ALERT MEMORANDUM

Agencies Issue Proposal to Deduct TLAC Holdings from Capital of "Advanced Approaches" Banking Organizations

April 17, 2019

On April 2, 2019, the Federal Reserve issued a joint proposal with the FDIC and OCC that would require "advanced approaches" banking organizations to deduct from regulatory capital certain investments in unsecured debt securities (whether or not they qualify as total loss-absorbing capacity) issued by U.S. and non-U.S. G-SIBs and their U.S. intermediate holding companies. The proposed deduction for these covered debt instruments would be implemented through the U.S. Basel III capital rules' existing deduction framework for certain investments in regulatory capital instruments.

The Proposal updates a never-finalized 2015 proposal by the Federal Reserve and generally is consistent with the Basel Committee's 2016 standard on TLAC Holdings. However, the Proposal includes two significant burden-reducing modifications to the original 2015 Federal Reserve proposal. First, consistent with revisions the Basel Committee adopted in its final standard in response to industry comments, the Proposal creates a new exclusion for limited amounts of covered debt instruments to enhance the liquidity of TLAC debt. Such excluded instruments could not exceed 5% of the investing banking organization's common equity tier 1 capital and may need to meet other conditions. Second, the Proposal would apply only to "advanced approaches" banking organizations, rather than to all banking organizations regulated by the Federal Reserve, as initially proposed in 2015.

This Alert Memorandum includes two parts:

- A high-level overview of the Proposal, including a decision tree on the following page illustrating the analysis necessary to determine whether deduction of covered debt instruments would be required, and
- "Key Takeaways," which address the Proposal's expected impact and its interplay with other regulatory initiatives.

