Total Loss-Absorbing Capacity (TLAC): making bail-in feasible and credible instead of bail-out

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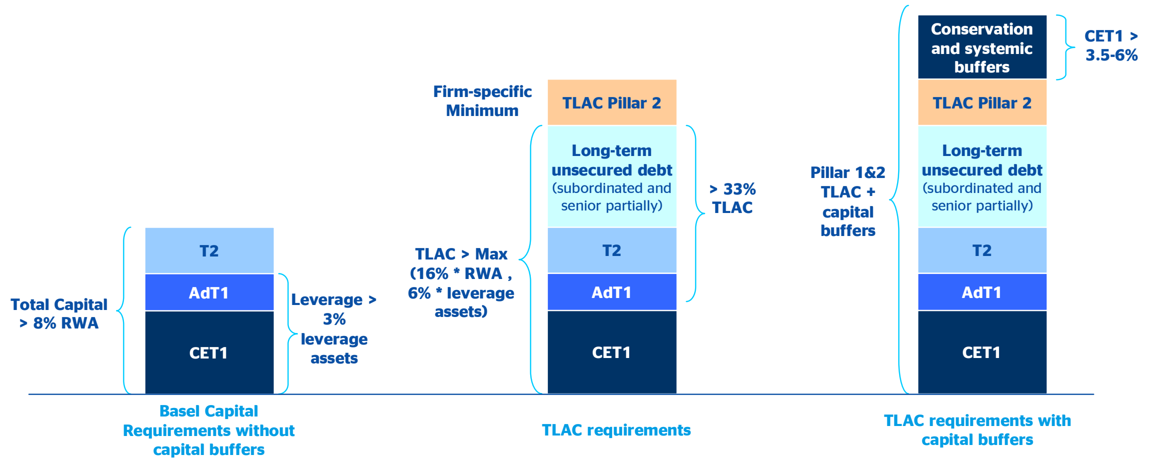
The new "loss-absorbing capacity" concept and the bail-in tool are the cornerstones of the new resolution regime, in which the shareholders and creditors should shoulder much of the recapitalisation burden. Banks must have enough liabilities with loss-absorbing capacity (TLAC). The FSB envisages that the TLAC should consist of instruments that can be legally, feasibly, effectively and operationally written down or converted into equity in case of resolution, in an amount that doubles the capital and leverage requirements (16% of RWA and 6% of leverage assets). Thus capital instruments and long term unsecured debt are broadly the instruments that may compose it.

TLAC minimum requirement proposed by the FSB



Source: BBVA Research

The final design of the TLAC is not yet clear, and nor is it yet consistent between countries. The FSB consultation and calibration period will be critical in designing the optimal TLAC, to ensure resolvability without unduly penalising financial intermediation and financial stability. In any case, we can venture that the TLAC is a new prudential ratio with a potentially similar impact on the banking industry as Basel 3 in terms of capital and funding management, banking risk and profitability.

Yesterday, the Financial Stability Board (FSB) released a draft consultation on the principles and characteristics of a minimum TLAC requirement.[1] The FSB paper will be under consultation until 2 February 2015. In parallel with the consultation period, the FSB with the collaboration of the Basel Committee on Banking Supervision will carry out a comprehensive Quantitative Impact Study (QIS) to assess the optimal Pillar 1 minimum TLAC requirement. The aim of this note is to describe and contextualise the main characteristics of the current FSB proposal.

[1] http://www.financialstabilityboard.org/2014/11/fsb-consults-on-proposal-for-a-common-international-standard-on-total-loss-absorbing-capacity-tlac-for-global-systemic-banks/

TLAC, a necessary complement to the bail-in tool

In the last few months, financial regulation of resolution has been making progress in providing the authorities with a series of instruments and competences to deal with banking crises in a preventive manner, protecting financial stability and minimising taxpayer exposure in the event of banking failures. As the central premise of the new regulation framework, **any banking rescue will have to be supported in the first instance by shareholders and private creditors** through the instrument known as the bail-in tool, instead of bail-out – in other words, taxpayers' support.

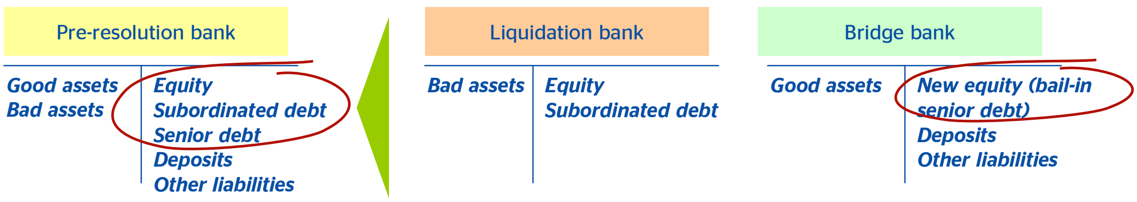
In order for this new banking rescue philosophy to be effective, banks must at all times have enough liabilities to absorb losses (so-called "Total Loss-Absorbing Capacity or TLAC"). This new concept means that when a bank is unviable, these liabilities will be used to recapitalise the institution and guarantee, in turn, those critical functions which are inherent to financial activity will be maintained.

