February 12, 2016

Comment on the Consultative Document: *TLAC Holdings* issued by the Basel Committee on Banking Supervision

Japanese Bankers Association

We, the Japanese Bankers Association (“JBA”), would like to express our gratitude for this opportunity to comment on the consultative document: *TLAC Holdings* issued by the Basel Committee on Banking Supervision (the “BCBS”).

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

<<General Comments>>

We understand the intention of the Consultative Document to establish a framework for the purposes of mitigating the risk of contagion with a view to ending the TBTF problem. However, we do not support the proposed approach to reduce the risk of contagion through the Tier 2 deduction approach because such approach may undermine consistency between the proposed regulatory framework and the Basel III corresponding deduction approach, and prevent banks from ensuring stable issuance of TLAC eligible instruments and liabilities in the market.

With the objective of stabilising the global financial system, it is crucial for each G-SIB to ensure the necessary volume of TLAC eligible instruments and liabilities without distorting the bond market and having an adverse impact on real economy. To this end, a framework needs to be designed in a manner to ensure smooth issuance of TLAC eligible instruments and liabilities in the market, taking into account the conditions unique to each jurisdiction’s bond market, for example, differences across jurisdictions in terms of capital market participants and investors classes in corporate bonds issued by banks.

Holdings of TLAC eligible instruments and liabilities are similar to general credit exposures in that they may incur losses upon failure of a G-SIB. A global framework has been established to address the concentration risk in credit portfolios through large exposure limit, and the limit on credit concentration to G-SIBs has been enhanced. Accordingly, the contagion of risks through the holdings of TLAC eligible instruments and liabilities will also be covered by the large exposure framework.

The TLAC requirements are a significant framework that minimise any effects on the financial system and real economy arising from the failure of G-SIBs. At the same time, they are a new framework imposed, which focuses on the holdings of TLAC eligible instruments and liabilities, in addition to the existing capital requirements. Therefore, it is not possible to completely assume at the moment what kinds of effects may be caused by the implementation of the TLAC requirements on, for example, the markets, real economy, and market liquidity currently showing a significant decline. Further, the interaction and a cumulative effect of various regulatory requirements currently being discussed, such as the review of measurement approaches for risk weighted assets, are uncertain. Therefore, the BCBS is requested to take a reasonable approach in carefully making decisions concerning the holdings of TLAC eligible instruments and liabilities to avoid an excessive regulation.

Our comments on specific issues, including the approaches proposed in the Consultative Document, are provided in the next section.

<<Specific Comments>>

1. Approach for the treatment of TLAC holdings

(1) We are opposed to the Tier 2 deduction approach. Separate approaches should be established for G-SIBs and non-G-SIBs

We do not support the proposed Tier 2 deduction approach. Tier 2 capital which is a capital instrument and TLAC eligible instruments and liabilities (e.g., TLAC eligible senior debt issued by a holding company) with the nature of debt have different inherent risks and features (in the event of resolution by a financial institution, Tier 2 will be used to absorb losses, in a manner subordinated to senior debt). Consequently, it is not reasonable to require the deduction of TLAC eligible instruments and liabilities from Tier 2, lacking consistency with the existing Basel framework, including the corresponding deduction approach.

While the Consultative Document highlights, as a benefit of the Tier 2 deduction approach, that it helps to reduce investments in TLAC eligible instruments and liabilities by banks, we believe the primary focus should not be placed solely on facilitating the reduction. The requirements for TLAC Holdings aim to mitigate the economic impact caused by the failure of a G-SIB by ensuring that TLAC instruments issued by G-SIBs are broadly held in smaller volumes. To this end, it is also a significant challenge to realise stable issuance of TLAC eligible instruments and liabilities through the market. Given that the market size and participants differ significantly across jurisdictions, and if financial institutions are unduly restricted in holding TLAC eligible instruments and liabilities, stable issuance of TLAC eligible instruments and liabilities may be impaired. Further, as a result of prioritising only the prevention of the risk of contagion, the liquidity of the bond market may considerably decline and market volatility may increase, which in turn increase the possibility of crisis. Such risk should also be assumed.

