Agencies Require Deduction of TLAC Debt Held by Category I and II Banking Organizations

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On October 20, 2020, the federal banking agencies issued a joint Final Rule that requires advanced approaches banking organizations—firms designated as Category I or II under the Interagency Tailoring Rule—to deduct from regulatory capital certain investments in unsecured debt securities issued by U.S. or non-U.S. G-SIBs. The debt instruments covered by the Final Rule include not only unsecured debt instruments that qualify as TLAC, but also unsecured debt instruments that are *pari passu* or subordinated to such TLAC debt instruments. The deduction for covered debt instruments is implemented through the U.S. Basel III capital rules' existing deduction framework for certain investments in regulatory capital instruments.

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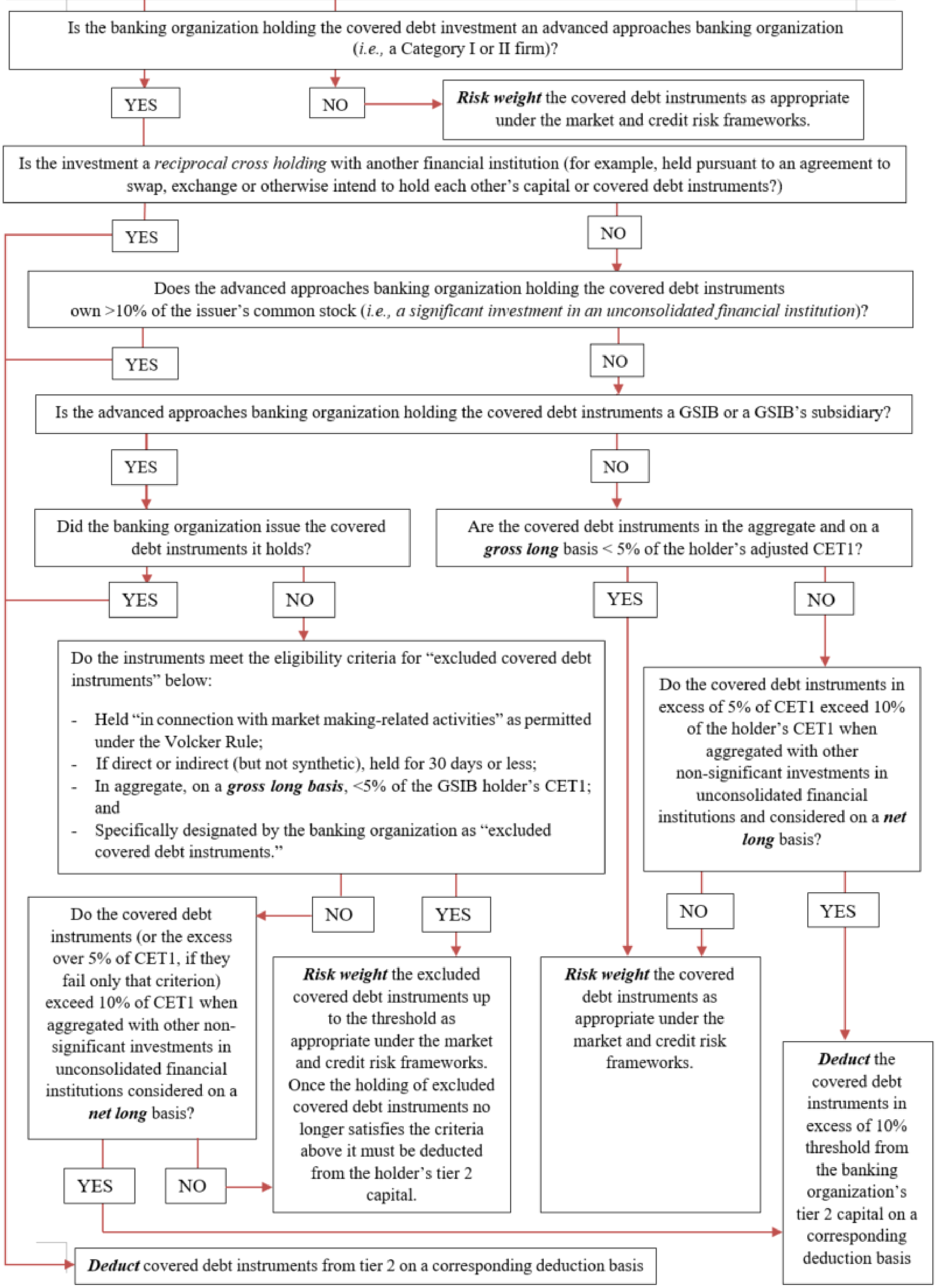
The Final Rule is broadly consistent with the Basel TLAC Holdings Standard, although the Agencies preserved the April 2019 Proposal's more conservative, asymmetrical treatment of TLAC holdings by requiring Category I and II firms to deduct covered debt instruments from their regulatory capital, rather than from their TLAC. The Agencies rejected comments requesting that the Final Rule align with the Basel approach.

