February 10, 2017

Comments on the Consultative Document: *Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs*, issued by the Financial Stability Board

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the consultative document: *Guiding Principles on the Internal Total Loss-absorbing Capacity of G-SIBs ('Internal TLAC')*, issued on December 16, 2016 by the Financial Stability Board ("FSB").

We respectfully expect that the following comments will contribute to your further discussion.

[General Comments]

1. <u>Need for ensuring flexibility for orderly resolution</u>

Resolution of G-SIBs entails significant uncertainty and individuality since it is influenced by various factors (e.g. difference in legal system for resolution across jurisdictions, difference in business portfolios and group composition across companies, circumstances leading up to resolution and market/economic environment). As such, there should be maximum flexibility with regard to the distribution of internal TLAC and the use of surplus TLAC at each G-SIB to ensure its orderly resolution.

As mentioned in the consultative document, it would be useful to provide home and host authorities with a certain level of confidence on G-SIBs' resolution so that incentives on the part of host authorities to ring-fence assets domestically should be minimized and global fragmentation of the financial system should be avoided.

It is our understanding that, from such a point of view, the consultative document highlights the importance of tailored resolution strategy development for each G-SIB at the Crisis Management Group ("CMG") and provides a set of high-level guiding principles on how internal TLAC should be used under the resolution strategy. While we support the overall framework set by the consultative document, we strongly request that the final rule clearly articulates that the guiding principles are not binding and bank-specific and flexible use of internal TLAC based on discussions at the CMG is

warranted. It is also very important to minimize adverse effects on business operations through dialogue with the G-SIB itself when home and host authorities discuss how to use the internal TLAC at the CMG.

We understand the need for home and host authorities to discuss and agree in principle on the use of internal TLAC at the CMG. However, with respect to the use of TLAC excluding internal TLAC (i.e., surplus TLAC), home authority that is responsible for group resolution of the G-SIB should maintain the discretion so that the effective and orderly resolution in line with the resolution strategy is ensured.

2. Guiding principles on surplus TLAC should be consistent with the TLAC Term Sheet.

Guiding Principle 7 defines surplus TLAC as TLAC at the resolution entity that is not distributed to material sub-groups in excess of that required to be held at the resolution entity to cover its own risks and requires home authorities to consider how surplus TLAC should be maintained. It is suggested that surplus TLAC be invested in assets that can be promptly and easily valued, and which are likely to retain sufficient value in times of market-wide stress.

Considering the objectives of the guiding principle, however, it is our understanding that maintaining surplus TLAC in the form of highly liquid assets at the resolution entity is not a requirement and down-streaming surplus TLAC within a group is not prohibited.

If that is not the case, banks that issue TLAC eligible senior debt out of its holding company using the structural subordination framework would face issues including (i) a concern that such issuance itself could lead to the breach of the conditions for the structural subordination, (ii) inconsistency with the Basel III liquidity requirements and other relevant requirements, and (iii) a concern that the holding company would incur significant losses.

Given these issues, consistency between the provisions set forth in the guiding principle on surplus TLAC and in the TLAC Term Sheet should be ensured. In addition, the guiding principle on internal TLAC should clearly state that treatment of surplus TLAC should be determined at the home authorities' discretion in conjunction with the resolution strategy.

(i) Inconsistency with the external TLAC's structural subordination framework

For banks subject to a single point of entry ("SPOE") approach where the resolution process starts by seizing a top holding company, the FSB's TLAC Term Sheet allows the top holding company to issue senior debt as TLAC-eligible instrument with structural subordination. In this case, the holding company should not have any excluded liabilities and become so-called "clean" holding company whose functions are kept as minimal as practical.

If, however, the SPOE bank is required to hold and invest surplus TLAC at its holding company level, it is assumed that funds raised by TLAC-eligible, long-term debts with residual maturity of one year or more will be invested in short-term assets which can be easily liquidated and whose price will remain stable in times of stress. It means that banks have to develop ALM functions and risk management functions for interest rate and foreign exchange at the holding company. This may rather reduce the resolvability of the holding company and contradict with FSB's various initiatives for ensuring effective resolution.

