The TLAC QIS: the next milestone in designing the optimal loss-absorbing framework

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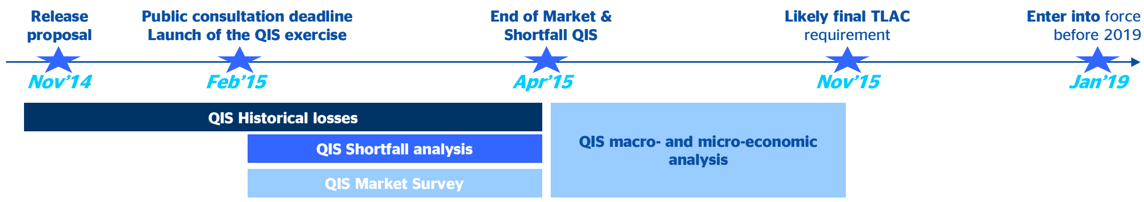
In November 2014, the Financial Stability Board (FSB) launched the consultation paper comprising a set of principles and features on the new total loss-absorbing capacity requirement (TLAC). The TLAC proposal has caused much stir in the financial community and has become one of the hottest regulatory concerns. Two weeks ago, on 2 February, the consultation period ended with the financial industry having expressed their positions on TLAC.

Figure 1
TLAC proposed calendar in 2015



Source: BBVA Research

As the FSB outlined in November, once the public consultation has ended, now is the time for carrying out a comprehensive Quantitative Impact Study (QIS) to define the optimal calibration of the TLAC. The QIS consists of four elements:

- **Historical losses back-testing**: setting a minimum TLAC as the maximum of 16-20% of RWA and at least twice the leverage ratio should be reviewed against the historical losses and recapitalisation needs over different crises. In conducting this analysis, it should be taken into account that past failures, especially during the recent global financial crisis, were mostly focused on narrow and undiversified banks. Moreover, global systemic banks (G-SIBs) have significantly improved their resilience (e.g. Basel 3 requirements, G-SIB buffers, ISDA protocols, etc.).
- **G-SIB shortfall analysis**: G-SIBs will have to fill out, during the first quarter of 2015, several templates at various different levels (at group consolidated and sub-consolidated per material or resolution entity levels) in order to assess the external and internal TLAC needs and current shortfalls. The FSB's templates are flexible, in order to deal with the different characteristics of MPE and SPE resolution strategies.

  For the purposes of understanding the differences between both strategies, the analysis should be done in two ways: i) at group level between the consolidated TLAC in SPE banks and the sum of external TLAC of the resolution entities in MPE banks, and ii) at an individual level between the internal TLAC in SPE banks and external TLAC in MPE banks. The group consolidated TLAC in a MPE bank does not show the real loss-absorbing needs. Subsidiaries' debt would only be used to absorb losses locally, rather than to recapitalise any other subsidiary or the parent.
- **Market survey**: The objective is to assess the potential changes in the debt markets in terms of market appetite, pricing, size, rating features, etc. The market survey is focused on three different targets based on their particular role: to issuers, to potential investors, and to credit rating agencies. Debt and financial markets are divergent around the world. Therefore, the questions and their

responses should be sufficiently granular to point out the potential different impacts depending on the development of the market.

- **Macro- and micro-economic impact**: Based on the outcomes of the previous analysis, that examines the need for expanding the issuance of TLAC eligible instruments and the prospective cost and market appetite, the macro- and micro-analysis will assess the impact on the financial sector and the consequences to the whole economy.

  When carrying out this analysis, a widely-used tool in the academic literature is the Modigliani-Miller theorem which supposes that the value of a bank is unaffected by how that bank is funded. Higher levels of capital and debt would reduce issuance spreads as the loss-given default decreases. Despite being a valuable principle in an efficient market, the real situation of debt capital markets across the world is far from being efficient and homogenous. In this sense, consideration should be given to the particular assumptions and characteristics of each market. This is particularly relevant in the context of emerging markets, where local authorities are stepping up their efforts to develop local bond markets and to improve local market infrastructure.[1]

Against this backdrop, a particular question to solve is whether emerging markets with underdeveloped local capital and debt markets are prepared to assume the future external TLAC requirements of a G-SIB's subsidiaries located in those markets, at reasonable cost and without posing financial instability risks. In some emerging markets, the only way to place debt in sufficient amounts is by issuing in foreign jurisdictions and in foreign currency. But divergent central banks' monetary policy and currency volatility will continue to be a key source of concern in the following years. In this regard, whether or not banks have to access foreign markets and currencies to cover their external TLAC, as well as its consequences, should be assessed carefully.

The FSB will revise the TLAC's principles and features based on the responses of the financial sector and the outcome of the overall QIS exercise. The calibration of TLAC and subsequent QIS are vitally important. Therefore, **the quantitative impact assessment (QIS) should be very ambitious in providing granular results based on the specific features of each market**. In particular, the QIS should review the impact on: developed and emerging market economies; international banking products; the depth of debt markets; the willingness of investors to buy this type of debt; the base of retail deposit funding; the refinancing risks and financial interconnectedness

[1] Committee on the Global Financial System (March 2014) "EME banking systems and regional financial integration" CGFS Paper Nº 51

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