COVINGTON

Questions and Answers: Federal Reserve Proposes Requirements for Long-Term Debt, Total Loss Absorbing Capacity (TLAC), and "Clean" Holding Company

November 9, 2015

Financial Institutions

On October 30, 2015, the Board of Governors of the Federal Reserve System (the "Board") released proposed rules intended to enhance the resiliency and resolvability of U.S. global systemically important banking organizations ("U.S. G-SIBs") and their top-tier holding companies ("Covered BHCs") and the top-tier U.S. intermediate holding companies of foreign G-SIBs ("Covered IHCs"). The Board's proposal is intended to be broadly consistent with the final international TLAC standard released by the Financial Stability Board on November 9, 2015, but is different (and more stringent) in some respects.

For U.S. G-SIBs, the core of the Board's proposal is to: require a Covered BHC to hold a substantial amount of "plain vanilla" unsecured long-term debt issued to unaffiliated third party investors ("external LTD"); prohibit it from entering into derivatives contracts with third parties; eliminate its issuance of short-term debt; and substantially curtail its issuance of other types of liabilities. The intended results are:

- To have a "clean" holding company where the right side of its balance sheet is comprised almost entirely of equity and external LTD that cannot "run" —so-called Total Loss Absorbing Capacity or "TLAC";
- To "structurally subordinate" such TLAC of the holding company to all "runnable" short-term debt issued by the G-SIB's operating subsidiaries, whether in the form of deposits, commercial paper, repurchase agreements, or other short-term obligations;
- In the event of the G-SIB's failure, to position the G-SIB's operating subsidiaries so that they can transfer all their losses to their holding company, with the losses being fully absorbed by the holding company's TLAC in order to fully recapitalize the subsidiaries and avoid any losses to the G-SIB's runnable short-term creditors; and
- To have a layer of unsecured long-term debt that is sufficiently large to be converted into the amount of equity required to reorganize the failed company as a new, adequately capitalized going concern.

Relatedly, the proposal would require a Covered IHC to issue to its foreign parent a substantial amount of unsecured long-term debt. This "internal LTD" must consist of instruments with specified features that, in the event of the Covered IHC's financial distress, would be used to

transfer all losses from the Covered IHC to the foreign parent so as to fully recapitalize the Covered IHC as a new, adequately capitalized going concern. Covered IHCs would also be subject to a "clean" holding company requirement.

These requirements would begin taking effect in approximately three years, on January 1, 2019, and would be fully phased in three years thereafter, on January 1, 2022. Comments are due on the proposal by February 1, 2016.

Set forth below are questions and answers intended to clarify key details of the proposal.

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1. How Does the Long-term Debt Requirement Generally Work for Covered BHCs?

A Covered BHC would be required to issue to third-party investors a minimum amount of long-term debt (“external LTD”), consisting of instruments with specified features that would absorb losses in order to recapitalize the Covered BHC in the event of its insolvency or resolution. A Covered BHC’s binding external LTD requirement would be the higher of two measures: one calculated as a percentage of risk-weighted assets (“RWAs”), and one calculated as a percentage of “total leverage exposure” (the denominator used in the calculation of the Supplementary Leverage Ratio (“SLR”)).

2. How Does the Long-term Debt Requirement Generally Work for Covered IHCs?

A Covered IHC would be required to issue to a foreign parent a minimum amount of long-term debt (“internal LTD”), consisting of instruments with specified features that would be used to transfer losses from the Covered IHC to the foreign parent and thereby recapitalize the Covered IHC in the event of its distress. A Covered IHC’s binding internal LTD requirement would be the highest of three measures: one calculated as a percentage of RWAs; one calculated as a percentage of total leverage exposure (if the Covered IHC is subject to the SLR); and one calculated as a percentage of average total consolidated assets.

