

# **TLAC'S TOLL**

**G-Sib funding faces an identity crisis under TLAC. European and North American bank counsel, treasurers and structurers speak anonymously - and candidly - about the regime's impact on their operations and bond markets**

**Danielle Myles, Editor**

To say bank bonds had a rocky start to 2016 would be an understatement. Over the first weeks of January, the market's significant gains from last year were essentially wiped out, with European issuers hit particularly hard. Undoubtedly, macroeconomic issues stemming from China's slowdown and the oil rout were partially to blame. But so too was the dawning realisation that a growing number of reforms mean even senior ranking bonds can be converted to equity if the bank runs into trouble.

Botched bail-ins by Italy and Portugal under the EU's new resolution rules were cited as the major regulatory culprit. But those principles reach far beyond the Bank Recovery and Resolution Directive (BRRD). The seemingly insatiable desire of rulemakers to make bank-issued instruments as equity-like as possible is, in fact, epitomised by the total loss-absorbing capacity (TLAC) standards released by the Financial Stability Board (FSB) late last year.

At the heart of TLAC is a familiar, and laudable goal: to ensure taxpayer funds aren't used to rescue a global systemically important bank (G-Sib), in an effort to avoid a broader economic catastrophe. But slapping additional capital requirements on the world's biggest – and by now, possibly safest – lenders has sparked debate about the philosophical direction of bank debt and its place on G-Sibs' balance sheets.

"Regulators have been very wishy-washy on whether TLAC is capital," says a vice president in a Canadian bank's treasury department. "They keep calling it debt, and yes, it is long-term debt. But if you breach the TLAC requirements the FSB rules are very clear that it will be treated as a capital breach."

Such double standards have disillusioned many in the industry. "You can't call something debt, and then for every other purpose call it capital," he adds. "The fact is TLAC will be more equity-like than sub-debt seven years ago. They have essentially eliminated debt from our capital structure and said you can only have capital."

This re-characterisation of senior bank debt is one of the most striking findings from IFLR's Bankers' Poll on the impact of TLAC – and its various incarnations – on European and North American lenders and their bond markets.

By blurring the boundaries between debt issued for funding and debt issued for regulatory purposes, the former could be significantly curtailed by the biggest lenders. Yet the results of IFLR's poll show that it's not just G-Sibs grappling with this

new mindset. Smaller banks, investors and national resolution authorities are all drawn into the paradigm shift. Until the US and EU finalise their respective TLAC regimes, opinion is divided on everything from compliance timelines to who will invest. Yet the findings are instructive in revealing senior bankers' fears and hopes for an asset class at the heart of global finance.

### The bottom line

A topic on which respondents agree is TLAC's impact on funding costs (see question 1). Very few will comply come 2019 by simply continuing their existing programmes. And in line with conventional wisdom, the equity-like characteristics of TLAC instruments mean issuer costs will exceed those for pure debt. Some votes, however, are nuanced. A number of respondents stress the negative impact will only be moderate, while others note that the extra expense depends on how the issuer is financed today.

"Of course it will have an impact, but especially for banks that are funded mainly by deposits. They will have to issue proportionally more instruments to comply with TLAC, and the cost of that is higher than of having depositors," says a European bank's FIG [financial institutions group] representative.

Even for those that don't rely on deposits, the cost impact depends on which instruments must be replaced. "If you are swapping seven-year opco senior for five-year holdco senior, the difference might be between 20 and 50 basis points. But if you are replacing commercial paper, then it's a lot more expensive," says one capital structurer at a UK bank.

The unanimous result to this question is fleshed out by the more varied responses to question 2. The FSB standards' implementation in the US and EU (the latter via MREL, or minimum requirement for own funds and eligible liabilities) will

make the price of G-Sibs' most senior paper cheaper for issuers – and more expensive for investors – because their safety benefits from the TLAC cushion. For the senior unsecured debt that qualifies as TLAC, 60% believe the requirements will have a moderate effect on pricing, while 40% think the impact will be significant.

A common qualifier is that premium will taper off, as the asset class matures into a reputable investment. "The first issuances will be expensive, but the anticipation is that so long as banks are able to issue significant amounts of TLAC-eligible debt, the price differential versus normal senior will decrease over time," explains a capital structurer at a European bank.