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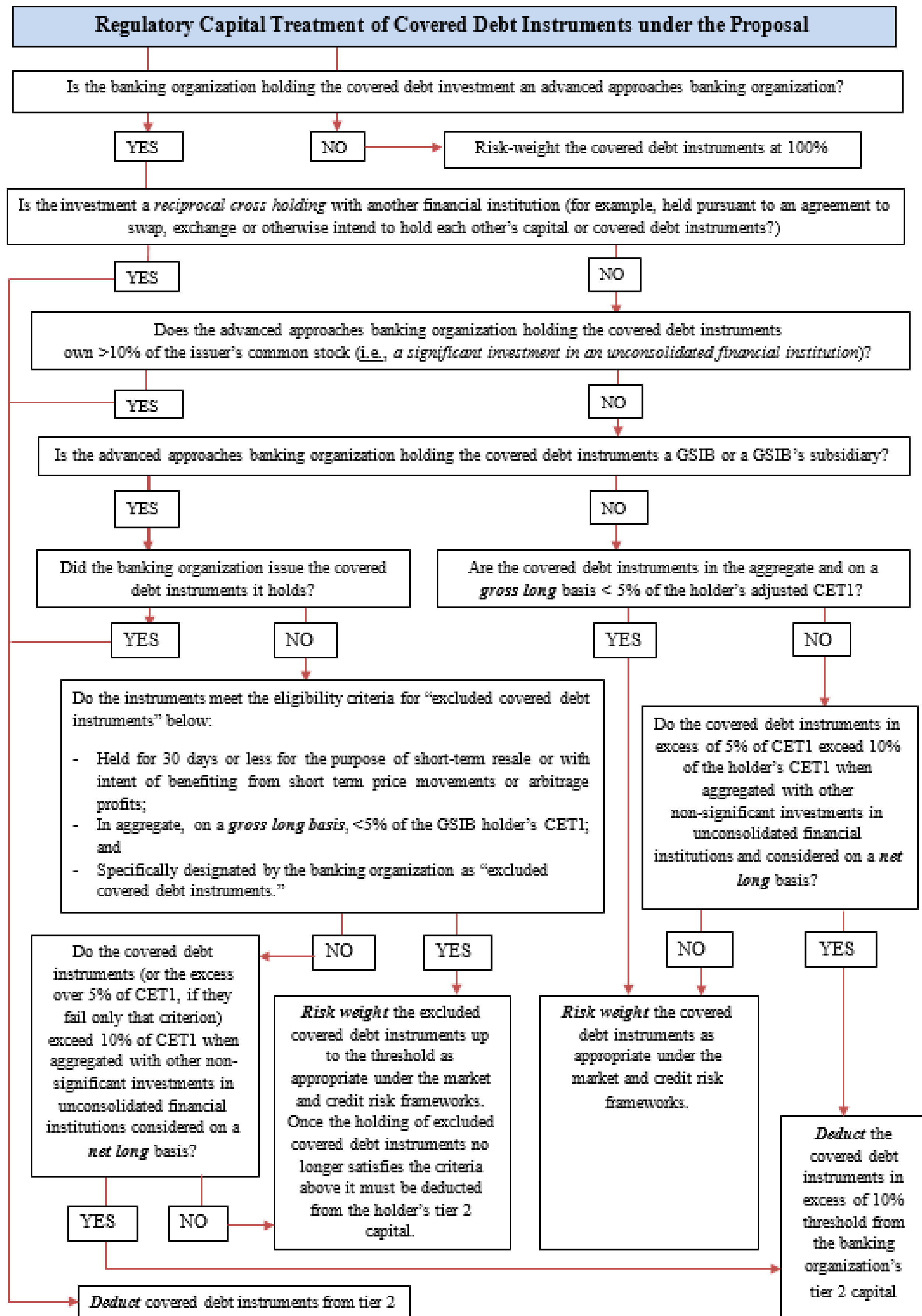
Regulatory Capital Treatment of Covered Debt Instruments under the Proposal
Is the banking organization holding the covered debt investment an advanced approaches banking organization?
YES
NO
Risk-weight the covered debt instruments at 100%
Is the investment a reciprocal cross holding with another financial institution (for example, held pursuant to an agreement to swap, exchange or otherwise intend to hold each other's capital or covered debt instruments?)
YES
NO
Does the advanced approaches banking organization holding the covered debt instruments own >10% of the issuer's common stock (i.e., a significant investment in an unconsolidated financial institution)?
YES
NO
Is the advanced approaches banking organization holding the covered debt instruments a GSIB or a GSIB's subsidiary?
YES
NO
Did the banking organization issue the covered debt instruments it holds?
Are the covered debt instruments in the aggregate and on a gross long basis < 5% of the holder's adjusted CET1?
YES
NO
YES
NO
Do the instruments meet the eligibility criteria for "excluded covered debt instruments" below:
- Held for 30 days or less for the purpose of short-term resale or with intent of benefiting from short term price movements or arbitrage profits;
- In aggregate, on a gross long basis, <5% of the GSIB holder's CET1; and
- Specifically designated by the banking organization as "excluded covered debt instruments."
Do the covered debt instruments in excess of 5% of CET1 exceed 10% of the holder's CET1 when aggregated with other non-significant investments in unconsolidated financial institutions and considered on a net long basis?
Do the covered debt instruments (or the excess over 5% of CET1, if they fail only that criterion) exceed 10% of CET1 when aggregated with other non-significant investments in unconsolidated financial institutions considered on a net long basis?
NO
YES
NO
YES
Risk weight the excluded covered debt instruments up to the threshold as appropriate under the market and credit risk frameworks. Once the holding of excluded covered debt instruments no longer satisfies the criteria above it must be deducted from the holder's tier 2 capital.
Risk weight the covered debt instruments as appropriate under the market and credit risk frameworks.
Deduct the covered debt instruments in excess of 10% threshold from the banking organization's tier 2 capital
YES
NO
Deduct covered debt instruments from tier 2

Overview of Proposal

I. Background

— Under regulations issued by the Board of Governors of the Federal Reserve System ("Federal Reserve") in late 2016, the top-tier bank holding companies ("BHCs") of U.S. global systemically important banking organizations ("G-SIBs") and the U.S. intermediate holding companies ("IHCs") of foreign banking organization ("FBO") G-SIBs (such IHCs, "covered IHCs") are required to maintain a minimum amount of total loss-absorbing capacity ("TLAC"), a requirement intended to enhance their resilience and resolvability under financial stress.

- The Federal Reserve's TLAC regulations ("TLAC Rule")[1] implement the TLAC Term Sheet[2] issued by the Financial Stability Board ("FSB") in November 2015.
- Under the TLAC Rule, TLAC consists of a minimum amount of unsecured long-term debt that meets certain eligibility requirements[3] ("LTD") and tier 1 capital (other than minority interests in consolidated subsidiaries). LTD need not be tier 2 capital, but if it separately satisfies the eligibility requirements for tier 2 capital, it may be included in the regulatory capital of a U.S. G-SIB or covered IHC.
- TLAC issued by foreign G-SIBs to satisfy the TLAC requirements of other jurisdictions may differ in certain respects.