In this context, setting a **minimum TLAC seeks the following objectives**:

- Banks need to have sufficient loss-absorbing liabilities to **avoid the need for a bail-out** with public funds in case of failure.
- A minimum amount of loss-absorbing liabilities would **recapitalise the failed institution** at a level that promotes market confidence and meets the going concern regulatory capital requirement (i.e. capital and leverage ratios) facilitating an efficient implementation of the resolution strategy.

Figure 1 shows an illustrative example of how the loss-absorbing liabilities (capital instruments and senior debt) may be used to restructure a failed institution.

Figure 1
Illustrative example of a resolution process which combines the bail-in with a bridge bank tool



Source: BBVA Research

TLAC nature: capital instruments and senior and subordinated debt

The FSB establishes that the TLAC should consist of instruments that can be legally, feasibly, effectively and operationally written down or converted into equity in case of resolution. Based on those principles, **capital instruments (CET1, AdT1 and T2), together with long-term unsecured debt – subordinated and senior debt – will be the instruments which would count towards the minimum TLAC.**

The inclusion of capital instruments is a positive element that recognises the different capital levels among global systemically important banks (G-SIBs) and their subsidiaries. Their inclusion (in comparison with the option of including only senior debt, which was considered in the early stages of the discussion) will provide banks with greater flexibility to optimise their liability structure with their preferred instruments.

Doubts arise however as to how treat unsecured debt. There is a consensus among authorities that **unsecured debt should be subordinated to instruments that are less credibly or feasibly loss-**

absorbing, but how to structure this subordination is a challenging question. In particular, a question of debate has been whether liabilities, that are *pari passu* with normal unsecured creditors and cannot effectively be written down or converted into equity (for example those arising from derivatives or corporate deposits), would be excluded from bail-in or not.

The **long-term unsecured debt subordination** could be structured in three different ways:

- Structural subordination through issuance of the long-term unsecured debt at the parent level, where the parent is a non-operating holding company.
- Statutory subordination through a different hierarchy of claims in the resolution regime.
- Contractual subordination through a new Tier 3 layer, which will absorb losses after junior debt but before any other liability. This approach is an option when the unsecured debt is issued by an operating bank, and the hierarchy of claims does not distinguish between debt and other liabilities.

With the introduction of the subordination feature, the FSB is clearly focused here on avoiding, as much as possible, having to use special resolution powers to bail in senior debt and exclude other liabilities such as corporate deposits, trading liabilities or derivatives. This approach is inconsistent with the European resolution regime that only partially complies with the statutory subordination criteria.[2] As shown Figure 2, the **FSB solves the subordination issue** by following a pragmatic approach:

Figure 2
TLAC composition proposed by the FSB

Source: BBVA Research

- Capital instruments and long-term unsecured subordinated debt, through structural, statutory or contractual approaches, would count **fully towards the TLAC**.
- Long-term unsecured unsubordinated debt which is pari passu with other liabilities **would count partially towards the TLAC**. The maximum contribution amount would be up to 2.5% of RWA or more if the final calibration exceeds 16% RWA. That is to say, any increase in the 16% RWA requirement could be covered with these non-subordinated liabilities (i.e., if the RWA requirement were set at 20%, then the limit of these non-subordinated liabilities would be set at up to 6.5% = 20 – 16 + 2.5).

This pragmatic solution is especially relevant for the continental European banks. Apart from the UK and Switzerland, few European banks have holding companies and issue the new senior debt from them. Moreover, there is a substantial volume of the unsubordinated senior debt (*pari passu* with corporate deposits and derivatives) issued at subsidiary operating level that would not count towards TLAC. Although the 2.5% of RWA threshold may help European banks to recognise partially this unsubordinated debt and

[2] Unsecured debt is subordinated to SME and retail depositors, but not to derivatives and corporate deposits (Bank Recovery and Resolution Directive - BRRD article 108). However, BRRD article 44 (3) allows the resolution authority to exclude certain liabilities from the bail-in.

smooth the issuance of the new senior subordinated debt, it is opposed to the G20 spirit to not penalize one particular business model or region.

Box 1. TLAC composition: narrow instruments versus principle-based approach

There was broad agreement among the FSB members that the TLAC instruments should be legally, feasibly and operationally available to absorb losses when needed. However, discussions during 2014 were polarised between two approaches: narrow or principle-based criteria.

Anglo-Saxons defend narrow eligible criteria

The US and some European authorities envisage that the TLAC criteria should be narrow and focused only on senior subordinated debt.

The rationale behind this position is that when a bank enters resolution, its capital is wiped out and the bail-in of the senior debt will be the only available and efficient tool to recapitalise the failed bank.

In particular, Fed Governor Daniel K. Tarullo said on 9 September 2014 that "*The Federal Reserve has been working with the FDIC to develop a proposal that would require the U.S. G-SIBs to maintain a minimum amount of long-term unsecured debt at the parent holding company level*".

Europe and Japan defend a principle-based approach

In contrast, the Europeans and Japanese had a wider view of the instruments that could count towards the TLAC. In particular, they envisage that instruments that fulfil some characteristics would be eligible.

