

Crédit Agricole Response to the BCBS Consultation on TLAC Holdings

Crédit Agricole Group (CAG)¹ is one of the 30 G-SIBs identified by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS)². As such CAG welcomes the opportunity to respond to the BCBS consultation on TLAC Holdings issued in November 2015. The consultative paper describes the BCBS proposed prudential treatment for investments of banks (either G-SIBs or non G-SIBs) in TLAC instruments issued by G-SIBs.

Key Messages:

We share the FSB concerns about the contagion risk and support the FSB idea for regulators to strongly disincentivise internationally active systemic banks only from holding TLAC issued by other G-SIBs.

However, the proposed BCBS approach (i.e. to deduct TLAC holdings from Tier 2 for all banks) will result in most of the upcoming issuances of TLAC eligible debt instruments to be held by non-banking actors. This contraction of the investors' base will lead to higher prices for G-SIBs' senior unsecured debt and as a consequence will reduce the capacity of the banking sector to finance the economy. It will also concentrate the holdings of G-SIBs senior unsecured debt instruments in the hands of non-regulated financial actors such as hedge funds or pension funds, which seems contrary to the risk mitigating objective.

We therefore make the following recommendations:

- The deduction should be proportional: like capital instruments that are deducted from regulatory own funds in accordance with their ranking, other TLAC instruments should be deducted from total TLAC when applicable, and not from Tier 2.
- When applying this deduction, we suggest that the current 10% of common equity threshold be topped up with another TLAC specific 10% threshold in order to ensure a live and deep

¹ Crédit Agricole Group is a leading international banking and insurance group with total assets of € 1,589 bln and net income group share of € 4.92 bln (as of 31 December 2014). Its Basel 3 Core Tier 1 ratio (fully loaded) is 13.1 %. It is present in 54 countries worldwide (22 countries in Europe) and servicing more than 50 million customers through a network of 7,000 branches solidly anchored in their territories. The group employs 140,000 people worldwide and offers a wide range of financial services, including retail banking, consumer finance, insurance, asset management, private banking, leasing, factoring and corporate and investment banking. Crédit Agricole Group intends to fulfil its role as a leading European player with global scale, while complying with the commitments that stem from its mutualist background. It focuses its development on servicing the real economy and is committed to the principle of responsible growth.

² <http://www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf>.

market for such TLAC instruments and to permit a limited level of activity, such as market making, to occur without banks being subject to a deduction.

- For banks not eligible to TLAC we recommend that, instead of a deduction, TLAC holdings be treated within the BCBS large exposure framework as it is already the case. In combination with the risk weighting framework this should provide sufficient comfort to prevent large concentrations of TLAC cross-holdings as well as limiting contagion in general within the sector.
- We consider that the proposed TLAC Holdings definition is far too broad and therefore leads to a disproportional reduction treatment. In particular, we strongly recommend not taking into account instruments ranking pari passu with excluded liabilities in the definition of TLAC Holdings.

Section 2 (Proposed Tier 2 deduction approach) and Section 3 (Other approaches considered)

We believe that the proposed approach to deduct TLAC Holdings that do not qualify otherwise as Basel III capital from Tier 2 is inappropriate for the following reasons:

- Such TLAC-eligible debt instruments rank senior to capital instruments, and provide the basis for recapitalisation by conversion into capital. They carry therefore far less risk of final loss in terms of both PD and LGD than capital instruments (notably CET1 and AT1 instruments). It would therefore be disproportionate to deduct them from Tier 2 as proposed. If and when converted upon resolution, these instruments will have to be deducted from the CET1 of the holder of the instrument in accordance with the existing Basel III deduction approach.
- Deducting TLAC holdings from Tier 2 instruments will have the effect of making investment in TLAC-eligible debt instruments economically unviable for the banking sector. As an illustration, we estimate that, for CAG, such a treatment would lead to a material reduction of the reported total capital ratio (potentially above 1%, but below 3%)³. Whilst this may meet the narrow aim of preventing contagion from a failing bank to other banks, it will also concentrate the effects on the non-bank and often non-regulated sector, where the potential for 'fatal' contagion may be higher. Besides, it will likely exclude banks as investors in these instruments and subsequently diminish the depth of this market while ample new issues are required in this (new) market over the next couple of years to enable banks to meet the new TLAC requirements⁴.

We therefore make the following recommendations when TLAC requirement is applicable to the holder of TLAC instruments:

- Like capital instruments that are deducted from regulatory own funds in accordance with their ranking, other TLAC instruments should be deducted from total TLAC when applicable, and not from Tier 2.
- In addition to the current 10% of common equity threshold, another 10% threshold specific to investments in TLAC instruments should be set up to ensure a live and deep market for such TLAC instruments. This is necessary to preserve banks' function as intermediary ensuring market liquidity for senior unsecured funding. Moreover, the difference between the minimum Pillar 1 capital requirement (8% without considering any buffer) and the minimum TLAC requirement (18% after 2022 without considering any buffer) is more than doubled and thus justifies the need for another specific 10% threshold.

For banks not eligible to TLAC we recommend that, instead of a deduction, TLAC holdings be treated within the BCBS large exposure framework as it is already the case. In combination with the risk weighting framework this should provide sufficient comfort to prevent large concentrations of TLAC cross-holdings as well as limiting contagion in general within the sector:

³ Estimates based on data as of 30 June 2015.

