Credit Product Insight

A Quick Primer on

Total Loss Absorbing Capacity Bonds

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Credit Product Insight – Deep Dive

Total Loss Absorbing Capacity Bonds

Introduction

Total Loss-Absorbing Capacity (TLAC) bonds are financial instruments issued by banks, particularly those identified as globally systemically important banks (G-SIBs). These bonds are designed to ensure that these banks have sufficient loss-absorbing and recapitalization capacity to maintain critical operations in the event of financial distress or failure. This mechanism is crucial to prevent taxpayer-funded bailouts and to maintain financial stability.

Key Characteristics

Purpose:
The primary goal of TLAC bonds is to provide a buffer that can absorb losses and facilitate the recapitalization of the bank if it becomes financially distressed.

Mechanism:
In the event of a bank's failure, holders of TLAC bonds may face losses before any taxpayer money is used for a bailout. This means they can be "bailed-in," with their value being written down or converted into equity to help recapitalize the bank.

Regulatory Measures:
These bonds are part of regulatory measures implemented following the global financial crisis of 2008-2009. They are intended to prevent major financial institutions from becoming "too big to fail," thus protecting the wider economy.

Issuance:
Banks issue these bonds to meet regulatory requirements set by bodies such as the Financial Stability Board (FSB), which drafted the TLAC rules in 2015. 30 specified Global Systemic Important Banks (GSIBs) must meet the minimum TLAC amount of 18% [1] of the banks' risk-rated assets.

The Rise of TLAC bonds

After the financial crisis in 2007-09, the G20 came together to discuss measures to manage the huge risk that could significantly affect the economy if/when G-SIBs fail. To avoid a publicly-aided bailout, regulators introduced TLAC-eligible liabilities instead, where debt is converted into equity through a "bail-in" method.

G-SIBs are required to maintain TLAC liabilities amounting to 18–20%[2] of their risk-weighted assets. These liabilities range from higher-risk instruments like common equity and additional tier 1 bonds (AT1s or cocos) to lower-risk tier 2 subordinated debt and senior TLAC bonds, which offer less protection than TLAC-excluded liabilities such as bank deposits and structured products.

[1] Financial Stability Board, Review of the Technical Implementation of the Total Loss Absorbing Capacity (TLAC) Standard (July 2019)
[2] Julius Baer, TLAC Bonds: What you should know (November 2022)

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Recent Issuance: ICBC's Plan to Issue TLAC Bonds

Industrial and Commercial Bank of China Ltd. (ICBC), the largest state-owned lender in China, is planning to issue up to ¥40 billion (approximately $5.5 billion)[1] of total loss-absorbing capacity (TLAC) bonds as early as April 2024. This initiative marks the first such issuance by China's major state-owned banks.

Key Details:

Underwriters:
ICBC has partnered with Citic Securities Corp. and Haitong Securities Corp. for the bond sale.

Structure of the Issue:
The bank plans to issue ¥20 billion in TLAC bonds with a three-year redemption option and ¥10 billion in bonds with a five-year redemption option. Depending on market demand, an additional ¥10 billion could be issued.

Purpose:
The issuance is part of a broader strategy by Chinese big banks to boost capital in response to modest profit growth, shrinking net interest margins, and increasing bad loans in 2023. The capital raised will help these banks meet global regulatory standards.

Background:
China's top five state-owned banks plan to issue up to ¥440 billion in TLAC bonds. ICBC may issue up to ¥60 billion of these domestically, with the possibility of issuing more in June based on market conditions.

Investor Base:
Major investors expected for the Chinese TLAC debt include larger commercial banks, wealth-management companies, asset managers, and insurers.

