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Will TLAC regulations fix the G-SIB too-big-to-fail problem?

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ABSTRACT

The efficacy of the Financial Stability Board's proposed requirement for minimum "total loss absorbing capacity" (TLAC) at global systemically important banks (G-SIBs) is assessed using a stylized model of a bank holding company and an equilibrium asset pricing model to value financial claims. I identify a number of G-SIB strategies that satisfy minimum TLAC requirements but fail to reduce implicit safety net subsidies that accrue to G-SIB shareholders or increase the resources available to recapitalize a failing G-SIB subsidiary. To meet the FSB's stated goals, TLAC requirements must impose minimum TLAC at all subsidiaries and restrict how TLAC funds can be invested. An equivalent, but much simpler solution is to significantly increase regulatory capital requirements on systemically important bank subsidiaries.

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1. Introduction

The Financial Stability Board [FSB] has proposed that global systemically important banks [G-SIBs] should be required to meet and maintain new minimum total loss absorbing capacity [TLAC] standards.[2] TLAC requirements will impose new capital structure restrictions on bank holding companies and, in some cases, on holding company subsidiaries. These restrictions may require G-SIBs to issue substantial amounts of unsecured debt that can be converted into equity to avoid bankruptcy in a bail-in strategy, or converted into receivership certificates in a regulator-administered resolution process. In special cases, the TLAC rules may require parent companies to issue TLAC debt and re-lend the proceeds to one or more subsidiaries so that this debt can be converted into equity or be forgiven by the parent company should the subsidiary need to be recapitalized.

G-SIB TLAC is composed of equity and debt claims that qualify as Basel III regulatory capital and other external debt. External debt will qualify as TLAC provided it is unsecured, subordinated to most other claims, and has a remaining maturity of at least one-year. The FSB proposal recommends a TLAC requirement in the range of 16–20 percent of risk-weighted assets, with an absolute TLAC floor of 2 times the Basel III leverage ratio.[3] The final calibration of minimum TLAC requirements is left to the discretion of national supervisory authorities.[4]

According to the FSB, the objective of the TLAC requirement is,

> [T]o ensure that the G-SIBs have the loss absorbing and recapitalization capacity necessary to help ensure that, in and immediately following a resolution, critical functions can be continued without taxpayers' funds (public funds) or financial stability being put at risk.[5]

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[1] The views in this paper are those of the author alone. They do not represent the official views of the American Enterprise Institute.

[2] Financial Stability Board (2014).

[3] The Basel III leverage ratio is Tier 1 capital divided by total consolidated exposure which include all on- and off-balance sheet positions calculated using specific regulatory guidelines. The minimum Basel III leverage ratio is 3 percent; the US minimum Basel III leverage ratio is 5 percent for all advanced approach BHCs and 6 percent for all advanced approach banks.

[4] The specific details of US regulations specifying minimum TLAC for US G-SIBs have not been finalized. The Federal Reserve Notice of Proposed Rule Making (October 28, 2015) proposes that a parent BHC of a designated US G-SIB maintain TLAC that is equal or larger than: the greater of 18 percent of the BHC's consolidated risk-weighted assets or 9.5 percent of its total leverage exposure measured using the Basel III leverage ratio protocols.

[5] Financial Stability Board (2014), p. 13.

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Moreover, the FSB further intends that,

> TLAC, in conjunction with other measures should act to remove the implicit public subsidy from which G-SIBs currently benefit when they issue debt and incentivize creditors to better monitor G-SIBs' risk taking.[6]

There are many ways a G-SIB might alter its capital structure and investments to satisfy the FSB's TLAC proposal. For example, the parent company of a TLAC resolution group might issue TLAC-compliant debt and invest the proceeds in low-risk assets. Moreover, the optimal G-SIBs strategy for TLAC compliance may depend on whether the bank is organized as a universal bank (as is common in European markets) or managed through a holding company structure (as is typical in the United States). In this paper, I will consider alternative strategies that could be used by a US bank holding company (BHC) to satisfy a given TLAC requirement.

My TLAC analysis is based on a theoretical model of a BHC that owns two subsidiary banks. The model includes a parent BHC that issues external debt and equity claims to fund its ownership of equity and debt claims issued by its subsidiary banks. The parent BHC may also own nonbank assets, but it is primarily a vehicle for owning, financing, and managing subsidiary banks.

Using an equilibrium pricing model to value bank assets and financial claims, I consider alternative strategies that the BHC might use to satisfy a new 16 percent TLAC requirement. The TLAC requirement supplements an existing 8 percent minimum regulatory capital requirement.[7] I assume that, prior to the imposition of a 16 percent minimum TLAC requirement, the 8 percent minimum regulatory capital requirement is binding at both the parent BHC and bank subsidiary levels. I use this model to analyze the impact of alternative strategies that a G-SIB potentially could use to satisfy the FSB's proposed minimum TLAC rule.

