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Statement of the Shadow Financial Regulatory Committee on

TLAC: The Last Nail in the Coffin of Too Big to Fail?

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The Shadow Financial Regulatory Committee (SFRC) has long urged that regulators place greater emphasis on market discipline to supplement supervisory discipline of financial institutions. Fifteen years ago, the SFRC supported the use of regular issuance of subordinated debt to function as a form of market discipline (Statement 160). The recent proposal to require Total Loss Absorbing Capacity (TLAC) in the capital structure of Global Systemically Important Banks (G-SIBs) could be viewed as a variant of this idea. It is designed to provide contingent capital that would recapitalize a troubled institution automatically and provide a greater buffer against loss for taxpayers. Because holders of TLAC claims will be explicitly at risk of loss, they will have strong incentives to monitor and discipline the risk-taking of the institutions that borrow from them. The Committee believes a properly structured TLAC requirement could enhance the safety and soundness of the banking system, but it requires a refinement of the concept of eligible long-term debt (LTD) to be effective.

TLAC is the last major structural element in an elaborate regulatory architecture that was mandated by the G-20 in the wake of the financial crisis of 2008-10 with the intent of ending Too Big To Fail. In parallel, many other countries introduced new regulatory structures that addressed the same concerns. The Dodd-Frank Act (2010) served as the blueprint for reform in the United States.

The reforms place greater emphasis on crisis prevention that include more and better quality capital, better-calibrated risk weights, and the introduction of a leverage requirement, liquidity requirements, and enhanced supervision. They also emphasize the development of resolution tools to ensure that any G-SIB could be restructured without intolerable spillovers to the rest of the financial system or the real economy. These include the introduction of living will requirements and the development of strategies to deal with obstacles to the orderly resolution of a global financial institution.

Implementation of an international resolution strategy faces numerous and daunting challenges that threaten to derail the approach. For example, any cross-border resolution strategy cannot work unless host authorities are willing to cooperate with the home country and refrain from spontaneously ring-fencing the entities within their jurisdiction. TLAC reduces this incentive for ring fencing by reassuring the host country that the G-SIB has sufficient resources to protect critical operations in the host country.

In cooperation with the Bank of England, the United States has developed the Single Point of Entry Strategy that attempts to separate the financial restructuring of a troubled institution from the operational structuring. Separation enables a timely financial restructuring by lodging the external financing transaction in the holding company. This provides time to accomplish an operational restructuring that will protect the provision of essential services without imposing losses on taxpayers.

The TLAC requirement specifies that the claims must be held outside the banking system and be automatically available to write-down or convert into equity in a resolution. Only the top-tier holding company would enter into a resolution proceeding, allowing operating subsidiaries to be recapitalized by pushing losses up from the operating subsidiaries to the top-tier holding company. The subsidiaries would be transferred to a new debt-free bridge holding company that would keep the operating subsidiaries out of insolvency proceedings. External TLAC claims on the top-tier holding company would be transformed into equity claims on the new bridge institution. The US proposal envisions a "clean" top-tier holding company that is primarily financial in nature and issues long-term debt, the proceeds of which are down-streamed to its subsidiaries in the form of internally held equity and subordinated debt. The write-down of these claims is the mechanism through which losses in the operating company would be up-streamed to the top-tier holding company.

The resolution of the top-tier holding company would be triggered when it can no longer absorb these losses and fails to meet its regulatory requirements. It should be able to avoid a resolution if it has sufficient buffers of equity and TLAC outstanding or can issue new equity and external debt to continue to meet the regulatory minimums.

The TLAC proposal requires that this external debt be long-term, but the position taken by the Committee in its earlier subordinated debt proposal is preferable. Institutions should be required to regularly roll over a sufficient portion of their external debt so that they will be subject to the market discipline of placing new issues of debt on a regular basis. This ensures that the resolution process will be initiated promptly when the market has lost confidence in the solvency of the group rather than at the sole discretion of the regulator, who have frequently been reluctant to react. This would institutionalize a market-based form of prompt corrective action that the Committee has long advocated and that was largely absent from the regulatory structure before the crisis.

Although the TLAC requirement should strengthen the loss-absorbing capacity of banks, it is not likely to be the final nail in the coffin of Too Big To Fail. The TLAC requirement is layered on top of an overly complicated capital adequacy framework that already requires G-SIBs to monitor and comply with dozens of capital and liquidity ratios. While some of these requirements enhance safety and soundness, the cumulative complexity imposes deadweight costs on G-SIBs that are inevitably passed on to customers. Moreover, it requires substantial regulatory resources that could be employed to better use elsewhere.

Regulators should rationalize and streamline this cumbersome structure in order to provide more transparency to the regulatees, investors, and the regulators themselves. A good to place to start would be the elimination of the concept of Tier 2 capital, which appears to have no function whatsoever with the introduction of TLAC. More broadly, we favor ending the hopeless and ill-advised quest to make capital requirements more risk-sensitive and rely instead or more robust leverage ratios that proved much more informative during the crisis and have been advocated by the SFRC from its establishment in 1986. Market participants recognized a fundamental truth that apparently eluded the regulators: losses can only be absorbed by common equity, not risk-based capital.