



Finance Watch response to FSB's consultation on Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in resolution

Brussels, 30 January 2015

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Only the questions that are relevant to Finance Watch are reproduced here.

For further questions, please contact Paulina Przewoska, senior policy analyst at Finance Watch.

1. Is a common Pillar 1 Minimum TLAC requirement that is set within the range of 16 – 20% of risk-weighted assets (RWAs), and at a minimum twice the Basel III leverage requirement, adequate in the light of experiences from past failures to support the recapitalization and resolution objectives set out in this proposal? What other factors should be taken into account in calibrating the Pillar 1 Minimum TLAC requirement?

Although much has been done to improve the Basel framework, Risk Weighted Assets are in FW's opinion not the best predictor of G-SIB resilience, due to the so-called bank regulators' paradox: that *large complex and interconnected banks need very little capital in the good times, but they can never have enough in an extreme crisis. Separation of fundamentally different business segments is required to deal with this problem.*¹.

Bearing in mind our comments about the general concept of TLAC below, we welcome the idea of a loss absorbency requirement based on the leverage ratio, which is not dependent on risk weights and internal models and is a much better predictor of bank's distance to default.

However it has to be noted that the combination of the two metrics on which the TLAC requirement is based might distort incentives. The proposed construction means that for banks with a ratio of RWA to total assets (RWA density) of up to 37.5% (16%*37.5% = 6%) the leverage ratio will be a binding constraint, whereas for banks with a higher density the RWA will decide the amount of loss absorbency capital required. This will add to incentives to engage in RWA-optimization and, combined with the Basel framework, might promote certain balance sheet compositions and business models over others especially if it becomes a standard not only for G-SIB banks². Therefore there is a need to keep the Basel I floor and to effectively benchmark the internal models against a standard portfolio.

4. Should TLAC generally be distributed from the resolution entity to material subsidiaries in proportion to the size and risk of their exposures? Is this an appropriate means of supporting resolution under different resolution strategies? Which subsidiaries should be regarded as material for this purpose?

5. To what extent would pre-positioning of internal TLAC in material subsidiaries support the confidence of both home and host authorities that a G-SIB can be resolved in an orderly manner and diminish incentives to ring-fence assets? Is a requirement to pre-position internal TLAC in the range of 75 - 90% of the TLAC requirement that would be applicable on a stand-alone basis, as set out in the term sheet (Section 22), appropriate to satisfy the goals of the proposal and ensure that TLAC is readily and reliably available to recapitalize

¹ Adrian Blundell-Wignall: Bank business models and the Basel system: Complexity and interconnectedness, OECD

² The average RWA density for European Banks in 2010 was 35% (source: EBF An in depth look at RWA)

subsidiaries as necessary to support resolution? Can this pre-positioning be achieved through other means such as collateralized guarantees?

The TLAC proposal has the objective of providing sufficient loss-absorbing and recapitalization capacity to promote the orderly resolution of G-SIBs. This capacity is aimed at protecting the critical banking functions in the banking group. Non-critical functions do not have to be protected.

The effectiveness of the resolution of systematically important banking groups will depend not only on the amount of the loss absorbency capacity (as long as the losses might be covered the ring-fencing is not likely) but also on their group structure. The more complex, intertwined and untransparent the banking group and the distribution of its critical functions the less effective the TLAC proposal. Please refer to our answer to question 14 where we consider structural measures to be a pre-requisite to make the TLAC proposal effective.

Moreover, there is a general concern that basing the loss absorbency concept on debt might in effect replace implicit subsidies with expectations that bank management will be 'bailed out' by creditors. The only instrument having full loss absorbency capital is equity – CET1. In theory the existence of bail-in able debt should increase market discipline. But on the other hand, as long as market confidence remains, the G-SIB's will have an incentive to take on more risks. When the first G-SIB instruments are bailed-in and market confidence in them disappears, the effectiveness of TLAC instruments will evaporate.