Those voting 'moderately' believe the impact will be mitigated by the simple fact that bail-in principles have existed under different guises for some time. Dodd-Frank

**They have essentially eliminated debt from our capital structure and said you can only have capital**

gave US G-Sib debt TLAC-like characteristics in resolution, and depositor preference has been a pillar of many bank regimes, including Australia.

But there are jurisdiction-specific issues at play here, too. The US has proposed stripping all covenants out of G-Sibs' senior unsecured bonds, other than those relating to non-payment and bankruptcy causing acceleration. This would create substantial differences between the investor protections in G-Sibs' notes versus those of smaller issuers, meaning they will be penalised on price. "The acceleration language is the biggest point around the Fed's proposal," says a structurer at a US bank.

A counsel at another US bank concurs:

**1. Do you expect these new requirements will negatively affect funding costs for G-Sibs?**

Yes: 100%



[No: 0%]

**2. To what extent do you think TLAC, MREL and LTD requirements will affect the pricing of G-Sibs' senior debt?**

Moderately: 60%



Significantly: 40%  
[Not at all: 0%]

"If the covenant packages have to change, we are fearful the pricing could definitely be significant." She says industry is working with regulators to help them understand the purpose of the other covenants, but there's little clarity on which way they will rule.

In Europe, some say TLAC and MREL's impact on pricing is actually being kept in-check by unconventional monetary policies. "I've been saying for some time that the price of senior unsecured debt for banks should go up quite a lot," says one European bank representative. Today's supply-demand dynamics mean spreads, as compared to other asset classes, are narrower than they should be – and he doesn't expect that to change anytime soon. "With interest rates where they are and against the backdrop of the European Central Bank's (ECB) asset buying programmes, I think investors will still pay up for bank paper. If we were in a different environment, the effect on costs would be steeper," he adds.

**Investor base**

This significant buy-side interest in bank bonds is reflected by 41% of respondents believing no investor classes are likely to be deterred from G-Sibs' senior unsecured debt as a result of TLAC (question 3). "Most investors we talk to won't stop buying them," is one US counsel's emphatic response.

This is partly based on track-record. "What the US has proven so far is that everything is attractive but at a price," says a financial adviser at a US bank. The instruments will come at a concession and as a US-based European bank counsel notes, G-Sibs are regarded among the safest investments: "Investors come to us for credit; they believe in the credit of the

issuer and its ability to pay up – in both coupons and redemption. TLAC won't change that, TLAC will not change the credit of [his bank]."

By and large, respondents expect investment mandates to be adjusted accordingly – certainly for home country G-Sibs. However, investors may be less receptive to borrowers from foreign jurisdictions where bail-in risk is less understood.

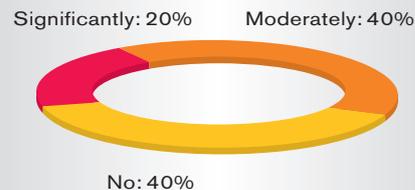
If any investor class will be deterred, it is likely to be retail. According to one respondent, they will shun products that are too risky or complex, including because of TLAC instruments' "inadequate customer protections". Others draw lessons from the regulatory capital market. "Certainly with some of the new generation Tier 1 instruments there is an explicit prohibition against distribution into retail, and quite frankly a lot of the senior stuff doesn't go into retail to begin with, so I don't think they are relevant in this regard," says a US bank financial adviser.

It's a similar thought process for insurers. Many have trouble investing in non-viability contingent convertible (CoCo) or other hybrid capital instruments as they are problematic under their own capital regime. "These could arguably be deemed by a regulator to be similar," says the Canadian bank treasury official.

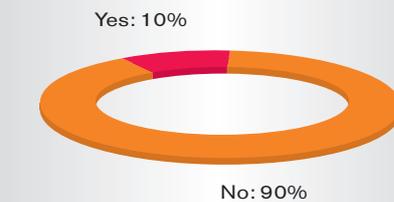
Paradoxically, this is exactly the same reason why one quarter of respondents – overwhelmingly from Europe – believe insurers will find instruments that qualify as TLAC, but not regulatory capital, attractive (question 4). They suggest that as Solvency II has all but stopped insurers buying additional tier 1 (AT1) and made them a rarity in tier 2, they could be drawn to other TLAC-eligible instruments.