Specific Concerns for China:

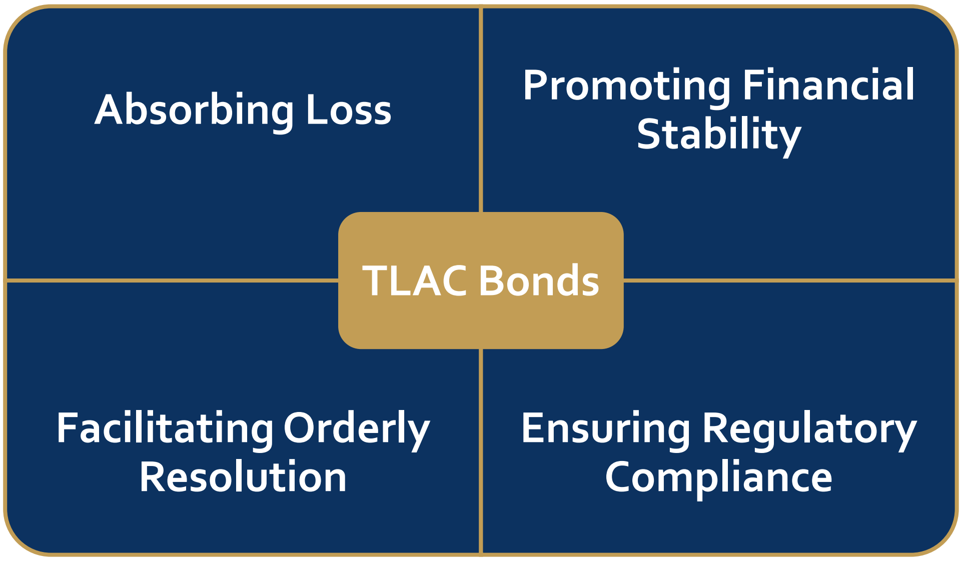
Regulatory and Implementation Risks:
The effectiveness of TLAC bonds in enhancing bank resiliency depends on the regulatory framework and the enforcement of these regulations. Any gaps in implementation could diminish the intended stability effects.

Economic Integration:
As Chinese banks continue to expand their operations globally, the integration of such regulatory measures needs to be smoothly handled to avoid market disruptions.

Domestic Economic Conditions:
The broader context of the Chinese economy, including state policies and the health of the real estate sector, significantly affects the banking sector's stability. A downturn could impact the banks' ability to manage additional capital requirements effectively.

[1] Bloomberg News, China's ICBC Plans $5.5 Billion Sale of Loss-Absorbing Bonds (April 2024)

Functions of TLAC Bonds



Loss Absorption:
TLAC is strategically crafted to boost the capability of banks, especially Global Systemically Important Banks (G-SIBs), to handle losses during periods of financial distress. It guarantees that these institutions have ample unsecured debt instruments and total loss-absorbing capital available to manage potential losses. Oversight of this crucial requirement is conducted by federal bank regulatory agencies, including the Federal Reserve Board and the Basel Committee on Banking Supervision.

Promoting Financial Stability:
TLAC (Total Loss-Absorbing Capacity) requirements enhance financial stability by setting minimum capital thresholds for banks, enabling them to absorb shocks and maintain adequate capital buffers. This reduces systemic risks and stabilizes the financial system, particularly in mitigating risks from too-big-to-fail and unconsolidated entities.

Facilitating Orderly Resolution:
In the event of a bank failure, TLAC is vital in supporting an orderly resolution process. It confirms that banks possess the necessary recapitalization capacity to sustain their critical operations and comply with the minimum TLAC standards. This capability is vital for a smooth and controlled resolution procedure, monitored by regulatory bodies and the Federal Reserve System.

Regulatory Compliance:
TLAC is a regulatory mandate enforced by the Federal Reserve and the Basel Committee on Banking Supervision, requiring banks to maintain specified capital levels. Non-compliance can severely impact a bank's operations and financial stability.

