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The Pros And Cons Of The Fed's Recent Proposal For U.S. Banks' Total Loss-Absorbing Capacity

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*(**Editor's Note:** The following is Standard & Poor's Ratings Services' response to the Federal Reserve's November 2015 proposal: "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies." The views expressed here are those of Standard & Poor's Ratings Services and do not reflect the views of any other affiliate or division of Standard & Poor's Financial Services LLC. Our current ratings criteria are not affected by our comments on the consultative document.)*

As regulators in the U.S. continue to move toward ensuring that the banking system is better prepared to handle financial stress--particularly if a global systemically important bank (GSIB) were to fail--a recent proposal from the Federal Reserve is another step in that direction. The Fed's notice of proposed rulemaking for total loss-absorbing capacity (TLAC) outlines the minimum required amounts of TLAC that U.S. GSIBs would need to maintain to ensure their operating subsidiaries can recapitalize in case of failure. TLAC can come in the form of senior unsecured debt, subordinated debt, hybrids, and equity issued from the nonoperating holding companies (NOHCs).

While Standard & Poor's Ratings Services believes the Fed's proposal is a necessary step forward in maintaining the stability of the global banking system by putting in place an effective resolution regime, regulators must still take care that well-intentioned rules don't contain within them the seeds of future sources of failure. As is always the case with regulatory efforts, the challenge is to minimize unintended consequences to the utmost extent possible. In this case, it will be important that in the process of complying with new TLAC regulations, which will cause the issuance of additional debt for some banks, bank management teams remain cautious and vigilant so as not to add risks to their enterprises.

Overview

- Although the level of capital that needs to be maintained under the total loss-absorbing capacity (TLAC) proposal should suffice to recapitalize a failed global systemically important bank (GSIB), regulators and bank management teams need to be cautious and vigilant so that the very issuance of the TLAC to prepare for a failure does not generate incremental vulnerability related to refinancing risk and a higher risk appetite.
- The amount of TLAC that U.S. GSIBs will need to issue seems manageable from a market supply perspective, as long as long-term debt with acceleration clauses (outside of nonpayment) counts as TLAC.
- We think the resilience of entities subject to TLAC regulation would benefit from being able to maintain a degree of flexibility in terms of distribution of regulatory TLAC across their subsidiaries globally in order to reallocate buffers, if needed, as risks emerge within particular entities of a group.
- TLAC disclosure is an important component for investors to better assess their risk positioning in the payments waterfall and to enhance the credibility of the resolution plan.

In Standard & Poor's view, the progress that regulators have made toward putting in place a viable U.S. resolution regime is sufficient to deem the likelihood of the U.S. government providing support to the banking system uncertain.

As a result, in early December 2015, Standard & Poor's removed extraordinary government support uplift from its ratings on the eight U.S. GSIB NOHCs by lowering the ratings on the banks by one notch (see "U.S. Global Systemically Important Bank Holding Companies Downgraded Based On Uncertain Likelihood Of Government Support"). Due to the construct of the U.S. resolution regime, in which NOHC creditors could ultimately provide capital support to the operating entities, we took no negative actions on these banks' operating entities, and on certain banks, placed the ratings on CreditWatch positive, as we await the final TLAC rule. We capture this potential capital support for the operating entities of these institutions via a Standard & Poor's measure called additional loss-absorbing capacity (ALAC). ALAC, which has a number of similarities with TLAC, recognizes instruments meant to be bailed in (meaning creditors would bear some of the burden by having a portion of the debt they are owed written off) near or at the point of nonviability, thus reducing the default likelihood of a bank's senior creditors, or in the case of the U.S., its senior operating company creditors.

