
Problems and Opinions

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TLAC: SYSTEMIC RISK ISSUES AND THE IMPACT ON STRATEGIES OF CROSS-BORDER BANKS

INTRODUCTION

In November 2014, the Financial Stability Board (FSB) published a Consultation Paper¹ on Total Loss Absorbing Capacity (TLAC) outlining the capital requirements that globally active and systemically important banking groups, so-called G-SIBs, should meet in order to ensure the orderly resolution of such financial institutions without either disruption of critical functions or the use of taxpayers' money. Given that this has essentially been the last prominent item left on the G-20's agenda for regulatory reform after the financial crisis, the proposed rules had widely been anticipated and, accordingly, market reaction to the FSB's paper has been restrained. However, as analysts, bank managers, and academics have begun to examine the proposals more deeply, it has increasingly become clear that the proposal will probably have significant impact on the institutional structure and the competitiveness of cross-border banking groups. Moreover, the introduction of TLAC may have side-effects on systemic stability that will have to be addressed in the further development of the proposed rules lest they create new sources of vulnerabilities.

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¹ FSB (2014a)

I) THE RATIONALE AND KEY FEATURES OF THE TLAC PROPOSAL

Ending “too big to fail” has been one of the key aims of regulatory reforms after the financial crisis. The aim entails two separate, yet closely interrelated objectives: First, to ensure that the cost of the failure will be borne by the owners and creditors of the failed institution and that the resolution of the failed bank does not necessitate the use of taxpayers’ money; second, to make sure that the failure of a large and complex financial institution will not have negative repercussions for the rest of the financial system and that critical functions will continue to be provided.²

From this dual objective it follows logically that large and complex financial institutions must hold sufficient capital to absorb losses as well as to recapitalise critical activities after the absorption of those losses without recourse to public-sector assistance. Thus, TLAC consists of two components: First, the minimum capital requirements according to Basel 3; second, the new Gone-Concern Loss Absorbing Capacity or GLAC.

According to the FSB’s proposal, the TLAC provisions will apply to G-SIBs as identified by the FSB (currently: 30³), initially excluding those G-SIBs that are headquartered in emerging markets (which, in effect, would exclude the three Chinese G-SIBs). While the FSB proposes that TLAC be applied to G-SIBs, it is probable that in many jurisdictions TLAC-type requirements will be imposed on domestic systematically important banks, or D-SIBs, too – after all, the logic and objective of the TLAC proposal applies to D-SIBs, too.

In response to regulators’ requirements and legal provisions such as the Dodd-Frank-Act and the EU’s Bank Recovery and Resolution Directive (BRRD), financial groups, in the context of their resolution planning, have to decide on their structure for resolution. Essentially, regulation allows two models for this: the Single Point of Entry (SPE) or the Multiple Point of Entry (MPE) model of financial resolution.⁴ In the former, a banking group would be wound up as a single entity; this model typically applies to banking groups that have a holding structure on top of the organisation. In contrast, MPE strategies tend to be applied by banking groups with separate, legally independent operating units. Frequently, these are banking groups that have historically grown through the acquisition of (often foreign) subsidiaries. For the matter at hand, the differentiation between SPE and MPE strategies is important, because, within any banking group, the TLAC requirement will apply at the level of each resolution entity within the group

² In addition, assuming that “too big to fail“-banks tend to be cross-border banks, too, an effective regime for multi-jurisdictional resolution is needed. Cf. Zhou et al. (2014), p. 435.

³ Cf. FSB (2014b).

⁴ Cf. FSB (2013).

and separate TLAC will have to be placed at the respected level of the group.⁵ The FSB points out, though, that the aggregate TLAC requirement should be invariant to the number of resolution entities.

According to the FSB's initial thinking, the TLAC requirement is to be set at 16–20% of group RWA and 6% of total assets; both conditions must be met simultaneously. The additional capital buffers under Basel 3, viz. the Capital Conservation Buffer (CCB), the surcharge for systemically important financial institutions (SIFIs), and countercyclical capital requirements, will be added on top, because they should be available to serve the purposes they were intended for.⁶ Considering all of these components, total capital requirements for G-SIBs will exceed 25% of RWA, once TLAC enters into force in, as currently planned, 2019. At least one third of the TLAC requirement will have to consist of debt instruments. TLAC must consist only of liabilities which can be effectively written down or converted into equity without either disrupting critical services or giving rise to legal challenges. In any case, certain types of liabilities, such as insured deposits, covered debt, or liabilities arising from liabilities are excluded from the list of eligible instruments.⁷ In addition to the statutory requirements (so-called “Pillar 1”), which will need to be met by all G-SIBs, authorities will be free to impose additional requirements (“Pillar 2”) if they deem this appropriate and necessary given the structure, risk profile, and complexity of an individual banking group.

