BANKING SECTOR ANALYSIS

China | How asset securitization can help Chinese G-SIBs to meet the TLAC rule

Betty Huang/ Le Xia

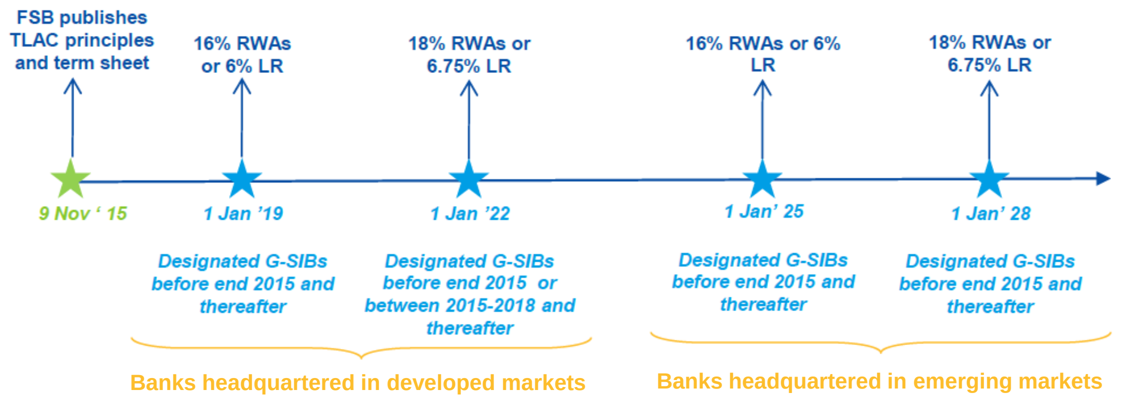
Summary

- The TLAC proposal ("total loss-absorbent capacity") aiming to enable Global Systemically Important Banks (G-SIBs) to have adequate loss-absorbing and recapitalisation capacity in the event of bank failure. Under the TLAC framework, G-SIBs are required to hold additional capital or other eligible instruments supplementary to the Basel III requirements. In an extreme case, the total amount of Basel III regulatory capital and TLAC-eligible instruments for a G-SIB could reach 26.5% of its RWAs(Risk weighted assets).
- China needs to fully comply with the TLAC requirements no later than 2028, with an additional 6-year compliance period compared to advanced countries. However, the relative underdevelopment of China's domestic bond market poses a serious challenge to four Chinese G-SIBs for TLAC compliance.
- Nevertheless, China's regulators can help their G-SIBs to overcome the funding gap of the TLAC compliance by accelerating asset securitization, which could remove part of bank assets from their balance sheets and reduce their RWAs. We gauge the impact of securitization on Chinese G-SIBs' funding gap of TLAC compliance. We find that the shortfall would more than halve if the four Chinese G-SIBs could gradually increase the portion of securitized assets to 50% of their consumer loans.

What is the TLAC rule?

The 2008 financial crisis highlighted the importance of Global Systemically Important Banks' (G-SIBs) to have adequate loss absorbing capacity and recapitalisation capacity in the event of failure. The Financial Stability Board (FSB), in consultation with the Basel Committee, proposed -"total loss-absorbent capacity" (TLAC) as a key parameter to gauge capital strength of G-SIBs .The aim is to reduce the impact of failure of G-SIBs and end the moral hazard of banks' too big to fail (TBTF) phenomenon. This long awaited proposal was finalized in the recently G-20 summit meeting held in Antalya Turkey of November 2015.