Proposed TLAC Levels Should Be Sufficient To Recapitalize A Global Systemically Important Bank In Resolution

In our view, the amount of consolidated TLAC that the Fed is proposing banks hold should--when converted into equity--be sufficient to recapitalize a U.S. GSIB to an adequate capital level on a going-concern basis. We consider a bank that achieves a 7% risk-adjusted capital (RAC) ratio (according to our calculation, see "Banks: Rating Methodology And Assumptions," published Nov. 9, 2011) to be adequately capitalized. Based on our assessment, we believe that the required amount of TLAC would be sufficient to recapitalize a GSIB after experiencing a 'A' (substantial) stress scenario, which includes a GDP decline of up to 6%, market losses of 60%, and an unemployment rate of up to 15% (see "Understanding Standard & Poor's Rating Definitions," published June 3, 2009).

According to the Fed's notice of proposed rulemaking (NPR), the amount of TLAC held must total the greater of: 18% of the GSIB's risk-weighted assets (RWAs) (excluding a capital conservation buffer and GSIB surcharges), or 9.5% of total leverage. In addition, the U.S. TLAC proposal contains a separate long-term debt (LTD) minimum requirement. GSIBs must hold LTD that amounts to the greater of: 6% of RWAs (excluding a GSIB surcharge), or 4.5% of total leverage. (The capital conservation buffer and GSIB surcharges are additional capital requirements above minimum levels, to ensure GSIBs have adequate capital in times of stress.)

We recognize the value of LTD to recapitalize a bank after failure in that LTD will be in place subsequent to a failure--unlike equity, which could be depleted as a bank experiences losses. However, in our opinion, the dissipation of equity should only be a concern if regulators are too slow to bring a GSIB into resolution.

Outside of this, we believe equity is a stronger source of solvency for banks than debt that can be bailed in. There are two reasons for this. First, a higher required amount of LTD increases a bank's refinancing risk. Although issuing LTD amid a low-yield environment--in which investors crave yield--is not that difficult, if the yield environment or the perceived risk increases, such has been the case so far in 2016, issuing debt becomes more challenging. In addition, U.S. banks will be competing with additional TLAC issuance by non-U.S. global banks, the amount of which could be significant. At the very least, the additional interest cost for TLAC issuance for the U.S. GSIBs, cumulatively, would be much more significant than the $680 million estimated in the proposal and could result in banks taking on additional risk in the search for profitability to service the debt.

The second issue we have regarding higher required LTD is that it increases the leverage of a GSIB as an ongoing entity, particularly for depository institutions that otherwise wouldn't be carrying this magnitude of debt if the TLAC rule were not in place. This additional leverage could undermine the financial stability of a bank as an ongoing entity, as the bank seeks to put these additional funds to work. Indeed, it not only would weigh on profitability, but it also would add to a GSIB's debt servicing burden, putting more pressure on the operating subsidiary to generate revenue. Higher requirements of LTD could also result in an increase in double leverage as the holding companies downstream capital to their operating subsidiaries. That said, we recognize that if a GSIB's RWAs were to increase, it would need additional TLAC, which could limit the amount of additional risk GSIBs could take on by downstreaming capital to their subsidiaries.

The TLAC proposal also points to allowing only 50% of LTD coming due between one and two years to count toward the requirement. We support this proposal because it is broadly in accord with our ALAC criteria (we exclude amounts of instruments maturing within 12-24 months that exceed 0.5% of projected Standard & Poor's RWAs, see "Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity," published April 27, 2015), and because it gives GSIBs an incentive to extend their maturity profiles. That said, in our ALAC criteria, we also take a qualitative view of the entire maturity profile of LTD, ensuring that it is not weighted too heavily in any particular year. Although a bank may have sufficient TLAC to recapitalize after failure, if it has a disproportionate amount of debt coming due in any particular year, that could add to its refinancing risk that ultimately could lead to failure.