Also, the holding company needs to carry out hedging operations as part of the asset liability management and investment management including interest/FX risk management. However, if associated liabilities that rank pari passu with external TLAC exceed 5% of the external TLAC, its structural subordination will be denied.

(ii) Inconsistency with the Basel III liquidity requirements and other relevant requirements

The consultative document states that surplus TLAC should be held in the form of "assets that can be promptly and easily valued, and which are likely to retain sufficient value in times of market-wide stress." In practice, such assets are considered to be similar to HQLA under the LCR framework but the definitions of the two assets are not clear.

If the two assets discussed above are different, G-SIBs need to hold both high liquid assets, one for recapitalization purposes when a group company enters into resolution and the other as HQLA for a liquidity buffer in times of market-wide stress. This will unduly reduce the profitability of G-SIBs as well as their leverage ratio.

On the other hand, if the two assets are the same and can be counted towards both surplus TLAC and HQLA under the LCR framework, they have different impact depending on whether G-SIB's resolution entity is a holding company or not. More specifically, if the resolution entity is a holding company, that G-SIB has to hold surplus TLAC at the holding company and HQLA to satisfy LCR requirements at subsidiaries, whereas the G-SIB whose resolution entity is an operating bank can count the single set of assets toward both surplus TLAC and HQLA under the LCR framework at the same time. This should leave SPOE banks unfairly disadvantaged vis-a-vis multiple point of entry ("MPOE") banks in terms of liquidity and leverage ratio requirements.

(iii) A concern that the holding company would incur significant losses

If a bank is required to hold and invest surplus TLAC at the holding company, it would face structural negative carry as a result of raising long-term funds with structural subordination and investing in short-term government papers.

Based on the recent issuance by Japanese banks, interest rate on TLAC eligible senior debt (10 year, U.S. dollar) issued by the holding company is approximately 3.50% per annum, whereas treasury bill (3 months, U.S. dollar) yields approximately 0.5% per annum. This translates into approximately -3.0% per annum, i.e. negative carry. If a bank raises 5 trillion yen equivalent of TLAC eligible senior debt and invest it all in treasury bills, the estimated loss incurred at the holding company reaches approximately 150 billion yen equivalent per year.

The surplus TLAC framework that penalizes the G-SIBs with a focus on domestic operation or limited number of subsidiaries necessary to maintain critical functions, i.e. less important G-SIBs in terms of global financial system, does not make any sense and contradicts with its objectives. It should not by any means require banks to hold funds not distributed to overseas material sub-groups at the holding company.

In this respect, the TLAC Term Sheet stipulates that:

(1) Authorities in the resolution entity's jurisdiction may decide to apply internal TLAC requirements to subsidiaries or sub-groups within their jurisdictions.
(2) TLAC that is not pre-positioned should be readily available to recapitalize any direct or indirect subsidiary as necessary (i.e., how to maintain surplus TLAC with in a group is not specified), and

(3) Authorities should ensure that there are no legal or operational barriers to this.

Taking into account the objective of the TLAC Term Sheet, the guiding principles should specify the following:

(1) The home authority can, at its discretion, designate domestic subsidiaries as material sub-groups ("MSG");
(2) Surplus TLAC is defined as "TLAC which is not pre-positioned within the group"; and
(3) The home authority can, at its discretion, determine how surplus TLAC is maintained and managed.

[Our response to questions]

Question 1 (Guiding Principle 2) What factors should the relevant authorities take into account when determining the composition of material sub-groups and the distribution of internal TLAC between the entities that form the material sub-group?

In general, host authorities have incentives to demand internal TLAC for subsidiaries in their jurisdictions as much as possible. To curb such incentives for host authorities to ring-fence the assets and ensure the effective use of group-wide resolution resources, there should be sufficient transparency and accountability with regards to the identification of the material sub-group.