Hedge funds and yield-hungry high-net

**5. Do you expect these new requirements will affect G-Sibs' funding diversification?**



**6. Do you expect non-G-Sibs to 'fill the gap' by issuing more securities that are not LTD or TLAC-eligible to meet investor demand?**



worth (HNW) investors aren't likely to be tempted. According to the structurer at the UK bank, they won't find that intermediate slice of TLAC, long-term debt attractive at current levels.

The overriding view, however, is that decisions will be based on risk appetite, which is not consistent within any investor class. "In general, investors do not care whether an instrument is recognised as regulatory capital. They don't make the distinction based on a label, they will decide based on the return and bail-in risk," says the European bank structurer.

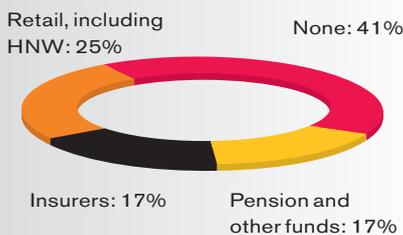
Consistent with the most popular vote in question 3, G-Sibs are widely regarded as being relatively safe, meaning that 50% would have enough comfort to invest – particularly given there is plenty of cushion to protect TLAC instruments from bail-in.

**Less instruments, same issuers**

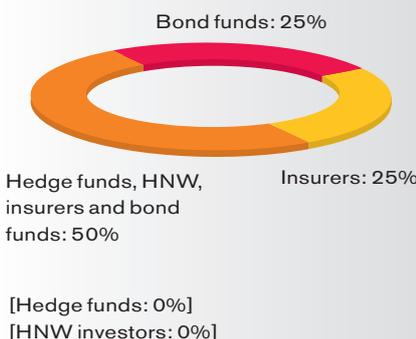
One of the most contentious topics is the extent to which the new regime will affect G-Sibs' funding diversification (question 5). The results were split – 40% vote 'no', 40% 'moderately' and 20% 'significantly'. Supporting arguments are even more fragmented.

The question was asked with specific reference to retail-oriented instruments, which the FSB term sheet excludes from eligible securities. Since TLAC was first floated in late 2014, the structured products community has feared the market will grind to a halt if G-Sibs are disincentivised from issuing. The problem was thought to be particularly pronounced

**3. Which investor classes are likely to be deterred from, or choose not to invest in, senior unsecured debt of G-Sibs as a result of TLAC, MREL or LTD?**



**4. What types of investors do you believe would find debt instruments that qualify as TLAC or LTD, but do not otherwise qualify as regulatory capital, attractive?**



in continental Europe, where a number of lenders rely on the asset class.

But IFLR's findings suggest this isn't a major issue. European respondents agree there are banks that have historically relied on retail, and in the US it's common among broker-dealers. But on both sides of the Atlantic, the bigger G-Sibs tend to be either deposit- or institutionally-funded. And if in the future banks are funded less by retail investors, it won't be solely attributable to TLAC. Rather, it's because of deep-rooted scepticism surrounding unsophisticated investors funding banks via debt securities.

It's also because of the sheer volume of funds many have to raise under TLAC. "Will they have to start looking for the new marginal buyer? Yes they probably will. But I'm not sure it's because of the exclusion of the retail instruments," says the UK bank structurer. "It's because they are looking at a big quantum. They will need to crack on with it so they will need to pay up and go to the institutional market."

American respondents also cite the scale of issuance as a reason why retail funding will diminish. One who works in origination notes that a significant number of institutions historically use a combination of senior benchmark, senior sub-benchmark plus some form of structured notes. "In some cases 40% of their funding comes from non-benchmark. So to the extent those outlets go away, diversification is going to be limited," she says.

Both she, along with another US bank counsel highlight the Fed proposal's requirement for long-term external debt to be governed by US law. The country's G-Sibs will not be able to issue into other jurisdictions that also require bonds be issued in local-law format. "Aussie dollars would go away – and that is something that has been used historically – and there is still a question about Formosa bonds' eligibility. So G-Sibs may have to rely less on non-US markets," says the counsel.

