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1. Introduction

At the 2013 St. Petersburg Summit, the G20 Leaders called for the development of proposals by end-2014 on the adequacy of loss-absorbing and recapitalisation capacity of global systemically important banks (G-SIBs). In response to this request, the Financial Stability Board (FSB) in consultation with the Basel Committee on Banking Supervision (Basel Committee) published its proposed minimum standard for “total loss-absorbing capacity” (TLAC). The TLAC framework was recently finalised and published by the FSB.

The TLAC regime includes a set of principles and a set of minimum requirements contained within a term sheet. Section 15 of the term sheet states the following:

In order to reduce the risk of contagion, G-SIBs must deduct from their own TLAC or regulatory capital exposures to eligible external TLAC instruments and 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 Basel Committee will further specify this provision, including a prudential treatment for non-G-SIBs.

In this document the Basel Committee sets out for consultation its proposed deduction treatment for banks’ investments in TLAC, and its proposals on the extent to which instruments ranking pari passu with TLAC should be subject to the same deduction treatment.

In addition to the requirements of Section 15 of the term sheet, the TLAC principles and FSB’s Key Attributes of Effective Resolution Regimes for Financial Institutions (“Key Attributes”) are important factors driving the Basel Committee’s proposal. The first TLAC principle is to ensure that G-SIBs have “sufficient loss absorbing and recapitalisation capacity available in resolution to implement an orderly resolution that minimises any impact on financial stability, ensures the continuity of critical functions, and avoids exposing taxpayers (that is, public funds) to loss with a high degree of confidence”. However, the scope of the TLAC requirement does not determine the scope of liabilities which may be exposed to loss in resolution. Rather, according to the Key Attributes, “resolution powers should be exercised in a way that respects the hierarchy of claims”, with some, limited, flexibility to depart from the general principle of equal treatment of creditors within a creditor class.

The Basel Committee’s proposal changes the calculation of regulatory capital for all internationally active banks (both G-SIBs and non-G-SIBs). The changes to the Basel III text to give effect to the proposed treatment are set out in Annex 1. The Committee would welcome comments on all aspects of the proposed treatment. Comments should be uploaded by 12 February 2016 using the following link: www.bis.org/bcbs/commentupload.htm. All comments will be published on the website of the Bank for International Settlements unless a respondent specifically requests confidential treatment.

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2. Proposed Tier 2 deduction approach

The Basel Committee proposes that internationally active banks (both G-SIBs and non-G-SIBs) be required to deduct their net TLAC holdings\(^3\) that do not otherwise qualify as Basel III capital from their own Tier 2 capital (ie in a manner consistent with the Basel III treatment of banks' investments in the Tier 2 capital of other banks). This section sets out the rationale and specifics of this proposed approach.

Under Basel III, banks are required to deduct their holdings of capital instruments on a corresponding basis.\(^4\) This means the deduction should be applied to the same component of capital for which the capital would qualify if it was issued by the investing bank itself. For example, holdings of Tier 2 capital should be deducted from the investing bank's own Tier 2. This approach has the effect of removing the double counting of capital\(^5\), which can act as a significant source of contagion in the banking and financial sectors. Without deduction, cross holdings of capital can mean that the failure of one institution can lead to the erosion of capital, and potential failure, of an investing bank.

If the investing bank does not own more than 10% of the common shares of the issuer, the abovementioned Tier 2 capital holdings are deducted to the extent that they exceed a threshold, with amounts below the threshold risk weighted instead.\(^6\) If the investing bank owns more than 10% of the common shares of the issuer, the Tier 2 capital holdings are deducted in full.\(^7\) Furthermore, if a bank is required to make a deduction from a particular tier of capital and it does not have enough of that tier of capital to satisfy that deduction, the shortfall will be deducted from the next higher tier of capital (eg if a bank does not have enough Tier 2 capital to satisfy a deduction resulting from investments in Tier 2, the shortfall will be deducted from the investing bank's Additional Tier 1).

The Basel Committee considered extending the Basel III corresponding deduction approach to holdings of TLAC. This would have required G-SIBs to deduct their investments in TLAC from their own TLAC resources. However, such an approach does not work well for non-G-SIBs, which will not be subject to the TLAC regime and so may not have sufficient TLAC resources from which to apply deductions. As a consequence, the Basel Committee proposes that all banks be required to treat their holdings of TLAC as investments in Tier 2 capital for the purposes of the deduction rules. This approach has the following benefits:

\(^3\) In this consultative document ‘TLAC holdings’ refers to holdings of TLAC qualifying instruments of a G-SIB, excluding any instruments that qualify as regulatory capital. Net TLAC holdings refers to gross TLAC holdings net of eligible short positions in TLAC. The netting of long and short positions in TLAC will be governed by the netting conditions set out in Basel III, which currently apply to regulatory capital holdings. See paragraphs 80 and 84 of the Basel III standard: http://www.bis.org/publ/bcbs189.pdf

\(^4\) Paragraphs 80 to 89 of the Basel III standard.

