are likely to be pushed by the market to start to meet the requirements well in advance of the official deadline, the official date is still highly important, and will have some effect on market expectations. The market-impact study should consider this question and, given the effects of the restructuring of the entire corporate debt market implied, may well conclude that a later starting date would be prudent. This would be all the more appropriate if a final TLAC requirement at the higher end of the spectrum were decided upon, contrary to industry advice.

Furthermore, the market-impact analysis should consider the market impact of D-SIBs' anticipating having to comply with similar rules in the future, and EU banks' of all sizes preparing for compliance with MREL. Beyond regulatory requirements, there is the further likelihood that the market will push *all* banks to meet something like these standards, further compounding market effects.

Regardless of where the final deadline is established, it would make sense for the requirements to be phased-in over time (again, the details to be informed by the market-impact study and the QIS). For example, a schedule of phasing-in the TLAC requirements pro-rata over a reasonable period to be determined by market analysis from the start date, would give banks an appropriate amount of time to restructure their liabilities, and to adjust to resultant market changes in an orderly manner, minimizing market disruption (especially in smaller markets).

As discussed in the answer to Question 9 with respect to non-holding company structures, in some jurisdictions it may be necessary to obtain statutory changes to make feasible the extent of subordination required by the term sheet. The time necessary to complete such legislative changes (which will affect a large number of G-SIBs, and the time required for refinancing the debt stack with qualifying TLAC) should be considered when setting the final conformance date.

Once the framework is finalized, the conformance period should be no less than 36 months later. It will be difficult for banks to issue TLAC-compliant instruments before the framework is closed and such a minimum period is required to bring funding structures into compliance.

It should be made clear that the conformance period applies to internal TLAC for material subsidiaries as well as external TLAC.

Market Impact and Other Aspects

14. How far is the TLAC proposal, if implemented as proposed, likely to achieve the objective of providing sufficient loss-absorbing and recapitalization capacity to promote the orderly resolution of G-SIBs?

The industry has long accepted the need for LAC conceptually. It is critical to eliminating the fear of TBTF, and assuring confidence in orderly resolution. Subject to the comments in this letter as to many details, the TLAC proposal should achieve its goals if appropriately modified and implemented.[34]

15. What will be the impact on G-SIB's overall funding costs of the adoption of a Pillar 1 Minimum TLAC requirement?

As indicated in Part III of these comments, the industry attaches the highest importance to the full range of impact analysis that the FSB has planned.

Microeconomic QIS. The new requirements will almost certainly raise bank funding costs – probably not just for G-SIBs – and such increase can be expected to have fallout effects on real-economy financing costs, which should be examined closely in the QIS. Pending the QIS and market-impact analyses, it is difficult to assess potential funding costs with accuracy given many open questions associated with the proposal, including of course the size of the Pillar 1 requirement, the potential for Pillar 2, eligibility of existing core long-term debt instruments such as senior debt, whether any categories of instruments such as structured notes are excluded, and the feasibility and cost associated with restructuring of ineligible instruments. As noted above, the implementation schedule would have a substantial impact on the latter factors.

Market impacts. Furthermore the QIS question of funding-cost impact on G-SIBs cannot be dissociated from the market-impact analysis. This is, in part, because G-SIBs, EU banks of all sorts seeking to meet MREL requirements, and (probably) D-SIBs from other markets will all be competing for the finite supply of investment funds on offer. Banks of all sizes will also be competing with other large debt issuers.

In addition, it is essential to focus on the fact that there is not one, single market for TLAC-type paper. Different investor types focus on different parts of the market. For example, investors for Tier 2 instruments have historically been more limited than, and clearly distinguishable from, investors in senior debt, and investors in equity. If significant tranches of instrument issuance, such as structured notes, are excluded from TLAC, that would also exclude a significant source of investment supply and add pressure on other markets. It cannot be overstated that a wide, deep, and liquid market

[34] *See*, e.g., IIF, Cross-Border Resolution Working Group, *Achieving Bank Resolution In Practice: Are We Nearly There Yet?* 4 (2014), available at https://www.iif.com/news/achieving-bank-resolution-practice-are-we-nearly-there-yet; IIF, *Making Resolution Robust- Completing The Legal And Institutional Frameworks For Effective Cross-Border Resolution Of Financial Institutions* (2012), available at https://www.iif.com/publication/iif-proposes-key-steps-strengthen-cross-border-resolution-major-multinational-banks; see also, IIF / GFMA, *supra* note 4.

with diversified investor participation will be essential to absorb the size of TLAC issuances that will be required.

See the response to Question 9 regarding the importance of not impeding underwriting and market making.