More specifically, identifying subsidiaries that do not meet the quantitative criteria set out in Section 17 of the TLAC Term Sheet as the material sub-group based solely on the qualitative criteria should be strictly limited. It should be done on an exceptional basis when a group of subsidiaries offers critical functions in the host country. In addition, bundling subsidiaries with no direct capital relationship and different business models just because they are in the same jurisdiction and identifying them as the material sub-group based on quantitative criteria should be subject to the scrutiny. Host authorities should explain clearly the logic and reasoning behind it to the home authority and the G-SIB.

If the host jurisdiction does not have a national legal system necessary to implement internal TLAC framework, host authorities should take responsibility to establish the legal system. If G-SIBs have a material subsidiary in the jurisdiction where the national legal system is not established, the guiding principle should specify that the distribution of internal TALC to such material subsidiary is not required.

Guiding Principle 2 in the consultative document does not refer to internal TLAC requirement for non-wholly owned subsidiaries. Requiring internal TLAC beyond ownership ratio in a subsidiary means the resolution entity may need to absorb losses beyond its responsibility as a shareholder. Therefore, internal TLAC requirement on non-wholly owned subsidiaries should be consistent with the local legal system.

Question 2 (Guiding Principle 4)

What are your views on the treatment of regulated or unregulated non-bank entities as set out in guiding principle 4? If such entities were included within a material sub-group, how should the relevant authorities calculate an internal TLAC requirement?

We support the treatment set out in Guiding Principle 4 and believe that the inclusion of non-bank entities within a material sub-group should be strictly limited.

Considering the main objectives of the TLAC standard; (i) to avoid putting the financial system at risk; (ii) to avoid losses on taxpayers and (ii) to ensure the continuity of critical functions in the event of resolution of a financial institution group, decision to include any non-bank entity in a material sub-group should be based only on whether "the entity is material to the exercise of the firm's critical functions" or "the entity is highly interconnected with the G-SIB as a whole" as set out in the guiding principle 4.

Currently, there are no bank-equivalent prudential regulations and resolution regime for non-bank sectors including securities, consumer financing, credit cards and leasing. This means that national authorities don't believe that such business activities pose a systemic risk in the first place.

As such, the need to include these non-bank subsidiaries in a material sub-group is extremely low.

The securities sector in some jurisdictions is subject to the sector-specific capital requirements imposed by supervisory authorities but not subject to those by the Basel Committee on Banking Supervision ("BCBS") incorporated in the banking act.

In such jurisdictions, only the securities firm which is a subsidiary of the resolution entity subject to the BCBS's capital requirements would be subject to both the BCBS's capital framework and the sector-specific capital framework. Consequently, such a securities firm may need to maintain capital more than required under the sector-specific capital framework. This could result in reduced capital and funding efficiency, leading to unlevel playing field with other securities firms.

Also, if such securities firms are forced to prepare for the new and additional requirements, they may find it difficult to maintain the customer service level due to the increasing cost.

Question 3 (Guiding Principles 5 and 6)
Do you agree with the roles of home and host authorities in relation to the host authority's determination of the size of the internal TLAC requirement, as set out in guiding principles 5 and 6? What additional factors, if any, should the host authority take into account when setting the internal TLAC requirement?

We basically support the role of the host authority to determine the size and other internal TLAC requirements in consultation with the home authority as set out in Guiding Principle 5 and 6. The guiding principles, however, should clearly state the host authority to fulfill its accountability by providing clear evidence to the home authority in addition to the consultation with the home authority when the host authority identifies material sub-groups and set internal TLAC requirement, because the determination by the host authority could lead to ring-fencing for the benefit of its own jurisdiction.

Furthermore, if the sum of internal TLAC requirements exceeds the amount of external TLAC necessary for group-based orderly resolution, it means that the resolution strategy established by the home authority may not function as intended. Given the objective of TLAC to ensure orderly resolution of G-SIBs, it is important that the resolution strategy developed by the home authority responsible for G-SIB's resolution and internal TLAC requirement are well aligned.

