February 12, 2016

Basel Committee on Banking Supervision (BCBS)
Centralbahnplatz 2
Basel, Switzerland

Industry Comments on BCBS Consultative Document: TLAC Holdings

Dear Sirs:

The Institute of International Finance and the Global Financial Markets Association (the "Associations") appreciate the opportunity to contribute to the discussion of the captioned Consultative Document and look forward to further exchanges with the Financial Stability Board on this important topic.

Introduction

The Associations have welcomed and supported the goals of the international program catalyzed by the Financial Stability Board's *Key Attributes of Effective Resolution* (the "FSB"; the "Key Attributes") from the beginning. Total Loss Absorbing Capacity ("TLAC') is essential to achieving those goals. The Associations therefore also accept the need for some restrictions on cross-holdings of TLAC in order to avoid the risks of contagion in the regulated financial sector. While broadly supportive of the aims of the Basel Committee's current TLAC Holdings consultation, the Associations offer the following comments in a constructive spirit, stressing the need for the final TLAC Holdings rules to be proportionate, and well-ground, and for the calibration of such final rules to take into account the needs of market liquidity and depth, balancing legitimate concerns about contagion with other economic effects of the proposals, taken in the context of the whole suite of post-crisis reforms.

Executive Summary

The Associations agree with the basic goals of having TLAC available to assure orderly resolution of G-SIBs without recourse to public funds, and the concomitant goal of avoiding contagion. Nonetheless, reconsideration of the proposal is necessary to achieve these goals in the most proportionate and effective manner, taking due account of the need to sustain a substantial market for TLAC and capital instruments in financial institutions generally. Supporting healthy markets for the very large amounts of TLAC that will be required will be important to the success of an effective bank resolution as intended by the FSB.

Reconsideration needs to include differences in the effects on and differing needs of, G-SIBs and non-G-SIBs as they would be affected by the TLAC holdings rules.

The proposed Tier 2 deduction approach is not optimal or necessary and would needlessly burden banks' ability to participate in healthy markets for TLAC. This note outlines ways to meet the goals of the Committee expressed in the consultative document while better supporting vital markets for TLAC.

The straightforward solution specifically for market making would be to add a dealer exception, which would recognize the importance of market making by banks for overall market liquidity, and which would be consistent with the approach commendably opened for consideration by the Committee as part of the Fundamental Review of the Trading Book.

Subject to the application of such a dealer exception, the basic rule should, instead of the Tier-2 deduction approach, be a like-for-like deduction approach for G-SIBs, allowing holdings of TLAC to be deducted against TLAC resources insofar as available, rather than directly against Tier 2 instruments. This would recognize that the debt component of TLAC is effectively a separate asset class, and should be treated as such. For non-G-SIBs, not directly subject to TLAC requirements under the FSB Term Sheet, the basic rule should focus on a Large Exposures ("LE") approach, providing adequate protections against contagion risks in a manner that would be both simpler to administer and more flexible. While the Associations are always concerned about level playing field issues, they consider the level playing field arguments for the proposed approach misplaced.

The Committee's consultation document correctly recognizes the need for an allowance for market-making and other purposes,[1] but the proposed treatment is needlessly narrow and will unnecessarily constrain both market making activities by G-SIBs in TLAC and other bank paper, and investment by those non-G-SIBs that have historically been an important part of the market of G-SIB paper.

Beyond the proposed dealer exception, the Associations propose a separate threshold for TLAC holdings, in addition to the existing Basel III deduction threshold for bank capital instruments. Further, the existing threshold should be adjusted to incorporate an overflow allowance for spillover TLAC deductions insofar as a given bank does not have sufficient TLAC and must take deductions against Tier 2. Calibration of these additional thresholds would need to be considered carefully but the Associations suggest the separate threshold could be at 10% of CET1, on the same basis as the existing threshold, subject perhaps to a monitoring period for evaluation. This would recognize the specific characteristics of the debt component of TLAC and allow for more necessary capacity for G-SIBs to make markets in TLAC and other bank instruments.

There should, in addition, be an exemption for market-making holdings of own or parent TLAC debt. The proposed full-deduction approach for own TLAC debt should be reconsidered.

[1] The industry assumes – but the point should be confirmed explicitly in the final version of the TLAC Holdings document – that the existing Basel III five-day exception for holdings for *underwriting* purposes should apply to TLAC, as to any other bank instrument. See Basel III: a Global Framework for Resilient Banks and Banking Systems, paragraph 80 (2011) (http://www.bis.org/publ/bcbs189.pdf).

For non-G-SIBs, a LE approach would be necessary and entirely sufficient to avoid dangerous concentrations and contagion, regardless of whether a non-G-SIB holds TLAC for market making or investment purposes. Banks are used to managing their business in accordance with LE rules. There is no obvious reason why banking should be treated differently from other sectors for LE purposes.

Identification of TLAC for purposes of application of the holdings rules will be a significant issue that should not be underestimated. Banks will need to be able to rely on disclosures or representations about the TLAC status of instruments in which they may deal or invest without further diligence requirements. Easy, reliable identification of what constitutes TLAC subject to the holdings restrictions will be also be essential to healthy, liquid markets. This applies to all instruments in all markets, but especially to emerging-market instruments, "indirect and synthetic holdings," subordinated instruments, and pari-passu instruments, each posing particular issues discussed in detail below. The goals of the TLAC Holdings proposal would not be compromised significantly if pragmatic adjustments were made to facilitate identification of TLAC in the market. In particular, the exclusion from the scope of the deduction of all non-TLAC instruments that rank pari passu with TLAC or with excluded instruments should be considered.