Whether the market judges that sufficient clarity about bail-in risks has been achieved will also affect costs. This is likely to vary from market to market; whereas there is considerable evidence bail-in risk has already been priced in for US issuers, the same may not be true in other markets. These changes are indicated, in some cases, by changes of rating agencies' assessments regarding the application of sovereign ratings uplifts, which, however, tend to lag market perceptions.

The interactions of substantial issuances to meet TLAC and MREL requirements need to be assessed against the needs of corporate, sovereign, and infrastructure issuers at the same time, especially if (as is widely discussed) the European economy is able to move toward more non-bank financing.

While investors have concerns about bail-in risk, bank paper may, in many cases, still be more attractive than that of many other issuers (both for risk reasons and because bail-in risk may raise the yield on bank paper). Thus, the effects of the volumes of issuance likely from banks need to be looked at not just from the perspective of banks' funding needs, but from the perspective of their effects on the overall corporate bond market, and likely effects on the pricing of other corporate bonds. (These considerations may, at the very least, suggest a longer phasing-in period, and they should incorporate the financial-stability vs. real-economy finance balancing that will have to be done.)

See also the responses to Questions 10 and 16.

16. What will be the impact on the financial system and its ability to provide financing to the real economy?

This is a fundamental question for the macro QIS and market-impact analyses. Many banks and local associations are looking into the question and will have views. At this stage, the associations have not done the extensive economic analysis that would be required to answer this question with any degree of authority.

However, as the FSB's own discussion indicates, among the issues that need to be considered are the impact on shareholder returns of new levels of funding, and new funding mixes.[35] Such impacts are likely to be very uneven across business models and across firms, so the QIS will need to take a highly nuanced view of its assessment.[36]

One effect that seems quite likely is that, especially in markets where the need to change funding mixes will change the more, TLAC requirements will give further impetus to the shift to non-bank funding. That likely outcome needs to be weighed, however, against the fact that large amounts of bank funding will affect the overall bond market, as discussed above, given the potential for market competition between bank and other corporate issuance.

[35] *See generally*, FSB, *supra* note 2 at 8, which recognizes that in response to the proposed minimum TLAC requirements "G-SIBs may pass on a share of their higher funding costs to their clients, prompting a shift of banking activities to other banks without necessarily reducing the amount of activity."

[36] *See supra* responses to Question 9 and accompanying text for further discussion on the likely difficulties faced by both holding and non-holding companies as a result of proposed TLAC requirements.

Under certain circumstances, the prospect of locking up resources in more marginal or less stable markets could also dissuade global banks from participation in such markets, with ultimately detrimental effects on such markets, and on the global market that the FSB and G20 are committed to defending. Conversely, high internal TLAC requirements may also have unpredictable effects on pricing and competition in such markets.

As discussed with regard to Question 5, the proposals for internal TLAC create a real danger of increasing the "brittleness" of groups unless moderated to the amount actually necessary to comfort hosts, and no more, and implemented flexibly. However brittleness is not just an issue for the profitability or financial efficiency of groups from a microeconomic perspective: it is more importantly a significant issue at the macroeconomic and macroprudential levels.

The loss of efficiency that groups would suffer the more their internal resources are ring-fenced in particular subsidiaries and jurisdictions would contribute to what many observers already see as a significant regulatory fragmentation of the market. Fragmentation in turn will lessen the resilience of the system as well as of specific groups because it will impede effective response to problems in different jurisdictions. Fragmentation will also lower the performance of the international financial system in support of a vibrant and growing global economy because of the inefficiency in allocation of capital and other resources. As such, fragmentation resulting from excessive pre-positioning requirements would contradict one of the major G20 goals as reiterated since 2009.

Consideration should also be given to competitive equity and the preservation of the important principle of national treatment, especially if significant discrepancies arise between local institutions and subsidiaries of global banks.

See also the discussion of Question 1.

Broader market impacts. The discussion of the "impact of the proposal on the financial system and the real economy" in the "Overview" preceding the termsheet, notes that the FSB intends to assess the *macro*economic impacts of the TLAC proposal, as well as the effects on firms and markets. This is appropriate, although that discussion seems somewhat to prejudge the issues. Some initial suggestions as to approaching this part of the impact assessment follow.

First, in assessing the macro effects of the proposals, it will be important to consider the potential for material increase in the cost of issuance for all corporate borrowers. To the extent that G-SIBs are issuing high volumes of debt, and required to maintain high capital and liquidity levels, it seems unlikely that the market would accept lower coupons from similarly rated corporate issuers. This effect will increase with the volume of G-SIB (and, as discussed below, D-SIB) issuance.