The FSB's Key Attributes highlighted the importance of cooperation and coordination between home and host authorities in resolution of G-SIBs and now guiding principles on internal TLAC are proposed by this consultative document. But some jurisdictions have already published their own rules to identify material sub-groups and set the size of the internal TLAC requirement.

Since those developments significantly undermine the effectiveness of this consultative document and violate provisions set out in the TLAC Term Sheet, we strongly request the FSB to take appropriate actions against those jurisdictions. At the same time, home authorities should be granted the veto power against such a unilateral determination by host authorities as necessary in order to ensure the application of the TLAC Term Sheet and the guiding principles on internal TLAC.

Question 4 (Guiding Principle 7)
How should TLAC at the resolution entity that is not distributed to material sub-groups ('surplus TLAC') be maintained to ensure that it is readily available to recapitalise any direct or indirect subsidiary, as required by the TLAC term sheet?

As discussed in general comments, it is important for home and host authorities to discuss and agree on how TLAC should be held and distributed in a G-SIB group with maximum flexibility since resolution of G-SIBs entails different resolution frameworks across jurisdictions and different group/business structures across G-SIBs.

Also, requiring banks to hold surplus TLAC at the holding company level just because it is a resolution entity and to invest it in the form of assets that can be promptly and easily valued and are likely to retain sufficient value in times of market-wide stress would not be consistent with external TLAC's structural subordination framework and the existing liquidity requirements under the Basel III. It will also lead to operational issues like significant losses at the holding company level. The home authority therefore should have discretion in deciding which entities should hold surplus TLAC and how such surplus TLAC should be invested in accordance with the resolution strategy.

In this regard, a material operating entity in the home jurisdiction should be allowed to hold surplus TLAC so that the holding company would not be forced to engage in undue hedging operations and risk management. That way, unfair treatment of SPOE banks under the LCR framework can be resolved by harmonizing the concepts of high liquid assets correspondent with surplus TLAC and HQLA under the LCR framework. Upstreaming losses at a material sub-group, even if it is unintended, to the holding company using surplus TLAC at that operating entity can be done easily and hence the effective and orderly resolution can be ensured.

Question 5 (Guiding Principle 8)
What are your views on the composition of internal TLAC, as set out in guiding principle 8? In particular, should there be an expectation of the inclusion within internal TLAC of debt liabilities accounting for an amount equal to, or greater than, 33% of the material sub-group's internal TLAC?

The composition of internal TLAC (equity, senior debt and subordinated debt, etc) should be determined on a case by case basis by taking into account functions and

characteristics of the instruments. Therefore, it is not appropriate to uniformly apply "33% debt expectation" to the composition of internal TLAC.

In particular, when the material sub-group holds sufficient internal TLAC in the form of capital, requiring it to replace capital with debt or increase debt would not be appropriate from the prudential standpoint as well.

Also, as discussed later, the level of point of non-viability ("PONV") set for internal TLAC is likely to be different across host jurisdictions and also different from that of external TLAC in the same jurisdiction.

Against this backdrop, internal TLAC should not necessarily have same features as external TLAC and those should be determined individually depending on the size of the material sub-group as well as characteristics and complexity of its businesses. The CMG should discuss and determine this to ensure recapitalization in a timely manner.

With respect to the capital structure of the material sub-group, it is worth noting that G-SIBs make decisions with due consideration on accounting and tax regimes in both home and host jurisdictions as well as regulatory requirements. Applying single set of internal TLAC composition could result in conflict with other regulatory requirements or unfavorable treatment under accounting and tax regimes.

Question 8 (Guiding Principle 12)

Do you agree with the obstacles to the implementation of internal TLAC mechanisms set out in guiding principle 12? How should G-SIBs and authorities address those obstacles and what additional obstacles, if any, might arise?

