TLAC implementation in retail banks in Emerging Markets: the Multiple Point of Entry model

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Q: What is the relation between TLAC and the banking organisational models?

Achieving an effective resolution regime to resolve banks quickly, avoiding disturbances to the financial system, minimizing the use of public funds – thus protecting taxpayers – and ensuring continuity of the critical financial services is one of the main goals of the authorities in the current regulatory reform. The FSB TLAC proposal is one of the cornerstones of this reform. Banks must have enough liabilities with loss-absorbing capacity in order to ensure that institutions are easily resolvable and shareholders and creditors shoulder the bulk of the recapitalisation burden.

International banking groups vary significantly in their business models, corporate and legal structures, and their financial and operational interdependencies. The optimal design of the TLAC should take into account the firm's idiosyncratic characteristics. In fact, the TLAC requirement should be flexible enough to accommodate the different banking structures. The way cross-border banks plan to die should be consistent with the way they lived.

The FSB outlines two polar resolution approaches for resolving global banks: the Multiple Point of Entry (MPE) and Single Point of Entry (SPE) resolution strategies, although many hybrid options may lie in between.

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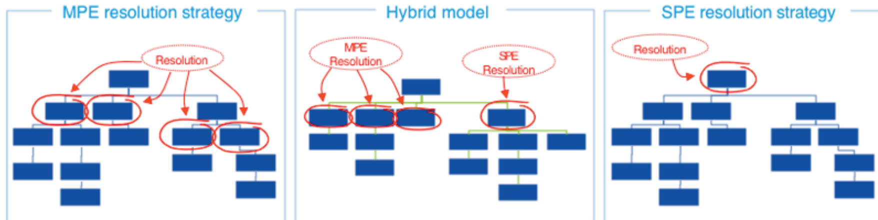
- Multiple Point of Entry: This involves the application of resolution powers by two or more resolution authorities to different parts of the group, including strategies in which a group is broken up into two or more separate parts. There is no need for the resolution powers applied to the separate parts to be the same, and they could involve different resolution options. This implies that each legal entity or sub-holding in the group that may be subject to a separate resolution action should have sufficient TLAC individually to cover its likely losses in resolution and those of subsidiaries below it for which a separate resolution is not planned[41]. This strategy fits with decentralized business models based on subsidiaries, local retail funding and very limited intra-group positions.
- Single Point of Entry: A single national resolution authority applies resolution powers at the top level (either holding or parent company). The SPE strategy operates through the absorption of losses incurred within the group by the ultimate parent or holding company through, for example, a bail-in. Therefore, TLAC in SPE banks should be placed at parent level and downstreaming to each material subsidiary via internal loans or collateralized guarantees, so-called internal TLAC. Internal TLAC mitigates host resolution authorities' concerns that the home authority may not trigger bail-in at the parent company level and then recapitalize the loss-making bank subsidiary. This strategy fits naturally with the model of branches, with wholesale funding and sizeable intra-group positions.

SPE and MPE resolution strategies are the opposite ends of a spectrum where many resolution options may lie in between. There is no binary choice between the two approaches. In practice, a hybrid approach, which combines both schemes, might be appropriate to accommodate the structure of a bank to the local regimes in the key jurisdictions where it operates. This could be the case of the Eurozone, where recent progress towards Banking Union and related institutional developments have paved the way to implement a feasible SPE scheme for a banking group with presence in two or more Eurozone countries. In particular, advances in terms of a Single Rule Book, a Single Super-

41. See Fernández de Lis (2015)

vision Mechanism, the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) are breaking down the national banking barriers and paving the way to a single jurisdiction in the Eurozone.

Figure 1 (BBVA Research)



Q: How could be the TLAC be business model neutral?

A key challenge that the FSB has to face is to develop a business model-neutral TLAC approach. As a general principle, the implementation on the TLAC should not create "per se" incentives for banks to move artificially from one model to the other. As regards the MPE resolution scheme, two key characteristics should be preserved:

– MPE banks should not have to comply with a TLAC requirement at consolidated level but at the resolution entity level. TLAC at a consolidated level in an MPE bank does not reflect the real loss-absorbing capacity across the group. In fact, any resolution group in an MPE bank will have to issue its own TLAC-eligible instruments to potentially absorb its own recapitalization needs. Thus, any excess of TLAC in a resolution group will not be used to compensate any potential shortfall in a sibling resolution group within the whole MPE group. For this reason, the total TLAC needs in an MPE group should only be calculated as the sum of the external TLAC of each resolution group. The TLAC at each MPE subsidiary should be based on the local regime with similar characteristics as the domestic players, thus ensuring a local level playing field. The TLAC guidelines proposed by the Financial Stability Board are applied in a first instance only to G-SIBs. However, it will be for each country to put in place the legal framework which implements TLAC. Host resolution regimes will need, therefore, to be applied to Domestically Systemically Important Banks (D-SIBs) as well as G-SIBs. If not, they will not address the Too-Big-To-Fail problem in a comprehensive manner within each jurisdiction.

Q: What is the impact of TLAC on the funding structure of MPE subsidiaries funded with retail deposits?

Most of the subsidiaries of the GSIB which would comply with MPE characteristics are located in emerging markets. This emerging market footprint determines the challenges that MPE subsidiaries will face in complying with the TLAC requirement.

First, most emerging countries have a limited degree of development of local capital and debt markets. Second, the limited local investor base is very narrow and mainly composed by insurance companies and pension funds. Their low-riskiness investment mandates would probably set limits to invest in debt instruments with loss-absorbing and subordinated features. Finally, those subsidiaries in emerging markets are highly capitalised and are mainly funded with deposits.

Against this backdrop, deposit-funded subsidiaries located in those markets would be forced to issue either external or internal TLAC-eligible liabilities. As shown below, deposit-funded banks have at least two alternatives in order to comply with the TLAC requirements, which would call into question their retail and stable funding model.