The Amount Of Debt That U.S. Banks Would Need To Raise Should Be Manageable

Based on second-quarter 2015 data, we calculate that the eight U.S. GSIBs collectively will need to raise about $100 billion of additional capital to meet the proposed requirements. This seems manageable considering that regulators are giving banks until the end of 2018 to achieve this, and that banks could reposition their balance sheets in the interim, which would reduce the amount of additional capital needed. That said, our $100 billion estimate assumes that all legacy senior unsecured debt instruments--except for instruments with maturities of less than one year, 50% of LTD coming due within two years, and structured notes--qualify for TLAC. The NPR, though, states that eligible external LTD that gives the holder a contractual right to accelerate payment for reasons other than insolvency or nonpayment will be excluded. Our sample review of senior unsecured covenants indicates that there are other types of acceleration clauses, outside of nonpayment, in most indentures.

Some of these other types of acceleration clauses are:

- Failure to deposit adequate capital in a sinking fund,
- Default in the performance of any breach of covenant or warranty,
- Failure to maintain existence as a corporation or to maintain the charter of a subsidiary bank, and
- The sale of any portion of a subsidiary bank, except under certain circumstances.

Regulators have a few options, in our opinion, to solve this matter: disallow all senior unsecured debt due to the acceleration clauses and have banks issue LTD that meets their standards; grandfather legacy debt but ensure new debt issued meets their standards; or force banks to rewrite the covenants, which we understand would be a difficult undertaking.

Although we recognize that any acceleration before regulators are prepared to declare a bank nonviable and move it into an orderly resolution would certainly cause a hiccup in their plans, we also believe that banks would be unlikely to violate these acceleration clauses before they reach the point of nonviability. As such, we believe the potential unintended consequences of not grandfathering LTD outweigh the potential benefits of disallowing such LTD from counting toward TLAC.

Should regulators choose to disallow outstanding LTD from qualifying as TLAC, we believe that would mean banks would need to issue at least $700 billion of additional LTD, an amount far in excess of the $120 billion the Fed referenced in its notice. This indicates to us that this option perhaps has a lower probability of occurrence. However, if banks need to reissue debt, that would generate unnecessary refinancing risk, mitigated somewhat by the fact that a portion of legacy TLD would have naturally rolled off as it matured. Still, U.S. banks will be competing with additional TLAC issuance by non-U.S. global banks, and the supply will likely result--at the very least--in higher funding costs, impairing profitability.

If outstanding LTD with acceleration clauses (outside of nonpayment) does not qualify as TLAC, we would be unlikely to raise our ratings on the four GSIB operating banks (Bank of America, Citigroup, Goldman Sachs, and Morgan Stanley) that currently are on CreditWatch with positive implications because their ALAC ratios would be below the threshold for the additional rating notch under our criteria.

If regulators choose to grandfather legacy LTD, but require that going forward banks issue debt without additional acceleration features, this would create two tiers of senior unsecured debt--one with additional acceleration clauses, and one without. Although the market may slightly differentiate these instruments from a price perspective, we wouldn't differentiate them from a ratings standpoint because we don't consider these acceleration clauses very meaningful, and the probability of default would be the same.

Finally, the proposal also suggests that LTD must be governed under U.S. law to count in TLAC. We believe this stipulation is in place so that regulators don't encounter unnecessary complexities when attempting to resolve a GSIB, such as a holdup in an international court, when attempting to bail the instrument in. We believe instruments issued under foreign law, despite a possible delay, will ultimately be treated the same, in terms of creditor hierarchy and losses, as debt issued under U.S. law. If this is not the case, the advantages of debt issued under foreign law need to be made clear not only in the offering, but also in any quarterly public filings.

If regulators decide to disallow any debt issued under foreign law from TLAC, we would also not include it in our ALAC ratio. However, for a majority of institutions, we don't believe there is a sufficient amount of LTD outstanding issued under foreign law for this to have rating implications.

Prepositioning Of TLAC Is An Important--And Complicated--Factor

Although the amount of TLAC that banks will be required to hold seems adequate to withstand significant stress, we believe that prepositioning of the capital in material subsidiaries is an important consideration that could lead to unintended consequences. We see material prepositioning requirements as further evidence of the ongoing fragmentation of the banking system, leading to trapped capital and liquidity for global banks. The ensuing reduced fungibility of capital and liquidity, for a given aggregate amount of capital and liquidity, could lead to reduced resilience to external shocks. Ultimately, systematic and material prepositioning needs would, in our view, increase capital and liquidity needs for these groups, with possible unintended macroeconomic consequences.