The Final Rule did, however, make a few targeted changes to address commenter concerns. The Agencies leveraged the Volcker Rule's framework for identifying market making activities by Category I firms in order to make less burdensome the determination of securities that may be excluded from the deduction requirement because they are held for market liquidity and market-making purposes. Furthermore, in response to comments noting that long-term derivative exposures are an integral part of market-making practice for TLAC instruments, the Final Rule also removes, for Category I firms, the 30-business-day holding limit for derivatives that reference covered debt instruments and that are entered into for market making. In addition, the Final Rule adopts certain beneficial changes to the TLAC buffer calculation that were proposed by the FRB in 2018 in a separate rulemaking relating to recalibration of the eSLR.

The Final Rule will become effective April 1, 2021, while changes to Forms FR Y-9C and FR Y-14 will become effective June 30, 2021.

This Alert Memorandum provides a high-level overview of the Final Rule, and includes a decision tree illustrating the analysis necessary to determine whether deduction of covered debt instruments would be required. This Alert Memorandum also highlights key takeaways which address the Final Rule's expected impact and its interplay with other regulatory initiatives.

Regulatory Capital Treatment of Covered Debt Instruments under the Final Rule



Overview of the Final Rule

I. **Background:** The Final Rule[1] marks the culmination of several aspects of prior rulemakings:

— *The Proposal.* In April 2019, the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB"), and the Federal Deposit Insurance Corporation ("FDIC", and together with the OCC and FRB, the "Agencies") jointly issued the Proposal.[2] The Proposal was designed to amend the Agencies' regulatory capital rules[3] to implement the Basel TLAC Holdings Standard[4] for investments by advanced approaches banking organizations in covered debt instruments, which include both long-term debt ("LTD") and certain other unsecured debt obligations issued by U.S. or non-U.S. global systemically important banking organizations ("G-SIBs") and covered U.S. intermediate holding companies ("IHCs"). Please see our Alert Memo, dated April 17, 2019, for further background on the proposal and the Basel TLAC Holdings Standard.[5]

— *The Interagency Tailoring Rule.* In November 2019, the Agencies revised the criteria for determining the applicability of regulatory capital and liquidity requirements for large U.S. banking organizations and the IHCs of certain foreign banking organizations ("FBOs"). This "Interagency Tailoring Rule" defines "advanced approaches banking organizations" to include those subject to Category I standards (*i.e.*, U.S. G-SIBs) or Category II standards (*i.e.,* banking organizations with at least $700 billion in total consolidated assets or at least $75 billion in cross-jurisdictional activity and more than $100 billion in total consolidated assets), and any insured depository institution ("IDI") subsidiaries of such banking organizations. The Interagency Tailoring Rule indicated that the Agencies expected to limit application of the TLAC deduction requirements to firms subject to Category I and II standards.

— *The eSLR Proposal.* In April 2018, the FRB and the OCC issued a proposal[6] ("eSLR Proposal") that would recalibrate the enhanced supplementary leverage ratio ("eSLR") buffer for G-SIBs and their IDI subsidiaries regulated by the FRB or the OCC. Although the eSLR Proposal focused on recalibrating the leverage buffer applicable to U.S. G-SIBs, the Agencies also proposed a material technical change to the calculation mechanics of the TLAC buffer for U.S G-SIBs and U.S. IHCs subject to internal TLAC requirements (*i.e.*, IHCs of G-SIB parent FBOs). This technical change to the TLAC buffer has been adopted in the Final Rule although the other aspects of the eSLR Proposal have not been finalized.[7]

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1 Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations; Total-Loss Absorbing Capacity Requirements (Oct. 20, 2020), https://www.fdic.gov/news/board/2020/2020-10-20-notice-dis-a-fr.pdf (the "Final Rule"). As of the date of this Memorandum, the Agencies' complete version has not yet been published in the Federal Register.

2 84 Fed. Reg. 13814 (April 8, 2019) (the "Proposal").

3 12 C.F.R. Parts 3 (OCC), 217 (FRB) and 324 (FDIC) ("Capital Rules").

