BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: August 15, 2023

To: Board of Governors

From: Staff[1]

Subject: Proposal to require certain large banking organizations to issue minimum amounts of loss-absorbing long-term debt

ACTIONS REQUESTED: Staff requests approval to invite public comment on a proposed rule that would (1) establish a long-term debt (LTD) requirement for certain large insured depository institutions (IDIs) and large U.S. holding companies; (2) establish "clean holding company requirements" for these holding companies; (3) apply a stringent capital treatment to large U.S. banking organizations' holdings of LTD issued by other large banking organizations; and (4) make technical amendments to the Board's total loss-absorbing capacity (TLAC) rule for U.S. global systemically important banking organizations (GSIBs) and intermediate holding companies of foreign GSIBs to address items that have been identified through the Board's administration of the rule.[2] Staff also requests authority to make technical, non-substantive changes to the attached materials prior to publication in the *Federal Register*. The proposal would be issued jointly with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency.

EXECUTIVE SUMMARY:

- The proposal would support financial stability by improving the resiliency and resolvability of large banking organizations.
- The proposal would require a large banking organization to maintain outstanding a minimum amount of LTD that could be used to absorb losses if it fails.

---

[1] Michael Gibson, Molly Mahar, Catherine Tilford, Juan Climent, Elizabeth MacDonald, Francis Kuo, Lesley Chao, and Lars Arnesen (Division of Supervision and Regulation); and Mark Van Der Weide, Charles Gray, Reena Sahni, Jay Schwarz, Josh Strazanac, Brian Kesten, and Jacob Fraley (Legal Division).

[2] The proposal would also amend reporting requirements to align with the new LTD requirements in the proposal. Changes to the Call Report are expected to be proposed by the Federal Financial Institutions Examination Council in the near term.

- Loss-absorbing LTD would increase the potential options available to the FDIC to resolve a large banking organization's IDI subsidiaries and would likely decrease costs to the Deposit Insurance Fund. It would also decrease the likelihood that uninsured depositors would bear losses and thus could reduce the risk of bank runs.
- U.S. GSIBs are already subject to an LTD requirement. The proposal would generally require large banking organizations with $100 billion or more in consolidated assets that are not GSIBs to comply with an LTD requirement at the holding company and IDI levels.[3]
    - Under the proposal, a holding company would issue LTD and would generally not be permitted to engage in certain activities that could complicate resolution. These are known as the clean holding company requirements.
    - The proposal would also generally require that IDIs with $100 billion or more in consolidated assets and any affiliated IDIs issue minimum amounts of LTD to their parents.
    - Covered IDIs without a covered entity parent could issue LTD externally to the market or, where applicable, internally to their non-covered entity parents (*e.g.*, where such parent is an insurance savings and loan holding company).
- The LTD requirement is calibrated to be sufficient to fully recapitalize failed banking organizations. The proposed calibration is lower than the LTD requirements currently in force for U.S. GSIBs.
- Under the proposal, banking organizations would get credit for existing outstanding LTD that meets certain criteria and would have three years to come into compliance with the new requirements. The requirements would be phased in over the three-year period.
- Staff estimates that the banking organizations covered by this proposal would need to issue approximately $70 billion in new LTD, equivalent to about 27 percent of the total LTD requirement. Maintaining the higher level of LTD is likely to moderately increase funding costs over time.
- Comments on the proposal will be accepted after publication in the *Federal Register* until November 30, 2023.

[3] Holding companies subject to the proposed LTD requirement include Category II, III, and IV bank holding companies, savings and loan holding companies, and U.S. intermediate holding companies of non-GSIB foreign banking organizations (collectively, "covered entities").

DISCUSSION:

A. Background

The recent failures of three non-GSIB large banking organizations—SVB Financial Group, Signature Bank, and First Republic Bank—have highlighted the risks posed by the disorderly resolution of certain large banking organizations. These recent failures were characterized by financial weaknesses that prompted significant withdrawals by uninsured depositors at unprecedented speeds, fueled by advances in digital banking and the prevalence of social media. These events also highlighted that the failure or stress of a single firm of this size can spread to other firms, particularly in the event depositors perceive uninsured deposits are at risk of loss.