Figure 1
TLAC threshold



Source: FSB and BBVA Research

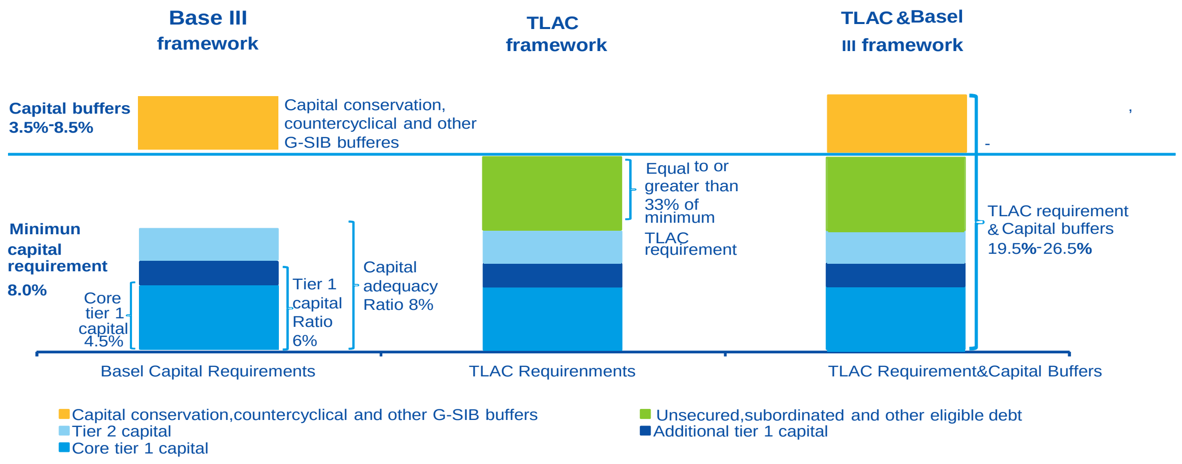
The TLAC rule is applicable for the current 30 G-SIBs and their entities in the world. In contrast with the bail-out measure acted by government using taxpayers' money, TLAC rule is a bail-in measure which requires the banks to use their own capital in crisis times. Under the TLAC framework, GSIBs are expected to increase the amount of capital other than the requirement set out by the Basel III framework. The eligible TLAC tools are specifically required to be convertible into equity or be written down when banks enter into resolution procedure.

TLAC framework set a minimum level for G-SIBs globally, with different implementation timetable for G-SIBs headquartered in developed economies and emerging markets. (Figure 1) China is the only emerging market where a number of G-SIBs are headquartered. To date there are 4 G-SIBs in China, namely the Bank of China (BOC), Industrial and commercial bank of China(ICBC), Agricultural bank of China(ABC) and China construction bank(CCB) respectively ("Large Four" henceforth).

Relationship between TLAC and Basel III

Minimum TLAC is an additional requirement to minimum regulatory capital requirements under the Basel III regulatory framework. In particular, capital that counts towards minimum regulatory capital (8%) may also count towards satisfying the Minimum TLAC requirement. However, not all types of regulatory capital under the Basel III can be used to meet Minimum TLAC requirements. For example, the Common Equity Tier I capital used to meet the minimum TLAC requirement cannot be used to meet capital buffers in Basel III, which include the conservation ratio of 2.5%, other G-SIBs capital buffer of 1%-3.5%, and countercyclical ratio of 0-2.5%). The FSB also requires that a G-SIB's other TLAC-eligible instruments (long term unsecured debt) that are not also eligible as regulatory capital, is equal to or greater than 33% of their Minimum TLAC requirements. That being said, in an extreme case, the total amount of Basel III regulatory capital and TLAC-eligible instruments for a G-SIB could be as high as 26.5% of its RWAs (Figure 2).

Figure 2
Relationship between TLAC and Basel III



Source: FSB and BBVA Research

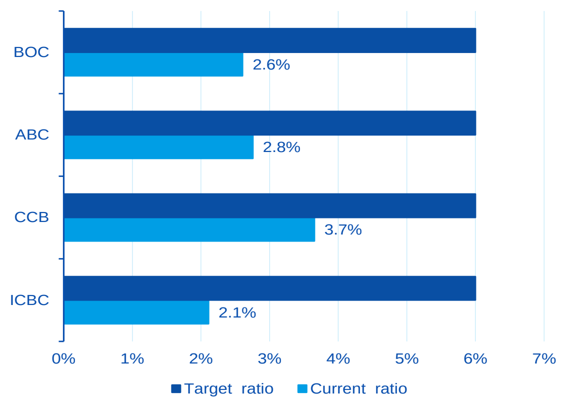
How will the TLAC rule affect China's G-SIBs?

The implementation of the TLAC rule is set to have far-reaching impact on China's banks, in particular for the four Chinese G-SIBs. Frist and foremost, China's four G-SIBs will face a large funding gap. Now bond instruments only account for around 2-4% of G-SIBs' risk weighted assets. However, it is required that TLAC long term(great than one year) unsecured bond instruments of a G-SIB should be equal to or greater than 33% of the minimum TLAC requirements (16-18% of a G-SIB's RWAs). It means that a Chinese G-SIB's TLAC-eligible instruments should be at least equivalent to 6% of its RWAs by 2028.(Figure 3)That being said, Chinese G-SIBs need to issue a large amount of TLAC-eligible instruments so as to meet the TLAC rules. According to some industry estimates, by 2025 these four G-SIBs need to issue additional TLAC-eligible bonds worth around USD 400 billion.