3. How Do the TLAC Requirements Generally Work for Covered BHCs and Covered IHCs?

A Covered BHC would be required to issue a minimum amount of total-loss absorbing capacity (“external TLAC”), generally consisting of tier 1 capital issued directly by the Covered BHC plus external LTD. A Covered IHC would be required to issue a minimum amount of total-loss absorbing capacity to a foreign parent (“internal TLAC”) generally consisting of tier 1 capital issued directly by the Covered IHC to a foreign parent plus internal LTD. If a Covered BHC or IHC satisfied its regulatory capital requirements, including applicable buffers, it would be permitted to meet all of its remaining TLAC requirement with external or internal LTD, respectively. Because debt is usually a less expensive source of funding than equity, Covered BHCs and IHCs are likely to find it more attractive to satisfy their TLAC requirements solely by issuing external or internal LTD, respectively.

4. In General, What Is the Overlap Between the Long-term Debt Requirements and the TLAC Requirements?

As a practical matter, they substantially overlap, with each producing a different required amount of the same type of unsecured long-term debt. The external LTD requirement for Covered BHCs and the internal LTD requirement for Covered IHCs are relatively straightforward: as described above, they each specify a required ratio of long-term debt to assets and exposures. In contrast, the TLAC requirements are less straightforward, “back door” methods for establishing a different minimum amount of the same type of long-term debt. As a result, the TLAC requirements may or may not require a particular Covered BHC or Covered IHC to hold more long-term debt than the straightforward requirements for minimum external LTD and minimum internal LTD.

5. What Levels of External LTD and External TLAC Would a Covered BHC Be Required to Maintain?

A Covered BHC would be required to maintain minimum levels of external LTD and external TLAC as depicted in the following chart. The external LTD and external TLAC requirements would each be calculated under the more stringent of two methods that use two different

denominators: the Covered BHC's RWAs and the Covered BHC's total leverage exposure. The RWA measure would include a minimum requirement plus a "buffer" that, if not fully satisfied, would subject the Covered BHC to restrictions on capital distributions and discretionary bonus payments similar to the capital conservation buffer in existing regulatory capital requirements.

Requirements Applicable to Covered BHCs After Conformance Period (Beginning January 1, 2022)	
External LTD Requirement	**External TLAC Requirement**
Greater of: ▪ 6% of RWAs, plus G-SIB surcharge; or ▪ 4.5% of total leverage exposure	Greater of: ▪ 18% of RWAs,[1] plus a buffer of: ● 2.5% of RWAs; plus ● method 1 G-SIB surcharge; plus ● any countercyclical capital buffer; or ▪ 9.5% of total leverage exposure

RWAs: the greater of the Covered BHC's risk-weighted assets as calculated under the standardized approach and the advanced approaches.

Total leverage exposure: the denominator of the SLR.

G-SIB surcharge: the Covered BHC's binding capital surcharge under the Board's U.S. G-SIB surcharge rule.[2]

Method 1 G-SIB surcharge: the Covered BHC's G-SIB surcharge calculated under method 1 of the G-SIB surcharge rule, which is generally less than or equal to the Covered BHC's binding G-SIB surcharge.

Countercyclical capital buffer: any amount required to be held under the countercyclical capital buffer of the banking agencies' existing regulatory capital requirements, which is currently set to zero.[3]

[1] RWAs would be 16 percent as of January 1, 2019 and would increase to 18 percent as of January 1, 2022.

[2] *See* 12 C.F.R. Part 217, Subpart H.

[3] *See* 78 Fed. Reg. 62,018, 62,040 (October 11, 2013).

6. What Instruments Would Qualify as Eligible External LTD?

Eligible external LTD would be debt issued directly by the Covered BHC that is unsecured, "plain vanilla," has a minimum remaining maturity, and is governed by U.S. law.

Eligible external LTD would not be permitted to be guaranteed by the Covered BHC or a subsidiary of the Covered BHC, or to be subject to any other arrangement that legally or economically enhances the seniority of the instrument.[4]

"Plain vanilla" means that the instrument could not:

- be a structured note;
- have a credit-sensitive feature (such as an interest rate that is reset periodically based on the Covered BHC's credit quality);[5]
- include a contractual provision for conversion into or exchange for equity in the Covered BHC; or
- provide its holder a contractual right to accelerate payment (including automatic acceleration), other than a right that is exercisable: on one or more dates specified in the instrument, in the event of the insolvency of the Covered BHC, or on the Covered BHC's failure to make a payment on the instrument when due.