Maintaining a minimum amount of LTD at covered entities, and at IDIs with at least $100 billion in consolidated assets (together with any other IDI affiliates, covered IDIs), increases the range of resolution options available to the FDIC and reduces the cost of resolution to the Deposit Insurance Fund. For example, LTD increases the likelihood that the FDIC would be able to transfer the assets and all of the deposit liabilities, including uninsured deposits, of a failed covered IDI to a bridge bank in compliance with the least-cost test. The use of a bridge bank could preserve the franchise value of the IDI and may give the FDIC additional time to execute a variety of resolution strategies, such as selling or effectuating a spin-off of the recapitalized bridge bank. The presence of LTD also decreases the extent to which the FDIC would need to rely on the Deposit Insurance Fund to make insured depositors of a failed covered IDI whole. The presence of a minimum LTD requirement could also decrease the incentives for depositors or other creditors to run from a covered IDI that is going through a period of stress.

The proposal follows an advance notice of proposed rulemaking (ANPR) the Board and the FDIC issued in October 2022, regarding the usefulness of a potential LTD requirement in resolving a large banking organization or its IDI subsidiaries.[4] Public feedback on the ANPR, which was received prior to the March bank failures, raised concerns about the potential cost of an LTD requirement for large banking organizations, and expressed skepticism that the material distress or failure of such banking organizations would pose risk to financial stability.

---

[4] Resolution-Related Resource Requirements for Large Banking Organizations, 87 Fed. Reg. 64170 (Oct. 24, 2022).

Commenters further argued that post-2008 increases in levels of capital and liquidity at large banking organizations have significantly reduced their probability of default. Staff has considered these concerns in developing the proposal.

B. LTD Requirements

The proposal would require covered entities and covered IDIs to maintain a minimum amount of eligible LTD equal to the greater of 6 percent of risk weighted assets (RWAs), 3.5 percent of average total consolidated assets, and 2.5 percent of total leverage exposure if the covered entities or covered IDIs are subject to the supplementary leverage ratio rule. This calibration would help ensure that a covered entity or covered IDI would have enough LTD so that, in the event the company's equity capital is fully depleted when it enters resolution, the eligible LTD would generally be sufficient to replenish the company's capital to at least the amount required to meet minimum capital requirements, when converted to equity.[5]

The proposal would require that covered IDIs consolidated by a parent that is a covered entity issue minimum amounts of LTD to their parent to ensure loss absorbing resources are available at the IDI in the event of the covered entity's failure. Covered IDIs without a covered entity parent would be permitted to issue LTD externally to the market or, where applicable, internally to their non-covered entity parents (*e.g.*, where such parent is an insurance savings and loan holding company).

The proposal would require that debt instruments issued to satisfy the minimum LTD requirement meet certain criteria designed to ensure that the LTD can readily absorb losses in resolution. The eligibility criteria in the proposal would require that the LTD be paid in and issued directly by a covered entity or covered IDI, have a remaining maturity of more than one year from the date of issuance, be unsecured, not contain exotic features such as embedded derivatives, be governed by U.S. law, and have a minimum principal denomination of at least $400,000.[6]

---

[5] For example, the 6 percent calibration is derived from a common equity tier 1 capital requirement of 4.5 percent of RWAs plus a capital conservation buffer requirement of 2.5 percent of RWAs, minus expected balance sheet depletion caused by losses in failure equivalent to 1 percentage point of RWAs.

[6] The eligibility criteria for LTD generally align with the criteria specified for LTD under the TLAC rule for U.S. GSIBs. *See* 12 CFR 252.61 "Eligible debt security"; 12 CFR 252.161 "Eligible external debt security" and "Eligible internal debt security."