We think the resilience of entities subject to TLAC regulation would benefit from being able to maintain a degree of flexibility in terms of distribution of regulatory TLAC across their subsidiaries globally in order to reallocate buffers if needed as risks emerge within particular entities of a group. This flexibility, though, should be considered along with ensuring that an adequate amount of TLAC is prepositioned in the major subsidiaries, so that local regulators do not start to ring fence the local entity, which would impair the facilitation of an orderly wind-down. In applying our ALAC methodology, we have raised the 5% and 8% thresholds for certain large internationally active banks to reflect this prepositioning risk.

The Financial Stability Board (FSB), as part of its November 2015 guiding principles for TLAC, stipulated that each material subsidiary must maintain internal loss-absorbing capacity (ILAC) of 75%-90% of the external minimum TLAC requirement. This amount should be determined by the host authority (the regulator in the country where the subsidiary operates) of the material subsidiary, in consultation with the home authority (U.S. regulators, in this case), and should be prepositioned at the material foreign subsidiary. As such, the U.S. TLAC NPR did not address minimum ILAC for foreign subsidiaries of U.S. GSIBs, leaving that to host regulators to ultimately decide.

But the TLAC proposal does address foreign bank intermediate holding companies (IHCs) operating in the U.S. The U.S. TLAC proposal calls for foreign bank IHCs operating in the U.S. to maintain TLAC levels largely in line with that of U.S. GSIBs, as well as based on whether the IHC is expected to enter resolution. For IHCs that are not expected to enter resolution in the event of the failure of the foreign parent GSIB, they will be subject to TLAC requirements of the greater of: 16% of RWAs and 6% total leverage exposure (if subject to the supplementary leverage ratio) and 8% of average consolidated assets. For IHCs that are expected to enter resolution in the event of the failure of the foreign parent GSIB, the required TLAC levels are a bit more stringent: the greater of 18% of RWAs and 6.75% total leverage exposure (if subject to the supplementary leverage ratio) and 9% of average total consolidated assets. The IHC will also be subject to minimum LTD levels, and the LTD is required to be issued to the parent entity--not externally--along with a contractual trigger to ensure that it converts into Tier 1 common equity should the entity come under significant stress. Overall, the requirements seem more stringent than the FSB TLAC rules, and if more countries were to follow this example, that would exacerbate the fragmentation of global banks, in our opinion, and further hamper the fungibility of capital and liquidity.

There are possible funding and cost implications of the IHC TLAC proposal as well. For example, some foreign subsidiaries are currently set up as self-funded entities, issuing debt in the U.S. capital markets to ensure that there is a funding match with loans issued and that there are no currency mismatches. However, under the TLAC proposal, the debt will be issued to the parent entity, which means the parent would be the source of funding. This could lead to misallocated capital costs for the U.S. foreign subsidiary if not managed properly by the parent, but at the very least, it will likely pressure IHCs' profitability because they will need to hold additional debt. Moreover, debt levels will likely be locked in for longer periods of time, particularly for IHCs with sizable broker-dealers, which could not only raise the cost of funds, but also takes away some of the flexibility of the funding model. Furthermore, the additional capital will be trapped at the U.S. subsidiary, which will take away flexibility from the parent in terms of helping a subsidiary in a different jurisdiction that may be in need of additional funds.

The Internal TLAC Requirement For Domestic Subsidiaries Is Still In Question

The TLAC proposal is considering internal requirements for material subsidiaries of U.S. GSIBs domiciled in the U.S. The proposal is considering setting requirements for either: "contributable resources," which are resources to be kept at the NOHC and available for all subsidiaries, or "prepositioned resources," which are debt and equity in the form of internal TLAC to be maintained at each material domestic subsidiary.

