BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: December 5, 2016

To: Board of Governors

From: Daniel Tarullo DKT

Subject: Draft final rule establishing total loss-absorbing capacity, long-term debt, and clean holding company requirements for global systemically important banks

Attached are a memorandum to the Board and draft *Federal Register* notice regarding a final rule that would establish long-term debt ("LTD") and total loss-absorbing capacity ("TLAC") requirements, as well as restrictions on certain arrangements that could impede a resolution proceeding ("clean holding company requirements"), for top-tier U.S. bank holding companies that are global systemically important banking organizations ("covered BHCs") and U.S. intermediate holding companies of foreign global systemically important banking organizations ("covered IHCs"). The purpose of the final rule is to promote the financial stability of the United States by enhancing the resiliency of covered BHCs and covered IHCs and enhancing their resolvability under both the U.S. Bankruptcy Code and Title II of the Dodd-Frank Act. The final rule is based on a proposed rule that the Board issued in 2015.

The draft final rule would require covered BHCs to maintain outstanding a minimum amount of eligible LTD, which is defined as unsecured long-term debt governed by U.S. law that is plain vanilla (i.e., has no complex features that would interfere with its loss-absorbing capacity), that has a remaining maturity of at least one year, and that could be converted into equity in order to absorb losses and recapitalize the firm's operating subsidiaries in a resolution. Under the proposed rule, debt issued with certain acceleration clauses or debt governed by foreign law would not have satisfied the proposed LTD requirements. In response to comments, debt that was issued prior to December 31, 2016, and that contained such acceleration clauses or was governed by foreign law would be grandfathered as eligible LTD under the draft final rule. This grandfathering should significantly reduce the burden of complying with the requirements of the draft final rule.

The requirements in the draft final rule are generally the same for covered BHCs and covered IHCs – for example, long-term debt issued by covered IHCs would be required to be unsecured, plain vanilla long-term debt governed by U.S. law that has a remaining maturity of at least one year. However, under the proposal, covered IHCs would have been required to issue their LTD internally to their foreign parents. Under the draft final rule, covered IHCs that plan to enter into resolution proceedings in the U.S. under their foreign banking organization parent's multiple-point-of-entry resolution strategy would be allowed the option to issue their LTD externally to third-parties on the same terms as covered BHCs. In addition, and as under the proposal, debt issued internally by a covered IHC would be required to contain a contractual conversion trigger to allow the Board to convert the debt to equity on a going concern basis if the Board determines the covered IHC is in danger of default and certain other conditions are met. The contractual conversion trigger requirements in the draft final rule, however, have been modified from the proposal to respond to concerns raised by commenters that this feature would cause the debt to be treated as equity for tax purposes.

Covered BHCs and covered IHCs also would be required to maintain a minimum amount of TLAC under the draft final rule composed of tier 1 capital issued directly by the covered firm and eligible LTD, as described below. As under the proposed rule, the minimum amount of TLAC required under the final rule for covered IHCs would depend on whether a firm is expected to enter a resolution proceeding at the level of the foreign banking organization parent or at the level of the covered IHC. The draft final rule also includes TLAC buffers that are analogous to the buffers required under the Board's regulatory capital rules. The buffers in the draft final rule would provide symmetry with the capital rules and help to ensure adequate levels of TLAC. A breach of a buffer would result in limitations on capital distributions, such as dividends, and certain bonus payments.

The TLAC and LTD requirements in the draft final rule would apply as of January 1, 2019. Though the proposal contained a limited phase-in period until January 1, 2022, the grandfather of existing LTD is expected to mitigate the need for a longer phase-in period.