— Section 15 of the FSB TLAC Term Sheet directed the Basel Committee to clarify the regulatory capital treatment of a banking organization's investment in TLAC instruments. Contemporaneous with the release of the FSB TLAC Term Sheet, the Basel Committee released a consultation paper that proposed a deduction treatment for TLAC holdings built upon the Basel III capital framework's existing provisions addressing deductions by banking organizations of certain holdings of regulatory capital instruments, including those issued by other banking organizations ("TLAC Holdings Consultation").[4]

— The Federal Reserve's 2015 notice of proposed rulemaking to adopt the TLAC requirements included a proposal requiring deduction of certain TLAC holdings that was broadly consistent with the TLAC Holdings Consultation.[5] However, the final TLAC Rule adopted by the Federal Reserve in December 2016 did not include the proposed deduction requirements. The Federal Reserve determined to address the regulatory capital treatment of such investments jointly with the Office of the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation ("FDIC" and, together with the OCC and the Federal Reserve, the "Agencies") and to allow the Agencies to consider the Basel Committee's final standard on TLAC holdings ("Basel TLAC Holdings Standard"), released in October 2016.[6]

- The Basel TLAC Holdings Standard addressed industry comments—most significantly comments requesting a modification to facilitate deep and liquid secondary markets for non-regulatory capital TLAC instruments—by introducing a limited exclusion from deduction

[1] 82 Fed. Reg. 8266 (Jan. 24, 2017).

[2] See Financial Stability Board, Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet (Nov. 9, 2015) ("FSB TLAC Term Sheet"), http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

[3] 12 CFR §§ 252.61 and 252.161 (definitions of "eligible debt security" and "eligible Covered IHC debt security," respectively).

[4] Basel Committee on Banking Supervision, Consultative Document – TLAC Holdings (Nov. 9, 2015), http://www.bis.org/bcbs/publ/d342.pdf.

[5] 80 Fed. Reg. 74926 (Nov. 30, 2015) ("2015 Proposal").

[6] Basel Committee on Banking Supervision, Standard – TLAC Holdings: Amendments to the Basel III Standard on the Definition of Capital (Oct. 12, 2016), http://www.bis.org/bcbs/publ/d387.pdf.

for holdings of such instruments in order to enhance their liquidity.

II. The Proposal[7]

— The Proposal generally would amend the Agencies' regulatory capital rules[8] to implement the Basel TLAC Holdings Standard for investments:

- by "advanced approaches" banking organizations
- in "covered debt instruments," which include both LTD and certain other unsecured debt obligations issued by U.S. G-SIBs, non-U.S. G-SIBs and covered IHCs.

— Currently, under the Capital Rules, non-regulatory capital covered debt instruments issued by U.S. G-SIBs, non-U.S. G-SIBs and covered IHCs generally are subject to a 100% risk weight under the standardized approach.

III. Applicability—"Advanced Approaches" Banking Organizations

— In contrast to the 2015 Proposal, the Proposal would apply only to advanced approaches banking organizations, a change aimed at reducing the Capital Rules' complexity for smaller banking organizations. However, the preamble indicates that the Agencies are considering ways to address the risks of investments in covered debt instruments by smaller, non-advanced approaches banking organizations.

— The pending interagency prudential standards tailoring proposals for U.S. BHCs ("Domestic Tailoring NPR") and FBOs and their IHCs ("FBO Tailoring NPR," and together with the Domestic Tailoring NPR, the "Tailoring NPRs") would narrow the scope of advanced approaches banking organizations to encompass only banking organizations subject to Category I or II standards (as described in the Tailoring NPRs).[9] The Agencies noted that commenters should consider the Proposal in conjunction with the Tailoring NPRs when submitting comments.

IV. Covered Debt Instruments

— The Proposal defines "covered debt instrument" broadly to include:

- eligible, non-tier 2 LTD issued by a U.S. G-SIB or covered IHC (or instruments that are *pari passu* with or subordinated to such LTD other than qualifying regulatory capital),[10] and
- unsecured debt issued by a non-U.S. G-SIB or any of its subsidiaries, other than a covered IHC, for "the purpose of absorbing losses or recapitalizing the issuer or any of its subsidiaries" in resolution (or debt instruments that are *pari passu* with or subordinated to such debt instruments, other than qualifying regulatory capital).