The *Summary of Findings from the TLAC Impact Assessment Studies* issued by the BCBS on November 9, 2015 states that, according to the QIS, in general terms, neither G-SIBs nor non-G-SIBs hold very significant amounts of G-SIB-issued TLAC, and even when moving to the wider definitions, G-SIBs do not currently hold significant amounts of each other's liabilities. The QIS however covers only 134 banks from across the world, and responses are made on best-efforts basis for this study that covers a new aspect which has never been addressed before, i.e. the holding amount of TLAC eligible instruments and liabilities. Therefore, this QIS may not be able to precisely capture the impact of introducing the TLAC Holdings framework. Further, the QIS could not sufficiently capture the degree of impact because its analysis is limited to a static analysis, and does not undertake a dynamic analysis that covers cases where business environment surrounding banks has drastically changed or TLAC holdings framework is imposed. Consequently, the approach to determine the holdings requirements primarily based on the TLAC QIS is not considered to be appropriate.

It is more reasonable to establish a framework that applies separate approaches depending on the degree of systemic risk associated with respective banks that hold TLAC eligible instruments and liabilities, in light of the intention and objective of the Consultative Document, which is to establish a framework that reduces the risk of contagion associated with excessive TLAC holdings with a view to ending the TBTF problem. Therefore, applying different approaches tailored to G-SIBs and non-G-SIBs that have a different degree of systemic risk are considered to be appropriate, as discussed below.

(i) Approach for G-SIBs

<u>For G-SIBs, we propose the approach to deduct holdings of eligible TLAC instruments and liabilities issued by other G-SIBs from the amount of their own issued eligible TLAC instruments and liabilities.</u>

The objective to restrict excessive holding of TLAC instruments and liabilities by

G-SIBs and mitigate the risk of contagion across G-SIBs will be attained without taking the proposed Tier 2 deduction approach. We propose an alternative approach of deducting holdings of eligible TLAC instruments and liabilities issued by other G-SIBs (excluding regulatory capital instruments) from the amount of their own issued eligible TLAC instruments and liabilities (excluding regulatory capital instruments; if the amount of their own issued eligible TLAC instruments and liabilities is not sufficient to absorb the deduction, the excess should be deducted from their own Tier 2.)

(ii) Approach for non-G-SIBs

For non-G-SIBs which are not identified as systematically important in the global financial system, the introduction of a new framework for TLAC holdings is not appropriate. The existing large exposure framework can reduce the risk of contagion.

The Consultative Document specifies the following as shortcomings of the approach using the existing large exposure framework for reducing the risk of contagion: (i) it would not remove double-counting of TLAC, and (ii) it provides no practical upper bound on the losses that banks can suffer from the failure of multiple G-SIBs. For the shortcoming (i), non-G-SIBs, in the first place, are not required to issue TLAC instruments and liabilities, and therefore the double-counting issue of TLAC would not occur. Whereas with regard to (ii), further reduction of risks through the introduction of an additional framework other than the large exposure limits lacks necessity, because the potential expansion of losses through a chain-reaction bankruptcy of multiple G-SIBs can be reduced to a considerable extent by enhancing the prudential regulations such as the implementation of G-SIB buffer and TLAC holding requirements between G-SIBs. Additionally, the requirement proposed in the Consultative Document contradicts the FSB TLAC framework in that it is under the assumption that the simultaneous failure of multiple G-SIBs will occur. In the FSB TLAC framework where the objective is to establish an orderly resolution of a financial institution, such systemic risk is not taken into consideration.

In this view, the new framework should not be introduced for TLAC holdings by non-G-SIBs. Further, the Tier 2 deduction approach proposed by the BCBS, if applied, would complicate the framework, since this would have an impact on regulatory capital (CET1, AT1 and Tier 2) defined under the current Basel III framework.