The Committee on Bank Supervision has been briefed on the draft final rule, and I believe the attached materials are ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: December 5, 2016

To: Board of Governors

From: Staff[1]

Subject: Draft final rule establishing total loss-absorbing capacity, long-term debt, and clean holding company requirements for U.S. global systemically important bank holding companies and U.S. intermediate holding companies of foreign global systemically important banking organizations

ACTIONS REQUESTED: Approval of the attached draft Federal Register notice and draft final rule that would (1) establish long-term debt ("LTD") and total loss-absorbing capacity ("TLAC") requirements for top-tier U.S. bank holding companies that are global systemically important banking organizations ("Covered BHCs") and U.S. intermediate holding companies of foreign global systemically important banking organizations ("Covered IHCs"), and (2) restrict these companies from entering into certain arrangements, such as issuing short-term debt to third parties or entering into certain derivatives and other qualified financial contracts with external counterparties to further improve their resolvability and the resiliency of their operating subsidiaries ("clean holding company requirements"). Staff also requests the authority to make technical and minor changes (e.g., wording and formatting) to the attached materials to prepare them for publication in the Federal Register.

EXECUTIVE SUMMARY: The draft final rule would require Covered BHCs and Covered IHCs to maintain outstanding minimum levels of LTD and TLAC, and would impose related buffers on top of the minimum TLAC requirement. The requirements in the draft final rule would increase the resiliency of these companies and improve their resolvability under the U.S. Bankruptcy Code and under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") without the need for government or taxpayer support. The draft final rule is based on a proposal issued by the Board in October 2015, with modifications in response to comments.[2] The key elements of the draft final rule are summarized below.

[1] Messrs. Gibson, Van Der Weide, Campbell, and Ms. Harrington (Division of Banking Supervision and Regulation), and Mr. Alvarez, Ms. Schaffer, and Messrs. McDonough, Schwarz, Giles, Frischmann, and Buresh (Legal Division).

[2] 80 Federal Register 74926 (November 30, 2015).

A. External LTD and TLAC requirements for Covered BHCs (U.S. GSIBs)

- Eligible external LTD is defined under the draft final rule as a debt instrument that is issued directly by a Covered BHC, is unsecured, is "plain vanilla," is governed by U.S. law, and has a remaining maturity of more than one year. (Federal Register notice, pp. 51-77.)
  - The Covered BHC would be required to maintain external LTD in an amount equal to the greater of (1) 6 percent of RWA plus the firm's surcharge under the GSIB surcharge rule, and (2) 4.5 percent of total leverage exposure. (Federal Register notice, pp. 29-42.)
  - In response to comments on the proposal, the draft final rule grandfathers LTD issued on or before December 31, 2016, that has impermissible acceleration clauses or that is subject to foreign law. (Federal Register notice, pp. 66, 73.)

- Eligible external TLAC is the combination of (1) common equity tier 1 capital and additional tier 1 capital issued directly by a Covered BHC plus (2) eligible external LTD. (Federal Register notice, pp. 42-43.)
  - The Covered BHC would be required to maintain outstanding eligible external total loss-absorbing capacity ("eligible external TLAC") in an amount not less than the greater of (1) 18 percent of risk-weighted assets ("RWA"), and (2) 7.5 percent of total leverage exposure (the denominator of the supplementary leverage ratio ("SLR") in the Board's capital rules). (Federal Register notice, pp. 29-42.)
  - A Covered BHC also would be subject to an RWA-related TLAC buffer equal to 2.5 percent plus the firm's surcharge under the Board's GSIB risk-based capital surcharge rule ("GSIB surcharge rule"), and, in response to comments received on the proposal, a leverage-related external TLAC buffer equal to 2 percent, in addition to the minimum TLAC requirements, that operate like the capital buffers in the Board's capital rules for bank holding companies. A breach of either buffer would result in restrictions on distributions and discretionary bonus payments (Federal Register notice, pp. 43-51.)

- Impact Analysis: As of September 30, 2016, four of the eight Covered BHCs are estimated to have TLAC or LTD shortfalls. The aggregate external TLAC shortfall of the four Covered BHCs is approximately $56 billion, the aggregate external LTD shortfall is approximately $49 billion, and the aggregate shortfall for the external LTD and TLAC requirements together would be approximately $70 billion, which represents a significant decline from the estimated $120 billion aggregate shortfall estimated in the proposed rule. Staff estimates that the aggregate increased funding cost for Covered BHCs as a result of the rule range from approximately $680 million to $2 billion annually. (Federal Register notice, pp. 77-86.)

