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UniCredit reply to the BCBS consultation on “TLAC Holdings”

Introduction

Section 15 of the TLAC Term Sheet foresees that G-SIBs must deduct from their regulatory capital investments in eligible TLAC liabilities issued by other G-SIBs in a manner generally parallel to the existing provisions in Basel III that require a bank to deduct from its own regulatory capital certain investments in the regulatory capital of other banks.

The Term Sheet entrusts the Basel Committee for Banking Supervision (“BCBS”) with the task to further specify this provision, including a prudential treatment for non-G-SIBs.

The BCBS consultative paper goes beyond this approach by extending the G-SIBs general obligation to deduct TLAC holdings issued by other G-SIBs to all other internationally active banks. Further to this, the paper foresees also a deduction of some instruments which are not / not anymore / only partially TLAC eligible.

General Comments

UniCredit agrees with the objective of the proposal, namely to reduce the potential for a G-SIB in resolution to spread contagion into the global banking system. However, UniCredit believes that a fundamental reconsideration of the proposed Tier 2 deduction approach is required and that a better risk-targeted approach should be developed for the following reasons:

- in order to be compliant with the requirement to hold a sufficient quantity of TLAC, G-SIBs will need to issue a significant amount of additional loss absorbing instruments. In order not to eliminate an important investor base, the framework must be mindful of the market depth and funding capacity of investors to allow banks to fulfil the new requirement at a sustainable cost and within a reasonable period of time. Requiring banks to deduct their TLAC holdings from Tier 2 will simply eliminate them as potential investors and market makers. The latter point also negatively affects liquidity, which will lead to higher spreads and funding costs for banks;
- banks are equipped to take and to manage risk. They are also supervised based on high prudential standards. If international banks are eliminated as potential investors for TLAC eligible instruments, other investors must replace them: unregulated and not supervised shadow banks, retail investors, UCITS. Instead of shifting the potential risk associated with investments in TLAC to these sectors alone, a well balanced approach that limits bank investments into TLAC, but does not eliminate banks as potential investors, is more sustainable. Such an approach has also positive effects in terms of risk diversification. From a global financial stability perspective it is probably preferable to accept some well contained contagion effects across a wide range of investors rather than to concentrate the effects on a smaller group;
- TLAC is inherently less risky than equity, as TLAC eligible debt instruments rank senior to capital instruments, and provide the basis for recapitalization by conversion into capital. This

implies a lower probability of suffering losses and consequently lowers contagion risk. Therefore a Tier 2 deduction of TLAC instruments is certainly overly conservative and not justified. In fact, the assumption that a full deduction from Tier 2 is overly conservative is indirectly confirmed in the consultative paper itself, as it acknowledges that: “the cost of Tier 2 capital can be expected on average to exceed the cost of TLAC,.....”. Therefore, this proposed Tier 2 deduction approach would unduly penalize TLAC eligible instruments by disregarding their lower risk profile and lower PD;

- the G-SIB buffers (1.0% - 3.5% of CET1) were specifically designed to address the “too big to fail” risk of those banks. As TLAC only applies to G-SIBs, this buffer should be included as a mitigant for the intra G-SIBs risk. Without allowing the G-SIB buffer to be counted as a mitigant, the G-SIBs are being unduly burdened both in absolute economic terms and when compared to non G-SIB banks.

Comments on specific aspects of the proposed treatment

1. Proposed Tier 2 deduction approach

We agree with the aim of limiting contagion by introducing prudential restrictions for the holding of TLAC eligible instruments. However, limiting potential contagion through Tier 2 capital deductions is overly conservative and ignores the negative impact on the market depth and available funding capacity.

In order not to overly constrain the TLAC funding market, international banks other than G-SIBs, should not be subject to a Tier 2 deduction when investing into TLAC issued by G-SIBs. An alternative and more adequate prudential restriction would be to make such investments subject to large exposure limits.

For G-SIBs investing in other G-SIBs’ TLAC, the proposed 10% threshold adopted from the existing Basel capital framework needs to be tailored to the different nature and risk of TLAC items. In order to create a deep and liquid TLAC market within the necessary time frame, the threshold should be raised to a value in the region of 20% or higher. Such a threshold would be appropriate because:

- of the lower risk of TLAC compared to equity;
- the market for non-regulatory capital TLAC notes is expected to be larger than the existing market for Basel 3 capital products (where a 10% threshold is already applied through the Financial Sector Entity definition).