\(^5\) The terms ‘double counting’ or ‘double gearing’ of capital refers to the situation when capital of one entity is simultaneously recognised within the capital base of another entity. Double counting of capital within the banking system can occur when one bank has an investment in the capital of another bank. Double counting can be removed by applying a regulatory adjustment to deduct the amount of capital that is being double counted.

\(^6\) Where a bank holds investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation and where the bank does not own more than 10% of the issued common share capital of the entity, the total of all holdings (in Common Equity Tier 1, Additional Tier 1 and Tier 2 instruments of such entities) that in aggregate exceed 10 % of the bank’s common equity must be deducted following a corresponding deduction approach (paragraph 81 of the Basel III standard).

\(^7\) Where a bank holds significant investments in the capital of banking, financial and insurance entities that are outside the scope of regulatory consolidation, all investments that are not common shares must be fully deducted following a corresponding deduction approach (paragraph 85 of the Basel III standard).
• As the cost of Tier 2 capital can be expected on average to exceed the cost of TLAC, the approach can be expected to provide sufficient disincentive for banks to invest in TLAC, thus reducing potential contagion from the failure of a G-SIB.

• Even in cases where banks do invest in TLAC, the Tier 2 they will need to maintain to absorb the deduction will help to reduce contagion from the failure of a G-SIB.

• It can be applied consistently by both G-SIBs and non-G-SIBs, thus avoiding the creation of any level playing field issues.

• It utilises the current provisions of Basel III, meaning it can be implemented with minimal changes.

The proposed approach expands the set of instruments subject to the Basel III deduction approach from holdings of regulatory capital instruments to also include TLAC holdings:

• Where a bank owns less than 10% of the common shares of the issuer, holdings of TLAC of that issuer would be deducted – subject to a threshold – from the bank’s Tier 2 capital.

• Where a bank owns more than 10% of the common shares of the issuer, holdings of TLAC of that issuer would need to be fully deducted from the bank’s Tier 2 capital.

One of the aims of the Basel III deduction threshold is to permit a limited level of activity, such as market making, to occur without banks being subject to a deduction. Therefore, an issue that the Committee will consider as part of the consultation process is whether any adjustment to the existing threshold, set at 10% of a bank’s own common equity, is warranted.

Holdings of own TLAC and reciprocal cross holdings

Basel III requires banks to fully deduct on a corresponding basis:

• investments in their own shares and other own capital instruments they have issued, if these are not already derecognised under the relevant accounting standards (paragraph 78 of Basel III); and

• reciprocal cross holdings of capital that are designed to artificially inflate the capital position of banks (paragraph 79 of Basel III).

The Basel Committee proposes to extend the above approaches of full deduction, i.e., deduction without any threshold, to holdings of own TLAC and reciprocal cross holdings of TLAC that are designed to artificially inflate the TLAC position of banks.

3. Other approaches considered

The Basel Committee considered various other approaches to the treatment of TLAC holdings. These are briefly outlined here such that respondents to the consultation can also assess the merits of these approaches relative to the proposed Tier 2 deduction approach.

3.1 Common Equity Tier 1 deduction

Although Tier 2 deduction helps reduce the contagion that results from cross holdings of capital or TLAC, it does not remove it altogether. Even with a full deduction from Tier 2 capital, the investing bank will suffer losses to its Common Equity Tier 1 (CET1) if its exposure to TLAC is written-down or converted to common shares in resolution. To more fully insulate the investing bank from the impact of the failure of a G-SIB, it could be argued that a CET1 deduction is necessary. However, such an approach would
either result in a more onerous treatment of TLAC holdings than for Additional Tier 1 and Tier 2 capital holdings under Basel III, or would necessitate a change to Basel III to implement a CET1 deduction for all holdings of regulatory capital and TLAC to achieve consistency.

3.2 Penal risk weight

An appropriately conservative risk weight may be able to address the credit risk associated with holdings of TLAC. However, unless set at a level that is equivalent to a deduction, such an approach will not remove the double counting of TLAC.