Finally, there is a clear need for appropriate phase-in of the final requirements, given the operational complexity of identifying TLAC, the need for reliance on disclosures that will themselves be phased in over time, and the ongoing process for adoption of requirements in various jurisdictions. An implementation date of 2022 seems appropriate.

A fundamental problem underlying the industry's concerns about the consultative document is that the QIS on which it is based is unreliable for technical reasons, as a result of the significant difficulty of the estimates that were required (given that requirements were not in place and many assumptions had to be made) and because of the procedures required for banks' completion of the forms. It should not be used to inform the final TLAC holdings requirements.

Section 2: Proposed Tier 2 Deduction Approach

The Associations believe that a fundamental reconsideration of the proposed asymmetrical Tier 2 deduction approach is required, both for G-SIBs and for other banks that are not subject to TLAC requirements as G-SIBS.

The debt portion of TLAC is inherently less risky than equity and other regulatory capital instruments. (The debt portion of TLAC would rank senior to equity and would generally be converted to equity in case of a resolution. Even where write-down rather than conversion of debt is required, TLAC debt is much less likely than equity to be written off completely, given its seniority). Therefore, the TLAC holdings provision should be evaluated and designed separately from the existing restrictions on cross-holdings of bank capital, especially equity. It is furthermore unclear why TLAC holdings should be subject to the same treatment as that in place currently for other regulatory capital, which is in effect more punitive if TLAC holdings are merely added to the existing allowance. There is no reason to deviate from the more symmetrical, like-for-like approach of the current Basel cross-holdings capital deduction.

More appropriate approach. A more symmetrical, appropriate and proportionate means of implementing restrictions on cross-holdings would be to allow a G-SIB to deduct exposures to TLAC of other issuers from own TLAC or other applicable loss-absorbing capacity requirements (subject to the discussion of the threshold below), with deduction from Tier 2 (or other levels of regulatory capital if necessary) insofar as its TLAC is insufficient, consistently with the current Basel corresponding-deduction approach.

The argument for the Tier 2 deduction approach of the consultative document is based in large part on a discussion about level playing field issues between G-SIBs and non-G-SIBs; however it is important to recognize that the playing field is un-level by virtue of TLAC requirements' only applying to G-SIBs. The Associations conclude that it is not appropriate to draw a sharp line and to justify the Tier-2 Deduction Approach on grounds that corresponding deduction "does not work well for non-G-SIBs". The Associations do not find the fairness arguments persuasive or necessary. Although the Associations are, as a matter of basic principle, diligent to defend the level playing field, they and their members do not see the need to drive the Tier-2 Deduction Approach for G-SIBs from the position that (some) non-G-SIBS may lack a substantial amount of their own TLAC from which to deduct TLAC holdings.

There is in fact no "level playing field" issue here: it is the G-SIBs that are subject to an additional requirement; and G-SIBs are also subject to additional buffers and heightened prudential supervision. Non-G-SIBs may choose or be required to issue TLAC or similar instruments under local rules. There is no reason why TLAC as an "extra" resource compared to the basic capital requirements should not be used for corresponding-deductions purposes or why any bank would be fundamentally disadvantaged if it does not face such a requirement yet invests in other banks' TLAC.

For G-SIBS, an approach that would be consistent with the overall Basel corresponding deduction approach, *viz.* like-for like, TLAC for TLAC insofar as available, then Tier 2, etc., is fair and proportionate, and should be adopted. This approach would address the double-leverage and contagion questions that are discussed in the consultative document in a manner more consistent with the current Basel method than the rigid Tier 2 deduction approach as proposed.

For non-G-SIBs, which are not subject to TLAC requirements at the global level (although in some countries some of them may be subject to similar requirements), LE restrictions, both in their existing forms and in accordance with the Basel rules to be phased in over the next few years, provide adequate safeguards.

The industry hopes that experience with reliance on LE for non-G-SIBs will demonstrate that the deduction approach is redundant to the coverage of the relevant issues by LE rules and that the Committee will therefore be able to reconsider and remove TLAC deductions at some point in the future.

Allowing deductions from TLAC as opposed to just Tier 2 would provide more stability for a firm suffering losses, and would be less pro-cyclical than the Tier 2 deduction approach. For example, under the hypothesis that the current 10% deduction proposal is maintained, assume Bank X for any reason suffers losses that begin to reduce its total capital position (bringing it nearer to the PONV). This would create a substantial risk that the deductions themselves might bring the firm's regulatory capital down, perhaps to below the PONV threshold. By contrast, using the more-inclusive TLAC denominator would be inherently more stable, as it would drop as a result of losses in a much smaller proportion, less likely leading to severe problems as a result of the deductions, allowing more options for recovery, and perhaps reducing the risks of alarming news about a firm that could destabilize the market before the firm itself has the chance to take recovery measures.

In addition, it would be appropriate to exclude holdings of own TLAC from the calculation, as discussed further below.