B. LTD and TLAC requirements for Covered IHCs (U.S. IHCs of Foreign GSIBs)

- Resolution strategy: The LTD and TLAC requirements for a Covered IHC in the draft final rule depend on the resolution strategy of the Covered IHC:
  - A non-resolution Covered IHC would be expected to remain a going concern under its parent foreign banking organization's single-point-of-entry resolution strategy. (Federal Register notice, pp. 94-97.)

  - A resolution Covered IHC would be expected to rely on resolution proceedings in the United States under its parent foreign banking organization's multiple-point-of-entry resolution strategy. (Federal Register notice, pp. 94-97.)

- Eligible external LTD: In response to comments received on the proposal, the final rule provides a resolution Covered IHC with the option to issue LTD externally to third parties in a manner similar to Covered BHCs and consistent with the Covered IHCs resolution strategy. (Federal Register notice, pp. 86-88.)
  - This external LTD is subject to the same requirements as those that apply to eligible external LTD issued by Covered BHCs: the LTD must be issued directly by the Covered IHC, be unsecured, plain vanilla, governed by U.S. law, and have a maturity greater than one year. (Federal Register notice, pp. 86-88, 113-118.)
  - In response to comments on the proposal, and consistent with the treatment of external LTD issued by Covered BHCs, the draft final rule grandfathers external LTD issued by a resolution Covered IHC on or before December 31, 2016, that contains impermissible acceleration clauses or that is subject to foreign law. (Federal Register notice, pp. 115-116, 119-120.)

- Eligible internal LTD: A non-resolution Covered IHC is required to issue internal LTD to its foreign GSIB parent or to a foreign wholly-owned subsidiary of its foreign GSIB parent. (Federal Register notice, pp. 115-118.)
  - A resolution Covered IHC has the option to issue internal LTD. (Federal Register notice, p. 116.)
  - The required terms of eligible internal LTD generally are the same as those of eligible external LTD with one key distinguishing feature: internal LTD must contain a contractual provision under which the Board could convert the LTD into equity under specified conditions. (Federal Register notice, pp. 122-129.)

- LTD Requirements for Covered IHCs: A Covered IHC would be required to maintain LTD in an amount equal to the greatest of (1) 6 percent of total RWA, (2) 2.5 percent of total leverage exposure (if applicable), and (3) 3.5 percent of average total consolidated assets, as computed for purposes of the tier 1 leverage ratio as calculated under the Board's capital rules (U.S. tier 1 leverage ratio). (Federal Register notice, pp. 97-108.)
  - This requirement is the same for all Covered IHCs regardless of their resolution strategy and, in response to comments received on the proposal, reflects the same balance sheet depletion assumption afforded to Covered BHCs. (Federal Register notice, p. 23-24, 107.)
  - Non-resolution Covered IHCs must satisfy this requirement with eligible internal LTD while resolution Covered IHCs could satisfy this requirement with both eligible internal LTD and eligible external LTD. (Federal Register notice, pp. 20-22, 105.)

- Covered IHC TLAC is the combination of (1) common equity tier 1 capital and additional tier 1 capital issued directly by a Covered IHC plus (2) eligible LTD issued internally or externally, depending on the Covered IHC's resolution strategy. (Federal Register notice, pp. 86-88, 108-111.)

- Non-resolution Covered IHCs: A non-resolution Covered IHC would be required to maintain TLAC in an amount not less than the greatest of (1) 16 percent of RWA, (2) 6 percent of total leverage exposure (if applicable), and (3) 8 percent of average total consolidated assets, as computed for purposes of the U.S. tier 1 leverage ratio. (Federal Register notice, pp. 97-108.)
- Resolution Covered IHCs: A Resolution Covered IHC would be required to maintain outstanding eligible TLAC in an amount not less than the greatest of (1) 18 percent of the Covered IHC's RWA, (2) 6.75 percent of the Covered IHC's total leverage exposure (if applicable), and (3) 9 percent of the Covered IHC's average total consolidated assets, as computed for purposes of the U.S. tier 1 leverage ratio. (Federal Register notice, pp. 97-108.)
- Covered IHCs also would be subject to an RWA-related TLAC buffer equal to 2.5 percent that is similar to the capital conservation buffer in the Board's capital rules for bank holding companies. Any breach of the buffer would result in restrictions on distributions and discretionary bonus payments. (Federal Register notice, pp. 111-113.)