If G-Sibs do issue less securities that aren't TLAC-eligible, the next natural question is whether other issuers will step in to fill the gap (question 6). This receives a lukewarm response. "Obviously a lot of them will try, but the question is whether there is any demand for their paper," says one US counsel – a comment that goes back to investments being credit decisions. Some believe the sheer volume of non-TLAC instruments that will be taken out of the market by G-Sibs can't be compensated for by smaller issuers, while others say smaller banks and corporates have

## TLAC: back to basics

The FSB proposed TLAC standards in November 2014 and issued final standards on November 9 2015. They require G-Sibs, of which there are 30 today, to hold set amounts of: common equity Tier 1; AT1; Tier 2; and unsecured, subordinated and other eligible long-term debt. By 2019, G-Sibs' TLAC must be at least 16% of their risk-weighted assets, and six percent of the Basel III leverage ratio denominator. In 2022, those requirements rise to 18% and 6.75%, respectively.

To qualify as TLAC, instruments must contain a contractual trigger, or be statutorily subordinated, such that the relevant regulator can write-down or convert it into equity, to avoid a public bailout.

The US Federal Reserve released draft implementing regulations on October 30 2015. The consultation period closed on February 1 2016, and final rules are expected by autumn.

In November 2014 the EBA launched a consultation on regulatory technical standards (RTS) for MREL, as mandated by the BRRD. MREL's principles are consistent with, and in fact go further than, TLAC and so the same regime will be used to comply with the FSB's latest framework. In July 2015 the EBA submitted draft RTS to the European Commission, which must endorse them before they are submitted to parliament for approval. The Commission has requested amendments to the RTS, and it's not clear when finalised rules will be introduced.

explicitly stated they won't issue more. "The driver for issuing structured notes will be the structuring fees and profits, not this," says one North American respondent.

Ultimately, some think the issue is nothing more than a storm in a teacup: "The structured note decision by regulators is a strange one, as the riskier notes are getting the better treatment in liquidation. But I think industry is overblowing the issue – I just don't think structured notes are a huge market."

### Compliance

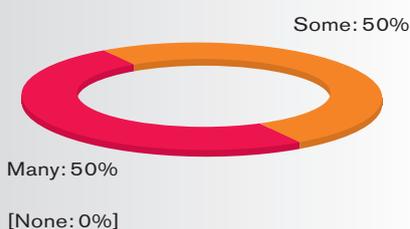
Another divisive issue is how many banks will try to comply before the 2019 deadline (question 7). Most respondents caveat their vote by saying the timeline will differ from bank-to-bank in line with how capitalised they are today. The ahead-of-schedule compliance with the latest Basel accord is used as a touchpoint by many in speculating about TLAC compliance, but interestingly, it's led to different conclusions.

For the 50% voting 'many', the fact TLAC is part of the larger capital requirements push means they won't delay processes that are already in motion. Respondents list some G-Sibs – Credit Agricole, Deutsche Bank and France's BPCE – as being nearly compliant today.

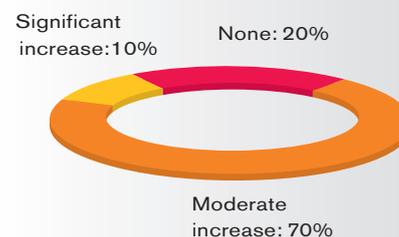
But the other half of respondents cite myriad reasons why only some will try to comply early. They distinguish this latest regime from Dodd-Frank's implementation of Basel III, which saw US banks race to take advantage of a short window to replace trust preferred securities before losing their status as Tier 1 capital. "There was an impetus to accelerate compliance with Basel III which was done well in advance of the deadline. But with TLAC the process will be slower," says one US respondent. "What is the incentive to issue 10-year debt today when if you did it closer to the actual compliance deadline you would get more credit for it?"

European G-Sibs are expected to heed the warning of Swiss banks' recent Basel experience. Implementing regulations were

#### 7. How many G-SIBs do you expect will attempt to achieve compliance before the 2019 compliance deadline?



#### 8. What impact will LTD/TLAC compliance have on legal and compliance expenses for G-Sib issuers?



initially drafted to allow low trigger and high trigger Tier 1 and Tier 2 securities to qualify as regulatory capital. Years later, that was narrowed to include only high trigger Tier 1 and holdco instruments.

"Switzerland changed its regulatory capital eligibility requirements after its banks had spent five years and god knows how many hundreds of millions of francs on coupons issuing what turned out to be the wrong structure," says a UK respondent. "We've seen time and time again that there is nothing much to be gained by going early, as the regulators keep moving the goalposts."