The Single Point of Entry strategy and pre-positioning of internal TLAC also raises a concern that creditors of a bank's subsidiaries might expect to be bailed out by creditors of the parent entity. In other words, G-SIB subsidiaries could be inappropriately protected from their losses, albeit by parent company creditors not public resources.

12. What restrictions on the holdings of TLAC are appropriate to avoid the risk of contagion should those liabilities be exposed to loss in resolution?

The proposed solution aims at placing the TLAC-eligible instruments outside of the banking system to avoid contagion. But a bail-in of bank instruments, especially on a large scale, could also create distress in other parts of the financial system (e.g. among insurers, and asset managers holding bonds that are wiped out). As Randall Kroszner, a former Federal Reserve governor, points out - **moving losses around does not make them disappear**³. It raises two issues: who in the end will cover the losses, and will the TLAC capacity be big enough to absorb the losses?

Only if we assume that end-investors are fully informed and able to price the risks inherent in TLAC instruments can we move to the second concern about their capacity to bear the losses.

Should one of the G-SIBs fail the system might be able to absorb the losses but if there is a joint default of G-SIBs there might not be enough capacity to cover the losses in other parts

³ <http://www.ft.com/intl/cms/s/0/9d7113e6-69a2-11e4-8f4f-00144feabdc0.html?siteedition=intl#ixzz3lxclp0uc>

of the financial system. A financial system in which individual banks appear individually sound might still be unstable because they are exposed to common risks. Typically, highly diversified universal banks may be more correlated with one another, creating a higher risk of joint bank defaults. This is a major concern as what matters is not so much when one bank is in trouble, but rather when they all experience difficulties at the same time. Without addressing the macroprudential issues, the TLAC proposal is unlikely to succeed in a case of multiple G-SIB defaults. Therefore there is a need to address the G-SIBs' contribution to systemic risk resulting from their balance sheet correlation and procyclical leverage creation.

14. How far is the TLAC proposal, if implemented as proposed, likely to achieve the objective of providing sufficient loss-absorbing and recapitalization capacity to promote the orderly resolution of G-SIBs?

The TLAC proposal will not be sufficient in isolation. Resolution plans and additional buffers are a major step forward, but the complexity of bank structure and activities are still impediments to banks resolvability in the EU.

The TLAC proposal aims to protect bank's critical functions with an assumption that they are properly identified and structured in a way that allows the appropriate distribution of loss absorbency within a group. Non-critical functions could then be liquidated.

And indeed the resolution planning in the EU, as defined in BRRD, offers a vehicle to address potential impediments to resolution resulting from complexity of structure and activities. However, in FW's opinion in the absence of clear ex ante structural measures the resolution powers might not be fully executed. As the European Banking Authority rightly pointed it out in its opinion: *in the absence of a legal segregation, as proposed by the High Level Group, it might be extremely difficult for a supervisory authority to exercise its discretionary judgment and impose a break up of a universal bank, especially if other competent authorities are not responding with similarly harsh measures in comparable cases.*⁴

Therefore FW is convinced that an effective bank structural reform is needed to make the TLAC proposal effective.

Moreover, bail-in-able debt is supposed to increase market discipline. However, it might also result in a shift from implicit public guarantees to guarantees coming from parent entity creditors, especially in a Single Point of Entry resolution strategy. Please refer to our answer to questions 4 and 5 above.

The calibration of internal TLAC, identification of critical functions and transparency will be key here. The more transparent the group structure and the division between its critical and non-critical functions, the greater the chances of an effective resolution.

The proposal is also based on the assumption that the holders of TLAC instruments will be able to absorb possible losses. As long as the risk of joint defaults is not properly addressed this assumption might not hold.

⁴ Opinion of the European Banking Authority on the recommendations of the High-level Expert Group on reforming the structure of the EU banking sector

16. What will be the impact on the financial system and its ability to provide financing to the real economy?

The FSB initiative is positive insofar as better capitalized banks are able to lend more. However, the reliance on RWA and internal models might on the contrary promote the wrong business model.

As the proposal does not address macroprudential risk, especially from being too interconnected to fail, it does not remove entirely the issue of future disruptions to the real economy.