Those characteristics are unsecured, residual maturity over one year, non-operational, with loss absorption capacity in legal terms, etc. The crucial difference is that this approach includes equity and capital instruments.

This approach is aligned with the minimum requirement of eligible liabilities (MREL) criteria defined in the European BRRD.

The FSB compromise closer to the principle-based approach, but with some nuances

The eligibility of the capital instruments in the TLAC may be seen as a victory for supporters of a principle-based approach, but setting a minimum (33%) of additional tier 1 instruments, tier 2 and senior debt would also ensure that a failed G-SIB has sufficient outstanding long-term debt to bail-in – excluding Common Equity Tier 1.

TLAC sizing: double capital and leverage requirements

In January 2011, the Bank of England released a discussion paper which created much of a stir in the financial community. The paper proposed that "*the optimal bank capital should be around 20% of risk weighted assets*".[3] As we describe below, the FSB proposal is roughly in line with the conclusions highlighted in that paper almost five years ago.

As a principle, the minimum TLAC should facilitate the recapitalisation of the failed bank at a level that meets capital and leverage requirements and promotes market confidence. In this context, the FSB envisages that the minimum TLAC should double the minimum capital and leverage requirement:

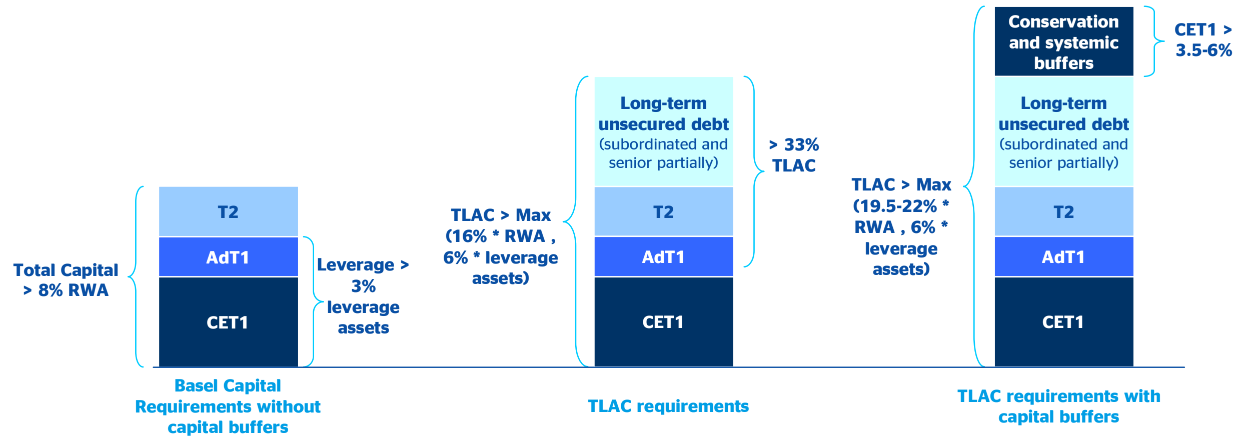
*Minimum TLAC without capital buffers = Max (16% * RWA, 6% * leverage ratio denominator)*

Moreover, in order to ensure that a G-SIB has sufficient outstanding debt to recapitalise the failed institution when the common equity tier 1 is wiped out, the FSB includes an additional constraint requiring that at least 33% of the TLAC is composed of junior and senior debt. As described in Box 1, the introduction of the 33% threshold could be understood as a concession to Anglo-Saxon concerns over including equity in the TLAC.

[3] Bank of England (January 2011), Discussion paper Nº 31 on "Optimal Bank Capital"

As shown in Figure 3, if the capital buffers are included, the minimum TLAC will largely exceed the 20% RWA reference. The exclusion of capital buffers in the minimum TLAC is one of the main industry concerns and the key reason for the vast increase in the TLAC requirement.

Figure 3
Pillar 1 TLAC minimum requirement proposed by the FSB



Source: BBVA Research

The introduction of leverage ratio rightly recognises the diversity of business models among G-SIBs. In fact, investment banks with low RWA density may breach the leverage ratio before the capital ratio, and therefore the TLAC liabilities and the bail-in tool would be used to restore the leverage ratio first. The opposite would be true for retail banks (RWAs would be binding and not the leverage ratio).

The **introduction of the leverage ratio challenges the calibration of the minimum TLAC**. It may be worth highlighting that the equilibrium between the RWA and the leverage threshold should be carefully assessed during the calibration period.

The current 16% of RWA and 6% of leverage ratio thresholds imply that banks with a RWA density up to 37.5% would be constrained by the leverage ratio, whilst the rest by the RWA. The 37.5% equilibrium is roughly in line with the average of the RWA density among European G-SIBs (35% as of June 2014). However, if the TLAC incorporates the conservation and global-systemic capital buffers, the minimum RWA threshold will rise to 19.5% - 22%.[4] Therefore, in order to maintain the RWA/leverage equilibrium in the TLAC requirement and not to penalise banks with high RWA density, the minimum leverage ratio should be revised above the 6% level (to a range between 7.3% and 8.2%).