The fact those goalposts haven't even been set yet is a more immediate hurdle. The US Fed is expected to finalise its rules by autumn, and nine months after the European Banking Authority (EBA) proposed MREL's regulatory technical standards, the European Commission still hasn't endorsed them. EU member states that have tried to get ahead of the game by introducing national legislation – most notably Germany with its plan to make all outstanding senior debt statutorily subordinated in bail-in – have had to go back to the drawing board after identifying unintended regulatory consequences.

"The markets have been terrible this year, but even if they do improve, people wouldn't know what to issue – so I don't know how people could get there right away," observes one US bank counsel.

Aside from timing, the other big compliance question is cost (question 8). It's a topic that sets TLAC apart from the vast majority of post-crisis reforms. While the revised Markets in Financial Instruments Directive requires the building

comparatively small. So small, that he still selects 'none'.

Some voting for a significant increase dismiss the question, jadedly noting that reforms and excessive costs go hand-in-hand. But one European bank structurer makes a rather convincing argument: "Banks will have to produce more data to convince, and demonstrate things to, more people. Whether you call that compliance or regulatory or legal costs, I definitely think they will be significant." For groups that are decentralised, and comprised of subsidiaries around the world, the cost will be higher as they must engage with more regulators.

The majority view, however, is that TLAC compliance costs will be moderate. The requirements can be overlaid onto systems already in place to meet other capital rules. "It's not like they are reinventing the wheel," says one counsel. US indentures and European medium term note (MTN) programmes will have to be updated to ensure they are TLAC-eligible under finalised rules, but the biggest expense could simply come from increasing headcount. "You are selling riskier instruments, so there will be more investment in fixed income investor relations work, and more legal risk so more due diligence," says one European bank representative. "For all that, you will need more staff."

### Pushing the boundaries

When asked whether the Fed's internal TLAC proposals for G-Sibs with an intermediate holding company (IHC) will prompt foreign banks to reduce their US presence (question 9), some respondents –

## Investors come to us because they believe in the credit of the issuer and its ability to pay up. TLAC won't change that

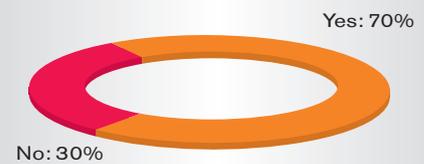
of bank-wide IT systems and the Volcker Rule required entire trading books be reviewed, TLAC offers a reprieve from the expense historically associated with being a law-abiding lender.

Twenty percent of respondents struggle to detect any link at all. "I think it will just be the funding cost – any compliance costs won't be nearly as much as other regulatory requirements," says one. Another concedes that lawyers will need to update risk factors and that TLAC issuance must be tracked, but he expects those costs to be

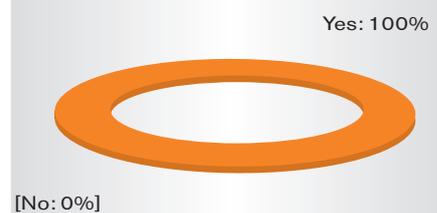
even those from Europe – spring to the Federal Reserve's defence. The FSB recommends internal TLAC of 75% to 90% of the sub-group's external TLAC if it were deemed a resolution entity. "The US version isn't more stringent than that," notes one European structurer. "You have a liquidity requirement that is slightly different, but in terms of the amount of pure, internal TLAC it's not more than what is in the FSB proposal."

Seventy percent, however, believe it will prompt an exodus. Some of them can't

**9. Do you expect foreign banks to reduce their US footprint as a result of the US's proposed internal TLAC requirements for foreign G-Sibs subject to an IHC requirement?**



**10. Do you expect a trickle-down effect, with regulators imposing similar requirements on D-Sibs?**



point to anything specific in the US rulebook to support their answer. Instead, they cite a string of expensive, regulatory requirements that are prompting many to rethink their American strategy, adding: "This is just one more additional headache."

But those who dig a little deeper still come to the same conclusion. They say US TLAC requirements clearly penalise the more active foreign banks because they are layered on top of IHC requirements. Dodd-Frank requires foreign G-Sibs with US assets of \$10 billion or more to house their US subsidiaries under an IHC, which must be capitalised as a standalone bank.

"For most of the global banks, the largest part of their US operations is a capital markets business," says the Canadian bank treasurer. "So they are basically being told to capitalise what are essentially broker-dealers as banks, and then because they are a G-Sib, to put TLAC on those entities as well."