A "structured note" would be defined as a debt instrument that: (a) has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of any asset, entity, index, or embedded derivative or similar embedded feature; (b) has an embedded derivative or similar embedded feature that is linked to one or more equity securities, commodities, assets, or entities; (c) does not specify a minimum principal amount due upon acceleration or early termination; or (d) is not classified as debt under U.S. Generally Accepted Accounting Principles. However, non-dollar denominated instruments or instruments whose interest payments are linked to an interest rate index could qualify as eligible external LTD.

Notably, questions have been raised about whether Covered BHCs' ***existing*** senior debt indentures contain acceleration clauses that would disqualify them as eligible external LTD. This could also create issues for a Covered BHC issuing ***new*** *pari passu* senior debt—without such acceleration clauses—that is intended to qualify as eligible external LTD. Existing debt that does not qualify as eligible external LTD, but is *pari passu* with debt that does qualify as eligible external LTD, would be subject to a cap under the "clean" holding company requirements discussed below in question 11.

Acceleration clauses permitted under the proposed rules would, however, be broader than the acceleration clauses permitted in a tier 2 capital instrument under the Board's regulatory capital

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[4] The Board requested comments on whether an *affiliate* of the Covered BHC could guarantee eligible external LTD.

[5] The instrument would be permitted to have an interest rate that is adjusted periodically independent of the Covered BHC's credit quality, in relation to general market interest rates or similar adjustments, such as a floating rate note tied to LIBOR.

rules. Unlike a tier 2 capital instrument, eligible external LTD may allow the holder to accelerate the instrument in the event of a payment default.

Debt would need to have a remaining maturity of more than two years to be counted fully toward the external LTD requirement. Debt with a remaining maturity of between one and two years would be subject to a 50 percent haircut for purposes of the external LTD requirement. Debt with a remaining maturity of less than one year would no longer count toward the external LTD requirement. Debt with a put right—that is, debt allowing the holder to require a redemption of the debt on demand prior to its stated maturity—would be treated as if it would mature on the day it first became subject to the put right.

The proposal would not require eligible external LTD to be contractually subordinated to general creditors of the Covered BHC, but the Board requested comments on whether to include such a requirement in the final rule.[6]

7. Would the Proposed Rules Grandfather Existing Instruments?

No. The Board requested comments on whether a grandfather provision is necessary or appropriate, but did not propose grandfathering existing debt instruments or liabilities for purposes of the LTD, TLAC, or clean holding company requirements.

8. Would the External TLAC Buffer Require a Covered BHC to Issue More Common Equity Tier 1 Capital Than Necessary to Meet the Existing Capital Conservation Buffer?

No. While the external TLAC buffer would be required to be satisfied solely with common equity tier 1 capital, a Covered BHC may use the same common equity tier 1 capital that it uses to meet existing minimum capital requirements and the existing capital conservation buffer to meet the external TLAC buffer. Any Covered BHC that meets existing capital requirements and the existing capital conservation buffer would not need to increase its common equity tier 1 capital to meet the external TLAC buffer.

9. Would a Covered BHC Be Required to Issue New Equity to Meet the External TLAC Requirement?

No. Eligible external TLAC would include eligible external LTD and tier 1 capital issued directly by the Covered BHC.[7] External LTD with a remaining maturity between one year and two years would count in full toward the external TLAC requirement, and would no longer count once its remaining maturity fell below one year.

As noted above, if a Covered BHC satisfied its regulatory capital requirements, including applicable buffers, it would be permitted to meet all of its remaining TLAC requirement with external LTD. Because debt is usually a less expensive source of funding than equity, Covered BHCs are likely to find it more attractive to satisfy their external TLAC requirements solely by issuing external LTD.