[4] 16% plus 2.5% of conservation buffer plus 1% - 3.5% of systemic buffer

Box 2. TLAC based on full recapitalisation of the pre-resolution bank may overestimate loss-absorbing need

As the FSB stated, the purpose of the total loss-absorbing capacity (TLAC) is to provide sufficient financial resources for a bank to be resolved, while minimising taxpayer capital support and without causing severe financial instability.

Thinking of optimal sizing of the TLAC, there is a mistaken trend towards ensuring that the bank should be fully recapitalised, after the bail-in, to the extent that it would be able to carry out the same activities as before entering the resolution process. In this context, some argue that the optimal amount of TLAC should be measured by taking into account the whole balance-sheet in a business-as-usual situation, that is to say, prior to entering into resolution.

This approach overestimates the minimum TLAC required if one takes into account that the restructured bank would in all likelihood be smaller than the old entity.

Critical economic functions' role

The minimum amount of TLAC should be limited to the amount sufficient to recapitalise those entities in the group that perform critical functions.

The main objectives of the resolution plan and the resolution strategy are to identify which functions are economically critical and should be preserved, and which are not and should therefore be liquidated.

Resolution is not resurrection

There are many doubts about the assumption that the bank would be the same size post-resolution. Entering into resolution is not a situation that happens suddenly at a bank, as the financial conditions usually deteriorate gradually.

In this regard, before entering into resolution, failed banks would already have taken several measures included in the recovery plan which would reduce its size, such as deleveraging, asset disposals, etc. Moreover, the resolution process implies a tougher business restructuring that would significantly reduce the bank's balance-sheet.

Therefore, the debate on how to plan for such recapitalisation (and thus to size TLAC) needs to be included in the forthcoming calibration and the Pillar 2 requirements should probably play a more prominent role.

TLAC sizing: A standard combined with a firm-specific requirement (Pillar 2)

The FSB term sheet for a requirement for TLAC includes a common minimum standard requirement of the total amount of loss-absorbing capacity that all G-SIB must hold at all times, regardless of their characteristics – the so-called Pillar 1 requirement.

This Pillar 1 requirement would be complemented by a firm-specific TLAC requirement for individual firms over and above the minimum standard – the so-called Pillar 2 requirement. With this two pillars approach, the FSB seeks the following objectives:

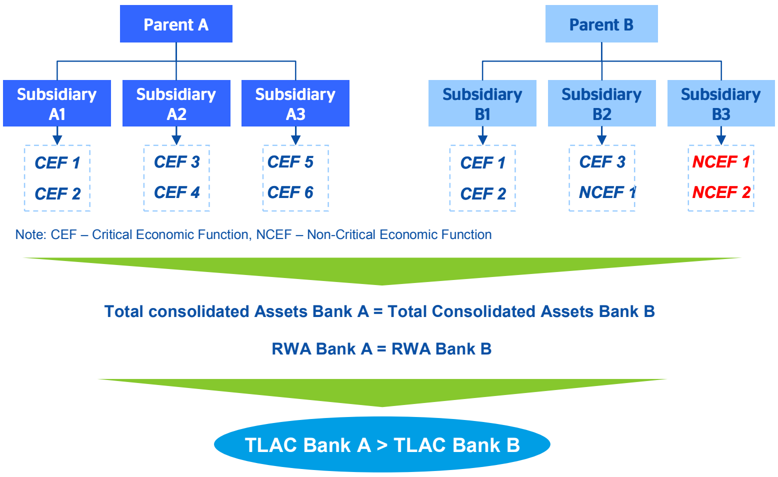
- Setting a common Pillar 1 TLAC requirement would help to achieve a level playing-field internationally.
- Setting a Pillar 2 requirement recognises that not all G-SIFIS are the same, and seeks to determine a firm-specific minimum TLAC based on the resolution features of each group, where the critical economic functions may play a key role.

The FSB envisages that supervisory and resolution authorities involved in the **Crisis Management Group would be responsible for determining the firm-specific minimum TLAC,** taking into account the recovery and resolution plan, their systemic features, their business model and complexity, the risk profile and the organisational structure.

Against this backdrop, the **critical economic functions in an institution may play a critical role** in determining the Pillar 2 TLAC requirement. As Sir John Cunliffe from the Bank of England argued in May, "*we are not seeking an amount of LAC capable of resurrecting any failing bank including the global giants. Rather, we are looking for sufficient LAC to recapitalise the entities carrying out critical economic functions to* *a level sufficient to regain and maintain market access. For the remaining entities, sufficient capacity to provide for an orderly run-off is what is required.*"[5]

For example, as shown Figure 5, two banks with the same balance-sheet and risk profile but carrying out different critical economic functions should not have the same minimum TLAC requirement. The bank which may pose higher systemic risk in case of failure – let us say, with more critical functions - should have more TLAC, in order to ensure a smoother and less disruptive resolution process. This higher TLAC should be imposed via a firm-specific requirement (a pillar 2 TLAC).