The Consultative Document also emphasises ensuring the level playing field with non-G-SIBs. However, since equal treatment is not applied to non-G-SIBs in the first place in that the TLAC framework is only applied to G-SIBs, applying the same treatment for the deduction approach is considered to lack necessity.

Introducing a new TLAC requirement to non-G-SIBs may lead to reducing the amount of TLAC holdings by banks subject to the prudential regulations including Basel III even carried out within appropriate risk-taking activities, and limiting the types of investors. Such situation may prevent issuance of TLAC eligible instruments and liabilities in the market.

Moreover, while the Tier 2 deduction approach to non-G-SIBs proposed by the BCBS, if introduced, would enhance the stabilisation of the banking system, it would result in an increasing reliance on specific sectors that are not subject to the prudential regulations, such as asset managers, pension funds and retail investors, on a global basis, and risks may concentrate on these sectors, thereby undermining the stability of the overall financial system. In particular, it is necessary to be reminded that issues associated with loss-absorbing capacity by TLAC eligible instruments and liabilities held by retail investors have not yet been addressed. Further, as discussed above, the liquidity of the bond market may considerably decline and market volatility may increase, which in turn increase the possibility of crisis. Such risk should also be assumed.

Introduction of the Tier 2 deduction approach to non-G-SIBs does not help designing a framework for loss allocation in a wide and shallow manner at a financial system wide level from a perspective of reducing the risk of contagion.

(2) Common Equity Tier 1 deduction and penal risk weight on TLAC holdings

We oppose to the "Common Equity Tier 1 deduction" and "penal risk weight on TLAC holdings" which would be stricter rules than the Tier 2 deduction approach.

The Consultative Document notes issues regarding the Common Equity Tier 1 deduction, specifying that such an approach would either result in a more onerous treatment of TLAC holdings than for Additional Tier 1 and Tier 2 capital holdings under Basel III, or would necessitate a change to Basel III framework. On the other hand, as to penal risk weight on TLAC holdings, it raises an issue that, unless the risk weight is set at a level that is equivalent to a deduction, such an approach will not remove the double counting of TLAC. We also think, as specified by the BCBS, that these approaches have issues; for example, these may be inconsistent with the objective of the Basel III corresponding deduction approach.

If an approach that will be stricter than the Tier 2 deduction approach proposed in the Consultative Document is implemented, such an approach may disincentivise banks for holding TLAC eligible instruments and liabilities within appropriate risk-taking activities, and hence prevent issuance of TLAC eligible instruments and liabilities in the market. Or, these approaches may result in holdings of TLAC being excessively concentrated in certain sectors, thereby undermining the stability of the overall financial system.

(3) If the deduction approach would be introduced, mitigating measures should be put in place

(i) TLAC holdings exemption threshold

We propose to recaliberate the level of threshold permitted under the Basel III and establish a new threshold at 12.5% of CET1 for the holdings of TLAC eligible instruments and liabilities, separately from the existing threshold set for regulatory capital.

While including TLAC eligible instruments and liabilities in the threshold established in the double gearing provision under the Basel III, if the threshold is not recaliberated, such threshold may have a significant impact on the banks' investment management strategy.

Further, G-SIBs are required to issue TLAC eligible instruments and liabilities in addition to existing regulatory capital (CET1, AT1 and Tier 2) for compliance with the TLAC requirements established by the FSB. Consequently, market-making capacity that enables smooth issuance of eligible TLAC instruments and liabilities should be secured by the expansion of the existing threshold.

Our proposal of the specific level of the threshold is to set a new threshold at a 12.5% of its own CET1 for holdings of TLAC eligible instruments and liabilities in addition to the existing threshold (10% of CET1). This 12.5% is determined by deducting the existing threshold, i.e. 10%, from 22.5% which is calculated according to the ratio of minimum TLAC requirement to current minimum capital requirement (= the level of existing threshold, i.e. 10%, x (minimum TLAC requirement 18% / current minimum capital requirement 8%).