The other factors listed in support of the Tier 2 deduction approach are also unpersuasive. (a) It is stated that this approach would provide a disincentive for banks to invest in TLAC, thus reducing potential contagion. While containing contagion is necessary it is also important to balance this goal against the need to have deep and liquid markets for TLAC instruments. It is also important to recognize that contagion risk is already directly addressed through LE requirements, pillar 2 charges relating to concentration risk, and the use of G-SIB buffers. Further, a like-for-like deduction approach would tend to neutralize any benefit from investing in TLAC instruments, achieving the policy objective of removing the incentive, but with a more targeted measure. (b) It is stated that it will increase the Tier 2 banks would need to absorb the deduction if they do invest in TLAC: it is unclear whether there is an intention to increase capital by this back-door method despite all the other post-crisis measures that have increased banks' resilience. Not only would this be anomalous given existing requirements under the Basel III capital regime, which specifies Tier 2 requirements, but it would also appear to be inconsistent with the FSB Term Sheet[2] requirements, which explicitly recognize the need for debt instruments beyond regulatory capital. The point here should be to take an appropriate approach to limiting TLAC holdings, not to impose new capital requirements, possibly in a manner that would distort markets further. And (c) it is asserted that the Tier 2 deduction approach "utilizes the current provisions of Basel III". We disagree with that conclusion and consider that, instead, it is inconsistent with the Basel deduction approach.

Level of Application. Any deduction approach, whether the TLAC deduction approach recommended here or the Tier-2 deduction approach, must take into account how TLAC is issued and held in banking groups. TLAC issuance may not necessarily occur out of the same legal entity that holds TLAC of other banks for market-making or investment purposes. Therefore, the TLAC Holdings rules should applied on a group consolidated basis, or at the consolidated basis of the resolution group as applicable, so as to allow calculation of the deduction to be done on an appropriate, proportionate basis.[3]

[2] The "Term Sheet" refers to the FSB's Total Loss Absorbing Capital Principles and Term Sheet (2015) (http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf).

[3] For avoidance of doubt, note that this analysis has nothing to do with internal TLAC. Allocations of internal TLAC are not relevant for purposes of the TLAC Holdings rules, which are driven by concerns about contagion in the industry.

<u>Section 2, paragraph 5 (deduction threshold)</u>

Need for reconsideration. The consultative document rightly recognizes the need to permit a limited level of activity, such as market-making, to occur without banks' being subject to deduction, but the proposed approach requires fundamental reconsideration, both from the point of view of G-SIBs, which may act as market makers, dealers, or underwriters, and (if the Associations' proposal for a LE approach is not adopted), for non-G-SIBs, which may be investors (and in some cases underwriters and market makers) in TLAC instruments.

Members are concerned that including TLAC in the existing 10% of CET1 limit would not support adequate capacity for the necessary market making to sustain a sufficiently large, vital market for TLAC and capital instruments of financial institutions generally, including smaller institutions. Therefore, the industry appreciates the statement that the Committee is ready to consider whether any adjustment of the 10% is necessary, and urges careful attention to this issue.

The need for issuance of TLAC instruments will be large. An estimated USD 4 trillion of total TLAC in the market seems a reasonable estimate, not including the Chinese G-SIBs, which will eventually add a substantial amount more to the total, perhaps another USD 1 trillion. Will the market be able to absorb and maintain liquidity in these large amounts?

The effects on market liquidity for other bank obligations and capital instruments also need to be taken into account given that, as proposed, such instruments would share the same limited market-making capacity with TLAC instruments. [4] The negative effects of the increased limitation on overall capacity seem likely to have a substantial impact in particular on the liquidity of smaller banks' paper, and hence their ability to raise capital in a crisis, such as 2008.

Market makers in bank paper are and are likely to be primarily G-SIBs and it is difficult to see other institutions' entering the market for bank paper in sufficient number or with sufficient resources to take up the slack if G-SIBs do not participate as fully as possible.

[4] Market makers are essential providers of liquidity, buying or selling to support client needs. and building and holding inventory to meet future customer demand. In many markets, market makers provide the vast bulk of the liquidity, and can be the only providers of liquidity in times of stress, when other market participants may withdraw. Without market-making, volatility can increase substantially. Reducing liquidity would have tangible costs for companies and investors alike and would pose obstacles to the free flow of capital and efficient allocation of resources throughout the global economies. In addition to providing liquidity, market makers play a critical role in helping clients to reduce and hedge risk, often by temporarily assuming risk to bridge to the other side of the market. Because of economies of scale, risk diversification and broad experience in risk management, market makers can often manage risk more effectively and less expensively than their customers or smaller institutions can on their own. As an example, consider a pension fund that decides to sell a large stake in a G-SIB's TLAC to fund its near-term pension obligations. To sell a large stake without significantly depressing the market price or signaling its intentions to the broader market, the pension fund will turn to a market maker to execute a large (or "block") trade. The market maker will buy the entire position from the pension fund, at a (small) discount to the market price, and resell it to the broader market. Depending on the prevailing market conditions, to avoid price dislocation, the market maker may need to hold a portion of the block on its own books and gradually resell the remaining stake.

On the investment side, careful consideration needs to be given to where purchasers of TLAC will be found. Given that, in certain markets, smaller banks may be significant investors in G-SIB TLAC, any decision that might exclude this significant part of the market should be weighed against the need to sustain a market of size, as discussed further below.

In summary, the solution to the contagion problem should be consistent with the capital framework and not add new requirements that deviate from the direction and logic of the capital framework, as does the Tier 2 deduction approach.

Dealer Exception approach. Taking a step back from the consultative document as proposed, it is important that a more holistic approach be undertaken, and therefore serious consideration should be given to the different approach to making allowance for market-making discussed in the Fundamental Review of the Trading Book, which states, "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 bank must have adequate systems and controls surrounding the trading of financial institutions' eligible regulatory capital instruments."[5]

Such an approach would have the advantage of being coherent with the trading book rules and avoiding the application of different rules affecting market making. It offers the most direct and the most efficient option for assuring sufficient market-making capacity in the interest of liquid markets, while also providing the necessary prudential controls.