Second, the TLAC requirement is likely to have a significant impact on the market for debt under one year (particularly if the suggestion to count as TLAC debt originally issued for over one year with at least six months' remaining maturity is not adopted). Banks are already under significant market regulatory constraints from the Liquidity Coverage Ratio (LCR), NSFR and leverage ratio to avoid issuing debt under one year. There are already indications in the US market that the absence of short-term paper is already having an effect on money-market funds as supply has diminished significantly. Therefore, the QIS should consider the cumulative effects of TLAC with other regulations on the yield curve within one year to determine the costs of such effects.

17. Do you have any comments on any other aspects of the proposals?

The following comments on specific Sections of the term sheet do not seem to fit comfortably in the questions as posed; therefore, they are addressed separately here.

TS Section 1: Scope of Covered Firms

The associations endorse the focus of requirements on G-SIBs only; however, in a number of dimensions, attention must be paid to D-SIBs and other institutions as well (as mentioned at various points in response to the questions):

- The final rules should not create undue competitive advantages for D-SIBs or other firms (or for G-SIBs).

- The QIS and market-impact studies should take into account the fact that D-SIBs, at least in some countries, are likely to be submitted to similar requirements, and, thus, will be competing in the market for TLAC instruments accordingly.

- The liquidity, depth, and breadth of the market for G-SIB TLAC paper should not be constrained more than strictly necessary; therefore, other financial institutions should not be restricted from holding G-SIB TLAC instruments: large-exposures and other existing prudential regulations already provide sufficient brakes on inter-connectedness.

TS Section 2: Minimum External TLAC Requirement

Application to Each Resolution Entity within Each G-SIB

The FSB proposal provides that a G-SIB may have more than one "resolution entity," which is an entity "to which resolution tools will be applied in accordance with the resolution strategy for the G-SIB." The proposal further provides that a resolution entity may be a parent or subsidiary operating company, or an ultimate, or intermediate holding company. Finally, the proposal provides that ***each*** resolution entity will be subject to the minimum external TLAC requirement.

In some structures, a holding company (or other group entity) guarantees the long-term debt issued by one or more funding companies that have no operations other than issuing debt, but may be considered resolution entities because they are allowed to fail under the G-SIB's resolution plan. Such guarantees may be provided *pari passu* with the holding company's own long-term debt. Under these circumstances, long-term debt issued by the funding company absorbs losses of the holding company or other relevant company on a *pari-passu* basis with debt issued by the relevant company.

A funding company that issues debt guaranteed by the holding company or another group company on a *pari-passu* basis, and that has no operations other than the issuance of debt, should not be considered a "resolution entity" separate from the holding company or relevant company that is the beneficiary of its funding operations. In other words, debt of a funding company that has no operations other than issuance of debt should not be treated as ineligible TLAC because the funding company is a party related to the resolution entity. Alternatively, if such a funding company were considered a resolution entity, it should not be required to meet a minimum external TLAC requirement separate from the holding company or other relevant company. To the contrary, TLAC-eligible debt issued by such a funding company should count toward the minimum external TLAC requirement of the holding company or other relevant company, and there should be no separate TLAC requirement for such a funding company.

See also the comments on TS Section 9 below.

Invariance

The intent of the statement "A G-SIB's Minimum TLAC requirement should be invariant to whether it has one or more than one resolution entities" is not understood. Clarification is needed as to what is the relevant scope for calculating the TLAC external requirement, especially for MPE groups, which are likely to be composed of two or more resolution entities or resolution (sub)groups. How can a G-SIB's minimum TLAC be invariant to the number of resolution entities, but still be calibrated on its RWAs? Because of consolidation effects (including the practical need to maintain buffers over the minimum for purposes of prudent risk management), it is not clear how the goal of "invariance" could be met if the present term sheet were to be implemented as proposed.

If an MPE bank group can demonstrate that its total TLAC requirement is greater than the requirement which would have applied had it been an SPE bank, what mechanism is proposed to reduce TLAC requirements in which entities in order to achieve this result?

Conversely, how could an SPE bank with multiple material entities be assured that its TLAC would not be greater than if it had been an MPE entity?

MPE Issues

The associations understand that, for MPE groups, TS Section 2 may be interpreted in such a way that the minimum TLAC requirement would be set in relation to the consolidated balance sheet of each *resolution group*, but that no such a requirement would be imposed for the overall group taken as a whole.[37] This interpretation needs to be clarified.

Even if the requirement is established at the level of each resolution group within an overall group, the QIS should evaluate whether the resulting aggregate requirement at the level of the group as a whole is appropriate, or whether the sum of the individual resolution group requirements is inappropriately high.

