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ALERT MEMORANDUM

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The Federal Reserve Proposes TLAC and Related Requirements for U.S. G-SIBs and U.S. Intermediate Holding Companies of Foreign G-SIBs

On Friday, the Federal Reserve issued its latest proposal to impose heightened regulatory capital and related requirements on the largest, most systemically important U.S. bank holding companies ("**Covered BHCs**") and on U.S. intermediate holding companies owned by comparable FBOs ("**Covered IHCs**").

The Federal Reserve's proposal includes:

- **Minimum external total loss-absorbing capacity ("TLAC") requirements for Covered BHCs**, which include a minimum level of **long-term debt ("LTD")** and related **TLAC buffers**;
- **Minimum internal TLAC and LTD requirements for Covered IHCs**, which differentiate between SPOE and MPOE groups and require eligible instruments to be issued by the Covered IHC to a foreign entity that controls the Covered IHC;
- **"Clean holding company" requirements** that impose stringent limitations on the ability of Covered BHCs and Covered IHCs to incur common types of non-TLAC-related liabilities; and
- A **new regulatory capital deduction** for any investment in the unsecured debt of a Covered BHC by state member banks, BHCs, large savings and loan holding companies and all IHCs.

Although the industry anticipated that the Federal Reserve's proposal would come in at the higher end of the Financial Stability Board's ("FSB's") expected global standard (due to be released on November 9th), the degree of divergence is greater than expected. In addition to diverging from the expected FSB calibration methodologies, the Federal Reserve has introduced limitations on the ability of Covered BHCs and Covered IHCs to incur common types of liabilities that would impose significant constraints on operational and financial flexibility. Further, in the interest of reducing "contagion" risk, the proposal would impose punitive capital treatment on the cross-holding of unsecured debt issued by Covered BHCs above certain thresholds. The Federal Reserve estimates that six of the eight Covered BHCs would have shortfalls under the proposed standards and that their aggregate shortfall would be approximately $120 billion.

The proposal requests comments by February 1, 2016.

The Federal Reserve's Board Memo (link provided below) includes a three-page bulleted executive summary of the proposal's key requirements and thresholds. We highlight in this Alert Memorandum certain key aspects of the proposal that are likely to be of particular interest in the context of the evolution of TLAC since the FSB initially proposed global standards in November, 2014. We will distribute a more comprehensive analysis of the Federal Reserve's proposal in the coming days, and we will of course be in close contact with clients during that time to discuss the proposal's implications for individual institutions.

Links to the Proposed Rule and Related Materials

- Text of Proposed Rule and Preamble[1]
- Board Memo[2]
- Depiction of Proposed LTD Requirement and Fully Phased-in Tier 1 Risk-Based Capital Requirements[3]

Key Issues of Note

I. Requirements for Covered BHCs

A. External TLAC and LTD Requirements; TLAC Buffer

- External TLAC requirement. The proposal's baseline external TLAC requirement would require a Covered BHC to maintain an outstanding eligible external TLAC amount that is no less than the amount equal to the greater of (i) 18% (compared to an expected FSB range between 16-20%) of the Covered BHC's total risk weighted assets ("RWAs") and (ii) 9.5% of the Covered BHC's total leverage exposure.[4] However, the complexity of the proposal's calibration methodology means that the actual TLAC requirements applicable to specific Covered BHCs and the relative costs involved in meeting these requirements will be institution-specific.
- External LTD requirement more burdensome than expected. The proposal establishes an external LTD requirement as a subcategory of the external TLAC requirement based on a dual calculation.
  - Covered BHCs would need to maintain an external LTD amount that is no less than the amount equal to the greater of (i) 6% of the Covered BHC's total RWAs plus the Covered BHC's Federal Reserve G-SIB risk-based capital surcharge and (ii) 4.5% of the Covered BHC's total leverage exposure.
  - As a percentage of total TLAC, the proposed external LTD requirement would appear to significantly exceed the 33% LTD requirement under the expected FSB global standard.

1 http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20151030a1.pdf.

2 http://www.federalreserve.gov/aboutthefed/boardmeetings/ltd-board-memo-20151030.pdf.

3 http://www.federalreserve.gov/aboutthefed/boardmeetings/ltd-chart-20151030.pdf.

4 This is the measure for total RWAs when fully implemented on January 1, 2022. Between January 1, 2019 and December 31, 2021, the measure of total RWAs will be 16%.

- TLAC buffer. The proposal would impose a TLAC buffer over and above the baseline external TLAC requirement. The amount would be based on a 2.5% buffer (comparable to the capital conservation buffer) and the Covered BHC's G-SIB surcharge as determined under method 1 of the Federal Reserve's G-SIB surcharge rule.

