EACB Comments

BCBS Consultative Document on TLAC holdings

Brussels, 12th February 2016

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Introduction

The members of the EACB welcome the opportunity to comment on the Basel Committee Consultative Document on 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.

General comments

We fully understand the FSB's concerns on contagion risk that may stem from investment in TLAC instruments, and we support the idea for regulators to strongly disincentivise internationally active systemic banks from holding TLAC issued by other G-SIBs.

However, due to the BCBS proposed approach (deduction of TLAC-Holdings from Tier 2 for all banks), the main share of the instruments to be issued as TLAC eligible debt will have to be held by non-banking actors. This contraction of the investors' base will lead to higher cost 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 pristine goal of mitigating contagion risk.

Thus, we believe that the Committee should take into account a solution within the large exposure regime.

Specific aspects

- *Proposed Tier 2 Deduction Approach*

In terms of capital instruments there should be an intrinsic correspondence within the deduction approach: as capital instruments are deducted from regulatory own funds in accordance with their ranking, other TLAC instruments should be deducted from total TLAC, and not from Tier 2.

For G-SIBs, there remains the possibility of double counting TLAC capital and intentionally raising the TLAC ratio, even though they comply with the double gearing regulation. Therefore, we believe deducting TLAC holdings from the G-SIBs' own issued TLAC would be the most appropriate approach.

In order for G-SIBs to ensure sufficient long-term debt to absorb losses under a financial crisis or to carry out its capital reconstruction, the FSB considers that it is desirable to set over 33% of external TLAC as debt. We believe that the approach to deduct the TLAC holdings from the G-SIBs own issued TLAC will increase the loss absorbency and provide sufficient long-term debt under its bankruptcy process, and would be in line with the FSB's expectations.

However, in order to ensure a market making function in the secondary market of TLAC, adverse effect prevention measures such as to exempt G-SIBs from temporary holding TLAC for underwriting purposes would be appropriate.

Considering the gap between the minimum capital requirement (8% without considering any buffer) and the minimum TLAC requirement (18% after 2022 without considering any buffer) the threshold should take into account of the inclusion of TLAC instruments to the deduction methodology to adjust overly punitive treatment.

We thus believe that the current 10% of CET1 threshold is not sufficient and should be topped up with another TLAC specific 15% threshold in order to ensure a lively and deep market for such TLAC instruments. This would also allow maintaining a minimum level of activity, such as market making, to occur without banks being subject to a deduction. As the overall required TLAC would be approximately at least twice as much as required capital, it would be consistent to increase the threshold applicable even if the threshold applicable to capital remains at 10%.

Moreover, we believe that a large exposure regime for non G-SIBs is far more adequate (see below). If a deduction approach were to be applied to restrict TLAC-holdings of non G-SIBs, it should be at least amended:

a) No general deduction from Tier 2 should be established: rather a corresponding deduction method should be deployed as it has been established under the current Basel III rules and the CRR rules respectively. In particular, many smaller and less complex institutions (for instance local banks in cooperative networks) do not issue and have any Tier 2 instruments at all. The deduction would thus be unfeasible or would unduly hit higher quality buffers.
b) The threshold for deduction of 10% is by far too low. The current TLAC QIS appears to be misleading. Many banks could not extract the TLAC holdings directly from IT systems and due to the time constraints, they left blank the relevant cells in the template. Therefore we suggest a new quantitative impact study to evaluate an adequate threshold that should be significantly higher than the suggested 10%; we are of the opinion that otherwise the interbank market would suffer especially in the areas of market-making, funding of smaller banks and other various types of inter-bank transactions and activities.

➢ *Large exposures regime is sufficient*

For banks outside the scope of TLAC we believe that, instead of a deduction, TLAC holdings should be treated within the BCBS large exposure framework.