C. Clean Holding Company Requirements: The draft final rule prohibits Covered BHCs and Covered IHCs from issuing short-term debt to third parties; entering into certain derivatives and other qualified financial contracts with external counterparties; providing certain guarantees of subsidiary liabilities or other arrangements that create disruptive default, set-off, or netting rights for subsidiaries' creditors; or allowing their liabilities to be guaranteed by one of their subsidiaries. (Federal Register notice, pp. 131-144.)

- In response to comments received on the proposal, Covered BHCs and Covered IHCs would be permitted to guarantee certain qualified financial contracts of their subsidiaries, to the extent such guarantees are in the future permitted by regulations governing stays on qualified financial contracts issued by the Board or other Federal banking agencies. (Federal Register notice, pp. 139-143.)

- The draft final rule imposes a cap on the external liabilities (other than those related to TLAC) of Covered BHCs and Covered IHCs equal to 5 percent of the value of eligible TLAC unless the firm's eligible LTD is contractually subordinated to the claims of third-party creditors. (Federal Register notice, pp. 145-152.)
  - Covered BHCs and Covered IHCs that issue their eligible LTD only as contractually subordinated debt are not subject to this requirement. (Federal Register notice, pp. 150, 151.)

D. Transition Period: All LTD and TLAC requirements would apply as of January 1, 2019. The final rule does not retain the proposal's extended phase-in through January of 2022 in recognition of the fact that observed shortfalls have declined substantially and a number of changes have been made to the final rule that will reduce the burden of complying with the requirements of the draft final rule. (Federal Register notice, pp. 155-157.)

E. Capital Deduction: The draft final rule does not include any of the proposed regulatory capital deductions for investments in the unsecured debt of Covered BHCs and Covered IHCs. These elements of the proposal are expected to be addressed jointly with the OCC and FDIC at a later time, which would allow for consistent application to all entities subject to the regulatory capital requirements of the federal banking agencies. (Federal Register notice, pp. 154-155.)

BACKGROUND:

In October 2015, the Board invited public comment on a notice of proposed rulemaking (proposal) to require Covered BHCs and Covered IHCs to maintain a minimum amount of total loss-absorbing capacity (TLAC), consisting of a minimum amount of long-term debt (LTD) and tier 1 capital.[3] In addition, the proposed rule prescribed certain buffers, the breach of which would result in limitations on the capital distributions and discretionary bonus payments of the firm. The proposal also included a separate requirement that these companies maintain a minimum amount of LTD. These requirements had two overall objectives: improving the resiliency of these companies and improving their resolvability in the event of their failure or material financial distress.

Improving the resiliency of banking organizations, and in particular large banking organizations, has long been a goal of the Board. The Board has had a long-standing practice of requiring large bank holding companies to maintain minimum amounts of regulatory capital in order to absorb losses.[4] Banking organizations subject to the Board's regulatory capital rules (Regulation Q) must maintain a minimum amount of regulatory capital and maintain a capital buffer above the minimum capital requirements in order to avoid restrictions on capital distributions and discretionary bonus payments.[5] The largest and most complex banking organizations are subject to additional capital buffers because of their greater systemic risk.[6]

The TLAC requirements in the draft final rule would build on, and serve as a complement to, the regulatory capital requirements in the Board's regulatory capital rules. While regulatory capital requirements aim to ensure that a banking organization has sufficient capital to remain a going concern, the TLAC requirements in the draft final rule aim to reduce the financial stability

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[3] *See* 80 FR 74,926 (November 30, 2015).

[4] *See* 12 CFR part 225, Appendix A (superseded as of January 1, 2015, by 12 CFR part 217).

[5] 12 CFR 217.11(a). The capital conservation buffer is composed entirely of common equity tier 1 capital

[6] These are the countercyclical capital buffer and the buffer in the Board's risk-based capital surcharge for global systemically important bank holding companies. 12 CFR 217.11(b); 12 CFR part 217, subpart H.

impact of a failure of a Covered BHC or Covered IHC by requiring them to have sufficient loss-absorbing capacity on both a going-concern and a gone-concern basis.