While these US-enhanced rules are designed to stop systemic risks within the domestic economy, they are effectively penalising moderately sized broker businesses because they are owned by a G-Sib. Standalone, US-headquartered dealers of a similar size benefit from a much lighter capital regime.

The US-based European bank counsel agrees that TLAC and IHC rules make it very expensive to maintain a US franchise, and that it will simply be a cost-benefit analysis. The Canadian treasurer agrees:

### 11. How do you anticipate that most G-Sibs will meet their internal TLAC requirements?



“Why would you dedicate so much capital just to support a dealer when quite frankly many of those portfolios could be housed in London, Zurich or some other book?”

But there are other considerations. Those with a sizeable US presence would have to substantially restructure and reduce their activities to get below the IHC threshold. Some have been willing to downstream capital from the foreign parent company to the IHC, but the viability of this depends

## I think industry is overblowing the issue – I just don't think structured notes are a huge market

on home country rules. Switzerland and the UK are a case in point. “If their regulators view TLAC going into the US as a capital deduction under their solo or standalone capital regimes, then it is incredibly punitive for them to operate in the US. They are better off keeping business within their home country banks,” says one respondent.

While US rules are set to penalise the local operations of foreign G-Sibs, its regulators aren't nearly as intent on clamping down on lenders that otherwise pose systemic risks at the domestic level. Known as D-Sibs, a growing number of national rulemakers are imposing TLAC-like requirements on these lenders (question 10). Under MREL, national resolution authorities are permitted to extend the requirements to non-G-Sibs; the UK and Nordics are already moving to do so. Canada, Australia, Singapore and Hong Kong are taking a similar approach.

But US authorities are forging their own path. “The US is probably the only one that doesn't already have something like

this in motion, and it's not something that is expected near-term down the line,” says the US bank structurer. A local counsel agrees that, in line with the decision to exempt small lenders from the full weight of Basel III, the US won't impose TLAC-like requirements on D-Sibs.

### Path of least resistance

Until the US and EU finalise their respective implementing regimes, it's difficult to know how G-Sibs will meet their internal TLAC needs (question 11). Twenty percent of respondents believe banks will use a combination of all available avenues. But the general view is that TLAC instruments – whatever they may be – will be most popular for the simple fact that they will be cheaper than regulatory capital. In permitting collateralised commitments to contribute capital to material subsidiaries as a substitute for internal TLAC, it appears the FSB is cutting G-Sibs some slack. But only 10% of respondents think there will be

enthusiastic uptake of collateralised guarantees. “They don't get used very extensively in any other type of bank financing,” notes the UK structurer. “There are some cases where you would do a fully funded synthetic ABS, but in the grand scheme of bank financing across Europe, it's pretty rare.”

### Accelerating failures

Irrespective of how difficult or easy G-Sibs will find TLAC compliance, the irony is that they are perhaps the last entities that need more safeguarding. By adding this extra layer of capital on top of Basel III buffers, some of today's safest credits are becoming shakier. And not because of any operational risk, but because they could breach an artificially imposed trigger that has been set too high.

Bank securities' tumultuous start to the year may have been triggered by the announcement of 2015 losses, but the subsequent sell-off was fuelled by fears surrounding CoCos. “With anything loss-absorbing, it's not about whether the bank has a lot of capital, it's the distance to their minimum requirement,” says the Canadian bank treasurer. “As those requirements increase, suddenly more banks get into trouble for being viewed as having potential issues relative to their required minimums.”

## Methodology

IFLR's Bankers' Poll was compiled with the help of the poll's sponsor firm, Morrison & Foerster.

With input and insight from partners Oliver Ireland and Anna Pinedo, poll questions were devised and targeted to best address the issues faced by North American and European banks in complying with TLAC and the regime's impact on bank debt markets.

Using recommended contacts from the editorial team and Morrison & Foerster, the poll was distributed to in-house counsel, treasurers and capital structurers at the largest banks across the two continents. Responses were obtained from a representative cross-section of those banks.

The poll provides banks with an anonymous forum to learn how their peers are coping with TLAC. To ease the concerns of the participants, anonymity was guaranteed to all respondents. To that end IFLR will not name the banks that agreed to interviews.