The analysis includes many strategies that satisfy minimum TLAC requirements. However, many of these strategies do not achieve the FSB's goal of reducing G-SIB implicit safety net subsidies or replenishing critical subsidiaries' going-concern capital before they reach a point of non-viability. To attain the FSB's stated goals, minimum TLAC regulations must be more proscriptive than the current FSB proposal. They must require full internal TLAC at all bank subsidiaries and put tight restrictions on how these subsidiaries use new TLAC funds. Without these restrictions, it is unlikely that G-SIBs will choose to adopt TLAC-compliant strategies that will remove its safety net subsidy and provide the loss absorbing capacity required to keep critical subsidiaries open and operating.

An outline of the paper follows. Section 2 reviews the policy developments that have created the need for minimum TLAC requirements. Section 3 reviews the FSB's proposed TLAC rules. Section 4 discusses the equilibrium pricing model and the stylized BHC used in the analysis. Section 5 considers alternative strategies that the BHC might use in order to meet a 16 percent minimum TLAC requirement. Additionally, Section 5 analyzes the efficacy of these alternative strategies relative to the FSB's policy goals. Section 6 summarizes the results of the TLAC analysis and discusses an alternative approach that satisfies TLAC goals by imposing heightened regulatory capital requirements on critical bank subsidiaries.

2. Background

The FSB 2011 report, Key Attributes of Effective Resolution Regimes for Financial Institutions, discusses the G-20 goal of creating strategies to resolve failing systemically important financial institutions (SIFIs). The FSB (p. 5) highlights the importance of developing techniques to resolve SIFIs "without severe systemic disruption, without exposing public funds to loss, and while ensuring continuity of systemically important (or "critical") functions." While strategic details will vary across countries, the FSB believes this goal can be achieved through recapitalization strategies that: (i) impose first losses on SIFI shareholders; (ii) convert unsecured and uninsured SIFI creditor claims into equity or receivership certificates; and (iii) use the resources of the SIFI creditors left in receivership to absorb residual losses and recapitalize subsidiaries so they can remain open, operating and continue to provide critical economic functions.

One approach for executing a SIFI recapitalization is a so-called "bail-in" strategy whereby debt is converted into equity to prevent legal resolution or bankruptcy. Bail-in strategies convert eligible financial institution liabilities into equity claims and recapitalize a SIFI before it fails. Bail-in forestalls the allegedly disruptive effects of legal bankruptcy or administrative resolution processes, especially on SIFI operating subsidiaries that provide critical services to the economy.

Many contract designs could be used to issue bail-in debt. While conversion triggers vary, all such contracts are a form of mandatory contingent convertible debt or so-called "co-cos." To date, the co-cos market has yet to mature. There is no "benchmark" conversion design for co-cos and secondary market trading is illiquid.[8]

An alternative approach to bail-in is to recapitalize SIFI operations within a judicial bankruptcy or supervisory resolution processes. When legal frameworks permit, a SIFI's parent financial company can be placed in receivership, and its subsidiaries transferred to a new bridge financial institution that functions as the new parent company. Since the failing SIFI's parent company's unsecured and uninsured debt claims are left in the receivership, the new parent institution has assets, but few if any liabilities. The bridge can sell new debt claims and use the proceeds to recapitalize and fund any failing SIFI subsidiaries. This keeps the subsidiaries open, operating, and out of secondary bankruptcy or receivership proceedings.

The FDIC's Single Point of Entry (SPOE) strategy is a leading example of a recapitalization strategy that takes place within a Dodd–Frank[9] Orderly[10] Liquidation (OLA) process. Some legal experts believe that a SPOE-like reorganization can also be accomplished in a judicial bankruptcy proceeding. Indeed H.R. 5421, "The Financial Institution Bankruptcy Act of 2014," commonly known as "Chapter 14" [and S. 1861 in the US Senate], amends the bankruptcy code so that it explicitly allows a SPOE-like recapitalization in a Chapter 11 judicial bankruptcy.

In order to facilitate bail-in or SPOE recapitalization, a SIFI must have adequate unsecured, uninsured debt available to convert into equity (in bail-in) or receivership certificates (in SPOE). After reorganization of claims priorities, the restructured SIFI must have a capital structure that will allow it to continue funding its subsidiaries' operations. To provide the necessary buffer, the FSB has proposed new TLAC requirements that would apply to G-SIBs.[11]

For G-SIBs, TLAC rules will impose a new set of capital structure constraints in addition to the Basel III risk-based capital requirements that banks and BHCs must satisfy. TLAC is supposed to

[6] Financial Stability Board (2014), p. 6.

[7] The 16 percent minimum TLAC assumption is arbitrary but inconsequential. The analysis could be repeated with any minimum TLAC setting.

[8] See Avdjiev et al. (2013) for a survey on the development of co-cos, or Flannery (2009), Duffie (2009), Culp (2009), Pennacchi et al. (2011), Bolton and Samama (2011), Sundaresan and Wang (2011), or Calomiris and Herring (2012, 2013) for alternative approaches for structuring co-cos bonds.

[9] Dodd-Frank Wall Street Reform And Consumer Protection Act (2010).

[10] Federal Deposit Insurance Corporation SPOE NPR (2013).

[11] Financial Stability Board (2014).

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