CLIENT ALERT

Federal Reserve Proposes TLAC and LTD Rule for GSIBs and IHCs

Continuing Chair Janet Yellen's stated goal of "ending the market perception that any banking firm is 'too big to fail,'" the Federal Reserve Board ("Federal Reserve") proposed a new rule on October 30, 2015, intended to improve the resiliency and resolvability of "covered BHCs" and "covered IHCs." As proposed, covered BHCs would include U.S. entities identified as global systemically important bank holding companies ("GSIBs") under the Federal Reserve's risk-based GSIB Capital Surcharge rule and covered IHCs would include the U.S. intermediate holding companies ("IHCs") of global systemically important foreign banking organizations ("FBOs") with $50 billion or more in U.S. non-branch assets that must be formed under the Federal Reserve's Enhanced Prudential Standards rule.

In summary: Under the proposed rule, covered BHCs would be required to maintain outstanding minimum levels of eligible external total loss-absorbing capacity ("TLAC") comprised of tier 1 regulatory capital and plain-vanilla[1] unsecured long-term debt ("LTD") instruments, and a related buffer. This "external" TLAC requirement would apply to loss-absorbing instruments issued by a covered BHC to third-party investors, which would be used to pass losses from the covered BHC to its investors in the event of failure. This is in contrast to "internal" TLAC (i.e., intercompany debt), which could be used to transfer losses among legal entities within a banking organization (e.g., from the operating subsidiaries to the parent holding company). Eligible external LTD with a remaining maturity between one and two years would be subject to a 50 percent haircut, while eligible external LTD with a remaining maturity of less than one year would not count toward the external LTD requirement. Covered IHCs would be required to maintain outstanding minimum levels of eligible internal TLAC and LTD issued to their foreign parent company, and a related buffer.

The proposed rule would also impose a "clean holding company" limitation by restricting certain liabilities that covered BHCs and covered IHCs may have outstanding that could impede orderly resolution. These restricted liabilities would include short-term debt to third parties (including deposits), qualified financial contracts with third parties, liabilities subject to upstream guarantees from a covered BHC's subsidiaries, and certain guarantees of its subsidiaries' liabilities. In addition, the clean holding company proposal would (1) cap the value of a covered BHC's liabilities (other than those related to eligible external TLAC and LTD) that can be *pari passu* with, or junior to, its eligible external LTD at 5 percent of the value of its eligible external TLAC and (2) require covered BHCs to make certain public disclosures that their unsecured debt would be expected to absorb losses ahead of other liabilities, including those of its subsidiaries, in a failure scenario. It will be interesting to see how investors react to these disclosures confirming they will suffer losses ahead of other creditors of the covered BHC or its subsidiaries.

Lastly, the proposed rule would require state member banks, bank holding companies, and savings and loan holding companies subject to the Federal Reserve's capital rules to apply a regulatory capital deduction treatment to their investments in the unsecured debt issued by covered BHCs.

Increased stringency for covered BHCs: Although more stringent than the Financial Stability Board's ("FSB's") final international external TLAC standard for FSB-designated global systemically important banks ("G-SIBs") issued on November 9, 2015,[2] the proposed rulemaking is nevertheless generally consistent with Federal Reserve Governor Daniel

[1] Under the proposal, "plain-vanilla" debt would exclude structured notes and most instruments that contain derivative-linked features.
[2] Under the FSB's standard, G-SIBs not headquartered in an emerging market economy will be required to meet a minimum TLAC of at least 16 percent of the resolution group's risk-weighted assets beginning January 1, 2019, and at least 18 percent beginning January

Tarullo's comments earlier this year that U.S. TLAC would likely be more heavily weighted toward including debt instruments that can be converted to equity at resolution. However, the eligible external LTD requirements are more punitive than some were expecting and are likely linked to the Federal Reserve's ongoing efforts encouraging GSIBs to place less reliance on short-term wholesale funding. At a minimum, a covered BHC would be required to hold: (1) an eligible external LTD amount that is not less than the greater of 6 percent plus its GSIB Capital Surcharge of total risk-weighted assets ("RWAs") percentage and 4.5 percent of its total leverage exposure; and (2) an eligible external TLAC amount that is not less than the greater of 18 percent of the covered BHC's total RWAs and 9.5 percent of its total leverage exposure. An external TLAC buffer that is similar to the capital conservation buffer in the Federal Reserve's Regulation Q would apply in addition to the RWAs component of the external TLAC requirement. While the different elements of the calculation may be a bit unwieldy, the RWAs component of the external LTD requirement will likely be a binding constraint for some covered BHCs and the supplementary leverage exposure component will likely impact others.