We believe credit risk is lower with a blend of the two options, in which the subsidiary maintains a minimum amount of equity and debt (enough to ensure the entity meets minimum Basel III regulatory levels of capitalization), and the NOHC holds the balance, largely in the form of high-quality liquid assets (HQLA). We believe this solution would provide comfort to creditors that the consolidated entity stands behind the domestic material subsidiary due to the minimum levels of prepositioned capital, but it would weaken the entity's ability to use the additional capital to take on more risk, should all the resources be streamed down to the operating entities. Moreover, this solution adds some flexibility to the group TLAC resources, should another subsidiary experience higher-than-expected losses.

Better Disclosure Of Banks' TLAC Is Essential

We believe transparent disclosure in public filings regarding TLAC is important in ensuring investors are better aware of what they own and where they stand in a bank's credit hierarchy. In our opinion, TLAC disclosure needs to apply to both the consolidated entity and the material subsidiaries. The disclosure should provide the TLAC ratio, along with the type and amount of instruments that qualify for TLAC, the maturity profile, the law the debt was issued under, and the amount of debt and date investors can force a company to repurchase such debt, if applicable. In addition, the disclosure should include a list of liabilities of both eligible and non-eligible TLAC, and the creditor hierarchy, including whether the hierarchy is contractual or statutory. For example, it should be clear to investors that, although an instrument such as a senior unsecured note with less than a year to mature is not TLAC eligible, it would still be positioned, from a creditor hierarchy standpoint, pari passu to TLAC-eligible senior unsecured debt with a longer maturity date.

Regarding the material subsidiaries, banks should also disclose their TLAC ratios, along with a breakdown of the liabilities that have been prepositioned and downstreamed from the holding company, accompanied by a maturity profile of these instruments. External liabilities (non-TLAC eligible) should also be listed along with a creditor hierarchy in relation to NOHC liabilities. This is especially important, particularly as it applies to subordinated debt the operating entity issues because there still seems to be opacity regarding under which circumstances, if any, such debt could absorb losses before senior unsecured debt issued at the NOHC.

Notably, after removing extraordinary government support uplift from our ratings on NOHCs, we now rate operating company subordinated debt the same as senior unsecured debt at the NOHC because we believe there are circumstances, such as the sale or wind-down of an operating subsidiary, in which these instruments could default before or simultaneously with senior unsecured NOHC debt.

Maintaining Caution Will Be Key

Although the level of capital that banks will need to maintain should suffice to recapitalize a failed GSIB, it will be important for bank management teams to be cautious and vigilant--so that the TLAC they issue to prepare for a failure is not the cause of a failure. To do this, bank management teams would need to ensure they don't stretch businesses to make up for profitability pressure due to having to hold additional debt, while regulators could tamp down some of the quantity of debt needed to be issued (due to the acceleration clauses) and ensure the additional debt is maintained at the NOHC in the form of HQLA. Without these elements in check, a bank's stand-alone credit profile could come under pressure.

Related Criteria And Research

Related Criteria

- Bank Rating Methodology And Assumptions: Additional Loss-Absorbing Capacity, April 27, 2015
- Group Rating Methodology, Nov. 19, 2013
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Understanding Standard & Poor’s Rating Definitions, June 3, 2009

Related Research

- What's Next In The Resolution Story For EMEA Banks?, Feb. 2, 2016
- U.S. Global Systemically Important Bank Holding Companies Downgraded Based On Uncertain Likelihood of Government Support, Dec. 2, 2015
- Bank Bail-In Should Become A More Credible Option Under The FSB's Final Total Loss-Absorbency Standard, Nov. 9, 2015

We have determined, based solely on the developments described herein, that no rating actions are currently warranted. Only a rating committee may determine a rating action and, as these developments were not viewed as material to the ratings, neither they nor this report were reviewed by a rating committee.