— The amount of covered debt instruments an advanced approaches banking organization would

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[7] 84 Fed. Reg. 13814 (Apr. 8, 2019).

[8] 12 C.F.R. Parts 3 (OCC), 217 (Federal Reserve) and 324 (FDIC) ("Capital Rules").

[9] Prudential Standards for Large Foreign Banking Organizations; Revisions to Proposed Prudential Standards for Large Domestic Bank Holding Companies and Savings and Loan Holding Companies (rel. Apr. 8, 2019), https://www.federalreserve.gov/aboutthefed/boardmeetings/files/foreign-bank-draft-fr-notice-1-20190408.pdf; Proposed Changes to Applicability Thresholds for Regulatory Capital Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations and Application of Liquidity Requirements to Foreign Banking Organizations, Certain U.S. Depository Institution Holding Companies, and Certain Depository Institution Subsidiaries (rel. Apr. 8, 2019), https://www.federalreserve.gov/aboutthefed/boardmeetings/files/foreign-bank-draft-fr-notice-2-20190408.pdf; Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 83 Fed. Reg. 66024 (Dec. 21, 2018); Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 83 Fed. Reg. 61408 (Nov. 29, 2018).

[10] Deduction of investments in regulatory capital instruments issued by another organization is already covered by the existing Capital Rules.

be required to deduct from its regulatory capital would be its net long position.

- Under the Capital Rules, a banking organization may net certain gross short positions in a particular capital instrument against a gross long position in that instrument to calculate its net long position.
- However, the proposed Liquidity Enhancement Exclusion from deduction, discussed further below, is based on the gross long position in covered debt instruments.

— Consistent with the treatment of investments in regulatory capital instruments under the Capital Rules, the amount of an advanced approaches banking organization's net long position in covered debt instruments would take into account:

- direct investments in covered debt instruments,
- synthetic exposures to a covered debt instrument, and
- indirect investments through an investment fund or index.

— Underwriting positions held for five or fewer business days would not be included as investments in covered debt instruments.

V. Mechanics of the Regulatory Capital Deduction

— ***Capital deduction for covered debt instruments.*** The Proposal would integrate covered debt instrument deductions into the existing framework for regulatory capital deductions under the Capital Rules. Capital deductions generally are required with respect to investments in capital instruments issued (i) by a banking organization itself or (ii) by an unconsolidated "financial institution," as defined in the Capital Rules. Investments in the capital of unconsolidated financial institutions are subject to certain limitations and deductions, calculated in accordance with the "corresponding deduction approach" (as described below).

— ***Deduction for investments in a banking organization's own covered debt instruments***

- Under the Proposal, G-SIB BHCs and covered IHCs would be required to deduct investments in their own covered debt instruments from their tier 2 capital or from the next higher (more subordinated) component of regulatory capital if they do not have sufficient tier 2 capital to give full effect to the required deduction.
- The Liquidity Enhancement Exclusion (described below) is not available for investments in a banking organization's own covered debt instruments.

— ***Deduction for reciprocal cross-holdings of unconsolidated financial institutions***

- "Reciprocal cross-holdings" may result from a formal or informal arrangement between two financial institutions to swap, exchange or otherwise hold each other's capital instruments.
- Consistent with the current treatment of reciprocal cross-holdings of capital instruments, under the Proposal, G-SIB BHCs and covered IHCs would be required to deduct any investment in covered debt instruments that they hold reciprocally with another financial institution from tier 2 capital using the corresponding deduction approach.
- The Liquidity Enhancement Exclusion is not available for reciprocal cross-holdings.

— ***Deduction for non-significant investments in unconsolidated financial institutions***

- Under the Capital Rules, a "non-significant investment in the capital of an unconsolidated financial institution" is an investment in any instrument issued by an unconsolidated financial institution in which the banking organization owns 10% or less of the issued and outstanding common stock ("non-significant investment"). A banking organization must aggregate its non-significant investments and apply the corresponding deduction approach to any

amount that exceeds 10% of the investing banking organization's common equity tier 1 ("CET1") capital.