The Associations note that the Basel Committee is planning a broader review of whether any adjustments to the existing Basel III threshold requirements for deductions of regulatory capital are warranted for activities such as market making, or instruments such as TLAC.[6] Therefore, if the dealer-exception approach is not immediately adopted, at the least, full consideration to such a dealer-exception approach should be included in the planned market-making review. Consideration should be given to a uniform approach to the dealer exception, rather than leaving it as a local supervisory option, as part of the Basel Committee's pending review of the dealer exception.

Proposed threshold insufficient for market making. Especially if a dealer exception is not provided for, the 10% threshold, adopted from the existing Basel structure, needs to be tailored to reflect an appropriate view of the TLAC market and the market for obligations of financial institutions overall.[7]

The appropriate allowance for market-making needs to be assessed in the context of the evolving appreciation of market-making issues by the public and the private sectors. Taken in the context of numerous other factors that have already reduced and will continue to dampen market-making

[5] BCBS Minimum Capital Requirements for Market Risk, paragraph 5, (http://www.bis.org/bcbs/publ/d352.pdf).
[6] BCBS Minimum Capital Requirements for Market Risk, cited above, at p. 4 and paragraph 5.
[7] See footnote 1.

activity, the proposed threshold would constitute a substantial additional impediment to banks' providing the needed level of market-making.[8]

As discussed above, TLAC is broader in scope and less risky than equity, so that a separate provision would be appropriate. Debt markets are also traditionally dependent on market makers and lack the liquidity characteristics of equity markets.

The scope of instruments within the proposed TLAC holdings deduction (including TLAC and pari-passu liabilities) is significantly broader than the instruments within the scope of the existing threshold. The difference between the minimum capital requirement (8% without considering any buffer) and the minimum TLAC requirement (18% after 2022 without considering any buffer) itself also suggests the need for a specific approach to the TLAC deduction.

A preferable approach. Given all the foregoing considerations, TLAC instruments should in effect be recognized as a separate asset class. And, in addition to provision for a dealer exception as in the fundamental review of the trading book, the deductions threshold should be modified on a basis adapted from the like-for-like corresponding deduction concepts of Basel III.

Such a deductions regime that would recognize the different status of TLAC and its impact on the overall market and on firms' ability to participate in the market for all instruments of financial institutions, should be designed as follows:

1) The TLAC Holdings rules should add a *separate, additional threshold for TLAC* holdings (i.e., holdings of TLAC qualifying instruments, excluding instruments that qualify as regulatory capital**),** to be calibrated as discussed further below. This would take into account the fact that banks would need to hold a stock of TLAC issued by other banks, including as part of market making activity (to the extent that a market-making exception is not introduced), and at the same time, avoid the risk of creating undue headroom within the existing 10% threshold that could potentially be used for unduly increasing exposure to financial sector entities' capital (rather than TLAC itself) if the threshold were simply increased; and

2) This separate threshold should be complemented by an *"overflow allowance"* in the current 10% capital-instruments holdings threshold to accommodate the fact that, if a bank does not have enough TLAC[9], it would need to deduct third-party TLAC exposures from Tier 2 capital, thereby increasing the amount of exposures subject to that threshold deduction calculation.

[8] See, e.g. PricewaterhouseCoopers. *Global financial markets liquidity study.* 2015. Retrieved from: https://www.pwc.com/gx/en/industries/financial-services/publications/financial-markets-liquidity-study.html; see also: Shane Worner, A Survey of Securities Market Risk Trends 2015 – Methodology and detailed results (Staff Working Paper of the IOSCO Research Department), December 2015, pp. 25-26; https://www.iosco.org/library/pubdocs/pdf/IOSCOPD516.pdf

[9] As noted above, for non-G-SIBs, TLAC or equivalent instruments against which the deduction would be taken need to be clarified, if the recommendation to allow non-G-SIBs to rely on LE instead of deductions is not accepted.

Such adjustments to the holding limits would be appropriate because of the lower risk of TLAC compared to equity and the importance for the sector overall – and for the success of the FSB international resolution approach – of maintaining large and liquid markets for TLAC. Given the risk characteristics of TLAC, it would not compromise to any significant degree the goals of the TLAC holdings restriction.

Calibration of the additional TLAC threshold should be given careful consideration, but a simple and straightforward approach would be to define it as 10% of CET1 on the same basis as the current threshold.[10] The calibration could be monitored through a transitional period and adjusted if it proved to be necessary on the basis of experience after a reasonable trial.[11]

The same separate-threshold approach should be applied to non-G-SIBs' deductions, if the Large Exposures approach is not adopted, despite the industry recommendation below.

Treatment of own-issued and parent TLAC. Large banks such as G-SIBs have traditionally done substantial amounts of market making in their own paper as well as paper of other banks. Markets count on this market making and it has become a well-established market expectation. Accounting rules generally require extinguishment of own debt held by banks. But the requirement is often only implemented (under both IFRS and US GAAP) after a short-term period during which own paper may be held for market making, as a practical expedient to avoid unnecessary P&L volatility. This implies that a corresponding deduction approach would be the natural result of the practical accounting process; however, in the event that a firm kept a gross trading position under the short-term market-making window, the current proposal would have anomalous results, given that it would require deduction against Tier 2 for the short market-making period, which would then need to be reversed and replaced with deduction against TLAC after the extinguishment is required. It seems anomalous to have in practice two conflicting treatments for the same positions, which would need to be changed frequently, leading to unnecessary capital volatility. And in particular it would be odd for short-term positions to result in harsher accounting treatment than positions that are held long enough to be extinguished. Of course, cross-holdings concerns do not arise with market making in own TLAC any more than any other instrument, and accounting rules prevent abuse of such holdings. During the (short) market-making period in which holdings, within strict limits, of own paper are allowed as a practical implementation of the accounting rules, the asset and liability sides are set off, so the double-counting issue is addressed automatically. When extinguishment is required under accounting rules, it effectively nets off the liability and asset sides of such paper, with mark-to-market adjustments insofar as needed.