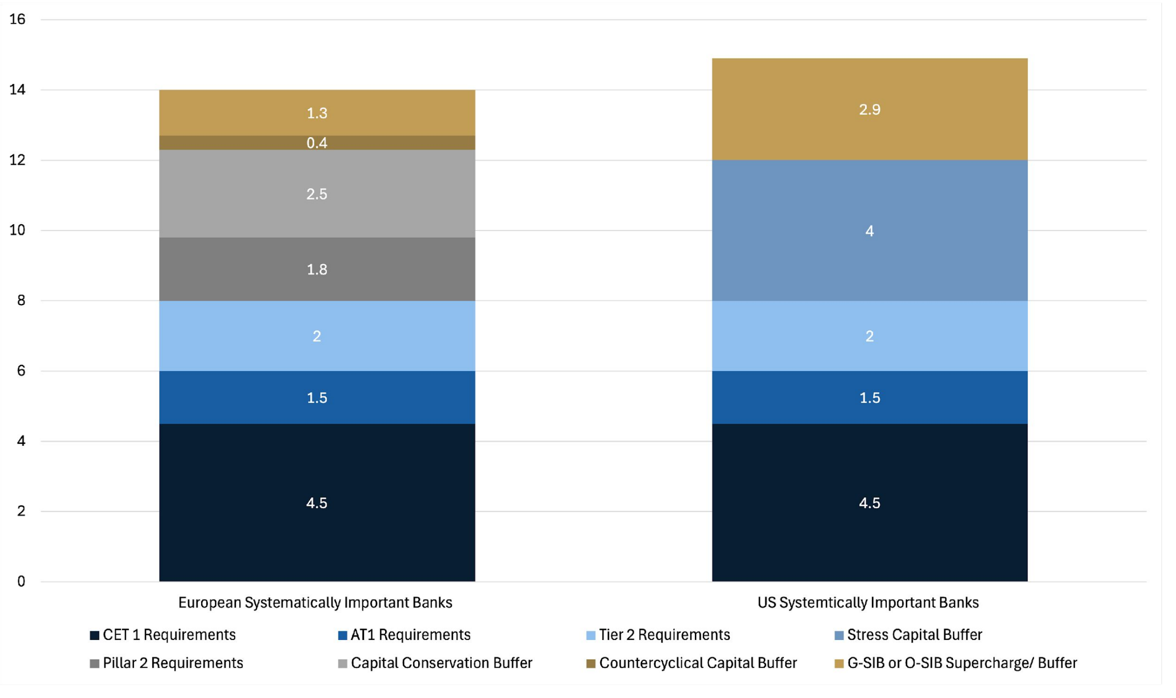
In May 2024, China's largest banks are issuing total-loss absorbing capacity (TLAC) bonds to meet global financial stability standards. Chinese banks, designated globally systemically important, must meet TLAC requirements equal to 16%[1] of risk-weighted assets by 2025. Industrial and Commercial Bank of China is launching ¥40bn[2] of TLAC bonds, while Bank of China is pricing ¥30bn[2].

[1] Fitch Ratings, Chinese G-SIBs to Pilot TLAC Issuance by Mid-2024 (April 2024)
[2] Financial Times, China's biggest banks launch first sales of special loss-absorbing debt (May 2024)

Comparison of overall risk-based capital requirements of EU and US SIBs

The capital requirements for US systemically important banks are marginally greater than for their European counterparts (14.9% compared to 14% of risk-weighted assets as of end-June 2023[1]). However, this slight variance is offset by a more substantial surcharge imposed by European regulations on resolution-related capital and debt.

(As a % of risk-weighted assets, at end-June 2023)



Components of the bank's capital structure

Covered Deposits:
These are the safest type of liabilities for a bank's creditors and depositors. Covered deposits are typically insured by a government insurance scheme, which means depositors are guaranteed to get their money back up to a certain limit, even if the bank fails. They are not subject to bail-in and carry the least credit risk.

Senior Debt Not Subject to Bail-in:
This type of debt is senior in the hierarchy of claims, meaning it is prioritized over other types of debt and equity in the event of a liquidation. However, it is not subject to bail-in rules, so holders of this debt are relatively protected compared to other creditors who hold bail-in eligible securities.

[1] Single Resolution Board (2023)

Bail-in Senior Debt:
This is a type of senior debt that can be subjected to bail-in. In a bail-in, creditors are forced to bear some of the losses by having their debt converted into equity or by taking a cut in the debt's principal amount. This helps stabilize the bank without needing taxpayer-funded bailouts.

Additional Tier 1 (AT1) and Tier 2 (AT2) Capital:
This type of capital can include instruments like contingent convertible bonds (CoCos). These are riskier than Tier 2 capital because they can be converted into equity or written down if the bank's capital falls below a certain level, which is predetermined by regulatory requirements.