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

5 See https://www.clearygottlieb.com/-/media/files/alert-memos-2019/agencies-issue-proposal-to-deduct-tlac-holdings-from-regulatory-capital.pdf

6 83 Fed. Reg. 17317 (April 19, 2018)

7 In the eSLR Proposal, the Agencies indicated that any intervening changes to the SLR's denominator (total leverage exposure) would necessitate reconsideration of the eSLR Proposal. In November 2019, the Agencies issued a final rule implementing changes to the SLR required under the Economic Growth, Regulatory Relief and Consumer Protection Act (the "EGRRCPA") which revises the SLR to exclude from total leverage exposure certain central bank deposits of a custodial banking organization or a custody bank but declined to

II. Scope of Applicability

— The Final Rule applies only to Category I and II firms and their subsidiary IDIs, consistent with the Interagency Tailoring Rule's definition of "advanced approaches banking organizations".

— The Agencies declined commenters' suggestion to expand the scope of banking organizations subject to the new deduction requirements, noting that the systemic risks associated with investments in covered debt instruments is greatest for advanced approaches banking organizations.

— However, the Agencies will continue to evaluate whether to take additional steps to address the risks of investments in covered debt instruments by non-advanced approaches banking organizations.

III. Covered Debt Instruments

— The Final ***Rule*** defines "covered debt instrument" broadly to include:

- eligible, non-tier 2 long-term debt ("LTD") issued by a U.S. G-SIB or covered IHC under the FRB's total loss-absorbing capacity rule ("TLAC Rule")[8] and instruments that are *pari passu* with or subordinated to such LTD other than qualifying regulatory capital;[9] and

- unsecured debt instruments issued by a non-U.S. G-SIB or any of its subsidiaries, other than a covered IHC, that (i) qualify under a local TLAC law or regulation or (ii) are *pari passu* with or subordinated to such debt instruments, including instruments that are eligible to be written down or converted into equity under a special resolution regime that addresses the failure or potential failure of a financial company.

— While generally consistent with the Proposal, the Agencies revised the definition to reduce the burden of identifying which instruments issued by non-U.S. G-SIBs would be covered debt instruments. The definition now applicable to non-U.S. G-SIB debt is more objective, avoiding potentially subjective and broad interpretations of whether the debt is for "the purpose of absorbing losses or recapitalizing the issuer".

- The Agencies also clarified in the preamble that a resolution regime that is consistent with the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions[10] would be a special resolution regime that addresses the failure or potential failure of a financial company. The Agencies indicated, as examples, that those regimes included in the ISDA 2015 Universal Resolution Stay Protocol and the ISDA 2018 U.S. Resolution Stay Protocol would qualify.

— The amount of covered debt instruments a Category I or II firm must deduct from its regulatory capital is 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 Liquidity Enhancement Exclusion, 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 a firm's net long position in covered debt instruments must take into account

reconsider the calibration of the eSLR in that rulemaking. 85 Fed. Reg. 4569 (Jan. 27, 2020).

8 12 C.F.R. §§ 252.61 and 252.161.

9 Deduction of investments in regulatory capital instruments issued by another organization is already required by the existing Capital Rules.

10 Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions," (October 15, 2014), https://www.fsb.org/wp-content/uploads/r_141015.pdf.

direct, indirect, or synthetic exposures to covered debt instruments.

— Underwriting positions held for five or fewer business days are not included as investments in covered debt instruments for purposes of the Final Rule.

IV. Mechanics of the Regulatory Capital Deduction

— ***Capital deduction for covered debt instruments.***

- The Final Rule integrates 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).

— ***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 Final Rule makes investments in covered debt instruments by Category I and II firms subject to the corresponding deduction approach as tier 2 capital, even if the covered debt instruments do not qualify as tier 2 capital.
- Notably, the Agencies declined to adopt commenters' recommendations to require deduction of covered debt instruments from a G-SIB BHC's or a covered IHC's TLAC rather than its tier 2 capital. The Agencies stated that such a change would disproportionally favor large banking organizations and would not adequately achieve the Agencies' regulatory goal in reducing interconnectedness among large banking organizations.

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

- Under the Final Rule, G-SIB BHCs and covered IHCs must deduct investments in their own covered debt instruments from their tier 2 capital under the corresponding deduction approach.
- The Agencies declined commenter's requests to make the Liquidity Enhancement Exclusion (described below) 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 Final Rule, G-SIB BHCs and covered IHCs will 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.
- For reasons similar to those noted above, the Agencies also declined to make the Liquidity Enhancement Exclusion available for reciprocal cross-holdings.