Figure 4
Critical economic function role when sizing TLAC



Source: BBVA Research

TLAC placement: tailored to the resolution strategy of each G-SIB

G-SIB banking groups vary significantly in their business models, corporate and legal structures, and their financial and operational interdependencies. Choosing the optimal way to resolve a G-SIB should take into account the firm's particular characteristics. The FSB recognizing the diversity among G-SIBs outlined two polar stylized approaches for resolving significant financial institutions: the multiple-point-of-entry (MPE) and single-point-of-entry (SPE).[6]

As a general principle, the minimum TLAC will be applied to each resolution entity within each GSIB in relation to its sub-consolidated balance sheet. In that vein, the appropriate allocation of the **TLAC will be determined by the preferred resolution strategy of each G-SIB**: at parent level in SPE banks and at each resolution subsidiary in MPE ones preserving subsidiaries which perform critical economic functions while liquidating those subsidiaries which does not perform critical functions.[7]

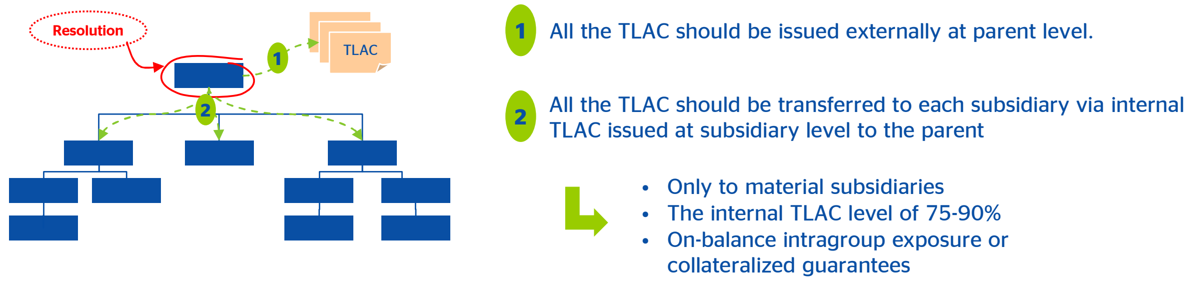
The main consequence for both resolution strategies is that the TLAC requirement would **not be assessed at group consolidated level**. Despite this common principle, the TLAC placement in each resolution strategy has the following different implications.

[5] "Ending Too Big Too Fail– progress and remaining issues". Speech at The Barclays European Bank Capital Summit (13 May 2014).
[6] Financial Stability Board (July 2013), "Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies"
[7] See Box 2

A) The internal TLAC will be the cornerstone in SPE banks

Under an SPE strategy, the resolution focuses on the entire group. After losses have occurred in any part of the group, a sole resolution process is initiated led by the home resolution authority, which executes a global resolution plan. The implementation of the resolution tools such as a bail-in occurs at the parent level only, and losses in subsidiaries are covered only through the holding company by means of a downstream of new capital.

Figure 5
Internal TLAC characteristics



Source: BBVA Research

In this regard, SPE banks would have to issue **external TLAC at parent level which will be to be transferred downstream via either on-balance sheet items or collateralised guarantees, so-called internal TLAC**, to the material entities within the group.

The main characteristics of the FSB's internal TLAC requirement are the following:

- Internal TLAC objective: Requiring parent banks of SPE groups to pre-position the external TLAC issued seeks to ensure confidence among all parties, especially between host and home authorities, in the credibility and effectiveness of the parent support in case of capital problems at subsidiary level.

  The internal TLAC may mitigate host resolution authorities' concerns that the home authority may not trigger the bail-in at the parent company level to recapitalise the loss-making subsidiary. In this scheme the host authority would have the capacity to trigger the bail-in of the internal TLAC in case the local subsidiary had entered into resolution, and the parent had not injected capital into it.

- Material subsidiaries: As we mentioned before, resolution is not "resurrection" and, therefore, the internal TLAC should be used to restructure those subsidiaries which are either relevant for the group based on their size or relevant for financial stability as they perform critical economic functions. The consequence is that internal TLAC should only be placed in those subsidiaries that are considered material.

  The FSB is proposing objective criteria based on a percentage (5%) of the consolidated risk-weighted assets, revenues and leverage exposure. The list of material entities in each group should be reviewed on annual basis in the context of the Crisis Management Groups.

- Internal TLAC level: In principle, all TLAC at group level should be externally issued by the parent and placed downstream in all material subsidiaries. However, the FSB is aware of the significant impact of this requirement on banks with centralised capital and liquidity management. Therefore, the FSB envisaged that the total quantum of internal TLAC may be less than the requirement set at the consolidated level for the resolution group in which that legal entity resides.

The 75% to 90% proposed range will be reviewed in the QIS. In any case, the home and host authorities in the Crisis Management Group should define the optimal internal TLAC in each subsidiary.

- Internal TLAC instruments: The characteristics of the internal TLAC instruments are one of the most controversial issues. Host authorities would tilt towards on-balance sheet instruments which are subordinated to the operating liabilities of the subsidiary. In contrast, SPE banks would prefer greater flexibility over how this downstream procedure is achieved. In particular, it could be structured so as to give the subsidiaries at which resources were to be held a legal claim to a portion of the pool, subject to some condition such as collateralised guarantees.

  Whereas host authorities would prefer on balance-sheet items, other forms of internal TLAC may be agreed by the Crisis Management Groups. A key challenging discussion will be over who has the power to trigger the internal TLAC: either the host or home regulator or by a joint decision.

