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FSB Finalizes Guiding Principles on Internal TLAC

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The Financial Stability Board (FSB) has a long history of taking the high road in proposing international financial regulatory standards. Its **Key Attributes for Effective Resolution Regimes for Financial Institutions** is an excellent example. That document established high standards for national laws governing the resolution of systemically important financial institutions (SIFIs). Another example was its role in the development of the **2015 ISDA Universal Resolution Stay Protocol**, which helped erase a material impediment to the successful resolution of a global SIFI. Finally, its **Total Loss-Absorbing Capacity (TLAC) Principles and Term Sheet** ensured that SIFIs would have enough external TLAC to successfully recapitalize their operations so that those operations could be continued or wound down in an orderly manner.

Measured against this legacy, the FSB's **Guiding Principles on Internal Total Loss-Absorbing Capacity of G-SIBs ('Internal TLAC')** is something of a disappointment. The guiding principles presented the FSB with a golden opportunity to propose mechanisms to foster mutual trust among home and host authorities that contributable assets located at the G-SIB's top-tier parent in the home jurisdiction will be used to recapitalize material subsidiaries in host jurisdictions. Instead of proposing such mechanisms, the guiding principles leave host authorities free to take self-protective actions to trap and ring-fence excessive amounts of assets in host jurisdictions. Moreover, because of a collective action problem, host authorities have a powerful incentive to hoard internal TLAC at the high end of the FSB's proposed range of 75-90% of external TLAC, instead of cooperating with or relying on cooperation from the home authority or other host authorities. Indeed, the Federal Reserve has already set its internal TLAC requirements at 90% of external TLAC and the EU has proposed to do the same.

The collective action problem arises if just one host authority imposes internal TLAC and related pre-positioned asset requirements at the top end of the FSB's 75-90% range. This self-protective action will trap some of the group's assets in the host jurisdiction and reduce the pool of contributable assets in the home jurisdiction by a corresponding amount. This reduction will increase the risk that the remaining contributable assets will not be sufficient to recapitalize all of the group's material subsidiaries in other host jurisdictions, unless the distribution of losses in a failure-resolution scenario matches the distribution of internal TLAC, which is highly unlikely. To mitigate these shortfall and misallocation of assets risks, other host authorities will be induced to impose similarly excessive internal TLAC requirements at the top end of the FSB's 75-90% range. In short, absent mechanisms designed to foster mutual trust among home and host authorities, host authorities will almost certainly impose excessive internal TLAC requirements if they observe or believe that other host authorities will do so. A more complete description of this collection action problem can be found **here**.

Trapping a global firm's assets in various host jurisdictions and depleting its contributable assets has at least two adverse consequences for both home and host authorities and the global financial system as a whole. First, because it is impossible to predict the actual distribution of losses in a failure-resolution situation, no host authority can be confident that a host subsidiary will not be the **black swan** – i.e., suffer losses of, say, 120% of external TLAC. If each host authority has required internal TLAC equal to 90% of external TLAC, there may not be enough contributable assets to recapitalize the black swan in the host jurisdiction, even if the firm has enough external TLAC to absorb all of its consolidated losses. Indeed, to the extent a firm's assets are trapped in host jurisdictions, the home authority will not be able to use those assets where they are needed in a failure-resolution situation, unless the distribution of losses matches the distribution of internal TLAC, which as noted above is highly unlikely. Thus, what appeared to be self-protective behavior may turn out to be self-destructive behavior by host authorities.

Second, the failure of a black swan subsidiary in a host jurisdiction could make it impossible to restore public confidence in the rest of the global firm. As a result, the rest of the firm could fail. In other words, allowing a global firm's assets to be balkanized in host jurisdictions and depleting its contributable assets would be an important new impediment to the successful resolution of the firm by its home authority, with serious adverse implications for the global financial system as a whole.

The FSB might have addressed both the mutual trust and collective action problems by proposing mechanisms such as secured support agreements, while encouraging home authorities to publicly commit not to interfere with the ordinary operation of such secured support agreements. Such secured support agreements could impose secured obligations on the top-tier parent and one or more funding vehicles of a G-SIB group to use their cash, intercompany receivables and other assets to recapitalize the group's material subsidiaries in a failure-resolution situation, including in host jurisdictions. Their obligations could be secured by the very assets that they would be contractually obligated to contribute. The agreements could contain triggers that would give material subsidiaries in host jurisdictions (and indirectly host authorities) the secured right to demand contributable assets prior to the time such subsidiaries reached their point of nonviability.