A company's gone-concern loss-absorbing capacity is different from the company's going-concern capacity in a few fundamental respects. Although regulatory capital does have the ability to absorb losses after a firm has entered resolution, the firm's regulatory capital, and especially its equity capital, is likely to be significantly or completely depleted in the lead up to resolution. Thus, if the ultimate goal is to have a failed firm re-emerge from resolution with sufficient capital to successfully operate as a going concern, there will need to be a new source of capital for the firm. In this regard, debt instruments, which count in regulatory capital in limited amounts and are subject to restrictions on their terms, are capable of absorbing losses in resolution. However, as discussed below, certain debt instruments are better able to absorb losses in a resolution proceeding and only these eligible debt instruments count toward the TLAC and LTD requirement in the final rule.

Improving resolvability was also an important goal of the proposal, and remains an important goal of the draft final rule. Efforts to ensure the orderly resolution of firms subject to the rule enhance financial stability. To further this objective, the largest domestic and foreign banks operating in the United States would be required to maintain a minimum amount of outstanding LTD instruments. This LTD also would count toward the TLAC requirements in the final rule. In the event that a company has significant losses or significant financial distress, the LTD that the company had issued could be used to replenish the company's equity capital. For example, in the event that a subsidiary of a Covered BHC or Covered IHC experienced losses, the losses would be passed on first to shareholders of the parent company, and if the losses exceeded the parent company's equity, to the holders of the company's debt. In this way, the LTD and TLAC requirements in the draft final rule would increase market discipline for Covered BHCs and Covered IHCs by making them bear the costs of issuing a minimum amount of LTD instruments that are capable of absorbing losses in a manner that would enhance the resiliency and resolvability of the organization. The final rule also will reduce liquidity run risk by requiring that Covered BHCs have a more substantial base of stable long-term debt funding that is structurally subordinated to funding at the operating subsidiary level, thereby supporting the continued operation of operating subsidiaries, even if the parent or another part of the firm is in resolution.

With respect to Covered IHCs, the final rule should, in the case of a firm with a single-point-of-entry (SPOE) resolution strategy, facilitate the recapitalization of a Covered IHC in the context of a cross-border resolution of the foreign parent without the need to place the Covered IHC into a resolution proceeding and, in the case of a firm with a multiple-point-of-entry (MPOE) resolution strategy, improve the ability of U.S. authorities to conduct an orderly resolution of a Covered IHC separate from its foreign GSIB parent, if necessary.[7] As in the proposal, the TLAC and LTD requirements in the draft final rule focus on Covered BHCs and Covered IHCs, because, as shown in the recent financial crisis, the failure or material financial distress of the largest financial firms has the greatest potential to disrupt U.S. financial stability.

The Board received approximately 50 comments on the proposal from banking organizations, trade associations, public interest groups, members of Congress, and private individuals. The comments addressed a wide variety of aspects of the proposal as described further below, including the potential costs and burdens of various aspects of the proposal. Staff also met with some commenters at their request to discuss their concerns with the proposal. Staff has reviewed the comments received in response to the proposal and modified the proposal to address commenter concerns in a manner consistent with the intended purpose of the final rule as described in more detail below. In addition, Board staff consulted with certain U.S. federal financial agencies and foreign regulators.

Shortly after issuance of the proposal, in November 2015, the Financial Stability Board (FSB) published a final international standard for the total loss-absorbing capacity of GSIBs.[8] The draft final rule also is generally consistent with the FSB standard, although the final rule adopts a minimum LTD requirement, unlike the FSB standard.

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[7] In an SPOE resolution, only the top-tier holding company of the failed banking organization would enter a resolution proceeding. The losses that caused the banking organization to fail would be passed up from the subsidiaries that incurred the losses and would then be imposed on the equity holders and unsecured creditors of the holding company. The alternative to an SPOE resolution is an MPOE resolution, which generally would entail separate resolutions of different legal entities within the financial firm that could potentially be executed by multiple resolution authorities across multiple jurisdictions.