As a multi-jurisdictional agreement, the TLAC requirement must provide both home and host authorities with sufficient confidence that an institution can be resolved in a manner that disrupts critical services in neither the home nor the host jurisdiction. If such confidence did not exist, host authorities would react by ring-fencing local subsidiaries, intensifying the already visible trend for a re-fragmentation of financial markets.⁸ Reflecting these concerns, the TLAC proposal introduces the concept of so-called Internal TLAC, which would be applicable to each material non-resolution subsidiary incorporated in a jurisdiction other than the resolution entity. Internal TLAC would be pre-positioned on the subsidiary's balance sheet so that losses are automatically being passed on to the mother company allowing for a recapitalisation of the subsidiary without resolution measures. For the purpose of Internal TLAC, material subsidiaries are defined as those that comprise 5% of either consolidated Group RWA, revenues or leverage exposure, or are identified by the respective bank's Crisis Management Group as

⁵ As Gracie (2014, p. 5) notes: “It is worth noting that the resolution strategy governs TLAC, not the other way round”.

⁶ Cf. Gracie (2014), p. 3.

⁷ See FSB (2014a), p. 16 for the full list of excluded liabilities.

⁸ Cf. ECB (2014), p. 15–35 for evidence on the re-fragmentation of European financial markets.

material to exercise a group's critical functions. Internal TLAC requirements are scaled in proportion to the size and risks of the material subsidiary; tentatively, the FSB proposes that Internal TLAC is set at 75–90% of the Pillar 1 TLAC requirement that would apply if the local unit were a resolution entity itself. Internal TLAC is thus clearly a compromise between the interests of large, fully integrated cross-border groups, which would, in principle, prefer to exclusively hold TLAC at the group level, and the interests of host authorities, which would prefer fully capitalised, legally separate resolution entities within their jurisdiction.

II) IMPACT ON BANKING SECTOR STRUCTURES

It is interesting to note that analysts do not appear to be concerned about whether banks will be able to meet the TLAC requirements in quantitative terms.⁹ Instead, analysts seem to focus more on the implications that TLAC will have on corporate structures, especially those of European banks.

As mentioned above, the TLAC proposal does not prescribe a certain group structure, but is neutral as regards banking strategies and structures.¹⁰ Nonetheless, there is a wide-spread presumption that the TLAC proposal will benefit banks that have a holding-type structure.¹¹ In the consultation on the TLAC proposal, banking associations from jurisdictions, in which the alternative organisational model without a holding company at the top of the group is more prevalent, have indeed raised this point, suggesting more or less explicitly that the current TLAC proposal is biased in favour of US, UK, and Swiss banking markets.¹² The thinking behind this presumption is that a holding-type structure would enable a bank to issue senior debt at the level of the holding company; this debt would subsequently be passed on as Internal TLAC to the bank operating subsidiaries. The bank thus benefits from the ability to issue relatively cheap debt at the HoldCo level. Moreover, a clear layering of a bank's liability structure will be easier if all TLAC debt is issued at the holding level rather than in a dispersed fashion at the level of several OpCos, especially in light of the fact that banks usually have little to no liabilities at the HoldCo level that are not eligible for a bail-in (such as deposits or derivatives payable). In contrast, a more dispersed issuance at the level of OpCos would make the liability structure more difficult to understand for investors, who would then charge an "uncertainty premium" to banks whose liability structure was more complex.

⁹ Cf. e.g. Deutsche Bank (2014), p. 14 or Credit Suisse (2015), p. 15.

¹⁰ Cf. Gracie (2014), p. 2.

¹¹ E.g. Deutsche Bank (2014), p. 8, Credit Suisse (2015), p. 33.

¹² E.g. German Banking Industry Committee (2015), p. 3 and p. 6.