B. External TLAC Eligibility Criteria

- Limited eligibility of Tier 2 capital instruments. In sharp contrast to the FSB term sheet and expected global standard, which generally includes regulatory capital in TLAC, Tier 2 capital instruments would qualify as external LTD under the proposal only if they meet certain qualifications for eligible debt securities. It is unclear what portion of currently outstanding Tier 2 instruments can be expected to satisfy these eligibility criteria, but at least some instruments would be disqualified.
  - Must be issued directly by the Covered BHC. Minority interests in a consolidated subsidiary that qualify as Tier 2 capital under the U.S. Basel III rule would not qualify as eligible debt securities under the proposal because these instruments are not issued by the Covered BHC. (Similarly, common equity Tier 1 minority interests and additional Tier 1 minority interests would be disqualified from inclusion in external TLAC.)
  - May not be convertible to equity or guaranteed by an affiliate. Tier 2 instruments that provide for conversion into equity of the issuer (which would improve the instrument from a regulatory capital perspective) or instruments that incorporate a guarantee from an affiliate also would not qualify as eligible debt securities under the proposal.
  - No grandfathering. The proposal would not grandfather outstanding debt instruments, although the preamble does ask for comments on whether this treatment would be appropriate.
- Further limits on acceleration under consideration. The proposed definition of eligible debt securities would permit the holder to have an acceleration right in the event of nonpayment of principal or interest (or insolvency). However, the preamble notes that the Federal Reserve is considering imposing an additional restriction on eligible external LTD that would permit acceleration only in the event of insolvency. This would align the restriction on eligible external LTD with the corresponding requirements for Tier 2 eligibility in the U.S. Basel III rule.
  - Potential implications for existing senior unsecured debt. A limitation on acceleration would be inconsistent with the typical terms of senior unsecured debt. As a result, this could, if included in the final rule, effectively disqualify from eligible external LTD significant proportions of most Covered BHCs' existing senior unsecured debt.
- Only "plain vanilla debt"; no structured notes or derivative-linked features. The proposal would exclude structured notes—including instruments with variable principal amounts or embedded derivatives—from the definition of eligible debt security.
  - Potential implications for principal-protected instruments. The preamble states that this exclusion arises from the need to be able to readily ascertain the value of debt

securities subject to losses, but the definition's breadth would seem also to exclude principal-protected instruments with features consistent with orderly resolution principles. Indeed, by clarifying that floating interest rates based on an index such as LIBOR would be permitted, the proposal suggests a narrow view of the types of debt instruments that would qualify.

II. Requirements Applicable to Covered IHCs

- Internal TLAC generally based on Covered BHC external TLAC requirements. Covered IHCs would be subject to internal TLAC requirements that are generally based on the calibration methodology and criteria for external TLAC, with some tailoring and additional restrictions. The internal TLAC requirements for most Covered IHCs would be set at 89% of the external TLAC requirements for Covered BHCs, coming in at the top of the 75-90% range under the expected FSB global standard.
  - Must be issued to Covered IHC parent. Only instruments issued directly by the Covered IHC to a foreign entity that controls the Covered IHC would be eligible as internal TLAC, to ensure that (i) losses are upstreamed to the parent and not transferred to other U.S. entities and (ii) the conversion of internal TLAC instruments does not result in a change in control of the Covered IHC.
  - Excludes externally-issued instruments. Externally-issued instruments would not count towards a Covered IHC's LTD or TLAC requirements.
- LTD requirement extended to internal TLAC. Unlike the expected FSB global standard, the Federal Reserve's proposal would extend the LTD requirement to internal TLAC, establishing an even more complex calibration calculation than for external TLAC, and limiting flexibility for FBOs in meeting the internal TLAC requirements.
  - Covered IHCs would need to have an outstanding eligible internal LTD amount that is no less than the amount equal to the greater of (i) 7% of the Covered IHC's total RWAs, (ii) 3% of the Covered IHC's total leverage exposure (if applicable), and (iii) 4% of the Covered IHC's average total consolidated assets.
- Required convertibility/cancellation feature. Eligible internal TLAC instruments would also need to contain a contractual clause that results in the debt being converted into equity of the Covered IHC (or canceled) if the Federal Reserve issues a "debt conversion order." Significantly, this ensures that the Federal Reserve, and not the home country supervisor, would control any conversion.
  - Debt conversion order scenarios. The Federal Reserve would be able to issue a debt conversion order under a variety of circumstances, including if the Covered IHC enters or is about to enter proceedings under the Bankruptcy Code, the FBO is placed into resolution proceedings, or the Covered IHC is otherwise "in default or danger of default" (to be defined in accord with that term's definition in Title II of the Dodd-Frank Act).
- SPOE v. MPOE. As expected, the Federal Reserve's proposal distinguishes between SPOE and MPOE FBOs, with the latter subject to higher internal TLAC requirements.

The primary focus of the proposal appears to be on the resolution of FBO G-SIBs under an SPOE strategy; the proposal refers to an MPOE strategy as a "plausible contingency."