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[6] The proposal would, however, cap the amount of a Covered BHC's external vendor and operating liabilities, as discussed in question 11 below.

[7] The Board requested comments on whether tier 2 capital should qualify as eligible external TLAC.

10. What Types of Excluded Liabilities Would the Clean Holding Company Requirements Forbid a Covered BHC From Issuing Directly?

The proposal includes requirements to implement a so-called "clean" holding company by limiting the nature and amount of non-external LTD liabilities a Covered BHC could issue directly. The first set of clean holding company requirements would prohibit a Covered BHC from having the following types of liabilities outstanding:

- Third party debt instruments with an original maturity of less than one year, including any debt instrument that would create an obligation or option to repay the holder within one year of issuance;
- Qualified financial contracts,[8] including derivatives, with a third party;[9]
- Guarantees of a subsidiary's liabilities if the Covered BHC's insolvency or resolution would create default rights for a counterparty of the subsidiary; and
- Liabilities that are guaranteed by a subsidiary of the Covered BHC or would allow a third party to offset its debt to a subsidiary of the Covered BHC upon the Covered BHC's default on an obligation owed to the third party.

These provisions would effectively require a Covered BHC to "push down" any excluded liabilities into subsidiaries of the Covered BHC, with the effect that external TLAC would be structurally subordinated to such liabilities.

11. What Types of Non-external LTD Liabilities Would the Clean Holding Company Requirements Cap if Issued by the Covered BHC Directly?

The second set of clean holding company requirements would cap the amount of third party non-contingent liabilities that are not external LTD, are not otherwise prohibited for the holding company to hold, and are *pari passu* with or junior to eligible external LTD. The value of such capped liabilities would be limited to 5 percent of the value of the Covered BHC's total eligible external TLAC. Examples of capped liabilities include structured notes, vendor liabilities, and obligations to employees. The cap would not apply to eligible external TLAC, instruments that were eligible external TLAC when issued but have a remaining maturity of less than one year (as long as the holder does not have a currently exercisable put right), payables that are associated with such liabilities, and secured debt (to the extent it is secured).

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[8] Qualified financial contracts would be defined as in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which defines qualified financial contracts to include securities contracts, commodities contracts, forward contracts, repurchase agreements, and swap agreements. The Board requested comments on whether the prohibition on third party qualified financial contracts should include an exception for derivatives contracts that are intended to hedge the exposures of the covered holding company, and whether the final rule should grandfather pre-existing long-dated qualified financial contracts.

[9] A Covered BHC could enter into qualified financial contracts with its subsidiaries.

12. How Would the Proposal Affect the Regulatory Capital Treatment of Other Banking Organizations' Holdings of Covered BHC Debt?

The proposal would require ***any*** Board-regulated institution subject to regulatory capital requirements to make deductions from its capital for certain investments in the unsecured debt issued by a Covered BHC. Importantly, the deductions would apply to ***all*** types of unsecured debt issued by a Covered BHC, not just external LTD, and would only apply to debt issued by the Covered BHC directly, not by its subsidiaries. In addition, the deductions would not apply to underwriting positions held for five or fewer business days.[10] The Board requested comments on whether dealing and market-making positions should also be exempt from the proposed deductions.

The deductions would work similarly to the complex deductions for holding tier 2 capital of unconsolidated financial institutions under existing regulatory capital rules. For example, if the Board-regulated institution has a "non-significant investment" in the Covered BHC, i.e., 10 percent or less of the Covered IHC's outstanding common stock, and the aggregate amount of the Board-regulated institution's non-significant investments in the capital of unconsolidated financial institutions *and* the unsecured debt of Covered BHCs exceeds 10 percent of the Board-regulated institution's common equity tier 1 capital, the amount above 10 percent of the Board-regulated institution's common equity tier 1 capital would be deducted using the "corresponding deduction approach." In the case of unsecured debt issued by a Covered BHC, the Board-regulated institution would make the deduction first from tier 2 capital, and if it had insufficient tier 2 capital to make the full deduction, it would make the remaining deduction from additional tier 1 capital and then common equity tier 1 capital.