3.3 Large exposure limits

One of the stated objectives of the Basel Committee’s supervisory framework for measuring and controlling large exposures is to mitigate the risk of contagion between global systemically important banks. Therefore various types of large exposure (LE) limits were considered for the treatment of TLAC holdings, including: (i) relying on the new LE framework that is due to come into effect on 1 January 2019; (ii) introducing tighter limits on banks’ exposures to G-SIBs; (iii) introducing separate LE limits on holdings of TLAC issued by individual G-SIBs; and (iv) introducing an aggregate LE limit on holdings of TLAC issued by all G-SIBs.

The first of these is a simple approach as it requires no further changes to regulatory standards. It also puts an upper bound on the direct losses that banks can suffer from the failure of a single G-SIB. However, it provides no practical upper bound on the losses that banks can suffer from the failure of multiple G-SIBs, as would have occurred without the government bail-outs in the financial crisis that began in 2007, and no practical upper bound on the double counting of TLAC in the banking system. The same problems exist with the second and third approaches, with the second approach also suffering from the problem that the introduction of TLAC effectively tightens the LE regime for non-TLAC instruments which could result in adverse impacts on the interbank market. In contrast the fourth approach would give an upper bound on the losses that a non-G-SIB can suffer from its holdings of TLAC. However, it would represent a significant departure from the current aim of the LE framework which is focused on protecting banks against the failure of a single counterparty.

3.4 Deduction for G-SIBs and large exposures limit for non-G-SIBs

The proposed Tier 2 deduction approach could be applied to G-SIBs’ holdings of TLAC and non-G-SIBs’ holdings of TLAC could be subject to one of the large exposure requirements listed in Section 3.3. Alternatively, G-SIBs could be required to deduct their TLAC holdings from their own issued TLAC, rather than their Tier 2. Applying a different treatment to G-SIBs’ holdings and non-G-SIBs’ holdings could be appropriate given the greater systemic risk posed by G-SIBs. However, such a dual approach would add complexity to the Basel Committee’s standards, and for non-G-SIBs it suffers from the same shortcomings of the LE approaches described in Section 3.3.

8 See http://www.bis.org/publ/bcbs283.pdf
4. What constitutes a TLAC holding?

This section sets out the Committee’s planned approach for defining what constitutes a TLAC holding by an investing bank, and therefore the types of holdings that will be subject to the Tier 2 deduction approach outlined in Section 2.

The TLAC term sheet requires TLAC to be, in general, subordinated to a list of excluded liabilities (eg insured deposits) and provides for three ways to achieve this: contractual, statutory and structural subordination. This section of the consultative document considers whether other subordinated instruments that rank pari passu with TLAC should be treated as a TLAC holding, given that they may be subject to loss in resolution to the same extent as TLAC. The term sheet also specifies exemptions to the subordination requirement that permit, subject to certain conditions, senior instruments that rank pari passu with excluded liabilities to count as TLAC. This section of the consultation document therefore also considers how to treat senior instruments that are eligible as TLAC as a result of these exemptions and other pari passu liabilities.

In addition to the issues discussed in the sections below, the Committee proposes that the definition of a TLAC holding:

- exclude all holdings of instruments or other claims listed in the “Excluded Liabilities” section of the TLAC term sheet (eg deposits, derivatives, tax liabilities etc);
- include both instruments issued by G-SIBs headquartered in emerging market jurisdictions and G-SIBs headquartered in other jurisdictions (ie TLAC holdings should include TLAC instruments issued by Chinese G-SIBs, even though they are not initially subject to the minimum external TLAC requirement); and
- include direct, indirect and synthetic holdings of TLAC (ie consistent with the treatment applied to regulatory capital holdings).

4.1 Instruments subordinated to Excluded Liabilities

This sub-section focuses exclusively on the treatment of TLAC instruments meeting the requirements for contractual, statutory or structural subordination outlined in points a, b and c of section 11 of the TLAC term sheet and instruments that rank pari passu in the creditor hierarchy. Senior instruments that qualify as TLAC as a result of the application of the term sheet’s exemptions from the subordination requirements (the antepenultimate and penultimate paragraphs of section 11 of the term sheet) are covered in subsection 4.2.

The Committee considered the option of limiting the definition of TLAC holdings to holdings of instruments that are actively being recognised by the issuing G-SIB as TLAC. Such an approach has the advantage of addressing double counting of TLAC. However, this approach would exclude:

(a) instruments issued by banks that formerly counted as TLAC but now no longer qualify as they have fallen below the 1 year residual maturity requirement; and

(b) subordinated instruments that rank pari passu with TLAC instruments, but have never qualified as TLAC (eg a subordinated debt instrument with a 6 month original maturity).