(ii) TLAC holdings exemption for the purposes of market-making related activities

TLAC holdings for the purposes of market-making related activities should be excluded from the TLAC holdings framework.

G-SIBs have a considerably high presence in the underwriting and market-making activities in the capital markets of major jurisdictions. Given this, to ensure smooth issuance of TLAC eligible instruments and liabilities in the market and liquidity in the secondary market, it is considered necessary to take measures, for example, to ease the deduction requirement for temporary holdings for underwriting purposes and certain market making activities.

Additionally, following transactions should be excluded from the TLAC requirements: transactions that are executed by G-SIBs and non-G-SIBs in relation to underwriting and market-making related activities of TLAC eligible instruments and liabilities and that are reasonably designed not to exceed the needs of customers, users and counterparties. From risk management perspectives, in practice, there are cases where the maximum holding period is set at 6 months for senior debt held for the purposes of market-making related activities. Therefore, TLAC eligible instruments and liabilities with the holding period of 6 months or less should be excluded from the scope of the TLAC holdings requirements.

Further, the QIS determines the impact based only on the size of TLAC holdings. It is necessary to note that, even if the size of TLAC eligible instruments and liabilities held by individual banks is small, if banks curtail their market-making related activities at the same time, such behavior may have a significant impact on the issuance and liquidity of TLAC eligible instruments and liabilities.

(iii) Transitional arrangements

Certain transitional arrangements should be put in place.

If the holding requirements unique to TLAC would be introduced, this may drastically change the investors' behavior. As such, the impact on the buy side of TLAC eligible instruments and liabilities are difficult to predict completely. To ensure smooth issuance of TLAC eligible instruments and liabilities in the market, certain transitional arrangements should be put in place as mitigation measures. In light of this, TLAC eligible instruments and liabilities held before the finalisation of TLAC Holding requirements should at least be excluded. In addition, consistent with phase-in implementation of deductions under Basel III, it is requested to introduce a phase-in arrangement to "raise the percentage of deduction over 5 years from the introduction of the framework in 2019".

2. Definition of a TLAC Holding

(1) Debt liabilities that formerly counted as TLAC but now no longer qualify as they have fallen below the 1 year residual maturity requirement

To ensure consistency with the TLAC requirements established by the FSB, debt liabilities that formerly counted as TLAC but now no longer qualify as they have fallen below the 1 year residual maturity requirement should be excluded from the TLAC holdings requirements.

The TLAC requirements, including the TLAC Term Sheet, established by the FSB set out that debt liabilities whose remaining maturities are less than that reach the one year minimum maturity threshold will not qualify as TLAC. On the other hand, these liabilities are subject to the TLAC holdings requirements proposed under the Consultative Document. Therefore, the requirements proposed by the BCBS are not consistent with the FSB's TLAC requirements in that the TLAC issuer side and the holder side are subject to the different regulatory standards. (If debt liabilities that formerly counted as TLAC but now no longer qualify as they have fallen below the 1 year residual maturity requirement will be included in the scope of the holdings requirements, such debt liabilities should be counted as an eligible TLAC liabilities from the perspective of a G-SIB issuer.) Further, such difference would act as a significant disincentive for investors to purchase such debt liabilities, thereby preventing smooth issuance of TLAC eligible instruments and liabilities.

(2) Instruments subordinated to Excluded Liabilities

TLAC eligible instruments and liabilities held by a resolution entity should be excluded from the TLAC framework.

The Consultative Document proposes to include in the TLAC holdings subordinated instruments that rank pari passu with TLAC eligible instruments and liabilities, but have never qualified as TLAC. However, Excluded Liabilities held by a resolution entity should be excluded from the TLAC holdings requirement since such holdings are not counted as TLAC. Excluded Liabilities which are not bailed-in should at least be excluded from the TLAC holdings requirement.