While the proposal would only require deductions from the capital of Board-regulated institutions, including state member banks, bank holding companies, and savings and loan holding companies that are subject to the Board's capital requirements, the Board stated in the preamble to the proposed rules that it intends to consult with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation ("FDIC") regarding consistent treatment for all banking organizations subject to the agencies' regulatory capital rules.

13. What Foreign Banking Organizations Would Be Subject to the Internal LTD, Internal TLAC, and Clean Holding Company Requirements in the United States?

The internal LTD, internal TLAC, and clean holding company requirements would apply to the top-tier U.S. bank holding company of a foreign banking organization[11]—the IHC—if:

- the foreign banking organization would be a G-SIB based on methodology established by the Basel Committee on Banking Supervision;

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[10] The proposal would also include relief for "failed underwritings" with prior approval by the Board, though the proposal does not explain how prior approval could be sought and obtained given that failed underwritings occur without warning.

[11] Under existing Board rules, any foreign banking organization with $50 billion or more in U.S. non-branch assets is required to establish a U.S. top-tier intermediate holding company to own all U.S. bank and nonbank subsidiaries, with limited exclusions. *See* 12 C.F.R. § 252.153.

- the foreign banking organization would be a G-SIB if it were subject to the Board's G-SIB surcharge rule; or
- the IHC itself would be a G-SIB based on the Board's G-SIB surcharge rule.[12]

14. What Levels of Internal LTD and Internal TLAC Would a Covered IHC Be Required to Maintain?

Similar to the external LTD and external TLAC requirements applicable to Covered BHCs, the internal LTD and internal TLAC requirements for Covered IHCs would each be calculated under the most stringent of three methods: (1) based on the Covered IHC's RWAs; (2) based on its total leverage exposure (if it is subject to the SLR); or (3) based on its average total consolidated assets. The RWA measure would include a minimum requirement plus a "buffer" that, if not fully satisfied, would subject the Covered IHC to restrictions on capital distributions and discretionary bonus payments.

The level of required internal TLAC would vary depending on whether the Covered IHC is itself expected to enter resolution in the event of the failure of its foreign parent.[13]

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[12] The Board would make a determination of whether a foreign banking organization is a G-SIB using information reported by the foreign banking organization or its U.S. subsidiaries, information that is publically available, and confidential supervisory information.

[13] A Covered IHC would be a non-resolution entity if the home country resolution authority for the foreign banking organization has certified to the Board that its planned resolution strategy for the foreign banking organization does not involve the Covered IHC or its subsidiaries entering a resolution or bankruptcy proceeding in the United States.

<table>
<tr><th colspan="2">Requirements Applicable to Covered IHCs After Conformance Period
(Beginning January 1, 2022)</th></tr>
<tr><th>Internal LTD Requirement</th><th>Internal TLAC Requirement</th></tr>
<tr><td rowspan="2">Greatest of:
▪ 7% of RWAs;
▪ 3% of total leverage exposure (if subject to SLR); or
▪ 4% of average total consolidated assets</td><td>Covered IHC <u>not</u> expected to enter resolution in event of parent failure

Greatest of:
▪ 16% of RWAs,[14] plus a buffer of:
• 2.5% of RWAs; plus
• any countercyclical capital buffer;
▪ 6% of total leverage exposure (if subject to SLR); or
▪ 8% of average total consolidated assets</td></tr>
<tr><td>Covered IHC <u>expected</u> to enter resolution in event of parent failure

Greatest of:
▪ 18% of RWAs,[15] plus a buffer of:
• 2.5% of RWAs; plus
• any countercyclical capital buffer;
▪ 6.75% of total leverage exposure (if subject to SLR); or
▪ 9% of average total consolidated assets</td></tr>
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RWAs: the Covered IHC’s risk-weighted assets as calculated under the standardized approach.

Total leverage exposure: the denominator of the SLR.

Average total consolidated assets: the denominator of the generally applicable leverage ratio.