See also the discussion of general MPE concerns in Part II of this document, above.

SPE Issues

Regardless of the interpretation for MPE groups, there remains the problem that consolidation of internal TLAC is likely to multiply aggregate TLAC requirements for SPE Groups, which seems contrary to the somewhat opaque statement about TLAC being "invariant as to whether [a G-SIB] has one or more than one resolution entities."

Although the FSB's intent appears to be that aggregate TLAC of multiple material subsidiaries should not exceed the group TLAC requirement where the top company is an SPE resolution group, the industry is entirely convinced that aggregate group TLAC requirements will be substantially increased over what stand-alone requirements would be for such groups, to the detriment of their financial flexibility and capacity to provide credit to the real economy.

This point is discussed in the response to Question 5, and will certainly be an issue, especially if internal TLAC is set at the higher end of the proposed range.

[37] *See* FSB, *supra* note 2, at 13.

TS Section 9: Issuer

The requirement of TS Section 9 that external TLAC should be issued by resolution entities, seems to invalidate some useful funding strategies, although there is no apparent resolution-related reason why such strategies should be restricted. See the response regarding TS Section 2 for the role of certain funding companies.

In addition, a bank with some form of MPE strategy may issue TLAC externally under a single brand name, for the group (as is commonly the case for equity). The TLAC would then be downstreamed to its resolution entities as needed to satisfy the local external TLAC requirements (i.e. the full, external requirement, not the internal TLAC requirement). As would be clear from its resolution strategy, there would be no presumption of further support (although of course further support might be provided by the parent depending on the facts and circumstances). This approach should be permissible, and would meet all TLAC-related goals, but seems to be prohibited by the language of TS Section 9.

With respect to the third paragraph: for Tier 2 instruments with time to maturity over one year, but less than five years, the full amount without the maturity haircut imposed under regulatory capital rules should qualify as TLAC. The present language ("only to the extent that they are recognized as Tier 1 or Tier 2 capital instruments") suggests otherwise.

In other words, the fact that a security has a maturity of five years or less, as long as it is greater than one year, doesn't interfere with is loss-absorbing capacity in the event of resolution, or its bail-inability. TS Section 11 requires a minimum maturity of one year; therefore, haircutting debt greater than one year, but shorter than five would be inconsistent with the general terms of the proposal.

TS Section 14: Set-Off/Netting

The associations accept that instruments counting toward eligible external TLAC should not be subject to set off or netting rights that would undermine their loss-absorbing capacity in resolution.

TS Section 16: Governing Law

The requirement that external TLAC be governed by the law of the issuing G-SIB's home country should not apply where the home resolution authority is satisfied that it would be able to operate the bail-in measures available to it regardless of the choice of law. Thus, for example, the Federal Deposit Insurance Corporation's (FDIC) powers to "bail-in" by transferring assets to a bridge bank whilst leaving bailed-in instruments behind in the "bad bank" is not affected by the choice of law of the instruments to be bailed in.

The associations agree that where the choice of law of an instrument affects the potential availability of resolution techniques in respect of that instrument, the resolution authority should be able to make provisions relating to that choice of law (or, alternatively, disqualifying instruments whose choice of law inhibits their bail-in from qualifying as TLAC). However, since at least some resolution approaches are equally effective regardless of choice of law, it seems unnecessary to include this requirement for all cases worldwide. Therefore, instruments governed by a foreign law but containing legally effective contractual recognition provisions should be eligible for TLAC.

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The IIF and the GFMA and their working groups stand ready to support the FSB in its ongoing effort to improve cross-border resolution. Should you have any comments or questions on this letter, please contact David Schraa of the IIF at +1 202 390 8503 (dschraa@iif.com) or, for the GFMA, Gilbey Strub at +44 207 743 9334 (Gilbey.Strub@afme.eu) or Carter McDowell at + 1 202 962 7327 (cmcdowell@sifma.org).

Very truly yours,

Timothy D. Adams
President & CEO
IIF

Kenneth E. Bentsen, Jr
President & CEO
GFMA

APPENDIX 1: Description of the Signatory Associations

GFMA

The Global Financial Markets Association (GFMA) brings together three of the world's leading financial trade associations to address the increasingly important global regulatory agenda and to promote coordinated advocacy efforts. The Association for Financial Markets in Europe (AFME) in London and Brussels, the Asia Securities Industry & Financial Markets Association (ASIFMA) in Hong Kong and the Securities Industry and Financial Markets Association (SIFMA) in New York and Washington are, respectively, the European, Asian and North American members of GFMA. For more information, please visit http://www.gfma.org.

IIF

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