In addition, to reduce systemic risk and interconnectedness among firms, the proposal would apply a stringent capital treatment to large banking organizations' holdings of eligible LTD issued by other large banking organizations.[7] The stringent capital treatment would discourage cross-holdings of LTD by other banking organizations.

C. Clean Holding Company Requirements

To reduce potential risks to resolvability of covered entities, the proposal would impose clean holding company requirements to prevent covered entities from entering into transactions that could impede their orderly resolution. For example, these requirements would prohibit a covered entity from entering into transactions that could spread losses from the covered entity to subsidiaries and third parties. The requirements also limit the amount of a covered entity's liabilities that are not LTD to ensure that, in resolution, the losses of a covered entity are largely imposed on LTD holders.

D. Transition Periods

The proposal would provide a transition period of three years to covered entities and covered IDIs to comply with the rule, with incremental phase-in of requirements during that period.[8] The phased transition period is designed to facilitate compliance with the rule and minimize the effect of compliance on credit availability and credit costs in the U.S. economy. The proposal would also allow certain legacy LTD previously issued by covered entities and covered IDIs to count permanently toward the minimum requirements to provide firms with a reasonable period to transition their LTD to the required characteristics of eligible LTD. The proposal asks questions regarding the appropriateness of the proposed transition periods, particularly for Category IV covered entities.

E. Impact Analysis

Staff estimates that the total principal amount of LTD required under the proposal would be approximately $250 billion in aggregate. Considering current borrowing practices, approximately $70 billion of additional LTD would be needed to meet the aggregate

---

[7] The proposed deduction approach for certain LTD holdings (e.g., those above certain thresholds) would align with the regulatory capital deduction framework for LTD issued pursuant to the TLAC rule.

[8] The phase-in would require that covered entities and covered IDIs meet 25 percent of their LTD requirements by one year after finalization of the rule, 50 percent after two years, and 100 percent after three years.

requirement.[9] While covered entities and covered IDIs fully or partially meet the requirements currently, they would need to maintain the required levels of LTD in the future at all times. To the extent the additional LTD replaces less expensive sources of funding, the proposal could moderately raise funding costs for covered entities and covered IDIs. Staff estimates that, if the costs are fully absorbed by covered entities, the increased costs associated with the proposal could lower covered entities' net interest margin by roughly 5-10 basis points.[10] However, depending on their individual business decisions, covered entities and covered IDIs may in turn pass through some of these increased costs to equity holders, depositors, borrowers, employees, or other stakeholders. While an LTD requirement could affect a bank's choice of funding mix, the benefits of the LTD requirement – potential improvements to financial stability, greater flexibility in responding to the failure of covered entities and covered IDIs, increasing the likelihood of orderly and cost-effective resolution, and helping to reduce costs to the Deposit Insurance Fund from such failure – would outweigh the costs.

F. Amendments to the Board's TLAC Rule

The proposal would make technical changes to the TLAC rule to address items that have been identified through the Board's administration of the rule since it was finalized in 2017.

RECOMMENDATIONS:

For the reasons discussed above, staff recommends that the Board approve the attached draft notice of proposed rulemaking for publication in the *Federal Register* with a public comment period to end on November 30, 2023. Staff also requests that the Board delegate to

---

[9] Staff recognizes that the Basel III reforms proposal issued by the agencies would, if adopted, increase risk-weighted assets across covered entities. The increased risk-weighted assets would lead mechanically to increased requirements for LTD under the LTD proposal. The increased capital that would be required under the Basel III proposal could also reduce the cost of various forms of debt for impacted firms due to the increased resilience that accompanies additional capital (which is sometimes referred to as the Modigliani-Miller offset). The size of the estimated LTD needs and costs do not account for either of these potential effects of the Basel III proposal.

[10] Note the range is somewhat higher for Category IV covered entities as a group relative to Category II and III covered entities. Staff uses two alternative analyses to estimate rough upper and lower bounds for potential future effects on bank funding behavior and funding costs. Both analyses rely upon available data and simplifying and technical assumptions.

staff the authority to make technical, non-substantive changes to the attached materials prior to publication in the *Federal Register*.