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[14] RWAs would be 14 percent as of January 1, 2019 and would increase to 16 percent as of January 1, 2022.

[15] RWAs would be 16 percent as of January 1, 2019 and would increase to 18 percent as of January 1, 2022.

15. What Instruments Would Qualify as Eligible Internal LTD?

Eligible internal LTD would be required to satisfy the same basic requirements as eligible external LTD, as described above in question 6, but would also need to meet four additional requirements.

First, eligible internal LTD would be required to be contractually subordinated to all third party liabilities of the Covered IHC, with the exception of liabilities that are related to eligible internal TLAC, including: instruments that were eligible internal TLAC when issued but have a remaining maturity of less than one year; instruments that have been subject to a put right or could become subject to a put right within one year; and payables that are associated with such liabilities.

Second, eligible internal LTD would be required to include a contractual trigger pursuant to which the Board could require the Covered IHC to cancel the internal LTD or convert or exchange it into common equity tier 1 capital if:

- the Board determines the Covered IHC is in default or in danger of default; and
- any of the following circumstances apply:
  - the top-tier foreign banking organization or any subsidiary outside the U.S. is placed into resolution proceedings;
  - the home country supervisory authority consents to the cancellation, exchange or conversion, or does not object following 48 hours' prior notice from the Board; or
  - the Board has made a written recommendation to the Secretary of the Treasury that the FDIC should be appointed as receiver of the Covered IHC under Title II of the Dodd-Frank Act.

The contractual conversion provision would be required to be approved by the Board, though the proposal does not specify the procedures for seeking Board review.

Third, eligible internal LTD could not include *any* acceleration clause.

Finally, eligible internal LTD would need to be issued to a foreign parent entity that controls the Covered IHC.[16]

16. What Clean Holding Company Requirements Would Apply to a Covered IHC?

The same prohibition on excluded liabilities that would apply to a Covered BHC would also apply to a Covered IHC, except that certain restrictions would apply with respect to affiliates instead of subsidiaries.[17] Because eligible internal TLAC would be required to be contractually subordinated to all of the Covered IHC's third party liabilities, a 5 percent cap on third party *pari passu* and junior debt would be unnecessary for Covered IHCs and was not proposed.

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[16] In addition, eligible internal LTD, unlike eligible external LTD, would be permitted to have a credit-sensitive feature.

[17] A Covered IHC could not guarantee an *affiliate*'s liabilities if the Covered IHC's insolvency or resolution would create default rights for a counterparty of the affiliate. A Covered IHC would be permitted to enter into qualified financial contracts with an *affiliate*.

17. May a Covered IHC Issue Debt and Equity to Third Parties?

The proposal appears to permit Covered IHCs to issue debt and equity to third parties. Eligible internal LTD would be required to be contractually subordinated to any third party debt. In addition, the clean holding company requirements would prohibit third party debt from being in the form of an excluded liability. Third party debt and equity also would not count toward the internal LTD and internal TLAC requirements.

18. Would Other Banking Organizations Be Required to Deduct Their Holdings of Covered IHC Debt From Their Capital?

No. Unlike Covered BHC debt, Covered IHC debt would not be deducted from the capital of a Board-regulated institution that holds such debt.

19. Is the Board Considering Proposing Requirements for U.S. G-SIBs to Hold ***Domestic*** Internal TLAC?

Yes. The Board requested comments on whether the material domestic operating subsidiaries of Covered BHCs should be required to issue a form of internal TLAC to their parent companies in order to facilitate an "internal bail-in" and recapitalization of those subsidiaries. Covered BHCs might also be required to hold high-quality liquid assets that could be contributed to material domestic operating subsidiaries to prevent or mitigate their distress.

In addition, the Board's proposed imposition of internal LTD, internal TLAC, and clean holding company requirements on the top-tier U.S. bank holding companies of foreign G-SIBs strongly suggests that the Financial Stability Board and foreign national regulators might impose similar requirements on the foreign subsidiaries of U.S. G-SIBs.

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