Senior TLAC Bonds
Senior TLAC bonds, AT1, and Tier 2 debt differ notably in loss absorption criteria. AT1 bonds and Tier 2 debt are designed to convert into equity or be written off if certain financial thresholds are breached. In contrast, Senior TLAC bonds lack such provisions and are only at risk in severe financial crises after other capital defences fail. AT1s are perpetual and can defer coupon payments without penalty, whereas senior TLAC and Tier 2 bonds have fixed maturities and cannot skip coupon payments. Senior TLAC bonds also need at least one year of residual maturity to qualify as TLAC-eligible.

Common Equity:
This is the most basic form of bank capital and represents ownership in the bank. Common equity holders have the last claim on assets in the event of liquidation and thus bear the highest risk. However, they also stand to gain the most if the bank performs well, as they benefit from dividends and capital gains.

Factors to consider when investing in senior TLACs

Risk and Return Profile:
Senior TLAC bonds are positioned lower in the capital structure compared to traditional senior bonds and hence offer higher yields. This positioning makes them a more secure investment compared to AT1 and subordinated Tier 2 bonds. Investors need to assess whether the higher yield adequately compensates for the increased risk associated with these bonds.

Resolution Risks:
The resolution risk of TLAC bonds arises from the uncertainty surrounding their treatment during financial crises, as highlighted in the context of Credit Suisse.

> ***Inconsistency in Application***: Authorities asserted that TLAC bonds would absorb losses to prevent government bailouts. However, in the Credit Suisse situation, they chose alternative measures such as mergers & acquisitions (M&A) rather than effectively utilizing TLAC. Furthermore, senior TLAC bonds were unaffected while AT1 bonds were written off, undermining the reliability of TLAC bonds as a crisis safety net.
>
> ***Fear of Systemic Crisis:*** The reluctance to impose losses on bail-in debt holders arose from concerns that it could trigger a systemic crisis. This suggests that, despite the theoretical framework of TLAC, authorities may hesitate to apply it if they fear significant risks to financial stability.

The uncertainty regarding when and how TLAC bonds will be utilized in a crisis poses a resolution risk for investors. If authorities hesitate to apply TLAC principles, the expected higher returns on these bonds may not compensate for the potential risks of non-implementation during actual crises.

Macroeconomic and Bank-Specific Factors:
The performance of senior TLAC bonds can be significantly influenced by the macroeconomic environment. If the economy deteriorates, even well-capitalized banks may face financial distress, which could impact the stability of these bonds.

To ensure that the banks have sufficient capital to absorb any risk in case of insufficient liquidity, consider the following key factors:

- **Bank's CET1 Ratio**: This ratio is a critical measure of a bank's financial strength and its ability to withstand financial setbacks. (a bank's core capital, including common shares and retained earnings)
- **Capital Structure**: Understanding the hierarchy in the bank's capital structure is crucial to assess the risk associated with senior TLAC bonds.
- **Quality of Loan Books**: The health of the bank's loan portfolio can indicate potential future losses, influencing the bank's overall stability.

Callable Features and Implications:
Many senior TLAC bonds are callable, which means the issuing bank may choose to redeem them before maturity. Consider the following:

- **Non-Call Risks**: Especially in a high-interest-rate environment where it might be more economical for banks not to redeem these bonds.
- **Impact on Bond Pricing**: The possibility of a non-call can affect the bond's market price and its appeal as an investment.

Bank's Incentive to Call Bonds: As the Feds cut rates by 50 basis points[1], new bonds are likely issued with lower interest rates compared to older issuances. If the rate cuts do not signal an economic downturn, banks may choose to call existing higher-interest bonds to refinance their debt at these lower rates. This is financially advantageous for the bank as it reduces their cost of borrowing.

Call risk for Investors: For investors, the early redemption of TLAC bonds due to falling interest rates can be disadvantageous. If bonds are called, investors are forced to reinvest the returned capital at the current lower rates, which means they will earn less interest income than anticipated over the original term of the bond. This scenario can be particularly disappointing if the bonds were offering above-market yields when interest rates fall.

Market Trends and Historical Performance:
While non-call events have historically been infrequent, the current high-interest-rate environment could make them more common. Investors should analyze past market trends and how similar bonds have performed under various economic conditions to gauge potential future behaviors.

[1] Federal Reserve, Federal Reserve issues FOMC statement (September 2024)

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