This shortfall could be addressed through a combination of additional TLAC-eligible bond issuances and consolidation of banks' balance sheets (as well as their RWAs). However, a large amount of bond issuance could mean higher financing costs for banks compared to abundant and cheaper deposits in China.(Figure 4) Not to mention that the TLAC-eligible instruments are required to absorb loss prior to all other liabilities, which will put these instruments at a more disadvantaged position relative to deposits. In this sense, Chinese G-SIBs could face a greater challenge of meeting the TLAC requirements than their European peers, for which bond issuance has already constitutes an important funding source.

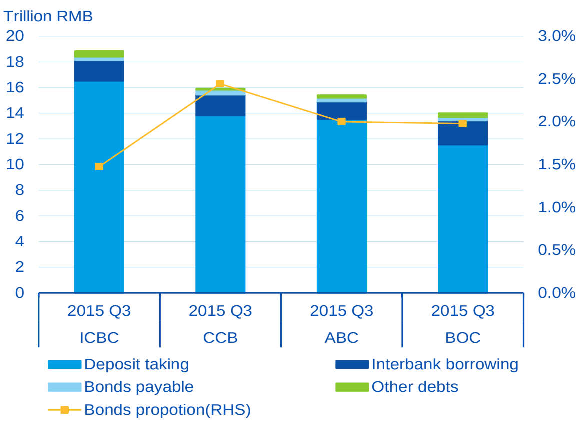
The implementation of the TLAC rule could also give rise to some negative incentives to other large banks that have not be included in the G-SIBs list yet. For example, to avoid being imposed on the TLAC rule, these large banks could adopt a more cautious attitude on expanding business scale and exploring international business opportunities. Moreover, the TLAC rule could make SIBs shift risks to other non-SIB banks and related sectors, for example insurance companies, asset management companies, and hedge funds since they are likely to be the holders of eligible TLAC tools. All the more so in China since banks are the largest buyers in domestic bond market. As a result, the implementation of the TLAC rule could produce the unintended effect of spreading systemic risks in a broader scope.

Figure 3
Bonds to RWAs ratio need to be increased…



Source: Wind and BBVA Research

Figure 4
Liabilities structure as of Q3 2015



Source: Wind and BBVA Research

Asset Securitization could help Chinese G-SIBs to comply with the TLAC

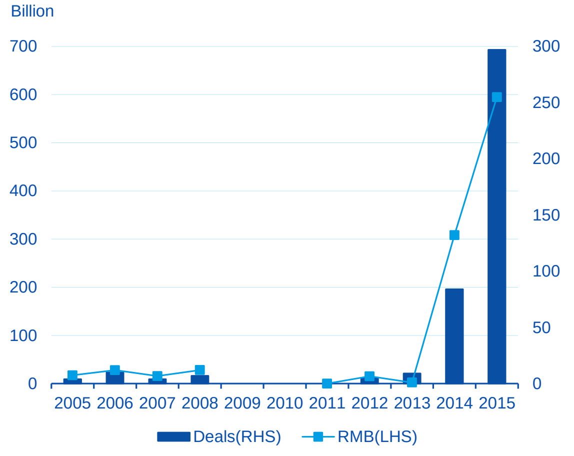
Asset backed securities (ABS) are securities whose income payments and hence value are derived from and collateralized (or "backed") by a specified pool of underlying assets (e.g. loans, mortgage, or credit card receivables etc.). Pooling these illiquid assets into financial instruments allows them to be sold to general investors; a process called securitization, and allows the risk of investing in the underlying assets to be diversified because each security will represent a fraction of the total value of the diverse pool of underlying assets. In the past 30 years, Special Purpose Vehicles (SPVs) have been utilized massively as a means of asset securitisation in both the US and Europe. In practice, an originator (normally a bank) transfers its assets to a SPV which is created specifically to acquire the assets and operate as a special legal entity with no relationship with the originator. The SPV pays for the assets by issuing securities to investors in capital market. The interest and principal due on the underlying assets will be used by the SPV to pay for the bearing interest of the securities at fixed or variable rates.

As explained in the previous section, the compliance of Minimum TLAC requirements could add great pressure on Chinese G-SIBs in issuing TLAC-eligible instruments in domestic bond market. Indeed, Chinese G-SIBs could consider consolidating their balance sheets via asset securitization so as to meet the TLAC requirements with less pain.

Now Chinese market of asset securitization is not well developed. Although China's authorities started to pilot the market of asset backed securities from 2005, the progress has been slow prior to 2009 in terms of both value and deal since the banking sector was flooded with ample liquidity from the "twin surplus" under both current and capital accounts. During 2009-2011, the pilot program was even suspended due to the authorities' increasing concerns over the ABS business model as the US subprime crisis just broke out.