- Non-significant investments that are under the 10% of CET1 capital threshold are risk-weighted as appropriate under the standardized and advanced approaches in the Capital Rules rather than being deducted from regulatory capital ("NSI Exclusion").
- Under the Proposal, an advanced approaches banking organization would be required to include any investment in covered debt instruments in the aggregate amount of its non-significant investments. As under the current Capital Rules, an advanced approaches banking organization would be required to apply the corresponding deduction approach to any such investments in covered debt instruments that, when aggregated with its other non-significant investments, exceed 10% of its CET1 capital.

- ***Liquidity Enhancement Exclusion.*** Consistent with the Basel TLAC Holdings Standard, to promote a liquid market in G-SIB non-regulatory capital TLAC instruments, the Proposal would permit an advanced approaches banking organization to exclude certain amounts of covered debt instruments from deduction (the "Liquidity Enhancement Exclusion").
- This exclusion would apply only if the investment in covered debt instruments is a non-significant investment in an unconsolidated financial institution. However, an investing banking organization would apply the Liquidity Enhancement Exclusion to its covered debt instruments before applying the NSI Exclusion.
- In addition, an investing banking organization that is a G-SIB or a subsidiary of a G-SIB (a "G-SIB Entity") must satisfy certain heightened requirements to take advantage of the Exclusion (as described below).
  - Under the Liquidity Enhancement Exclusion, an advanced approaches banking organization that is not a G-SIB or a subsidiary of a G-SIB must include in its aggregate non-significant investments only the amount of the gross long position of the investment in covered debt instruments that exceeds 5% of the CET1 capital of the investing banking organization.
  - An advanced approaches banking organization that is a G-SIB Entity would be required to comply with certain additional conditions to take advantage of the Liquidity Enhancement Exclusion:
    - The G-SIB Entity must specifically designate the instruments as "excluded covered debt instruments," and
    - Such "excluded covered debt instruments" must be held only "for 30 business days or less for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits."[11]
  - If an advanced approaches banking organization has investments in covered debt instruments that exceed the 5% of CET1 capital limitation (or do not meet the conditions above, in the case of a G-SIB Entity), such investments may still be eligible for the NSI Exclusion, as described above.

— ***Deduction for significant investments in unconsolidated financial institutions***

- Under the Capital Rules, a "significant investment in the capital of an unconsolidated financial institution" is an investment in which

[11] See Proposal, § __.2 (definition of "excluded covered debt instrument").

the banking organization owns more than 10% of the issued and outstanding common stock of the unconsolidated financial institution ("significant investment").[12]

- Under the Proposal, an advanced approaches banking organization would be required to deduct any investment in covered debt instruments issued by an unconsolidated financial institution in which the advanced approaches banking organization has a significant investment by applying the corresponding deduction approach.
- The Liquidity Enhancement Exclusion (described above) is not available for significant investments in unconsolidated financial institutions.

— ***Corresponding deduction approach***

- Under the "corresponding deduction approach" described in the Capital Rules, a banking organization must deduct investments from the same category of capital for which an instrument would qualify if it were issued by the banking organization itself. If a banking organization does not have enough of a particular capital component to make the full deduction required for that component, the banking organization must deduct the shortfall from the next, more subordinated form of capital (*e.g.*, the deduction must be taken from additional tier 1 capital if a banking organization has insufficient tier 2 capital).
- The Proposal would make investments in covered debt instruments by advanced approaches banking organizations subject to the corresponding deduction approach as tier 2 capital.

VI. Changes to Regulatory Reporting and Pillar III Disclosures

— As part of the Proposal, the Federal Reserve is proposing modifications to the instructions to the FR Y-9C (Consolidated Financial Statements for Holding Companies) to give effect to the regulatory capital deductions for advanced approaches banking organizations that are regulated by the Federal Reserve.

— The Agencies indicated that they will propose modifications to the FFIEC 031 (Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices), FFIEC 041 (Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only) and FFIEC 101 (Regulatory Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework) in a future interagency reporting proposal.

— In addition to modifications to the regulatory reporting forms affected by the Proposal, the Federal Reserve is proposing to modify portions of the FR Y-9C to add new public Pillar III disclosures regarding (i) the LTD and TLAC of reporting banking organizations, (ii) the LTD and TLAC ratios of such banking organizations and (iii) the TLAC buffers of such banking organizations. As part of these Pillar III disclosures, the Federal Reserve also is proposing amendments to the instructions for calculating eligible retained income, institution-specific capital buffers and distributions and discretionary bonus payments.