[8] Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution, Total Loss-absorbing Capacity (TLAC) Term Sheet, November 9, 2015 (hereinafter "FSB standard"), available at http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

SUMMARY OF THE DRAFT FINAL RULE

A. External LTD and TLAC requirements for Covered BHCs (U.S. GSIBs)

1. External LTD requirements for Covered BHCs

A. Eligible external LTD

The draft final rule would retain the same general eligibility criteria as the proposal for a Covered BHC's LTD to qualify as eligible external LTD. Specifically, under the draft final rule, eligible external LTD must be issued directly by the Covered BHC, and must be unsecured, plain vanilla (rather than being structured notes or containing derivative-linked features), and governed by U.S. law. As under the proposal, external LTD principal that is due to be paid in less than two years would be subject to a 50 percent haircut for purposes of the LTD requirement in the draft final rule, and external LTD principal due to be paid in less than one year would not count towards the LTD requirement or the TLAC requirement.

In addition to the above requirements, the draft final rule generally prohibits eligible LTD from containing any acceleration clauses that give the holder a contractual right to accelerate payment. The draft final rule, like the proposal, provides for an exception to this prohibition for acceleration clauses that are tied to either the insolvency of the Covered BHC or a failure of the Covered BHC to make payment on the instrument when due. The draft final rule modifies the proposal's allowance of acceleration clauses tied to non-payment to require that the non-payment continue for at least 30 days before the holder's acceleration rights vest. This modification is designed to ensure that such acceleration clauses are not triggered by an accidental or temporary failure to make payment by the Covered BHC.

Comments on the proposal indicated that nearly all outstanding LTD contains impermissible acceleration clauses (e.g., acceleration in the event of sale of a material subsidiary or in the event of failure to pay taxes or maintain a certain office) and that a good fraction consists of debt governed under foreign law. In light of these comments and to reduce the potential burden to comply with the final rule, the draft final rule would grandfather LTD that includes otherwise impermissible acceleration clauses or is governed under foreign law if the LTD is issued on or before December 31, 2016.

The final rule also includes a provision that allows the Board, after notice and opportunity for response, to order a Covered BHC to exclude from its outstanding eligible LTD amount any debt securities with features that would significantly impair the ability of such debt securities to take losses. This provision will help ensure that Covered BHCs do not create long-term debt instruments for the purposes of evading the requirements of the final rule.

The draft final rule would not permit principal-protected structured notes or trust-preferred securities ("TruPS") to qualify as LTD, despite requests by many commenters. Both structured notes and TruPS fail the eligibility requirements for eligible LTD. For example, under the draft final rule, LTD must be "plain vanilla," meaning that it cannot include embedded derivatives such as those included in structured notes. Similarly, TruPS are not issued directly by Covered BHCs, and by their nature are hybrid debt-equity instruments. Staff believe that the impact of not permitting these instruments to qualify as eligible LTD should be modest.

B. Calibration of Eligible External LTD for Covered BHCs

Under the draft final rule, a Covered BHC is required to maintain outstanding eligible external long-term debt instruments ("eligible external LTD") in an amount not less than the greater of (1) 6 percent plus the surcharge applicable under the GSIB surcharge rule (expressed as a percentage of total risk-weighted assets ("RWAs")) and (2) 4.5 percent of total leverage exposure. A number of commenters contended that the LTD requirements were either unnecessary or too high and would impose undue costs and burdens on covered entities but the draft final rule retains the calibration of the LTD proposal without modification.

The draft final rule, like the proposal, includes an LTD requirement that is separate from the TLAC requirement. Unlike equity, which is typically fully depleted at the point of failure, LTD can be used as a potential new source of capital in resolution.[9] The calibration of the minimum LTD requirements for Covered BHCs employed a "capital refill" framework in which a Covered BHC should have a minimum amount of LTD available such that, if the Covered BHC's going-concern capital is depleted and it enters resolution, the firm's LTD would be sufficient to absorb losses and fully recapitalize the Covered BHC's going-concern capital. Imposing an external LTD requirement would help to ensure that a Covered BHC would have a known and observable quantity of loss-absorbing capacity at the point of failure. Thus, the proposed external LTD requirements would more assuredly enhance the prospects for the

[9] Accordingly, the specific LTD requirements in the final rule depend on the precise structure and calibration of the Board's regulatory capital requirements. To the extent that these capital requirements are updated over time, the draft Federal Register notice explains that the Board would consider updating the associated external LTD requirement in an effort to preserve the general alignment between the Board's capital rules and the external LTD requirements.

successful resolution of a failed Covered BHC and thereby more strongly address the too-big-to-fail problem than would external TLAC requirements alone.