Therefore, positions in own-issued TLAC should not be counted against the threshold, much less deducted without threshold, as would be required by the last part of section 2 of the current

[10] Another approach for calibrating the new threshold, could be based on the minimum capital and TLAC requirements. The underlying assumption in this calibration method is that holding of these instruments would be proportional to the amount available in the market, which in turn is at least partly driven by the regulatory minimum. Under this approach, we would scale up the current 10% threshold, which applies today based on 11.5% minimum Total Capital (2.5% conservation buffer and 1% G-SIB buffer), by the new requirement including TLAC, which would be 21.5% (2022 level) for 1% G-SIB banks. This would result in a separate TLAC-specific threshold level of 8.7% (i.e. 18.7% - 10% current threshold)

[11] BCBS Minimum Capital Requirements for Market Risk, at p. 4 and paragraph 5, cited above.

consultative proposed document. The existing accounting rules would provide a built-in check against abuse of such an exemption, which would nonetheless be an important step toward assuring liquid markets for G-SIB TLAC.

Similar considerations apply to market making in a parent's TLAC (e.g., where the parent is a bare holding company with no market activity of its own). Although the accounting rules on offsetting own paper would not apply directly, operating subsidiaries of bank groups are subject to numerous prudential rules regarding their ability to hold and transact in related-company paper; therefore, the proposed exemption should be extended to transactions in parent paper by consolidated subsidiaries.[12] Furthermore, the final TLAC Term Sheet stipulates at section 9 that "TLAC-eligible instruments must not be funded directly or indirectly by the resolution entity or a related party of the resolution entity"; it would therefore appear inappropriate to apply a deduction for instruments that do not count as TLAC.

Additional strategy to enhance market-making capabilities without increasing risk. A supplemental strategy to reduce the burden of the rule on market-making for G-SIBS, which could be adopted without compromising the goals of the TLAC Holdings rules, especially if banks are required to deduct holdings in instruments which rank pari passu with TLAC, is that holdings should be permitted to be netted and deducted against a G-SIB's own resources that are no longer eligible as TLAC, e.g. where remaining maturity is less than a year. Such an approach would recognize that G-SIBs are likely to have issued a significant amount of bail-inable TLAC-type instruments that do not count as TLAC because of having fallen below the one-year threshold. This will probably represent on average 10-20% of a bank's non-equity TLAC, assuming a typical new-issue maturity of 5-10 years. While such positions do not count as TLAC, they would constitute substantial resources available for bail-in in any resolution. If such a bank holds a short-term, market-making position in TLAC, (including its own paper if the above-suggested exemption is not adopted) it should be able to offset such positions against the bail-inable resources provided by such instruments that are approaching maturity (in addition to using the available threshold). This relief would be especially important if the Tier 2 deduction approach is maintained.

Issues for non-GIBs. In addition to the effects on large banks' ability to continue sufficient market-making and related market activities, the effects of the present proposal on the ability of non-G-SIBs to invest for the longer term in TLAC of other banks needs careful attention. For many non-G-SIBs, investment concerns will be more of an issue than market-making, although certain D-SIBS in particular also have significant market-making activity in G-SIB paper.

While the Committee's desire to limit contagion to other parts of the banking sector is important and well-understood, it is also important to take into account the nature and structure of the market for TLAC, and the investment needs of certain banks outside the G-SIB or internationally active categories.

Certain non-G-SIBs that have excess liquidity but may lack investment opportunities with acceptable yield and risk characteristics have traditionally been significant investors in G-SIB

[12] For avoidance of doubt, these considerations do not extend to reciprocal cross-holdings of TLAC, which are treated in the last part of section 2 of the proposal.

paper, especially where markets for non-bank obligations are smaller. These include institutions such as Japanese regional banks. Whether such institutions would continue their investment patterns for TLAC of course remains to be seen, given their investment policies and risk assessments, but at the least, the TLAC Holdings rules should not create a bias against such investments.

Investments by such firms contribute to the overall capacity of the market to absorb G-SIB paper. Such investor banks are also well-situated to provide "market-discipline" feedback on the G-SIBs, which contributes to the effectiveness of the market. Such non-G-SIBs are of course subject to the full spectrum of prudential regulation, including LE and double-gearing restrictions, and supervision enhanced by all the post-crisis measures, so it is not obvious why additional restrictions on their ability to purchase G-SIB TLAC paper are needed.[13]

As discussed further below, it is important to consider LE limits in particular as an appropriate method for limiting their exposures to TLAC, rather than the deduction method. If it were concluded that specific TLAC limits were needed for such banks, after further analysis, then more leeway for both underwriting (in which some D-SIBs in particular are active) and investment needs to be considered carefully, taking into account overall market structure and effects, as well as prudential considerations. This should be in conjunction with the discussion of the TLAC deduction approach set out above.

Current QIS misleading on these points. The TLAC QIS[14], Section 5.2, could be read to support a conclusion that holdings of G-SIB TLAC by non-G-SIBs are likely to be relatively inconsequential. The Associations believe that it would be hazardous to draw such a conclusion from the QIS, given the limitations discussed below with respect to Section 5 of the consultative document, and some non-G-SIBs are likely to hold TLAC for investment purposes, or (in some cases) for underwriting or making markets in TLAC of other issuers.