However, it is not entirely clear that this presumption is in fact valid. It ignores that a subordination of debt can in fact be achieved by means of three mechanisms¹³: First *institutionally* via the corporate structure, where a holding-type structure subordinates debt placed at the level of subsidiaries by definition. Secondly, subordination can be achieved *statutorily* by means of legal provisions. This is in fact the case in the EU, where the BRRD gives resolution authorities the right to bail-in debt issued by any resolution entity of a bank. (To be fair, it should be noted that this option was not available to the FSB as it had to suggest a proposal that could be implemented in the multi-jurisdictional environment of the FSB's membership rather than in the single legal environment that the EU offers.) Thirdly, subordination can be achieved by means of *contractual* arrangements. While these may be difficult to understand for investors, the possibility to achieve the desired structure of seniority and subordination clearly is available even in the organisational model prevalent in Continental Europe.

More importantly, one would expect that investors look through the structure and realise that the *prima facie* senior debt issued at the holding level is in fact subordinated and will be bailed-in should a resolution become necessary. In this context it is worth noting that Credit Suisse, in an analysis of the TLAC proposal, points out that the advantage of banks that already have a holding-type structure does not lie in the holding structure itself, but in the fact that those banks already have a large amount of senior HoldCo debt outstanding. Compared to banks with newly established HoldCos this gives investors more confidence as there is a broader pool of senior debt to share losses.¹⁴ Empirically, senior debt issued at the holding level has in fact become more expensive following the publication of the FSB's TLAC proposal.¹⁵ Similarly, it should be noted that the rating of bank holding companies in the US tends to be lower than that of debt issued at the level of OpCos of the same companies.¹⁶

Against this background, it does not appear to be the case that the TLAC proposal will force banks that currently do not have a holding-type structure to move to one. This holds true all the more as moving towards a HoldCo structure is costly and time-consuming. It requires *inter alia* shareholder approval and an

¹³ Cf. Gracie (2014), p. 4.

¹⁴ Credit Suisse (2015), S. 33.

¹⁵ Credit Suisse, e.g., notes that spreads on senior debt by UK bank holding companies have risen by 25–30bp after the FSB's November 2014 announcement. Credit Suisse (2015), p. 8. Increases of similar size could be observed in the yields of senior debt issued by US bank holding companies, e.g. GS and JPMC.

¹⁶ E.g., for Goldman Sachs and Bank of America, HoldCo long-term debt is rated A-, their banking OpCo long-term debt is rated A; for JPMorganChase, HoldCo long-term debt is rated A, that of JPMorgan Bank A+.

evaluation of assets held in the legal entities which, in addition, may have adverse tax implications for the bank.

More importantly, there is an additional consideration which tends to work against a holding-type structure, at least for those G-SIBs that have a material share of cross-border and international business in their total assets: Host supervisors will most likely prefer a corporate structure with local resolution entities. The reason is simple: In spite of the envisaged pre-positioning of Internal TLAC and the right to impose additional local capital requirements, host supervisors are likely to feel uncomfortable with relying on parent companies based in a foreign jurisdiction to absorb losses. Host supervisors, especially those with material subsidiaries, prefer MPE over SPE resolution and will always prefer a local resolution entity that falls unquestionably under the power of the local resolution authority and the locally applicable law.¹⁷ Therefore, it is likely that TLAC will increase pressure from host authorities to designate systemically important local operations as separate resolution entities. This entity would then have to issue external TLAC, raising funding costs and making the firms less competitive in the respective local market and overall.

Indeed, TLAC will most probably make discussion within resolution colleges on the determination of resolution entities even more contentious, as host supervisors will try to impose an MPE-type resolution strategy on cross-border banking groups. Incidentally, from the strategic point of view of a G-SIB, this may open up some room for bargaining with individual authorities. More specifically, it may actually be advantageous for a cross-border group to treat its various foreign subsidiaries in a differentiated fashion.¹⁸ As mentioned, according to the FSB proposal the internal TLAC requirement will be set at a level of 75–90% of the external TLAC requirements. The exact point within that range will presumably reflect not only the risk profile of the respective entity, but also the relative bargaining power of the respective host supervisor. It is not unreasonable to suppose therefore that the percentage of internal TLAC would differ between two otherwise identical resolution entities within a banking group, depending on where the entity is located. For the bank, lower levels of Internal TLAC will always be preferable to higher ones, as Internal TLAC effectively traps capital in subsidiaries, where it will not be available to cover capital shortfalls in other parts of the group and may

¹⁷ Schoenmaker (2013, p. 120), e.g., observes that “(...) supervisors are increasingly adopting a national approach.” This includes (informal) requests for local subsidiaries and ring-fencing of assets in the host country.