Increased host regulation for covered IHCs: All covered IHCs would be required to hold an internal LTD amount that is not less than the greater of 7 percent of its RWAs, 3 percent of its total leverage exposure (for covered IHCs subject to the supplementary leverage ratio), and 4 percent of its average total consolidated assets. The outstanding amount of eligible internal TLAC that a covered IHC would be required to maintain would depend on whether the entity (or any of its subsidiaries) is expected to go into resolution in a failure scenario, as opposed to being maintained as a going concern while its foreign parent company is instead resolved. These instruments would be required to be issued internally within the FBO, from the covered IHC to the foreign parent. Covered IHCs that are not expected to enter resolution themselves would be required to hold an internal TLAC amount that is not less than the greater of 16 percent of its total RWAs, 6 percent of its applicable total leverage exposure, and 8 percent of its average total consolidated assets. Covered IHCs that are expected to enter resolution themselves would be required to maintain an internal TLAC amount that is not less than the greater of 18 percent of its total RWAs, 6.75 percent of its applicable total leverage exposure, and 9 percent of its average total consolidated assets. For all covered IHCs, an internal TLAC buffer similar to the Regulation Q capital conservation buffer would apply in addition to the RWAs component of the internal TLAC requirement.

Capital, liquidity, and resolution planning implications: The proposed TLAC rule is the latest—but certainly not the last—measure in the post-crisis regulatory response aimed at connecting capital and liquidity management with resiliency in order to reduce systemic risk. Other examples of this include the Basel III capital and liquidity minimum standards, namely the Net Stable Funding Ratio ("NSFR") and the GSIB Capital Surcharge, as both are meant to improve financial stability by discouraging short-term wholesale funding. The Federal Reserve may also consider further regulatory actions to ensure the adequacy of "internal bail-in" mechanisms so that operating subsidiaries can pass losses up to their parent holding company and the holding company can recapitalize its subsidiaries. Covered BHCs and covered IHCs will need to carefully consider ties between capital, liquidity, and resolvability in areas such as enterprise-wide governance, risk identification processes, related stress-testing scenarios, and interrelated contingency planning efforts in order to determine how best to leverage investments in systems and data that can be used to support these efforts.

Impact on funding and credit availability: The Federal Reserve estimates that covered BHCs' overall aggregate shortfall from the external TLAC and LTD requirements would be approximately $120 billion, or 1.7 percent of aggregate RWAs. This estimate is less than the sum of the separate aggregate shortfalls for external TLAC and LTD, because eligible external LTD would also count toward the external TLAC requirement. To make up this shortfall, the Federal Reserve further estimates covered BHCs may need to consider issuing $55 billion in likely more expensive eligible

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1, 2022. This minimum TLAC must be at least 6 percent of the Basel III leverage ratio denominator beginning January 1, 2019, and at least 6.75 percent beginning January 1, 2022.

external LTD in place of existing deposit funding and other lower-cost liabilities and issuing another $65 billion in place of long-term bonds (although this analysis assumes that covered BHCs would not replace their outstanding structured notes with eligible external LTD). The 50 percent haircut on eligible external LTD between one and two years to maturity may also be very challenging for treasury management, as this is more stringent than the FSB's standard of at least one year to maturity for TLAC-eligible instruments. Lastly, the Federal Reserve approximates that covered BHCs would likely employ an increased lending rate of 1.3 to 3.1 basis points as a result of the external TLAC and LTD requirements. In an effort to minimize the impact of these standards on credit availability and credit costs in the U.S. economy, most of the proposal's requirements would be effective January 1, 2019, with certain elements phasing in by January 1, 2022.

Comments on the proposal are due to the Federal Reserve by February 1, 2016.

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