The TLAC QIS also appears to suggest (at p. 4) that it should be read to support the current 10% limit for deductions; however, the QIS itself is subject to very serious questions and needs to be revisited (see Section 5 below). An important reason to stress the importance of a modified deduction with LE approach is that the industry believes any such reading or any definitive conclusions drawn from the current QIS may be misleading.

Even the current QIS's data show that there are certain banks that would be much more affected than the average (see page 31 of the QIS document). This probably indicates that certain banks that are the most active market makers would be severely affected, as is the industry's perception. This important point does not seem to get the attention it deserves in the QIS discussion.

Because TLAC has not been issued hitherto and identifying equivalents in today's market is tricky, it is not easy to give precise estimates; however, the Associations' members are

---

[13] It should also be made clear that intra-group lending within cooperative bank structures should not be caught by the TLAC Holdings restrictions.
[14] Basel Committee on Banking Supervision, TLAC Quantitative Impact Study Report (November 2015) (http://www.bis.org/bcbs/publ/d341.pdf).

convinced, as a business matter, that substantially more market-making capacity will be required than would be allowed by the existing 10% threshold alone. [15]

Section 3.3. Large Exposure Limits

The Associations consider that LE options were dismissed too quickly in the consultative document. LE options make sense overall but could be especially appropriate for non-G-SIBs, which are not caught by the Term Sheet language on deductions, which applies to G-SIBs only. As the discussion in Section 3.3 of the consultative document points out, reliance on LE limits would have the advantages of simplicity, given the existing LEs framework. It is also important to underscore the fact that banks in many jurisdictions are well-accustomed to implementing LE limitations for regulatory or internal risk-management purposes, and are making the transition to the pending Basel LE regime. LE limits (present and future) are part of the overall complex of prudential requirements to which banks manage. Such limits appropriately recognize that banks take risk as a normal part of their business, and that risk cannot (and should not) be eliminated completely. Such limits prevent what might be fatal exposures to a given bank, while allowing for the normal functioning of banks in the economy, and allowing them (within limits) to make use of special expertise or experience they may have developed with a given sector. The same logic should be applied to the financial sector: LE limits can limit the buildup of exposures to other institutions that could be fatal, while allowing the financial system (and vital markets) to operate smoothly and efficiently. Furthermore, Pillar 2 of Basel III can effectively act as a back-up to the LE regime, should concentrations not limited thereby develop in specific banks.

The proposal as published is inconsistent both with the overall LE regime and with the otherwise-applicable corresponding-deduction approach for cross-holdings in other capital instruments. Every effort should be made to make use of the existing, well-provisioned, tool box, and to avoid introduction of new tools for specific purposes. To reiterate, the existing post-crisis tool kit should be fully adequate and more proportionate to deal with reasonably managed risks in the financial system than the proposal.

The stated objections to use of LE limits are less than convincing, especially for non-G-SIBs.

The *issue of an upper bound* on aggregate TLAC holdings needs further analysis. It is not clear why the banking sector should be treated more severely than other sectors for LE purposes. Such a provision will inevitably limit the ability of the larger banks to underwrite paper of smaller banks, or to fund them directly. Moreover, too tight a limitation will also have significant detrimental effects on certain classes of smaller banks, which have been significant purchasers of larger-bank debt hitherto. LE limits and other prudential measures serve to limit undue exposures of banks. Such exposures to other sectors and industries have historically often been more risky than exposures to the financial sector, but appear to be well-contained by post-crisis reforms.

---

[15] A recent article is indicative of the problem, although some of the factual analysis may need refinement: Catherine Contiguglia, Basel proposal to cause 'huge problem' for TLAC market-making, Risk Magazine, December 2015 (http://www.risk.net/risk-magazine/news/2438802/basel-proposal-to-cause-huge-problem-for-tlac-market-making).

It is stated that tighter limits on banks' exposures to G-SIBs would suffer from tightening the overall LE regime for non-TLAC instruments, which could have adverse effects on the interbank market. That is certainly correct, but whether that approach or the approach proposed would be more detrimental to that market is largely a matter of calibration.

Conversely, it should be noted that the TLAC LE limit is really only relevant for the part of TLAC that is not made up of capital instruments that are already deducted anyway. This fact makes it more questionable why LE limits should not be sufficient to limit possible contagion through TLAC holdings.

Furthermore, a large proportion of existing LE limits (for both G-SIBs and non-G-SIBs) would be taken up by short-term interbank exposures (less than one year), so that the practical scope to invest in other TLAC is actually limited. As the proportion of recognized TLAC is relatively limited, this means that the contagion effects are also relatively limited.

Contrary to the flat implication of the document, separate LE limits on holdings of TLAC might or might not be more flexible than the proposed deduction approach, depending on calibration. LE-type limits are likely to be more manageable for many non-G-SIBs in any case.

Using the existing (or, if necessary, augmented) LE measures would adequately mitigate the risk of contagion insofar as non-G-SIBs are concerned, and there is no need for further double-gearing restrictions**,** especially taking into account the fact that many of them will have no TLAC requirements at all.

Aggregate limit. It is particularly striking that an "aggregate limit on holdings of TLAC issued by all G-SIBs" is rejected only because "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." Given that other aspects of the TLAC holdings proposal, especially the Tier 2 deduction approach, would represent at least as significant departures, it is hard to accept that as a reason not to give full consideration to an aggregate limit, if deemed necessary to make the LE solution acceptable. Use of the LE approach, even with the addition of an aggregate limit, would in any case be more coherent with the overall Basel III approach than the Tier 2 deduction approach.