¹⁸ In this context it is interesting to note that the contribution by the European Financial Congress in Poland to the TLAC consultation notes: “It should also be remembered that by allocating to a systemic subsidiary bank the assets earmarked for its resolution, the resolution entity that is the parent of the bank in question gains greater bargaining power in discussions concerning the scope of decisions it may make with respect to that bank.”, cf. EFC (2015), p. 8.

lead to a misallocation of capital. The interests of host supervisors and those of the top-level management of G-SIBs are, thus, exactly juxtaposed: While banks have an incentive to lower the levels of Internal TLAC, host supervisors will want to have as high levels of Internal TLAC as possible and to circumscribe managements' ability to transfer capital to other parts of the group.

III) ADDITIONAL FINANCIAL STABILITY CONSIDERATIONS

The TLAC proposal has a bearing on other aspects of financial stability, too.

Investor base

As has been the case with the market for Contingent Convertible (“CoCo”) bonds, in a first reaction to the FSB’s proposals, traditional bond investors, such as insurance companies and pension funds, expressed only little interest for TLAC-eligible debt instruments.¹⁹ In particular, investors stated that the risk inherent in TLAC-eligible debt and, hence, its pricing was hard to determine.

The lack of interest in the traditional investor base is compounded by the fact that banks themselves, which traditionally have been important buyers of each other’s debt, will be discouraged to invest in TLAC debt instruments. The FSB’s proposal states explicitly that “*it will be important to strongly disincentivise internationally active banks from holding TLAC issued by G-SIBs*”.²⁰ Consequently, the TLAC term sheet states that G-SIBs holding TLAC debt issued by another SIB must fully deduct this debt from their capital. It is suggested that a similar provision be enshrined in Basel 3 regulation for non-SIBs. The rationale for this prohibition is that authorities do not want to open a potential channel of contagion in the banking system. However, limiting the TLAC investor base to non-bank institutions such as hedge funds, insurance companies or pensions funds will not only severely limit the investor base (to the extent that these non-banks are interested in TLAC debt at all!), but also has a potential competitive effect: These non-bank investors are more prevalent in some markets than in others. Specifically their role and size is far greater in Anglo-Saxon financial markets than it is in Continental Europe.

This problem will be aggravated by the fact that, as mentioned, financial markets are re-fragmenting along national borders. This entails that the markets for sub-ordinated debt, too, will increasingly be national. If so, the ability to issue, to place, and to price such debt will be a function of the local investor base, which

¹⁹ Glover et al. (2015).

²⁰ Cf. FSB (2014a), p. 12.

varies between countries. Banks headquartered in countries with small, shallow and unsophisticated capital markets will therefore face higher costs of funding than their peers incorporated in markets with the opposite characteristics.

Resolution entities with deposit surplus

In the financial crisis, it could be observed that an excessive reliance on volatile, short-term wholesale financing created additional vulnerability for banks and acted as a catalyst for the aggravation of the crisis. As a consequence, regulators have insisted that banks increase their reliance on longer-term and stable sources of funding, including deposits.²¹ It is therefore somewhat ironic, that, relatively speaking, the TLAC proposal punishes those institutions that hitherto have heavily relied on deposit funding, because deposits are excluded from the list of TLAC-eligible liabilities. If deposit-heavy entities within a SIB are resolution entities, these entities will therefore have to issue relatively large amounts of TLAC-eligible liabilities. The funding costs of these entities would rise accordingly.²²

SIBs that have entities with such characteristics will therefore have an incentive to either create a holding-type structure, enabling them to issue (senior) TLAC paper at the holding level, or to merge the deposit-heavy entities into larger resolution entities that are more wholesale funded, so that the share of deposit funding is diluted. As discussed in section II, neither of these approaches is likely to be welcomed by host supervisory authorities in charge of the deposit-heavy entity, as the risk profile of that entity will rise compared to the status quo ante.