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

- *Current Capital Rules.* Under the Capital Rules, a "non-significant investment in the capital of an unconsolidated financial institution" is an investment in any capital instrument issued by an unconsolidated financial institution in which the banking organization also owns 10% or less of the issued and outstanding common stock ("non-significant investment" or "NSI"). 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 below this 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").

- *Final Rule with respect to Covered Debt Instruments.* Under the Final Rule, a Category I or II firm must include any investment in covered debt instruments that meets the NSI criteria in the aggregate amount of its non-significant investments. The banking organization may avoid deduction of a covered debt instrument if, when aggregated with its NSI, the NSI Exclusion (under 10% CET1) would apply. However, as under the current Capital Rules, a Category I or II firm must apply the corresponding deduction approach to its net long position in covered debt instruments that, when aggregated with its other non-significant investments, exceeds 10% of the firm's CET1 capital.

- *Liquidity Enhancement Exclusion.* Consistent with the Basel TLAC Holdings Standard, to support a deep and liquid market in G-SIB non-regulatory capital TLAC instruments, the Final Rule permits Category I and II firms to not deduct certain amounts of covered debt instruments (the "Liquidity Enhancement Exclusion"). Specifically:

  - A Category II firm need not deduct, under the non-significant investments provisions, the amount of the gross long position in covered debt instruments up to 5% of the CET1 capital of the investing banking organization.[11]

  - Category I firms are required to comply with certain additional conditions to take advantage of the Liquidity Enhancement Exclusion:

    - Category I firms must specifically designate the instruments as "excluded covered debt instruments;"[12]

    - The excluded covered debt instruments must be "held in connection with market making-related activities" as permitted under the Volcker Rule;[13] and

[11] The Final Rule clarifies that the basis (*i.e.,* CET1 capital, minus all deductions and adjustments) for calculating the 5% threshold for the Liquidity Enhancement Exclusion is the same as the basis for the 10% threshold for non-significant investments calculation. In other words, the two calculations will have the same denominator and apply the same deductions from and adjustments to the banking organization's CET1 capital.

[12] However, Category I firms are not required to designate all covered debt instruments held in connection with market making as "excluded covered debt instruments" (*i.e.,* this designation is only needed to the extent that a G-SIB wishes to use the Liquidity Enhancement Exclusion). A Category I firm could use the NSI Exclusion without having to use the Liquidity Enhancement Exclusion, and the NSI Exclusion permits exclusion on a net long basis.

[13] See 12 CFR 44.4 (OCC); 12 CFR 248.4 (FRB); 12 CFR 351.4 (FDIC).

- The Category I firm must hold any direct or indirect (but not synthetic) exposure to the excluded covered debt instrument for 30 business days or less. In a change from the Proposal, the Agencies excluded synthetic exposures from the 30-business-day limit to address commenters' concerns about burden on banking organizations' ability to use derivatives, particularly because maturities and holding periods of derivatives often exceed 30 days.

- If a Category I or II firm has investments in covered debt instruments that exceed the 5% of CET1 capital limitation (or do not meet the additional conditions, as applicable, for Category I firms), such investments may still be eligible for the NSI Exclusion on a net long basis, as described above.

- Finally, the Agencies:
  - intend to monitor Category I and II firms' holdings of covered debt instruments in the form of synthetic exposures, and
  - may issue an information collection proposal to collect quarterly data on advanced approaches banking organizations' non-significant investments in the capital of unconsolidated financial institutions and excluded covered debt instruments, as applicable.

— ***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 any capital instrument issued by a financial institution in which the banking organization also owns more than 10% of the issued and outstanding common stock of the unconsolidated financial institution ("significant investment").[14]

- Under the Final Rule, a Category I or II firm is required to deduct any investment in covered debt instruments issued by an unconsolidated financial institution in which the covered banking organization has a significant investment by applying the corresponding deduction approach.

- The Liquidity Enhancement Exclusion is not available for significant investments in unconsolidated financial institutions.

V. Revisions to the TLAC Buffer Calculation Mechanics from the eSLR Proposal

— The TLAC rule includes a TLAC buffer which operates in a manner similar to the parent-level eSLR buffer, subjecting a firm to progressively increasing restrictions on its capital distributions and discretionary bonus payments as its TLAC ratio descends into the buffer zone. The Final Rule adopts certain helpful changes to the TLAC rule to ensure that LTD is calculated the same way for each of the TLAC requirements that were included in the eSLR Proposal. Specifically, the Final Rule revises the external TLAC risk-weighted buffer level, the TLAC leverage buffer level and the TLAC buffer level for IHCs so that they use the same haircuts applicable to LTD that are currently used to calculate outstanding minimum required TLAC amounts. As a result, IHCs will no longer be subject to a 50% haircut on LTD instruments with a remaining maturity of between one and two years when calculating their TLAC levels for purposes of the TLAC buffers.