VII. Comment Period and Effective Date

— Comments on the Proposal are due by June 7, 2019.

— The Basel TLAC Holding Standard provides for the TLAC deduction requirement to take effect at the same time as the minimum TLAC requirements for G-SIBs under the FSB 2015 TLAC Standard (*i.e.,* January 1, 2019). The TLAC Rule's minimum

[12] A significant investment in common stock of the unconsolidated financial institution also is subject to separate limitations and deductions in combination with certain of its deferred tax assets and mortgage servicing assets. See 12 CFR § 217.22(d).

TLAC requirements came into effect in the United States as of January 1, 2019, but the Proposal may take at least through the end of 2019 to be finalized and become effective.

Key Takeaways

Below we highlight certain key takeaways from the Proposal.

— ***The covered debt instruments definition has been expanded significantly to include all TLAC-related instruments issued by FBO G-SIBs and their subsidiaries.*** In contrast to the 2015 Proposal, "covered debt instruments" would be defined broadly, but somewhat ambiguously, to capture any debt instrument issued by an FBO G-SIB or a subsidiary of a FBO G-SIB "that has the purpose of absorbing losses or recapitalizing the issuer or any of its subsidiaries in connection with a resolution, receivership, insolvency or similar proceeding" or that is *pari passu* with or subordinated to any such instrument. The Agencies appear to recognize the burden that would be associated with an investor's analysis necessary to determine if the debt securities issued by FBO G-SIBs and their subsidiaries would be "covered debt instruments" and request comment on alternative approaches that would capture the same set of instruments.

- The preamble notes the Agencies' expectation that the definition will capture "instruments that are pari passu [sic] to Excluded Liabilities if such instruments are recognized as external TLAC under home-country requirements as a matter of national discretion"[13] ("TLAC-Eligible Instruments"). As defined in the Basel TLAC Holdings Standard, "Excluded Liabilities" include deposits and other instruments to which TLAC-Eligible Instruments generally must be subordinated.[14] The Agencies expect all such TLAC-Eligible Instruments to be subject to a deduction from tier 2 capital (if the Liquidity Enhancement Exclusion and NSI Exclusion are not available).
- The Proposal's deduction requirement thus captures a broader group of unsecured debt instruments than the Basel TLAC Holdings Standard, which provides for a "proportionate deduction approach" for TLAC-Eligible Instruments rather than full deduction in all circumstances. Under the proportionate deduction approach, only a portion of holdings of TLAC-Eligible Instruments would be subject to potential deduction, depending on the amount of such liabilities that the issuing G-SIB uses to satisfy its TLAC requirements. The Agencies indicate in the Proposal's preamble that the proportionate deduction approach was not included in this U.S. Proposal because the Agencies believe it would increase the Capital Rules' complexity without producing a meaningful impact on the capital ratios of advanced approaches banking organizations.

— ***Certain other divergences from the Basel TLAC Holdings Standard move in the direction of greater conservatism.*** In contrast to the Basel TLAC Holdings Standard, under the Proposal, a G-SIB BHC's or covered IHC's holdings of its own covered debt instruments must be deducted from its tier 2 capital, rather than from its TLAC resources.[15]

— ***The Tailoring NPRs appear to have significantly narrowed the Proposal's applicability.*** The 2015 Proposal generally would have required all banking organizations that are subject to the Capital Rules to deduct their holdings of covered debt instruments (unless the instruments qualified for the NSI Exclusion). Because the Proposal would apply only to firms designated as Category I and II in the Tailoring NPRs (advanced approaches banking organizations), the proposed deduction for covered debt instruments would apply to a significantly smaller subset of banking organizations: the eight

13 Proposal, p. 13820.
14 Sections 10 and 11 of the FSB TLAC Term Sheet.
15 TLAC Holdings Standard, para. 78.

U.S. G-SIBs, Northern Trust and certain IHCs that may be designated as Category II firms. The designation of an IHC as a Category II firm will depend on whether the IHC has $75 billion or more in cross-jurisdictional activity, the definition of which is subject to potential modification under the Tailoring NPRs. However, the Federal Reserve has indicated that the IHCs of six FBOs may be within this range: Barclays, Credit Suisse, Deutsche Bank, Mizuho, Misubishi-UFJ Financial Group and Toronto-Dominion Bank.

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