Raising TLAC levels for deleveraging banks

Many European banks are still in deleveraging mode and shrink their balance sheets. For these banks, raising the volume of TLAC compliant capital is not possible as part of a process of organic growth where a growing balance-sheet volume is (partly) funded by issuance of TLAC-eligible capital instruments. Instead, these banks will have to actively substitute some hitherto used sources of funding with TLAC eligible capital.²³ While not impossible (assuming that there is a sufficient investor base for TLAC eligible capital, see above), this would require active capital management and may cause higher capital costs if existing sources of capital must be cancelled pre-maturely.

Splitting critical from non-critical functions

²¹ Cf. Basel Committee on Banking Supervision (2014), pp. 1, 3.

²² Cf. PwC (2014), p. 2.

²³ Cf. Alexander (2015).

The objective of TLAC is to ensure that sufficient capital is available within a group to maintain critical functions that cannot be wound up without disproportionately large negative consequences for the wider economy and / or for systemic stability. The emphasis here is on “critical”: It is only for those functions whose continuation is in the public interest that GLAC capital needs to be available. This refers, for instance, to deposit-taking activities or to payment services. In contrast, for non-critical functions the assumption is that these will simply be discontinued and wound up.

Assuming that this is indeed the rationale behind TLAC then it follows logical that it would rational for banking groups, with a view to lowering their overall TLAC requirements, to split their operations in a way that concentrates non-critical and critical operations in separate entities. For the former, no or only little GLAC would be required.

Assumption: RWA Bank A = RWA Bank B
 Systemic Risk: Bank A > Bank B
 Therefore, presumption is that TLA Bank A > Bank B



CA = Critical activities
 NCA = non-critical activities

If this were indeed the outcome of the TLAC proposal on the structure of banks, this result would presumably be in the interest of many financial regulators. Many supervisors have argued for a long time that complex large banking institutions need to be split up so that critical functions can be ring-fenced and continued in case of a failure. The Federal Reserve, e.g., has stated that rather explicitly that breaking up complex SIBs is indeed an implicit objective of the TLAC proposal.²⁴

²⁴ “By further increasing the amount of the most loss-absorbing form of capital that is required to be held by firms that potentially pose the greatest risk to financial stability, we intend to improve the resiliency of these firms. *This measure might also create incentives for them to reduce their systemic footprint and risk profile.*” Tarullo (2015), [my emphasis, BS].

Also, current regulatory initiative aimed at structural banking reforms such as the Vickers and Liikanen proposals implicitly aim at separating critical from non-critical operations.²⁵

Second-round effects

The FSB's proposal presents an elaborate framework for the resolution of a G-SIB. It is consistent with the objective that a resolved operating entity that offers critical functions has sufficient capital after resolution to maintain these critical operations. Implicit in the proposal is the view that the NewCo would be sufficiently capitalised if it met regulatory requirements. Indeed, the indicative range for TLAC capital given by the FSB, viz. 16–20% of RWA, would suggest exactly that, because this range would give the NewCo sufficient regulatory capital even assuming that all capital of the legacy institution was gone.²⁶

Thus, the FSB's proposal, in a way, implicitly – and, one is tempted to say, rather heroically – assumes that (i) the firm regains market access after resolution, and that (ii) markets will stabilise after the resolution and that therefore there will be sufficient time to rebuild the corporate structure as well as TLAC to prepare the institution for the next financial crisis. However, this ignores two critical issues: (i) The NewCo will have sufficient capital to meet regulatory requirements, but it will no longer have a HoldCo above it which would provide it with loss-absorbing capital. (ii) In a time of financial market stress – and the period following the resolution of a G-SIB inevitably will be such a time! – merely holding the regulatory minimum capital will not be sufficient for a banking institution. This will hold particularly true for an institution such as the resolved entity which will be a new institution without a track-record. It therefore follows: In order to become a viable institution that can fund itself in capital markets, a NewCo emerging from a resolution will probably have to hold significantly more than the regulatory minimum to establish confidence. Against this background, it seems likely that authorities will push entities into holding TLAC capital towards the upper end of the range currently suggested, in order to have a sufficient margin of error.