— The Final Rule also adopts the provisions from the eSLR Proposal that clarify that a new covered IHC has three years to conform to most of the

[14] 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).

requirements of the TLAC rule, and that align the articulation of the methodology for calculating the covered IHC's LTD instrument amount with the same methodology used for G-SIBs.

VI. Changes to Regulatory Reporting and Pillar III Disclosures

— As part of the Final Rule, the FRB modified the instructions to the FR Y-9C (Consolidated Financial Statements for Holding Companies) and FR Y-14 (Capital Assessments and Stress Testing information collection) to give effect to the regulatory capital deductions for Category I and II firms that are regulated by the FRB.

— In October 2019, the Federal Financial Institutions Examination Council ("FFIEC") proposed 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). The Agencies did not finalize these changes in connection with the Final Rule, but noted their intention to finalize them in the future consistent with the Final Rule.

— In addition to modifications to the regulatory reporting forms affected by the Final Rule, the FRB is modifying portions of the FR Y-9C and FY-14 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 FRB also is adopting amendments to the instructions for calculating eligible retained income, institution-specific capital buffers and distributions and discretionary bonus payments. In response to commenters' requests, the FRB confirmed that reporting of the LTD and TLAC leverage requirement for U.S. G-SIBs will only be based upon the supplementary leverage ratio denominator, consistent with the TLAC rule's leverage requirement.

VII. Effective Date

— The Final Rule will become effective on April 1, 2021, while changes to Forms FR Y-9C and FR Y-14 will become effective on June 30, 2021.

Key Takeaways

Below we highlight certain key takeaways from the Final Rule.

— *"Super-equivalence" to the Basel Framework Maintained, But Modest Burden Relief.* Despite commenter requests for reconsideration of the Proposal's divergence from the Basel TLAC Holdings Standard, the Final Rule disappointingly preserves the Agencies' super-equivalent implementation by requiring deduction of covered debt instruments from Tier 2 capital rather than TLAC.

However, the Final Rule does provide some burden relief in response to commenter concerns by providing a more objective and discernable standard to determine which instruments issued by non-U.S. G-SIBs will be considered covered debt instruments. This standard eliminates the ambiguity under the Proposal as to whether ordinary interbank transactions would potentially be subject to deduction, such as interbank deposits which are not subject to bail-in and therefore will not be considered covered debt instruments under the Final Rule.

The Agencies also simplified administration of the Liquidity Enhancement Exclusion by incorporating criteria from the Volcker Rule to identify whether covered debt instruments are held in connection with market making-related activities. Therefore, Category I and II firms should be able to leverage their existing systems when implementing the deduction.

— *No Indication of Whether the FRB is Actively Considering Recalibration of TLAC Requirements.* Vice Chair Quarles has made statements indicating that the FRB is generally considering recalibrating the internal TLAC requirements for IHCs toward the lower end of the TLAC standards established by the Financial Stability Board and/or streamlining the elements of the resolution loss absorbency regime.[15] The Final Rule makes a modest but material downward adjustment to the TLAC buffer calculation for IHCs. However, it remains to be seen whether Vice Chair Quarles and the FRB will continue to include revisions to the TLAC framework as a regulatory priority.

— *Future of the eSLR Proposal Unclear.* While the Final Rule incorporates the eSLR Proposal's technical amendments to the TLAC Rule, the Final Rule gives no indication as to whether the Agencies intend to finalize the eSLR Proposal's downward recalibration of the eSLR buffer or how they may recalibrate the eSLR given the changes to the SLR denominator under EGRRCPA. The eSLR Proposal, if finalized, would have resulted in early adoption of the leverage ratio buffer included in the Basel Committee's December 2017 revisions to the Basel III framework (set at one-half the relevant firm's G-SIB surcharge). Given that Vice Chair Quarles has indicated that the Agencies are already beginning work on the "Basel III Endgame" proposal to implement the Basel Committee revisions, the finalization of the eSLR Proposal may be significantly delayed if it is folded into that workstream, which has a target implementation date of January 1, 2023.

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[15] Financial Stability Board, Market Fragmentation: Updates on Ongoing Work (Oct. 14, 2020), https://www.fsb.org/wp-content/uploads/P141020-2.pdf; Randal K. Quarles, Vice Chair for Supervision, FRB, Trust Everyone—But Brand Your Cattle: Finding the Right Balance in Cross-Border Resolution (May 16, 2018).