Again, calibration would be crucial, but, if it were concluded that an aggregate limit on TLAC issued by all G-SIBs were necessary, an appropriate aggregate limit on TLAC exposures might be more manageable and achieve the goals of limitation of contagion with less ancillary damage on the overall market for bank paper or the investment programs of affected investor banks.

Section 3.4. Deduction for G-SIBS and large exposure limit for non-G-SIBs

The Associations' preferred approach would be to apply a dealer exception approach for market making, and otherwise a LE limit equally to all banks; however, if deduction must be mandated for G-SIBs, there is a good case for an adopting an appropriate corresponding-deduction approach for G-SIBs, combined with a large exposure limit for non-G-SIBs. Although this solution would indeed add some differences of detail to the Basel standards, the differences would be quite straightforward and do not seem to pose a risk of the kinds of complexity issues that have been of concern to the Committee in other areas. With respect to the LE side, as discussed with respect to Section 3.3 above, the Associations do not believe that the objections to the LE approach are as convincing as the consultative document argues they are.

Section 4. What constitutes a TLAC holding?

As a threshold matter, banks are very concerned about their ability to determine what constitutes a TLAC holding for purposes of these rules. Clarity is essential. Identification of TLAC is likely to be difficult and costly to do ad-hoc, especially for smaller banks. Ease of identification of TLAC will be critical for banks participating in the market, whether as market-makers or as investors. Therefore, maximizing ease of identification of TLAC should be a goal of both the final rules on TLAC holdings and on disclosure.

Much will depend on the forthcoming disclosure rules, but it is difficult to give meaningful comments without having had the chance to consider those rules.

Unduly complex or burdensome rules will inevitably lead to a narrowing of the TLAC instruments that a given bank will be willing to deal or invest in, most likely to the disadvantage of smaller issuers. Difficulty in determination of what constitutes TLAC subject to these restrictions may also have a significant effect on the depth and liquidity of the market.

It should be made very clear that banks transacting or investing in TLAC paper are entitled to rely on issuers' disclosures in prospectuses or other disclosure documents such as annual reports or publicly available regulatory filings without having to do further diligence or obtain legal opinions. Where a bank needs to obtain specific representations as to the TLAC status of an obligation from the issuer, it should be clear that banks are entitled to rely thereon without further inquiry, provided they are acting in good faith.

Particular consideration should be given to the ability of an investing bank to determine whether non-TLAC liabilities fall within the scope of the deduction owing to being pari passu with TLAC (as discussed further below).

It must be recognized that some issues, such as whether a particular instrument may rank pari passu with TLAC, may not be determinable from public disclosures; although for major deals it may be feasible to seek specific representations from the issuer, less burdensome means of allowing banks to make TLAC determinations should be a priority (see below).

Definition of TLAC Holding The present definition of "TLAC Holding" calls for the following comments:

> *Second bullet:* The concerns summarized above will apply equally (or more) to determining what constitutes a TLAC instrument of a Chinese bank (and consideration would need to be given to the effective date of adequate disclosure requirements for such requirements).

Third bullet: Identification of "indirect and synthetic" holdings of TLAC will be considerably more difficult than for regulatory capital holdings. As discussed above, identification of TLAC is far from straightforward; therefore, identification of "indirect and synthetic" holdings will be all the more complex. To the extent such holdings are caught by the rules, pragmatic guidance that banks can rely upon, or readily usable practical expedients, will be needed. (This problem applies to the issue of the validity of the existing QIS as well, as it was ambiguous whether the QIS required submission of indirect and synthetic holdings on the basis implied by this definition.)

Section 4.1. Instruments subordinated to Excluded Liabilities

The general issues about identifying TLAC discussed above apply to identifying subordinated instruments. Ultimately, reliance on disclosures is likely to be the only feasible, broadly applicable approach. It would certainly be more feasible for participants in the market to comply with an "actively being recognized" standard than the standard as proposed.

A number of specific questions need to be raised:

Where there is broad statutory subordination of debt as in Germany, does that imply that *all* holdings of such bonds must be deducted (subject to the 10% threshold)?

Does participation, e.g., in a five-year loan made by a G-SIB lender, constitute TLAC? Would a bank purchasing such participation have to deduct it? There is a live issue about such participations in the UK and certain other countries. Sweeping loan participations into the TLAC restrictions would further limit banks' ability to provide credit to society on a prudent basis, with appropriate distribution of risks and would have little to do with the purposes of the TLAC Holding proposals.

What about derivatives exposures to banks from countries with statutory subordination? See the discussion above under Section 4 about "indirect and synthetic" holdings of TLAC.

Although the discussion says that the intent is to avoid development of "mistaken expectations" about bail-inable non-TLAC instruments, it arguably would have the opposite effect of blurring that distinction and perhaps might induce the market to draw wrong conclusions about what counts as TLAC. Furthermore, it is highly questionable whether this document is the place to address a fundamental point about the FSB resolution regime that the market needs to understand; rather the FSB and Basel Committee (and the industry) should work to develop that appropriate market understanding.

Section 4.2. Instruments ranking pari passu to Excluded Liabilities

There is a strong case that any deduction approach should only apply to eligible TLAC and not to pari-passu instruments that are not TLAC (regardless of the proposed one-year maturity floor). If an instrument is not TLAC, there is formally no double-counting, and, as noted above, applying the limit to TLAC actively counted as such is likely to make disclosures and operation of the TLAC Holdings regime much easier and more transparent.