Responses and comments were obtained via off-the-record telephone calls during March 2016. While the more structured responses to the poll questions provided interesting statistics, a real sense of banks' concerns emerged from their explanatory comments. The topics raised in those interviews formed the basis of the conclusions drawn out of the main body of IFLR's analysis.

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It begs the question whether regulators' relentless pursuit of over-the-weekend resolutions is at the expense of keeping banks as a going concern. “They might want to have a perfect failure, but really they might want to rethink their priorities about avoiding a failure,” suggests one respondent.

Pushing the bar too high – including via TLAC – means banks will fall out of favour with their stakeholders more quickly. Deutsche Bank, regarded as one of the safest lenders and with rock-solid regulatory oversight, is experiencing that first hand. And its wobbles should not be taken lightly by its smaller, foreign counterparts. “Deutsche is a good bank,” says one North American respondent. “Think what will happen in a bad time with a bunch of marginal names?”

# A matter of context

**Timelines, investor appetite and gold-plating have divided opinion among poll respondents. The strictly legal view provides some greater clarity**

**I**FLR speaks with Morrison & Foerster's Anna Pinedo and Oliver Ireland, who helped compile the poll questions, about the most pressing issues presented by TLAC and its implementation in North America and Europe.

**There seems to be little consensus on the extent to which G-Sibs will try to comply before 2019. What's your view?**

**Anna Pinedo** I think most banks will try to comply before 2019, or at least provide some indication of the gap they need to fill so the market understands what to anticipate. In the US we're already starting to see that. A number of the G-Sibs used their Q1 earnings release to give investors a sense of their securities that are outstanding which, based on the Fed proposal, they think would be TLAC-eligible. And I think you will see more and more banks include those statistics in their earnings releases going forward.

**Oliver Ireland** The other thing is, as a practical matter you can't just sit there and wait. You need to have debt in place that qualifies as TLAC by the 2019 date, so banks will migrate towards that.

**Once there is full regulatory clarity, do you think we will see clear distinctions between which types of investors do and don't want to invest in instruments issued to comply with TLAC?**

**Ireland** I think that is going to be a little fuzzy for a while, as the risks you undertake as an investor in TLAC depend on what kind of shape the economy is in, and what the regulatory posture is towards bigger banks. There is a lot of uncertainty in both those areas – domestically and abroad. So I expect this to take some time to shake out. Also, there may be changes due to some classes of investors becoming more comfortable with the TLAC risk than they were initially.

**Opinion is divided on whether TLAC will lead to a shortage of structured notes, and if so whether non-G-Sibs will be able – or even attempt – to fill that gap. What do you expect in the US?**

**Pinedo** I don't think there will be a shortage of structured notes. Already in the US G-Sibs have found solutions to issue structured notes. And I'm confident that if they have found an approach to doing so, then non-US G-Sibs also will.

**What's that US solution?**

**Pinedo** Over the past two months we have seen most US G-Sibs establish subsidiaries of the parent bank holding company (BHC), and in the case of all but one, those subsidiaries are special purpose finance subsidiaries. And that entity is issuing structured notes that benefit from a BHC parent guarantee, which has been structured to comply with the Fed's proposed clean holding company requirement.

So while BHCs may want to issue principally TLAC-eligible securities, this gives them a vehicle from which they can

issue structured notes whereby the financing costs are no different to a parent issuance.

We aren't aware of any foreign banks doing this yet, but we are talking to those associated with a number of them about setting up similar arrangements.

**TLAC-like requirements are tipped to be imposed on many non-systemically important banks outside of the US. Do you think it will pressure US regulators to introduce something similar?**

**Ireland** The US already has several tiers of bank regulation, including for capital requirements. Obviously there are the G-Sibs, and then there are advanced approaches banking organisations (those with at least \$250 billion consolidated assets), then a tier from \$50 billion to \$250 billion, and then the below-\$50 billion category. For some purposes there is even a below \$10 billion tier.

There are two trends to watch for here. First, there tends to be a trickle down of regulatory requirements. They may not be binding rules, but the examiners will go around and encourage people to look up one tier to figure out how they should do their business. But at the same time there is a political movement in the US, which is common after major financial legislation in response to a crisis, whereby there is an effort to roll back regulatory burden on smaller banking organisations. There have been congressional hearings on less regulatory requirements for very well capitalised smaller banks, or raising the \$50 billion threshold in Dodd-Frank to some higher number.