⁴ The quantitative impact study of the BCBS estimates that TLAC shortfalls across the G-SIBs could be as high as €1.1 trillion when the fully loaded rules come into force in 2022 creating a significant gap between supply and capacity. Indeed, according to the March 2015 Basel monitoring report, the total mid-2014 CET1 of banks was €3.0 trillion (185 banks in the sample). So applying the 10% threshold would mean that TLAC Holdings of these banks above €300 billion (minus their holdings of instruments that qualify as regulatory capital) should be deducted from their Tier 2 (which was €395 billion at Mid-2014).

- According to the bail in waterfall, TLAC instruments that do not qualify as Basel III capital rank after CET1, AT1 and T2. While own funds will be used for loss absorption, other TLAC debts will contribute to recapitalization of the institution, and therefore, their holders will receive a share of a clean, stabilized institution. This share should retain a certain value, with a possible upside given the precautionary valuation that should be made at entry in resolution. Thus, it would not be proportionate to deduct 100% of such instruments and large exposure rules should suffice.
- In addition, we do not agree with the BCBS observation outlined in Section 3.4 about the complexity caused by application of a different treatment to G-SIBs and non-G-SIBs, but view this as an appropriate and simple solution.
- We do not share the BCBS concern pointed out in Section 3.3 that the large exposure approach provides no practical upper bound on the losses that banks can suffer from the failure of multiple G-SIBs as:
 - The risk of contagion between G-SIBs would already be treated by the proposed approach to deduct TLAC Holdings from their TLAC.
 - This risk will also be further limited within the new large exposure framework that is due to come into effect on 1 January 2019: a tighter limit will apply to exposures between banks that have been designated as G-SIBs. This limit has been set at 15% of Tier 1 capital instead of 25% for other exposures.

We therefore believe that relying on the new large exposure framework for non-G-SIBs is sufficient. Furthermore, within this framework, introducing tighter limits and banks' exposure to G-SIBs or an aggregate large exposure limit on holdings of TLAC issued by all G-SIBs should be avoided.

Section 4 (Definition of TLAC Holdings)

The document proposes in 4.2 that instruments ranking *pari passu* with excluded liabilities, in jurisdictions where the 2.5%/3.5% exemption is in force, be deducted when their original maturity is over 1 year.

The last paragraph of 4.2 considers an alternative whereby such instruments would not be deducted. We strongly recommend following this alternative and keeping these instruments out of the deduction for the following reasons:

- As demonstrated in the BCBS paper, it would be extremely challenging from an operational perspective to identify the senior unsecured instruments with the 2.5-3.5% allowance from the rest of the senior unsecured instruments. So the likely consequence is that the investors will have to deduct all of the senior unsecured instruments. It would therefore include instruments which are irrelevant here (e.g. long term derivatives contracts) and would require banks to apply the deduction to a much broader range of instruments than those really counting as TLAC (3.5% of RWAs counting as TLAC to be compared with other and varied senior unsecured liabilities possibly ranging from 10.0% to 20.0% of RWAs).
- It is important to remind that the 2.5%/3.5% come on top of CET1, AT1, T2 and liabilities which are subordinated to excluded liabilities and should thus be reached in very exceptional cases.

- It does not make sense to have such a deduction as there is the 2.5%/3.5% cap for these instruments. As a consequence in these jurisdictions, the basis for bail-in in this insolvency class of debt may be much larger. Hence the losses incurred by holders of these instruments within their class of debt are lower than the ones subordinated TLAC instruments holders will bear in their own class. The risk would therefore be sufficiently covered by risk management and does not require a disproportionate deduction approach to be dealt with.
- Those instruments are already subject to the large exposure limits.

Section 5 (Evidence from the QIS)

We wish to emphasize that if non TLAC banks are in the scope of deductions, as opposed to our proposal, there should be a detailed QIS and impact survey. More specifically the QIS and impact survey should focus on investors and analyze which impact the proposed Tier 2 deduction approach would have on their investment strategies. We must make sure that limiting the kind of investments non-G-SIBs are allowed would not raise more issues than the ones that would be solved.

Clarification requests

In addition to the foregoing comments, we request clarification regarding the following points:

- Internal TLAC: the BCBS document should make it clearer that TLAC Holdings deduction approach only applies to external TLAC instruments and not internal TLAC instruments.
- Holdings of own TLAC and reciprocal cross holdings:
 - The BCBS proposes to extend the Basel III approaches of *“full deduction to holdings of own TLAC and reciprocal cross holdings of TLAC”*. It should be reminded that, according to the final TLAC Term, instruments that are funded directly or indirectly by the resolution entity (or a related party of the resolution entity) cannot be counted as TLAC. It should therefore be made clearer that in the case of intragroup holdings no deduction approach is needed.
 - Besides, if despite our previous recommendations the BCBS still intends to consider all liabilities ranking pari passu with excluded liabilities that could receive recognition as TLAC by the issuing G-SIB to be deducted from Tier 2, this would possibly include such instruments as loans and advances. Requiring those instruments to be deducted from Tier 2 would be very detrimental for intragroup operations, particularly in the case of cooperative banks with a central body that performs, for instance, liquidity management and capital market functions.