9 See points a, b and c of section 11 of the TLAC term sheet.
At the point of resolution, the above instruments are expected to be exposed to losses at the same time and to the same extent as instruments that are actively being recognised as TLAC. As a consequence, to better meet the objective of limiting contagion, the Committee proposes to include the instruments in (a) and (b) above in the definition of a TLAC holding. In practice this means that both instruments actively receiving recognition as TLAC and instruments ranking pari passu should be treated as a TLAC holding by the investing bank. This approach should help to avoid the development of mistaken market expectations that only liabilities which qualify for TLAC, or are actively serving to meet TLAC requirements, will normally be exposed to loss in resolution, even where this involves a departure from the insolvency creditor hierarchy. It also should avoid providing regulatory incentives to minimise the amount of funding in issue which qualifies for TLAC.

4.2 Instruments ranking pari passu to Excluded Liabilities

The TLAC term sheet allows instruments issued by G-SIBs in certain jurisdictions to qualify as TLAC, subject to meeting the eligibility requirements, even though they rank pari passu to Excluded Liabilities. That is, the term sheet provides exemptions to the subordination requirement, thus allowing senior debt to count as TLAC. This recognition is subject to certain conditions, including the ability to bail-in the senior debt instruments without imposing losses on the Excluded Liabilities and without giving rise to material risk of successful legal challenge or valid compensation claims.

The exemptions are set out in the penultimate and antepenultimate paragraphs of section 11 of the term sheet. Regarding the exemption in the antepenultimate paragraph of section 11, the recognition of eligible senior instruments as TLAC is uncapped. Regarding the exemption in the penultimate paragraph of section 11, the recognition of senior instruments as TLAC is capped at 3.5% of RWAs (the cap is initially set at 2.5% of RWAs, but rises to 3.5% of RWAs when the minimum TLAC requirement is 18% of RWAs).

The Committee considered how to capture such senior liabilities subject to the exemptions in the definition of TLAC holdings. One way is to require investing banks to include in TLAC holdings all senior instruments that rank pari passu with Excluded Liabilities when the issuing G-SIB is located in a jurisdiction that applies the subordination requirements. However, the Committee has concerns that such an approach would capture too many senior liabilities. For example, it would capture short term (less than one year) interbank exposures in cases where the issuing bank is the resolution entity. It would also capture the full amount of debt ranking pari passu to Excluded Liabilities even in cases where the issuing G-SIB was only receiving partial recognition for the instruments as TLAC due to the application of the 3.5% cap. That is, the approach goes further than removing double counting of TLAC. To address this latter issue, the Committee considered applying an adjustment to the amount recognised as a TLAC holding based on the extent to which the issuer exceeds the 3.5% cap. For example, if the G-SIB resolution entity has funding that ranks pari passu with Excluded Liabilities equal to 5% of RWAs, it will only be able to recognise 70% (= 3.5/5.0) of this funding as External TLAC due to the application of the 3.5% cap. The adjustment would therefore result in only 70% this funding being treated as a TLAC holding by any investing bank. This would have the advantage of consistency with the recognition of TLAC by the issuer and therefore avoids an overall deduction which could exceed the amount of TLAC recognised by the issuer. Furthermore, the public disclosure in respect of each issuer of TLAC should contain sufficient information to enable the investing bank to calculate the proportion of

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10 This is in line with the principle in the Key Attributes that liabilities are generally exposed to loss in the order of the insolvency creditor hierarchy. There may be exceptions to this rule, for example in the EU there may be a departure from pari passu treatment in certain specific exceptional circumstances.
any funding class being recognised as TLAC by the issuer (70% in the example above). However, this type of adjustment: (i) may exclude from the deduction requirement funding that may expected to be bailed-in at the same time and to the same extent as senior funding receiving recognition as TLAC; (ii) would mean an investing bank could see the size of its deduction vary over time due to changes in recognition at the issuing G-SIB, even if the size of its investment remained fixed; and (iii) is affected by a time lag with regard to the disclosure of TLAC information by the issuing G-SIB.

As a result of the considerations outlined above, the Committee proposes that instruments ranking pari passu with Excluded Liabilities issued by G-SIBs in jurisdictions that apply the subordination exemptions should only be treated as a TLAC holding by the investing bank when they have an original maturity of over 1 year. This proposed treatment implies that all liabilities ranking pari passu with Excluded Liabilities that could receive recognition as TLAC by the issuing G-SIB are included as a TLAC holding for the investing bank. It also avoids unwanted effects on the short term inter-bank market.