B) External TLAC at subsidiary level should be based on local rules in MPE banks

At the opposite side of the resolution spectrum, under an MPE resolution strategy a distressed subsidiary of the group may need to be detached from the rest of the group involving the application of resolution powers by the local resolution authority without disrupting the operation of the rest of the group. This is likely to result in a break-up of the group into two or more separate parts, preserving essential functions without causing contagion to the rest.

This implies that each legal entity or sub-holding in the group that may be subject to a **separate resolution action should have sufficient individual TLAC to cover its likely losses** in resolution, and also those of its own subsidiaries for which a separate resolution is not planned.

This TLAC approach for MPE banking groups presents the following characteristics:

- Local TLAC based on local rules: The TLAC requirement at each resolution subsidiary or sub-group should be based on the regime established by the host authorities for banks with similar characteristics to the local entity. Therefore, it will be for each country to put in place the legal framework which transposes the FSB TLAC requirement.

  Moreover, these local resolution regimes will also need to be applied to Domestic Systemically Important Banks (D-SIBs) as well as local subsidiaries of G-SIBs. The level playing-field between G-SIBs' subsidiaries and local players should be preserved.

  As a consequence, the focus of the host requirements should be on the instruments and/or liabilities which are available in the local market in sufficient quantities to fulfil the local TLAC requirements, establishing a level playing-field between the local players, especially D-SIBs and foreign subsidiaries.

- Material subsidiaries: As mentioned above, all material subsidiaries in a banking group should have TLAC placed either internally (SPE approach) or externally (MPE approach). However, the concept of material subsidiaries may have different connotations between an SPE and MPE. Under an MPE scheme, material subsidiaries could be considered both, those which are relevant in their local market (e.g. D-SIBs), and those which are relevant in the group as the SPE requirement of internal TLAC.

In any case, the TLAC proposal leaves the door open because the host authority has always all legal powers to impose external or internal TLAC requirements based on their local laws

TLAC impact on the banking industry: similar to Basel 3

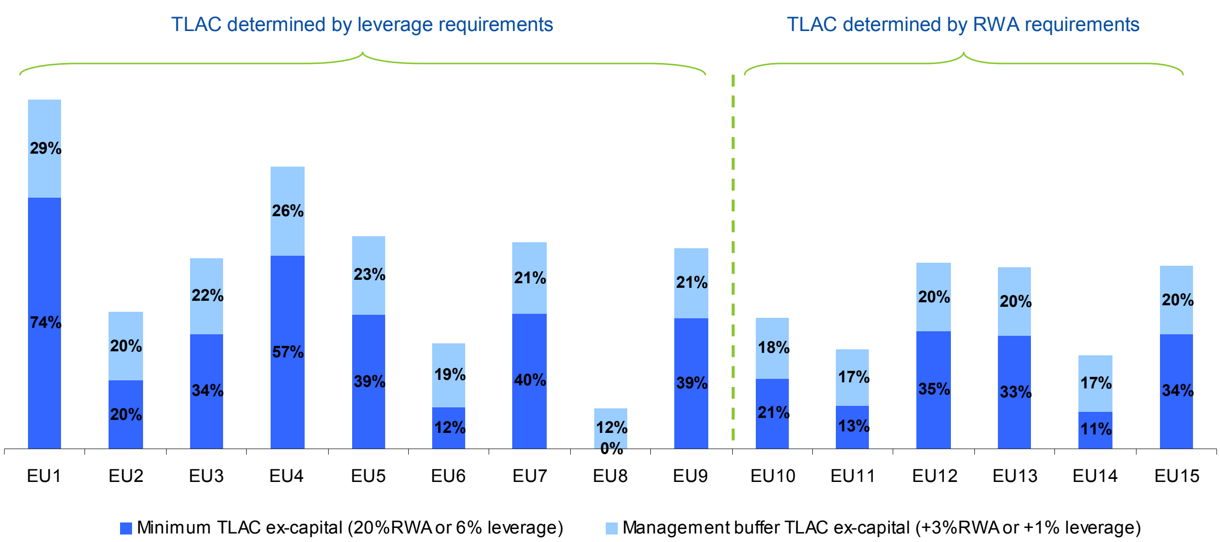
The TLAC is a new prudential ratio with a potentially **similar impact on the banking industry as Basel 3** in terms of capital & funding management, banking risk and profitability.

For banks, introducing the "loss-absorbing in case of resolution" characteristic into senior debt, and establishing a minimum requirement, will imply significant changes in the way in which banks design their financing structures, affecting their cost.

As shown in Figure 6, based on the outstanding capital amounts (Common Equity Tier 1, Additional Tier 1 and Tier 2) as of December 2013, European banks will need to have long-term unsecured debt, on average more than 28% of total capital, to comply with the minimum TLAC requirement (20% of RWA or 6% of leverage assets). Despite the need to comply with a minimum, banks will usually operate with a management buffer in order to avoid the punitive impact of not complying with the minimum. Therefore, if we assume 3% of RWA or 1% of total leverage assets as a management buffer, the additional TLAC needs will increase in 20% of the outstanding total capital in average.