Depending on tax treatment, there could be taxable profits in the course of recapitalization, where loss-absorbing capacity may be lost due to the resulting taxation. It is strongly requested that authorities in relevant jurisdictions cooperate and develop a coherent tax framework for internal TLAC.

Given the objective of internal TLAC to ensure recapitalization of material sub-groups and thereby to stabilize the financial system in the host jurisdiction, it is of particular importance for the host authority to make sure that tax treatment would not be an obstacle to recapitalization in its jurisdiction.

Also, jurisdictions that apply the large exposure framework to intra-group exposures should take measures to exclude internal TLAC instruments from its scope.

As indicated in Guiding Principle 12, application of the large exposure framework to intra-group exposures will impose an additional constraint on intra-group financing and could be an obstacle to internal TLAC framework.

Question 9 (Guiding Principle 13 and Annex 2)

Do you agree with the key features of contractual trigger language for internal TLAC, as set out in guiding principle 13 and in Annex 2? Should authorities consider the use of contractual triggers for internal TLAC in the form of regulatory capital instruments, including in cases where statutory point of non-viability powers exist in relation to such instruments?

The consultative document states that contractual triggers for internal TLAC should be the point at which the material sub-group reaches PONV, as determined by the host authority. But host authorities have an incentive to set PONV at a conservative (i.e. high) level as much as possible for their own benefits. As such, it is possible that host authorities could pull the trigger at an unduly high level, which could drive the entire group into bankrupt even though it is solvent. Therefore, PONV for the material sub-group should not be too conservative.

Moreover, from the standpoint of (i) ensuring level playing field with banks headquartered in the host jurisdiction and (ii) ensuring predictability for investors in TLAC instruments, PONV level for internal TLAC should not be significantly higher than that for external TLAC issued by the banks headquartered in the host jurisdiction.

Setting PONV at an unduly conservative level should be strictly avoided since it would impair investor's investment decision if such PONV is not disclosed. Even if it is disclosed, it would pose reputational risk on material subsidiaries and lead to the negative impact on their funding.

In order to ensure that PONV level for internal TLAC is consistent with the legal system in the host jurisdiction, substance of contractual triggers for internal TLAC including its PONV level should be subject to the consent from the home authority.

[Other issues]

(1) Definition of subsidiary (Guiding Principle 1)

It should be clarified that the term "subsidiary" means a subsidiary as defined in the consolidated financial statement standards applicable for accounting purposes in the home jurisdiction. The consultative document (the proposed guiding principles) does not explicitly define the term "subsidiary."

Since the definition of "subsidiary" differs across jurisdictions, there could be misunderstanding among authorities with respect to the identification and composition of the material sub-group and the internal TLAC requirements.

Under BCBS's regulatory capital framework and leverage ratio framework which the TLAC requirement refers to, the term "subsidiary" is defined as a subsidiary under the consolidated financial statement standards applicable for accounting purposes in the home jurisdiction.

In order to avoid misunderstanding with regard to the definition of "subsidiary" and to ensure consistency with the BCBS frameworks and the TLAC standards, the consultative document should specify that the term "subsidiary" shall mean a "subsidiary as defined in the consolidated financial statement standards applicable for accounting purposes in the home jurisdiction."

(2) Notification of the material sub-group and the size of internal TLAC (Guiding Principle 1)

The guiding principle should clarify the process to provide G-SIB of the material sub-group identification and the size of the internal TLAC requirement as well as the basis for such determination.

With those clarifications, G-SIBs will be able to have clear view on internal TLAC and enhance their compliance with the proposed guiding principles.

(3) Maturity of collateral backing the guarantee (Guiding Principle 9)

It is not necessary to apply the maturity requirement for TLAC-eligible instruments to the collateral backing the guarantee. Collateral should include cash, deposits and

short-term government debts. The contractual maturity on the collateral should not be an obstacle to an orderly resolution so long as it is appropriately managed.