2. Only instruments that count towards TLAC should be subject to prudential restrictions

The objective set out in the TLAC Term Sheet is that G-SIBs have the loss-absorbing and recapitalization capacity to ensure that, in and immediately following a resolution, critical functions can be continued without taxpayers’ funds or financial stability being put at risk. This means that TLAC is calibrated in a manner that ensures that a bank can be resolved by bailing-in or writing down TLAC eligible instruments only. Including non-TLAC eligible instruments into the deduction requirement goes therefore beyond the objective. All instruments that are not TLAC eligible should be consistently recognised as part of risk-weighted assets. In addition, it will be extremely difficult for investors and issuers to identify which liabilities, other than the ones constituting TLAC, shall be subject to prudential restrictions / deductions.

Furthermore, making synthetic TLAC holdings subject to prudential restrictions would be operationally too burdensome, difficult and costly to implement in an acceptable way, while the benefit is probably marginal. Also the identification of indirect or synthetic holdings of TLAC will be

considerably more difficult than for regulatory capital holdings. In the light of efficiency and proportionality of costs and administrative burden in relation to the potential benefit and the very objective of the new rules, no prudential restriction for synthetic holdings should be applied.

3. Instruments that are only partially TLAC eligible (e.g. statutory subordinated senior debt) should be subject to partial (and not to full) restrictions

The BCBS proposes that instruments (senior unsecured debt) ranking *pari passu* with excluded liabilities, but which qualify as TLAC pursuant to the exemptions of the TLAC Term Sheet, should be treated as TLAC holding when they have an *original* maturity of over 1 year.

This means that even in the case that only a certain portion of such instruments is recognized as TLAC eligible, the deduction will be applied to the entire class of these instruments. This approach is too conservative and poses level playing field issues.

UniCredit therefore suggests that the following approach, which was considered by the BCBS in the consultative paper, but rejected, shall be applied instead:

Section 11 of the FSB Term Sheet recognizes senior liabilities that rank *pari passu* with TLAC excluded liabilities to some extent only: 2.5% of RWAs or 3.5% of RWAs depending on whether the final TLAC is equal to 16% or 18% RWAs. A proportional restriction would result in the following: if for example the total of senior unsecured debt (bank bonds) that ranks *pari passu* with excluded liabilities is not more than 5% of RWAs and only an amount equal to 3.5% of RWAs counts towards TLAC, then the deduction has to take place in the order of 70% only. However, looking into each G-SIBs funding structure to identify the exact amount to be deducted may be extremely burdensome, especially as the funding structure is subject to permanent changes. For this reason and taking into consideration that generally this class of TLAC instruments is a lot bigger than the amount recognized for TLAC purposes no deduction should be required. The risk associated with such partially recognized liabilities should be adequately covered by normal risk management and, in any case, would be subject to applicable Large Exposure rules.

4. Further Comments

Market making

In order to ensure a deep and liquid market for TLAC instruments, a well-functioning market making in these instruments will be crucial. Such market making functions will be essentially carried out by G-SIBs and other large international banks. However, the BCBS proposal to deduct TLAC holdings from Tier 2 instruments will be detrimental to market making. The BCBS consultative paper recognizes the need for an allowance for market making, but does not go far enough.

The best solution would be a forward looking approach based on the Fundamental Review of the Trading Book, where it is stated: "Where a bank demonstrates that it is an active market-maker, then a national supervisor may establish a dealer exception for holdings of other banks' securities firms, and other financial entities' capital instruments in the trading book. In order to qualify for the dealer exception, the banks must have adequate systems of controls surrounding the trading of financial institutions' eligible regulatory capital instruments".

UniCredit believes that applying such an approach to TLAC instruments would have the advantage of being coherent with the trading book rules, avoid the application of different rules affecting market making and ultimately ensure efficient market making.

Identification / disclosure of TLAC instruments

For the moment it is not clear how, when and to what level of detail a G-SIB will be subject to TLAC disclosure rules. Much will depend on the forthcoming disclosure rules. These forthcoming rules should aim at maximising the ease of identification as difficulties to determine what constitutes TLAC may have a significant negative impact on the depth and liquidity of the future TLAC market. Unduly complex or burdensome rules will lead to a narrowing of the TLAC instruments that a given bank will be willing to deal with or invest in with resulting negative consequences for the depth and liquidity of the market. Therefore it should also be made clear that banks transacting or investing in TLAC instruments are entitled to rely on disclosures in the prospectus and are not required themselves to certify an instrument as constituting TLAC or not.

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