Those requirements are determined by the RWA density of each bank. Current 16% of RWA and 6% of leverage ratio thresholds imply that banks with RWA density up to 37.5% would be driven by the leverage, whilst the rest by the RWA.

Figure 6
Additional TLAC needs over total capital in European G-SIBs (in % of total consolidated capital as of December 2013)



Source: BBVA Research

The current FSB proposal clearly penalizes banks **bank operating structure compares against pure holding structures**. It requires the OpCo banks to issue debt that is subordinated, either contractually or statutorily, putting them at a very significant cost disadvantage. The TLAC proposal is compatible and shaped on US and Anglo-Saxon organisational models, organized under a pure holding company, but it is substantially burden for the majority of other banks in Europe. This should carefully be **analyzed during the calibration period**.

Investors in loss-absorbing debt, especially fixed income investors, would be more likely to suffer losses than before, which would be reflected in lower ratings for these instruments and the consequent demand for higher profitability.

Moreover, investor appetite for these instruments is uncertain substituted and the investors' base will for sure be limited since banks will not be able to hold them. In fact, a large proportion of bank senior is currently purchased by other banks and this investor base may need to be substituted.

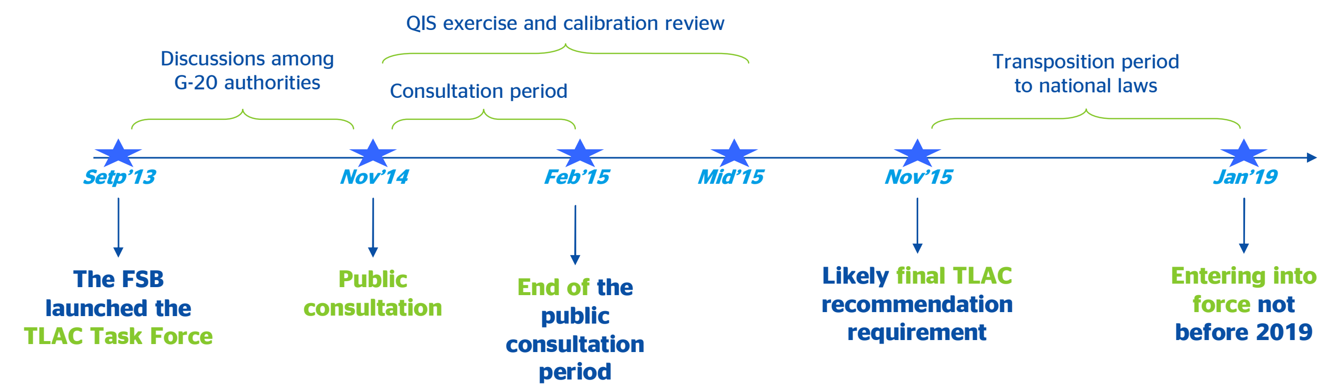
However, and what is more important, this new debt characteristic implies that investors would focus more on banks' fundamentals, encouraging positive discrimination between issuing entities, the rupture of the sovereign-banking link and, in short, increasing market discipline throughout the sector.

Finally, we should not forget that **supervisors and resolution authorities** will play an important role when determining the optimal TLAC for a group.[8] In the past, most of the responsibility in debt issues was borne by the market authorities. Supervisors and resolution authorities should make sure that banks have sufficient TLAC, with characteristics which do not prevent them from being bailed-in when necessary.

FSB calendar and key calibration and QIS challenges

The Financial Stability Board (FSB) released yesterday a draft consultation on the principles and characteristics of a minimum TLAC requirement. The FSB paper will be under consultation until 2 February 2015 and is likely to be approved by the next G20 2015 summit in Turkey. In parallel with the consultation period, the FSB will carry out a comprehensive Quantitative Assessment Study (QIS) in collaboration with the Bank Committee on Banking Supervision, to assess the optimal Pillar 1 minimum TLAC requirement.

Figure 7
The FSB's TLAC calendar



Source: BBVA Research

8 See the authority powers in relation to the loss-absorbing requirements in the article 45 of the European Bank Recovery and Resolution Directive (BRRD)

The TLAC **calibration and subsequent QIS that the FSB will carry out in 2015** is vitally important. In this regard, the FSB should consider two factors:

- The minimum TLAC should not be disproportionate and uneconomic. If TLAC instruments are not available in sufficient quantities, banks will be forced to deleverage, hampering their ability to provide credit that is vital to economic growth.
- The TLAC would increase the systemic risk and potentially undermine financial stability in financial systems founded mainly with deposits. Banks may be forced to leverage their balance-sheets artificially and/or be driven to a "riskier yield-hunting strategy" to compensate for the TLAC's cost. In this sense, the emerging markets' subsidiaries of G-SIBs could be the more affected.

  As the last BIS Global Liquidity Indicators report shows,[9] although the loan-to-deposit ratio (LtD) in emerging markets continued to trend up (0.87%), it remains well below advanced economy levels that are 25% higher. Therefore, covering TLAC requirements just with senior debt will significantly alter the funding structure.

