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12 February 2016

EBF Response to Basel Consultation on TLAC Holdings

The European Banking Federation (EBF) is supportive of the FSB' Total Loss Absorbing Capacity Standard to ensure that sufficient resources exist to safely resolve all covered banks, without impacting critical functions or using taxpayer funds. We now urge all jurisdictions to implement this framework consistently and within the spirit of the recent G20 agreement in Turkey. The framework when implemented needs to be mindful of the market depth and funding capacity of investors to allow banks to fulfil the requirements at sustainable cost.

While in principle, we understand the Basel Committee's intention to limit investments in TLAC of other banks, we have concerns with the approach taken, which may hinder the operation of a deep and liquid market in TLAC-eligible instruments. EBF members wish to express the following comments.

Key Messages:

- The notion of contagion: whilst we agree that the effects of contagion must be limited as far as is possible, contagion itself cannot be eliminated, as it is axiomatic that if TLAC is bailed-in, TLAC-holders must suffer from negative impacts. Any rules that seek to eliminate contagion from one sub-section of the population (e.g. banks) thus necessarily concentrate the impact of contagion elsewhere in the system. It may be preferable to allow moderate contagion effects across a wide population rather than to concentrate the effects on a smaller population, where it is more likely to prove 'fatal'.
- The severity of contagion: Given that Tier 1 and Tier 2 holdings are already subject to a deductions regime, which it is rightly not proposed to be amended, this proposal in reality deals only with TLAC-eligible instruments that are not Tier 1 or Tier 2. 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 credit risk than capital instruments, and this should be taken into account in the proposal. If and when converted, 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.
- The eviction effect of the deduction approach: the approach taken, of 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. 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.
- The EBF recognises the FSB view to disincentivise internationally active systemic banks from holding external TLAC issued by other G-SIBs in a manner generally parallel to deductions

for investments in regulatory capital instruments in other banks in order to mitigate contagion risk. However, for banks not subject to TLAC we recommend that, instead of a deduction, TLAC holdings be treated within the BCBS large exposure framework. 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. At the same time it avoids undue complexity and overly restrictive deductions in own funds by applying a deduction framework on institutions not subject to TLAC regulation. If such differentiated treatment is not put forward, 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 requirements).¹

- Furthermore, the principle for deduction of holdings of TLAC instruments should not be more severe than the principle for deductions in capital instruments already in place under the Basel framework. It would be necessary to exclude them being applied also to indirect holdings of TLAC.
- The Tier 2 treatment for TLAC eligible instruments that rank senior to Tier 2 instruments would unduly penalise these more senior instruments by disregarding the lower risk profile and lower PD of these instruments. The EBF therefore recommends deductions should be made from TLAC rather than Tier 2 as is currently proposed. Any excess should be deducted in the next layer, i.e. Tier 2, in line with the existing principles for deductions of own funds instruments.
- If the proposed deduction approach is retained and the positions of relevance for the threshold are broadly expanded to include TLAC holdings, we suggest that, in addition to the current 10% of common equity threshold, another 10% threshold specific to investments in TLAC instruments be set up to ensure an active, deep and liquid market for TLAC eligible instruments. Furthermore, an exemption for market-making activities, based on well-defined criteria should be considered. This is necessary to ensure banks' function as intermediaries providing market liquidity for senior unsecured funding.
- The EBF considers the asymmetric treatment, i.e. broadening the definition of TLAC holdings to cover instruments that are not or no longer TLAC eligible for the issuer, to be inappropriate. The definition should, in principle, be identical with the TLAC eligibility criteria. However, to avoid likely negative consequence for the market for senior unsecured instruments, we recommend that instruments which qualify for TLAC solely by virtue of the 2.5-3.5% allowances should not be subject to the deduction approach but be captured by large exposure limits.
- Furthermore, EBF members question how these instruments will be treated under Solvency II. If there is a different treatment, then this could give rise to arbitrage, if not different the market would become even smaller.

¹ 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).



Large Exposures – Sections 2 / 3.3 / 3.4

We believe that regulation of TLAC holdings via large exposure limits is appropriate and a fitting approach particularly for non-G-SIBs (cf. Section 3.4). We do not share the concerns 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 that adequately addresses the double counting of TLAC resources.

We furthermore do not agree with the BCBS observation outlined 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 as suggested by the BCBS should be avoided.

Section 2: Proposed Tier 2 deduction approach

Should the above approach not prevail, the proposed threshold approach (zero/less than 10% stake in a G-SIB) would generally be conceivable; but instead of any flat Tier 2 deduction, the corresponding deduction approach established by Basel III should, for the sake of consistency, be retained. However, for banks not eligible to TLAC we strongly recommend that, instead of a deduction, TLAC holdings be treated within the large exposure limits (as explained above). This large exposure framework is specifically aimed at protecting the bank from losses on counterparts.

Due to the BCBS proposed approach, the main part of the upcoming issued TLAC eligible debt instruments will have to be held by non-banking actors. This contraction of the investor 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 systemic risk mitigating objective.

If the proposed deduction approach is retained and the positions of relevance for the threshold are broadly expanded to include TLAC holdings, we suggest that, in addition to the current 10% of common equity threshold, another 10% threshold specific to investments in TLAC instruments be set up to ensure a live and deep market for such TLAC instruments. This is necessary to ensure banks' continue to function as intermediaries to provide market liquidity for senior unsecured funding. Moreover, the difference between the minimum 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.

In any case, we believe that adjustment of the relevant product types is required. In this context, we suggest limiting deduction to cash products (e.g. bonds) or to provide for an exception for regulatory trading book positions created, for example, by new securities issues.

Section 4: What constitutes a TLAC holding?

4.1 Instruments subordinated to Excluded Liabilities

Asymmetric treatment, i.e. broadening the definition of TLAC holdings to cover instruments that are not or no longer TLAC eligible for the issuer, is inappropriate, in our view. The definition should, in principle, be identical with the TLAC eligibility criteria, i.e. in particular, all instruments that, for example, do not or no longer fulfil the criteria under Section 9 of the TLAC term sheet (e.g. residual maturity of less than 1 year) should not be included in the TLAC holding. All positions that are not TLAC-eligible should be consistently recognised as part of risk-weighted assets.

4.2 Instruments ranking *pari passu* to Excluded Liabilities

We regard the proposed approach to have likely implications for the existing senior market. It does not seem to be possible to identify the senior unsecured instruments with the 2.5%-3.5% allowance from the rest of the senior unsecured instruments. The likely consequence is that the investors may need to deduct all of the senior unsecured instruments including those not included in 2.5-3.5%. To avoid the likely negative consequence for the existing senior market, we recommend that these instruments not be subjected to the deduction approach but be subject to the large exposure limits.

Section 5: Evidence from the QIS

The results of the QIS should be interpreted very cautiously, in our view. The study itself says at various points that not all the data delivered could be used and that certain information was missing (see penultimate paragraph of the Executive Summary or footnote 49). Generally speaking, this also raises the question for us of whether the QIS as a whole uniformly draws on a consistent set of data (did all banks really include TLAC holdings with a residual maturity of less than 1 year?)

Finally, we stress that if non TLAC-subject 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 analyse 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

- 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 Sheet, 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.