Figure 2 (BBVA Research)

Starting point

Assset		Liabilities	
Cash & bond	15	Equity	10
Loans	85	Deposits	90
	100		100

Loan-to-deposit ratio 94%

Alternative 1: reduction in deposit base

Asssets		Liabilities	
Cash & bond	15	Equity	10
Loans	85	TLAC	10
		Deposits	80
	100		100

Loan-to-deposit ratio 106%

Alternative 2: leverage balance-sheet

Asssets		Liabilities	
Cash & bond	15	Equity	10
New assets	10	TLAC	10
Loans	85	Deposits	90
	110		110

Loan-to-deposit ratio 94%

- On the one hand, banks may issue new TLAC-eligible liabilities but at the cost of reducing the deposit base. This would imply, among other effects, a deterioration of the funding profile. In particular, the loan-to-deposit ratio would significantly increase.
- On the other hand, banks could maintain the deposit base but artificially expand their balance sheets. The new TLAC-eligible liabilities would imply a significant increase in the funding costs. In order to compensate for the higher funding costs, banks would be forced to invest

these funds into riskier assets, typically in foreign currency, as explained below.

At the end of the day, either the reduction of deposit base or the leveraging of the balance sheet would lead to an overall increase of systemic risks and vulnerability to global liquidity shocks, thus increasing the pricing of the cost of credit to the economy. These are not desirable outcomes.

As stated above, MPE subsidiaries must comply with their own TLAC requirements as independent resolution entities. Whether this requirement is fulfilled by external or by internal TLAC, both options entail negative effects on financial stability in EMEs since either they increase the dependence on cross-border wholesale funding and foreign currency (in the first case) or they jeopardize the MPE model (in the second case). There are several channels through which these effects operate:

First, MPE subsidiaries operating in emerging economies would be forced to issue TLAC-eligible instruments in foreign currency since their local debt and capital markets are not developed enough to assume the expected issuance of TLAC paper. A particular concern is the potential issuance in foreign currency, since it will increase procyclicality and instability risks. Local regulations in emerging countries usually require banks either to match liabilities in foreign currency with assets in the same currency or to hedge those positions. The former would increase the vulnerability of the local financial system paving the way to potential contagion and/or exacerbating credit risk when there is a mismatch between the currency denomination of the debt and the currency denomination of the debtors' income. Argentina in 2001 and more recently Hungary have shown the potential risks of foreign currency lending for retail domestic customers. If currency hedging techniques are used instead, the profitability of the institution would be penalized and it will create maturity mismatches.

Second, issuing TLAC-eligible liabilities would increase cross-border lending, with potentially negative effects in financial stability of host countries. As the IMF has recently acknowledged on its Global Financial Stability Report of April 2015[42], "*the shift to more local as opposed to cross-border operations results*

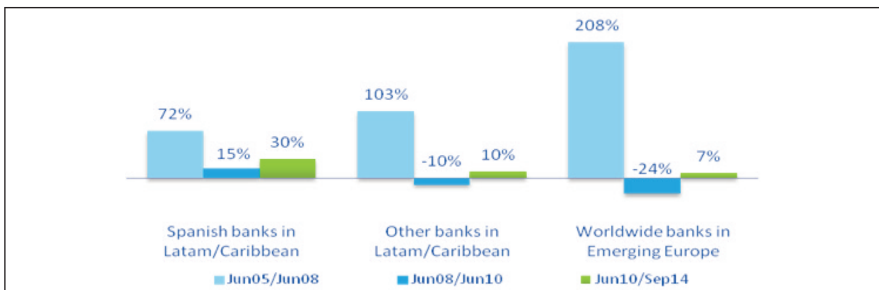
42. IMF Global Financial Stability Report (April 2015)

in a decline in the sensitivity of capital flows to global shocks and yields a reduction in contagion". According to this analysis, subsidiaries in emerging markets operating locally with an unbiased deposit-funded model behave less procyclically and are more resilient to withstand global shocks, but not necessarily idiosyncratic shocks.

Finally, instead of issuing externally, MPE subsidiaries may issue TLAC debt to the parent –the so-called internal TLAC. This would however jeopardize the viability of the MPE resolution scheme. One of the main prerequisites of the MPE model is the lack of systematic interconnections between the parent and its subsidiaries. Therefore, forcing the MPE parent bank to absorb TLAC-eligible liabilities issued by its subsidiaries may question the credibility of an independent resolution process for each resolution entity within an MPE group.

The recent Eurozone crisis has provided empirical evidence of the MPE business model strengths in terms of limiting contagion. Although the solvency problems in Spain were confined to savings banks, the liquidity restrictions affected all peripheral banks in a context of fragmented Eurozone financial markets, especially in 2010-2012. There was almost no contagion of these liquidity problems to Spanish banks' subsidiaries in Latin America, in sharp contrast with the impact of the euro crisis in Central and Eastern Europe, where European banks' branches operated mainly through cross-border lending with the parent. As Figure 1 shows, Spanish banks in Latam (with an MPE model) smoothed both the bubble and the bust, as compared to other international banks in the region (mostly SPE) or to international banks in Emerging Europe (also mostly SPE, based on branches or centralized model subsidiaries).

Figure 3 - Changes in foreign claims of reporting banks to Latam and Emerging Europe (BBVA Research)



To sum up, in the definition of TLAC and its application to emerging markets, regulators should avoid penalizing a model that has worked well in limiting contagion during the global crisis. This flexibility – which has been introduced for banks headquartered in emerging markets, but not for resolution entities with the same geographical scope – should apply to elements like the sizing of TLAC, the part to be covered with senior debt or the definition of internal TLAC.

References

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