  In this context, the FSB proposal establishes that G-SIBs that are headquartered in EMEs will not, initially, be subject to the Common Pillar 1 Minimum TLAC requirement. This must be thorough and comprehensive, to ensure that the economic consequences of the proposals are fully examined to ensure that calibration of TLAC is aligned with its cost and benefits, as this will have several implication not only for banks with headquarters in EMEs, but also with subsidiaries located in EMEs. For instances, subsidiaries of MPE banks in emerging markets should also be excluded accordingly from the TLAC requirements, otherwise there would incentives for arbitrage.

In a nutshell, the **FSB should carry out a comprehensive calibration and QIS,** taking into account the impact on: developed and emerging market economies; international banking products; the depth of debt markets; the willingness of investors to acquire these products; the impact on retail deposit funding; refinancing risks; linkages with government debt, and financial interconnectedness.

TLAC transposition in local laws: the European case

Once the consultation period has finished, G20 countries will have the compromise to transpose the TLAC requirements to their own resolution regimes. The FSB proposes in the consultation paper that the **TLAC requirement should not be in place before January 2019,** allowing G-SIBs to gradually adapt their funding structures to this new requirement.

Although TLAC consultation period is open and the final paper is not expected until the mid- or end-2015. It is worth mentioning that the regulatory debate in some jurisdictions is several steps ahead. In particular, European authorities got a final agreement for the Bank Recovery and Resolution Directive (BRRD) in April 2014 which incorporates a loss-absorbing concept, the Minimum Required Eligible Liability (MREL) similar to TLAC.

As shown in the Table 1, despite being the same concept, **the TLAC and the MREL definitions are not totally consistent** in all their features.

[9] Bank for International Settlements (October 2018), "Global liquidity: selected indicators."

Table 1
Differences between MREL vs TLAC requirement

	MREL	TLAC	Comparability
Scope of covered firms	• All credit Institutions and investment firms	• Global systemically important banks (G-SIBS)	✗
Objective	• To ensure that there is an appropriate level of loss-absorbing and recapitalisation capacity for the relevant group to be resolvable and that the critical functions can be continued without taxpayer (public) funding and avoiding adverse effects on the financial system.		✓
Eligible Instruments	• Equity, junior debt, senior debt, and other unsecured liabilities with residual maturity over 1 year.	• Equity, junior debt, senior subordinated debt and part of the senior unsubordinated debt which is pari-passu with excluded liabilities.	✗
Pillar 1 vs Pillar 2 approach	• Case-by-case approach (Pillar 2) based on each bank's characteristics: resolvability assessment; complexity, risk profile, etc.	• All banks should have the same Pillar 1 minimum TLAC requirement plus a Pillar 2 firm-specific requirement.	✗
Sizing	• MREL shall be calculated as a % of the institution's total liabilities and own funds, considering derivatives netting rights.	• Pillar 1 standard minimum: (16-20% of-RWA or 6% of leverage assets) plus Pillar 2 case-by-case requirements.	✗
Long-term unsecured debt subordination	• Statutory subordination through different hierarchy of claims. • Senior debt is subordinated to SME and retail deposits but *pari passu* with corporate deposits and derivates.	• Contractual subordination to all excluded liabilities such as derivatives, secured deposits, etc. • Despite the contractual subordination, the TLAC would accept a limited amount of senior debt without subordinated clauses.	≈
Placement SPEs: Internal TLAC	• No mentioned	• SPE banks would have to issue external TLAC at parent level and transfer it downstream via on-balance sheet items or collateralised guarantees, internal TLAC, to the material entities within the group.	✗
Placement	• At group or individual level, depending on the resolution strategy: under an SPE at consolidated group and MPE strategy at individual subsidiary level.	• TLAC should be place at each point of entry. It will be determined by the resolution strategy: at parent level under an SPE scheme and at subsidiary level under an MPE scheme.	✓
Disclosure	• Banks will have to disclose the amount, maturity and composition of TLAC/MREL maintained by each resolution entity and at each material subsidiary.		✓
Come into force	• MREL requirement is already approved and will come into force in 2016.	• No earlier than 1 January 2019	✗
Conditionality	• Not mentioned, but it is assumed that the breach of the MREL would imply the requirement of developing and carrying out an MREL restoration plan.	• A breach or likely breach of TLAC should be treated as severely as the minimum capital requirement.	≈

The EU has only recently **finalized a comprehensive and valuable framework for Recovery & Resolution** (BRRD) that combines two elements: i) a 8% of total liabilities minimum bail-in before applying any other financial arrangement (i.e., use the resolution fund or use public stabilization tools in exceptional circumstances), and ii) the requirement of a firm-specific minimum MREL based on the risk profile, the resolvability assessment, the critical functions, etc. Thus, FSB should come forward with a proposal that is **consistent with the thoroughly-negotiated and comprehensive approach on MREL in the BRRD** and take into account the heterogeneity of business models in Europe.

Nevertheless, we should not overlook that the BRRD empowers the EBA and European Commission to review the MREL by the end of 2016.[10] In this regard, it seems that the MREL may evolve towards the TLAC global framework after the EBA and European Commission review in 2016. Therefore, **the risk is low of having two different ratios in Europe in the long-term**.

10 See article 45 paragraphs 18 and 19 of the BRRD.

DISCLAIMER