Although the Federal Reserve recently imposed internal TLAC requirements on the top-tier U.S. intermediate holding companies of foreign G-SIBs equal to 90% of external TLAC, there is reason for hope that the Federal Reserve might revisit its decision and reduce its internal TLAC requirements to 75% of external TLAC. If it did, the EU might revisit its proposed internal TLAC requirements and reduce them to 75% as well. The reason for such reconsideration by the Federal Reserve is that President Trump issued an **Executive Order** calling on the U.S. Treasury to conduct a review of existing U.S. regulatory requirements in light of certain core principles for regulating the U.S. financial system. In its **first report** pursuant to that Executive Order, the U.S. Treasury called on the Federal Reserve to reconsider its internal TLAC requirement. Given that a majority of the Federal Reserve's Board is in the process of being replaced with people who should be committed to the core principles in the Executive Order, there is reason to hope that the new Board will reduce its internal TLAC requirements to 75% of external TLAC and encourage the EU to do the same.

While the final guiding principles were a missed opportunity to solve the mutual trust and collective action problems, the final version contained a few improvements over the proposed version that are worth noting:

- ***Material sub-group determinations.*** The final guiding principles give home authorities the primary role in determining whether a subsidiary or sub-group in a host jurisdiction is material or not. The proposed guiding principles would have given host authorities the primary role.
- Relationship between internal and external TLAC requirements. The proposed guiding principles stated that "there is no presumption that host authorities would apply a lower internal TLAC requirement if the sum of internal TLAC

requirements exceeds the resolution group's external TLAC." The final guiding principles deleted this statement, implying that the sum of a G-SIB's internal TLAC requirements should be less than its external TLAC requirement.

- ***Taking a parent's resolution strategy into consideration.*** The final guiding principles note that host authorities should consider a G-SIB parent's overall resolution strategy to facilitate the stabilization of entities within a material sub-group through the passing up of losses. U.S. G-SIBs have solved this problem in a way that should protect the interests of host authorities as effectively as internal TLAC requirements without depleting the group's contributable assets or trapping ring-fenced assets in host jurisdictions. Specifically, U.S. G-SIBs have put into place secured support agreements that impose fully secured obligations on the top-tier parent of the U.S. G-SIB groups to use their cash, intercompany receivables and other financial assets to recapitalize their operating subsidiaries in a failure-resolution situation.
- ***Taking operational continuity arrangements into consideration.*** The final guiding principles provide that in the case of unregulated or non-bank entities, a host authority should consider whether arrangements are in place to maintain the continuity of critical functions or critical shared services performed by those entities when determining the distribution of internal TLAC among the entities within a material sub-group. The proposed guiding principles were silent on this issue.
- ***Flexibility of the location of surplus TLAC.*** The proposed guiding principles suggested that external TLAC in excess of the amounts distributed to material sub-groups should be held at the parent company in the form of "readily available" assets. The final guiding principles add that they may be held in other entities, such as intermediate holding companies or other funding vehicles, provided there are no legal or operational impediments to transferring them back to the parent company or using them to recapitalize any direct or indirect subsidiary of the parent company.
- ***Contractual write-down or conversion features.*** The proposed guidelines stated that host jurisdictions should consider whether statutory write-down or conversion provisions should be supplemented with contractual write-down or conversion provisions. The final guiding principles deleted this provision, implying that such supplemental contractual provisions are not encouraged.
- ***Conformance period.*** A new guiding principle has been added clarifying that internal TLAC rules should provide a conformance period consistent with the

TLAC term sheet. This means that firms designated as G-SIBs prior to 2016 should meet internal TLAC requirements by January 1, 2019, and that any newly identified material sub-groups should have 36 months to comply with an internal TLAC requirement

Click **here** for an interactive spreadsheet that illustrates the adverse impact on surplus assets of excessive internal TLAC requirements.