Assuming the proposed treatment of pari-passu liabilities is nevertheless maintained as proposed, the issues with identification of TLAC holdings discussed above are relevant when applied to senior liabilities as proposed in paragraph 4.2 of the consultative document.

The last paragraph of 4.2 considers an alternative whereby instruments ranking pari passu with excluded liabilities (in jurisdictions where the 2.5%/3.5% exemption is in force) would not be deducted. The Associations strongly recommend following this alternative and keeping such instruments out of the deduction. Indeed, as implied by the consultative document itself, it would be extremely challenging from an operational perspective to identify the senior-unsecured instruments benefitting from the 2.5-3.5% allowance from the rest of the senior unsecured instruments of an issuer. The likely consequence as a practical matter would be to have to deduct all senior unsecured instruments, including instruments that are irrelevant here (e.g., long-term derivatives contracts), applying the deduction to a much broader range of instruments than those really counting as TLAC (3.5% of RWAs counting as TLAC to be compared with other, varied senior unsecured liabilities of perhaps 10-20% of RWAs).

It is important to be mindful that the 2.5% or 3.5% come on top of CET1, AT1, T1 and liabilities that are subordinated to excluded liabilities, and thus likely to suffer losses only in very exceptional cases.

Furthermore, the basis for bail-in in this class of debt may be much larger, given the 2.5%-3.5% cap. Hence the losses incurred by holders of this class of debt should be very substantially lower than for subordinated TLAC instruments. The remaining risks should be adequately covered by normal risk management and, in any case, would be subject to otherwise-applicable LE rules. The conclusion should be therefore that such risk should not require the disproportionate deduction approach that is proposed.

For the avoidance of doubt, let us note that the proposed limitation of the section 4.2 requirements to TLAC with an original maturity of over one year is a reasonable and practical measure as far as it goes, and the attention to the vitality of the short-term inter-bank market is appreciated. As discussed above, however, the industry believes that Section 4 as currently written is overly inclusive and raises significant operational difficulties.

<u>Section 5. Evidence from the QIS</u>

Point 5.1 of the QIS states that "among 54 Group 1 banks and 80 Group 2 banks filling in the worksheet, 18 Group 1 banks and 10 Group 2 banks have investments in TLAC liabilities". Based on members' experience with the worksheet, the Associations question the accuracy of this result. It is unreasonable to expect that only 30% of Group 1 banks and 12.5% of Group 2 banks had any holdings of TLAC instruments as the QIS results suggest. Specific QIS issues with respect to market making are discussed under Section 3.2 above. Therefore any conclusions drawn from the present QIS may be seriously misleading, with potentially material consequences for the market in TLAC.

Banks were required to fill in the QIS worksheets on a best-efforts basis. Since the holdings of TLAC liabilities – in particular under the four different cases to be considered – could not be extracted directly from IT systems but had to be collected and analyzed in an – at-least partially

– manual process, we suspect that a number of banks were unable reliably to do this work in the time available and initially left the relevant cells in the worksheet blank. The subsequent validation of the worksheets by competent authorities resulted in a requirement to fill the empty cells with “zero” values, as empty cells were not allowed by the validation rules.

As a result, the worksheets will show zero values in cases where banks actually had no holdings of TLAC instruments but also in cases – we believe many cases – where no information was available.

The worksheets will not show information about TLAC-type instruments of emerging market G-SIBs per the second bullet of the definition of TLAC Holding and, because of the inherent difficulties of identification, will generally not reflect the “synthetic or indirect” holdings of TLAC as discussed in the third bullet of the definition. With respect to the latter, while manual processes allowed banks to provide estimates of their direct holdings of TLAC instruments, synthetic holdings would, other than in exceptional cases, not have been identified and thus would not have been included in the data submitted.

Furthermore, the impact of the proposed extension of deduction beyond TLAC to liabilities ranking pari passu was not included within the scope of the QIS, adding another dimension of incompleteness and inaccuracy. Moreover, the non-final nature of the TLAC proposals at the time of the QIS appears to have contributed to difficulties and inconsistencies of interpretation.

The QIS results are more generally difficult to understand and interpret because of the deviations between the four cases expounded and the actual, final TLAC Term Sheet.

Section 7. Implementation date

Given the operational complexity of identifying TLAC holdings, as discussed above, a phase-in approach will be essential.

As also discussed above, disclosure will probably be critical to enable banks to identify most (perhaps not all) TLAC holdings. Only once the disclosure rules are issued and finally in place (in 2019 as we understand it currently) can this be done with the required accuracy; therefore a later phase-in date, perhaps 2022 for the TLAC holding and deduction rules should be provided.

Finally, members in certain countries note that the regulatory frameworks based on the FSB’s international standards have not yet been finalized in all jurisdictions, and therefore believe it would be preferable for the BCBS to hold off finalizing any TLAC holdings proposal until they are either finalized or clarified.

Conclusions

The proposed TLAC Holdings rules are an important aspect of finalizing TLAC as a part of the overall resolution regime for G-SIBs under the Key Attributes, yet the Associations conclude that the present proposal is disproportionate; would be difficult to apply in practice; and would have undesirable effects on the liquidity of markets. This discussion has attempted to suggest ways to avoid the difficulties of the proposal, without compromising its fundamental goals. The Associations and their members would be happy to meet with the Committee or any of its constituent authorities to discuss these considerations further.

Should you have questions or wish to pursue any aspect of these comments, please contact David Schraa (dschraa@iif.com) or Thilo Schweizer (tschweizer@iif.com) or Oliver Moullin (oliver.moullin@afme.eu).

Very truly yours,

David Schraa
Regulatory Counsel
IIF

David Strongin
Executive Director
GFMA