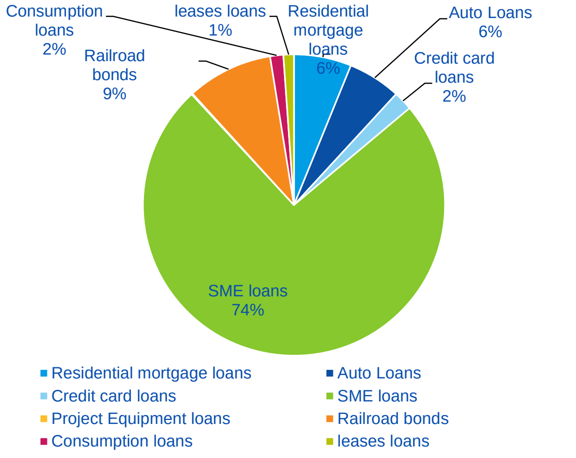
The development of ABS market gained momentum again after the authorities lifted the suspension. In 2015, partly due to the authorities' streamlined regulations, the value of new ABS issuance surpassed South Korea and Japan, reaching approximately 700 billion(Figure 5) Above all, most of the underlying assets for ABS are SME loans (74%) while consumer loans (including mortgage loans) only account for around 15% (Figure 6).

Figure 5
ABS market development in China



Source: Wind and BBVA Research

Figure 6
Weights of bank's ABS balance by 2015



Source: Wind and BBVA Research

Simple Scenario Analysis of the TLAC rule compliance

We gauge the impact of securitization on Chinese G-SIBs' funding gap for compliance of the TLAC requirements under two scenarios. Scenario A assumes no securitization to be carried out for G-SIBs while in Scenario B a significant proportion (50%) of consumer loans are assumed to be securitized and removed from G-SIBs' balance sheets. Both scenarios are based on a number of common assumptions as below:

- Growth rate of bank assets is line with our nominal GDP projection in which growth rate will gradually slow down to 5% by 2020 from current level of 6.9% ;
- The ratio of a bank's RWAs to total assets remains at the current level through the forecast horizon;
- Consumer loans gradually increased from 14.8% of current level to 40% of total assets by 2028 based on Japan's experience, implying a successful rebalancing of Chinese economy over the same period;
- TLAC eligible instruments of G-SIBs are expected to reach 8% and 10% of their RWAs by 2025 and 2028, by which we assume no further support for regulatory capital on top of the minimum 8% CAR;
- All the outstanding bonds issued by banks will be converted to be TLAC eligible.

In scenario A, the funding gap would be RMB 2,854 billion (or USD 440 billion at the current exchange rate) by 2025 and RMB 4,095 billion (or USD 630 billion) by 2028. (Table 1) However, in Scenario B the funding gap will significantly reduce by more than half (USD 172 billion by 2025 and USD 223 billion) provided that 50% of consumer loans are to be securitized and removed from the balance sheets of 4 G-SIBs (Table 2).

It is noted that the results under these two scenarios are suggestive. However, they show that accelerating asset securitization might be a feasible means for Chinese G-SIBs to meet their TLAC requirements in future.

Table 1
Scenario A

RMB Billion	2016	2017	2018	2019	2020	2021	2025	2028
Total Assets	79,895	84,848	89,939	95,335	100,102	105,107	127,759	147,897
TLAC requirement	16%	16%	16%	16%	16%	16%	16%	18%
RWAs	48,641	51,657	54,756	58,042	60,944	63,991	77,781	90,042
Required TLAC instruments	2,568	2,727	2,891	3,065	3,218	3,379	4,107	5,348
Funding Gap of debt	1,315	1,474	1,638	1,811	1,965	2,126	2,854	4,095

Source: Wind and BBVA Research

Table 2
Scenario B

RMB Billion	2016	2017	2018	2019	2020	2021	2025	2028
Consumer loans (CL)	13,373	15,846	18,540	21,500	24,515	27,778	43,668	59,150
% of CL securitization	20%	30%	40%	50%	50%	50%	50%	50%
Total Assets	77,220	80,094	82,523	84,585	87,845	91,218	105,925	118,322
RWAs	38,612	39,772	40,851	41,917	42,558	43,158	45,031	45,679
Required TLAC instruments	2,039	2,100	2,157	2,213	2,247	2,279	2,378	2,713
Funding gap of debt	785	847	904	960	994	1,026	1,124	1,460

Source: Wind and BBVA Research

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