Liquidity

The TLAC proposal centres on ensuring that a systemically important banking institution holds sufficient capital to ensure an orderly resolution and the continuation of critical banking functions. In contrast, the TLAC proposal

²⁵ Cf. Schildbach / Speyer (2013, pp. 141–153) for an overview and a discussion of the Vickers and Liikanen proposals.

²⁶ Gracie (2014), p. 3.

hardly touches upon the issue of liquidity²⁷ – even though liquidity is of at least as much if not greater importance to ensure the survival of an institution in times of crisis than capital. The resolved entity (NewCo) will – arguably (see above) – have sufficient capital to at least meet regulatory requirements, but it is far from obvious whether it would have sufficient liquidity. Again it needs to be kept in mind that the NewCo is an institution without a reputation that at the same time carries the negative legacy of the failed parent institutions, which may have caused losses at other banks. Hence, it is not unrealistic to assume that NewCo, in spite of it being declared a healthy and untarnished institution by resolution authorities, will be cut off from money markets initially or will at least find it expensive to tap markets for liquidity. Consequently, in addition to ensuring sufficient capital, some additional private or public sector mechanism to guarantee access to a sufficient amount of liquidity may be needed to make resolution work.²⁸

Roll-over of TLAC debt after crisis

Not much thought appears to have been given in the TLAC proposal to the question of whether banks will be able to roll-over maturing TLAC debt in periods of market tension. Based on past experience with the emergence of risk aversion in the aftermath of a crisis, it is not unreasonable to assume that the investor base for TLAC debt will dwindle after the first losses have been realised. In such a situation, rolling-over TLAC debt may become impossible and will certainly become more expensive.²⁹

The TLAC proposal addresses this problem by stipulating that TLAC-eligible debt instruments have a residual maturity of at least one year. In practice, authorities will also insist that TLAC-eligible debt be staggered so that in any one period only a fraction of TLAC-eligible debt issued by the institution in question matures.

Yet, while these measures mitigate roll-over risk, none of them will eliminate the fact that G-SIBs will be exposed to another form of prolongation risk. Moreover, from a systemic point of view, the TLAC proposal increases pro-cyclicality in the financial system, as banks' funding costs will increase in times of market tension. Obviously, this stands in contradiction to the general objectives of financial regulation.

²⁷ Cf. Goodhart (2015), p. 1.

²⁸ Cf. Zhou et al. (2014), p. 445.

²⁹ Cf. Goodhart (2015), p. 3.

CONCLUSION

The FSB's TLAC proposal puts into place the last major building block of the G-20 regulatory reform agenda. TLAC is based on the recognition that ending "too-big-to-fail" requires a framework which allows for an orderly winding-up of complex banking institutions that neither requires the deployment of public money nor threatens the disruption of critical financial services. Fundamentally, the proposal, as presented in November 2014, seems to set the right incentives for achieving these objectives, at least as far as capital requirements are concerned. However, because of a lack of progress in building truly supranational resolution regimes, TLAC, as it currently stands, will be insufficient to avoid negative side-effects on the organisational structure, efficiency, and competitiveness of cross-border banking groups. In addition, since TLAC focusses almost exclusively on capital requirements, it ignores other important aspects that have a bearing on systemic stability, such as liquidity, roll-over risk and second-round effects. These will have to be addressed before TLAC enters into force, if TLAC is to contribute decisively to safeguarding financial stability.

Abstract

The FSB's proposal on Total Loss Absorbing Capacity (TLAC) constitutes the last major building block of the post-crisis regulatory reform agenda for global financial markets. The proposal aims at creating the preconditions for an orderly liquidation of complex banking institutions that would ensure the continuation of critical financial services without the need to use taxpayers' money in the resolution. The FSB's proposals are fundamentally conducive to achieving these aims. However, the TLAC proposal will have considerable side-effects on the organisational structure and competitiveness of cross-border banking groups; specifically, it is likely to disadvantage banking groups with material foreign subsidiaries. Moreover, while the TLAC proposal provides a comprehensive framework concerning capital requirements for too-big-to-fail institutions, the treatment of other aspects which influence systemic stability, e.g. liquidity and rollover risk, are underdeveloped.

Key words: TLAC, systemic risk, cross-border groups, G-SIBs, banking structure

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