The Committee did consider an alternative approach that excludes from an investing bank’s TLAC holdings instruments ranking pari passu with Excluded Liabilities even when these are includable in the issuer’s TLAC due to the subordination exemptions. Although this approach is operationally simpler, the Committee is concerned that it would be inconsistent to give recognition to instruments as TLAC by the issuing G-SIB, but not recognise them as such by the investing bank. Furthermore, such an approach would disregard the fact that these liabilities could be exposed to losses at the same time as other liabilities recognised as TLAC under the relevant resolution regime.

5. Evidence from the QIS

The impact of the proposed approach is assessed in sections 4 and 5 of the Basel Committee’s TLAC Quantitative Impact Study Report.12

6. Other TLAC related changes to Basel III

In addition to specifying a treatment for holdings of TLAC by banks, the TLAC regime also necessitates changes to Basel III to specify how G-SIBs must take account of the TLAC requirement when calculating their regulatory capital buffers. In particular, it needs to state that any Common Equity Tier 1 that is being used to meet the TLAC requirement cannot be used to meet the regulatory capital buffers. The proposed changes are set out in Annex 1.

11 The assessment relates to the original maturity of the instrument, not the residual maturity. Therefore, instruments that have an original maturity of over 1 year will be treated as a TLAC holding by the investing bank even if the residual maturity is 1 year or less.

12 http://www.bis.org/bcbs/publ/d341.pdf
7. Implementation date

The proposed implementation date for the approach described in this paper is the same as the conformance date for the TLAC regime (ie 1 January 2019).
Annex 1

Changes to Basel III text

To give effect to the proposals outlined in this document, the following paragraph would need to be added to the Basel III text immediately after paragraph 77:

77a. For the purposes of paragraphs 78 to 85, direct, indirect and synthetic investments in the instruments of a G-SIB that qualify as TLAC (but that do not otherwise qualify as regulatory capital for the issuing G-SIB) should be treated as if they were investments in Tier 2 compliant capital instruments. Investments in TLAC:

(i) Include all holdings of instruments that are eligible to be recognised as TLAC by the issuing G-SIB according to the TLAC regime (irrespective of whether the G-SIB is subject to the minimum external TLAC requirement).

(ii) Include all holdings of instruments that rank pari passu to any instruments included in (i), with the exception of the instruments excluded by (iii) and (iv) of this paragraph.

(iii) Exclude all holdings of instruments listed in the Excluded Liabilities section of the TLAC term sheet.

(iv) Exclude all holdings of instruments that have an original maturity of less than one year that rank pari passu to Excluded Liabilities and that have been issued by G-SIBs in jurisdictions that apply the exemptions to the subordination requirements set out in section 11 of the TLAC term sheet.

The Basel III text will also need to specify that only CET1 in excess of that required to satisfy minimum regulatory capital requirements and the minimum TLAC requirement as a percentage of RWAs may count towards regulatory capital buffers, in line with Section 4 of the TLAC Framework. In this respect, the Committee proposes to make the following changes:

Footnote 47. Common Equity Tier 1 must first be used to meet the minimum capital and TLAC requirements if necessary (including the 6% Tier 1, and 8% Total capital and 18% TLAC requirements if necessary), before the remainder can contribute to the capital conservation buffer.

Paragraph 131. The table below shows the minimum capital conservation ratios a bank must meet at various levels of the Common Equity Tier 1 (CET1) capital ratios. For example, a bank with a CET1 capital ratio in the range of 5.125% to 5.75% is required to conserve 80% of its earnings in the subsequent financial year (ie payout no more than 20% in terms of dividends, share buybacks and discretionary bonus payments). If the bank wants to make payments in excess of the constraints imposed by this regime, it would have the option of raising capital in the private sector equal to the amount above the constraint which it wishes to distribute. This would be discussed with the bank’s supervisor as part of the capital planning process. The Common Equity Tier 1 ratio includes amounts used to meet the 4.5% minimum Common Equity Tier 1 requirement, but excludes any additional Common Equity Tier 1 needed to meet the 6% Tier 1 and 8% Total Capital requirements, and also excludes any CET1 needed to meet the TLAC requirement. For example, a bank with 8% CET1 and no Additional Tier 1 or Tier 2 capital, that has 10% of other TLAC instruments would meet all its minimum risk-based capital and risk-based TLAC requirements, but would have a zero conservation buffer and therefore be subject to the 100% constraint on capital distributions.

Footnote 53. Consistent with the conservation buffer, the Common Equity Tier 1 ratio in this context includes amounts used to meet the 4.5% minimum Common Equity Tier 1 requirement, but excludes any additional Common Equity Tier 1 needed to meet the 6% Tier 1 and 8% Total Capital requirements and the 18% TLAC requirement.