- Only applicable to IHCs owned by G-SIBs (but G-SIB criteria not based on FSB list). The proposal would apply only to IHCs owned by G-SIBs, but the proposal would not look to the FSB's designation of G-SIBs to define the scope of Covered IHCs. This approach could effectively impose a U.S. G-SIB designation methodology on FBOs that could supplant the home country supervisor's (or FSB's) determination.
  - G-SIB determination. An FBO would be considered a G-SIB under the proposal if the FBO determines that it meets the Basel Committee's G-SIB requirements, or if the Federal Reserve determines that the FBO meets either the Basel Committee's G-SIB requirements or the G-SIB designation methodology adopted by the Federal Reserve for U.S. BHCs under Regulation Q. (The proposal also would apply if the IHC itself would qualify as a G-SIB under Regulation Q, although it is unclear whether any FBOs would be designated as G-SIBs on that basis.)

III. Clean Holding Company Requirements

- Prohibited liabilities. As a complement to the proposal's TLAC and LTD requirements, the proposal's "clean holding company" requirements would prohibit a Covered BHC or Covered IHC from having certain types of third-party liabilities, including short-term debt and qualified financial contracts, and would prohibit certain downstream and upstream guarantees.
- No grandfathering. Existing liabilities of Covered BHCs and Covered IHCs would not be grandfathered, which could impose significant operational constraints on Covered BHCs in particular.
- Limitations on guarantees of subsidiary liabilities. Both Covered BHCs and Covered IHCs would be prohibited from guaranteeing (including under existing guarantees) a liability of a subsidiary if that liability includes a default right linked to the insolvency of the Covered BHC or Covered IHC, a common feature of existing guaranteed liabilities. (Default rights linked to receivership under Title II of the Dodd-Frank Act are permitted, but would be subject to the overrides under Section 210(c)(16) of Title II.)
- Cap on certain third-party liabilities for Covered BHCs. The proposal would limit the amount of certain third-party liabilities that a Covered BHC can have to 5% of the Covered BHC's eligible external TLAC. This could pose monitoring and compliance challenges since the cap would apply to liabilities such as external vendor and operating liabilities, obligations to employees, tax payables and liabilities created by court judgments.

IV. New Regulatory Capital Deduction for Cross-holdings of Unsecured Covered BHC Debt

- Requirements more burdensome than expected. Under the proposal, all state-member banks, BHCs and SLHCs with over $1 billion in total consolidated assets and all IHCs must deduct from their regulatory capital any investment in unsecured debt issued by

Covered BHCs in excess of certain thresholds. This deduction would be required regardless of the tenor of the instrument and regardless of whether the debt instrument would qualify as eligible external LTD.

- Expands on Basel III deduction for investments in unconsolidated financial institutions. The proposal would operationalize this deduction by expanding the current regime for the deduction of investments in unconsolidated financial institutions in the U.S. Basel III rule, treating such debt instruments in a manner similar to investments in Tier 2 capital instruments issued by unconsolidated financial institutions.
- Potential implications for underwriting and market making. The proposal would exempt from deduction underwriting positions held for less than five days, creating potentially significant implications for the ability of underwriters and market makers to underwrite and make a market in the unsecured debt of Covered BHCs.

V. Covered BHC Disclosure Obligations

- Enhanced disclosure requirement. The proposal would require a Covered BHC to include a description of the financial consequences to unsecured debtholders of the Covered BHC's resolution in securities offering documents and on its website or in public reports.
  - Scope of required disclosure unclear. The proposal does not provide many parameters for this disclosure, including the extent to which these requirements should take into consideration a Covered BHC's resolution strategy as reported in the public section of its Title I resolution plan.

VI. Consideration of Other Requirements, Including Domestic TLAC

- Additional domestic internal TLAC measures under consideration. The preamble to the proposal also describes an additional "domestic internal TLAC" measure that the Federal Reserve is considering to supplement the TLAC requirements for Covered BHCs and Covered IHCs. Domestic TLAC requirements would be designed to require the maintenance of "contributable resources" (in the form of high-quality liquid assets) at the level of the Covered BHC or Covered IHC, as well as "prepositioned resources" at the level of material operating subsidiaries (in the form of debt and equity investments in the covered subsidiary).
- Requirement to disclose eligible TLAC and LTD under consideration. The Federal Reserve indicated in the proposal that it is also considering requiring Covered BHCs and Covered IHCs to report publicly their amounts of eligible TLAC and LTD.

VII. Timing

- Effective date and phase-in period for TLAC RWA components. The proposal's requirements would generally come into effect on January 1, 2019, subject to a three-year phase-in period for the RWA components of the external and internal TLAC requirements, which would step up to maximum levels on January 1, 2022.

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If you have any questions, please feel free to contact:

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