Also, if deductions from Tier 2 would include non G-SIBs, there would be a significant reduction in potential underwriting of TLAC, making it very difficult for the market to absorb these new issuances under TLAC requirements. Considering the main purpose of TLAC-restrictions is to prevent a continuous contagion of bank failures, we consider the recognition of G-SIB holdings under the new Large Exposure regime as adequate and utterly complete for non G-SIBs. Establishing even greater restrictions would be overly punitive at the cost of detrimental impact to the interbank market.

The purpose of the double gearing regulation of Basel III is in fact to:

- restrain banks from cross holding capitals to be double counted and to intentionally raise its capital adequacy ratio;
- prevent the negative transmission chain of financial crisis by restricting capital investments between banks. Under this regulation, if an entity holds a Tier 1 capital of another bank, it would be deducted from its own Tier 1 capital.

We believe that the TLAC regulation should follow the same approach: it would be disproportionate for a non G-SIB, that does not have an obligation to issue TLAC, to have its Tier 2 capital deducted if it holds TLAC instruments. Non G-SIBs are subject to the double gearing regulation and must comply with the Large Exposure Limits to mitigate the risk of contagion during a financial crisis. The recent regulatory overhaul allows mitigating such risks through the existing framework and supervision. Additional restrictions should be considered carefully. It could also be noted that risk weights of large financial sector entities (for instance with balance sheet over € 70bn under the CRR) were already increased in Basel III where correlation factor was multiplied by 1,25. This increased effective risk weights by roughly 25%. Moreover, bank instruments are not eligible for LCR, so incentives for institutions to hold such instruments might be low.

We believe that a regulation that seeks deduction from Tier 2 capital, including non G-SIBs, would reduce potential underwriting entities of TLAC, and as a result, create a substantial problem hindering the smooth market digestion of TLAC, especially in the entity's home jurisdiction whose bond market that has less diversified investor base or ample liquidity.

With regard to the Basel Committee’s concern that the large exposure framework provides no practical upper bound on the losses from multiple G-SIBs failures, the Committee should consider that the possibility of such losses has been significantly lowered by the introduction of the prudential regulatory reforms, including G-SIB buffers, Leverage Ratio, Net Stable Funding Ratio, revised large exposures regime and other various Basel III requirements.

In particular, with regard to the large exposure framework:

- The risk of contagion between G-SIBs would already be treated by the proposed approach to deduct TLAC Holdings from their own TLAC.
- This risk would 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% as for other exposures.

We thus believe that relying on the new large exposure framework for non-G-SIBs is appropriate and 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 should be avoided.

- *Own TLAC and intragroup TLAC holdings*

The BCBS proposal should clarify further, to avoid any uncertainty, that TLAC Holdings deduction approach only applies to external TLAC instruments and not internal TLAC instruments.

With regard to intragroup TLAC holdings, the treatment of holdings of own TLAC should be also clarified. The consultation paper recommends extending the Basel III approach of full deduction for investments of banks in their own shares and other own capital instruments. As a consequence, when capital ratios requirements also apply at the solo level (e.g. in Europe under the CRR framework), a subsidiary of a G-SIB which holds TLAC instruments issued by the resolution entity would have to deduct them when calculating its own capital ratios. However, the final TLAC Term sheet stipulates that "*TLAC-eligible instruments must not be funded directly or indirectly by the resolution entity or a related party of the resolution entity*" (section 9). Thus, we recommend excluding intragroup TLAC Holdings from the scope of the proposal as it would appear unjustified to apply a deduction for instruments that do not count as TLAC.

If all liabilities ranking *pari passu* with excluded liabilities that could receive recognition as TLAC were to be deducted from Tier 2, this could result into including such instruments as loans and advances. Requiring those instruments to be deducted from Tier 2 would be very detrimental for intragroup operations, particularly in the case of cooperative banks with a central body that performs, for instance, liquidity management and capital market functions. We strongly recommend not taking into account instruments ranking *pari passu* with excluded liabilities in the definition of TLAC Holdings.

Finally, if TLAC eligible instruments invested prior to November 9th, 2015, were to be included in the Tier 2 deduction approach for non G-SIBs, it would create an enormous impact. At the very least a sufficient transitional period should be provided.