Loss-absorbing capacity requirements for resolution: beyond G-SIBs [1]

Executive Summary

Following the Great Financial Crisis (GFC) that started in 2007, authorities have developed resolution regimes for banks. Since the 2011 adoption of the *Key Attributes of Effective Resolution Regimes for Financial Institutions*, developed by the Financial Stability Board (FSB), significant work has been carried out by resolution authorities nationally and under the aegis of the FSB to develop credible and feasible resolution plans for systemically important ("systemic") banks and to ensure that those banks are resolvable under the resolution strategy or strategies set out in their plans.

Resolution enables authorities to manage the failure of a systemic bank in a way that minimises its impact on financial stability and economic activity without reliance on public funds. The core resolution strategies used to achieve this are based on the writedown and/or conversion of liabilities and shares of the failing bank to absorb losses and recapitalise its critical operations (bail-in), or the transfer of its critical functions to a financially sound recipient, or a combination of both. Loss-absorbing capacity (LAC) or other sources of funding are needed to support the execution of the chosen resolution strategy.

The funding required to implement the chosen resolution strategy may come from a range of sources. A primary source is LAC on the balance sheet of individual banks. LAC absorbs the losses and can also be used to recapitalise the bank in resolution or a successor, so that the failed bank's critical functions can continue to operate. Other sources include industry-sourced funds – deposit insurance and resolution funds – and, ultimately, funding may also come from governments through exceptional public solvency support.

While a global LAC standard exists for the largest, most systemic banks, there is no equivalent alignment on how resolution of other banks should be funded. For the global systemically important banks (G-SIBs), the international resolution framework is supplemented by the FSB Total Loss-absorbing Capacity (TLAC) Standard, which sets a standard for a minimum LAC requirement for that set of designated institutions. Nevertheless, consistent with the scope of application of the Key Attributes, systemic non-G-SIBs are also expected to be resolved because of their likely impact in the event of failure. Those banks are therefore subject to resolution planning and resolvability requirements. Funding is a key aspect of resolvability. However, unlike G-SIBs, which are sufficiently comparable within the class to support an internationally coordinated approach to LAC requirements, the greater diversity of systemic non-G-SIBs suggests a need to tailor funding requirements to the characteristics of local banking markets.

This paper reviews and discusses the use of LAC requirements to support the resolvability of systemic banks other than G-SIBs. Recent episodes of banking turmoil have highlighted the importance of LAC for such banks. As part of its consideration of the lessons learned from the 2023 banking turmoil, the FSB stressed the importance of discussing the costs and benefits of requiring non-G-SIBs to issue LAC instruments to support resolution. This paper explores the approaches in six jurisdictions to designing and implementing resolution-related LAC requirements for banks other than G-SIBs. The

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selected jurisdictions are Australia, Canada, the European banking union, Hong Kong SAR, South Africa and the United Kingdom.

The scope of LAC requirements varies across the featured jurisdictions, but each is framed by systemic considerations. The way in which these considerations define the scope broadly falls into one of two approaches. In one case, the LAC requirement applies only to banks that have been formally identified as systemic, in accordance with a process for designating domestic systemically important banks (D-SIBs) or systemically important financial institutions (SIFIs). While other banks may be within the scope of the resolution framework, they are not required to issue additional resolution-related LAC. Under the second approach, the scope of application of a LAC requirement is determined in resolution planning.

The approach to LAC calibration also varies but is informed by the scope of application. When LAC requirements apply to a designated set of systemic banks, they usually consist of a uniform requirement for all those banks and are generally anchored in the regulatory capital framework. Where the scope of LAC requirements is linked to resolution planning, calibration is bank-specific, within parameters and based on the bank's resolution strategy and assessment of its resolvability.

Tailoring LAC calibration to individual banks may offer greater confidence that LAC levels will support resolution, but it increases complexity. While tailoring better reflects the diversity in business models, a bank's preferred resolution strategy and its operating environment, there may be a risk that it reduces the transparency and predictability of the framework. A complex set of adjustments, involving a greater element of judgment, is also burdensome for resolution authorities and possibly increases their exposure to challenge.

It is valid to consider whether LAC requirements can be streamlined or simplified. Simpler frameworks can deliver sufficient levels of LAC to facilitate resolution. It is not possible to calibrate LAC requirements for individual institutions with scientific precision, and there may be advantages in terms of simplicity in a less tailored approach, even if that could require authorities to quantify requirements conservatively.

While experience to date shows that banks have not had significant difficulties in meeting LAC requirements, there is a trade-off between the scope of the requirements and the nature of the instruments that are eligible to meet them. Where LAC requirements apply to a more diverse set of banks, including banks that have not traditionally issued significant volumes of debt, such banks may rely largely or entirely on CET1 to meet those requirements. However, authorities need to consider the risk that CET1 will be largely depleted at the point of failure. Subordinated, long-term debt may constitute a more reliable source of loss absorbency and recapitalisation capacity in resolution, but this is weighed against costs across the cohort of banks that are subject to LAC requirements, their access to international markets and the capacity of local markets to absorb it.