So we will see those two trends compete

**US G-Sibs have found solutions to issue structured notes. And I'm confident that... non-US G-Sibs also will**

**Anna Pinedo,  
Morrison & Foerster**



with each other for a while, and the outcome will be politically driven.

**If there is a trickle down, does it blur the boundaries between G-Sibs and D-Sibs?**

**Ireland** Yes, but as a supervisor in any jurisdiction you don't want a cliff effect where you have one set of rules at a certain size level, and then the rules change dramatically if you fall below that level. You want something that is more progressive so that it tapers down as you get towards that threshold, and tapers up as you approach it. That means over time there will be an inevitable blurring of those lines. Otherwise banks will manipulate their balance sheets to get below the line; which is what we already see in the US.

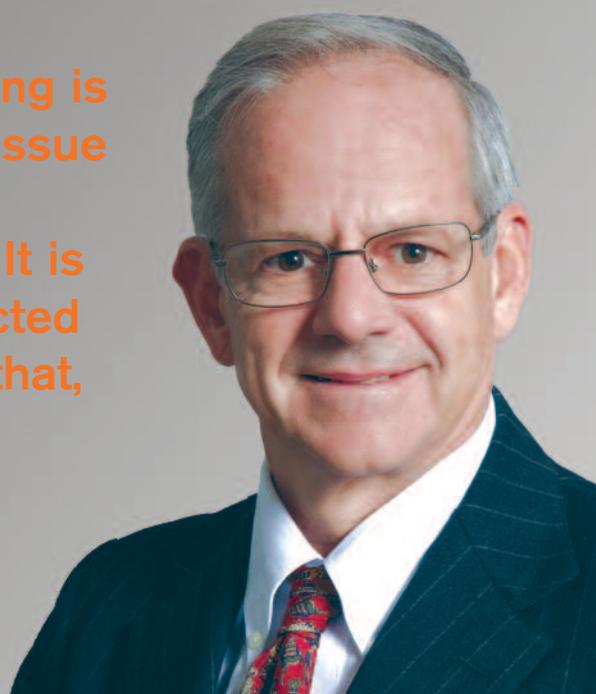
**Opinion is also divided on the extent to which TLAC will prompt foreign banks to reduce their US footprint. Which types of banks are most likely to do so?**

**Pinedo** I'm not sure that it's TLAC that would push them over the edge. I think it's the totality of all the requirements they would be subjected to. Many foreign banks were concerned about the intermediate holding company (IHC) rules and wanted to stay below the threshold that would subject to them to its requirements. Of course if they are G-Sibs and they are over the IHC threshold, they would be subject to TLAC, but I don't think TLAC alone would push them over the edge.

**Ireland** TLAC, in one form or another, will be in most countries. There may be some marginal differences in the US, but from what I've seen regarding foreign banks affected by US decisions it's most pronounced when there are big differences. So I'm thinking about things

**Grandfathering is the biggest issue in need of clarification. It is widely expected they will fix that, but I'm not completely confident**

**Oliver Ireland,  
Morrison & Foerster**



which don't have a counterpart in foreign jurisdictions like the Volcker Rule or, as Anna pointed out, the IHC requirement. It's those things that are rightfully having a bigger effect.

**Which aspects of US TLAC are most in need of regulatory clarification to ascertain the impact on the country's bank sector?**

**Pinedo** I think most market participants assume that the Federal Reserve is going to grandfather long-term outstanding debt securities that would qualify for TLAC, but for the presence of certain very benign covenants. Certainty on that is, I think, the single most important clarification as that affects greatly the amount of TLAC-eligible debt that would have to be raised. So that is probably very high on the list.

Around the edges, there are other aspects of the definition of eligible long-term debt.

For example, debt securities issued under English law or laws of other EU jurisdictions would not be eligible. That too would be important because many US G-Sibs have issued long-term debt under their euro or global MTN programmes, and those securities are governed by English law.

**Ireland** Anna is 100% correct, grandfathering is the biggest issue in need of clarification. It is widely expected they will fix that, but I'm not completely confident. There is the possibility that the Fed will make mistakes no matter how they do things. So, for example, rather than simply saying it's all grandfathered, they are likely to put some conditions on that, the nature and effect of which I don't know.

*IFLR spoke with Pinedo and Ireland on April 11*

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