2. TLAC requirements for Covered BHCs

As noted, the draft final rule would establish TLAC and LTD requirements that would supplement the Board's existing capital rules. While the capital rules establish a fixed amount of "going concern" capital that a covered institution must maintain, the Board's TLAC requirement would impose an additional requirement on Covered BHCs and Covered IHCs. The standalone LTD requirement would ensure that a significant portion of this loss-absorbing capacity would be available as a source of gone-concern capital.

A. Requirements of eligible external TLAC

Under the proposal, a Covered BHC's eligible TLAC would have been defined to include the sum of (1) the tier 1 regulatory capital issued by the Covered BHC (excluding minority interests issued out of subsidiaries), and (2) the Covered BHC's eligible LTD. The draft final rule adopts this definition without modification.

B. Calibration of external TLAC requirements for Covered BHCs

The draft final rule would require Covered BHCs to maintain outstanding eligible external TLAC equal to the greater of (1) 18 percent of RWAs and (2) 7.5 percent of total leverage exposure. Relative to the proposal, the leverage-based requirement reflects a 2 percentage point reduction, from 9.5 percent to 7.5 percent. Instead, as discussed below, the draft final rule includes a 2 percentage point buffer over the minimum leverage component of the external TLAC requirement.

Aside from the inclusion of the leverage-related buffer, the TLAC calibration in the draft final rule has not been modified from the proposal. Several commenters requested that the requirements be reduced or eliminated as they would cause an undue burden and result in significant costs for Covered BHCs. The draft final rule's TLAC calibration was informed by the historical loss experience of major financial institutions during the financial crisis, taking into account the actual losses experienced by such firms and the government recapitalization support such firms received. The calibration of the TLAC requirements in the draft final rule also took into account an analysis of extreme losses (those occurring in the tail of the distribution) experienced by large U.S. bank holding companies over the past several decades.

As in the proposal, the draft final rule includes an external TLAC buffer related to the RWA TLAC requirement. This buffer is similar to the capital conservation buffer in the Board's regulatory capital rules for bank holding companies. The external TLAC buffer is intended to provide parallelism with the capital rules and to help ensure that Covered BHCs maintain sufficient amounts of TLAC. As in the proposal, any breach of the buffer would result in restrictions on distributions and discretionary bonus payments.

In addition to the RWA-related TLAC buffer, the final rule also incorporates a buffer on top of the leverage-related TLAC requirement. This buffer is analogous to the enhanced supplementary leverage ratio buffer in the Board's regulatory capital rules for bank holding companies. This modification of the proposal will increase the consistency of the leverage capital rules and leverage TLAC rules for Covered BHCs. As in the case of the RWA buffer, any breach of the leverage-related buffer would result in restrictions on distributions and discretionary bonus payments.

3. Impact Analysis

As noted, based on quarterly financial information reported by U.S. GSIBs, supervisory information, and the revised requirements of the final rule, Board staff estimates that as of the end of the third quarter of 2016 the estimated aggregate shortfall for the U.S. GSIBs would be significantly less than originally expected. Under the final rule, the expected aggregated shortfall would be approximately $56 billion for the TLAC requirement, approximately $49 billion for the LTD requirement, and approximately $70 billion for the combined shortfall of the two requirements on an aggregate basis. This represents a significant decrease from the $120 billion estimated shortfall at the time of the proposal. Staff estimates that the aggregate increased funding cost for the Covered BHCs as a result of the rule would range from approximately $680 million to $2 billion annually.

B. LTD and TLAC requirements for U.S. IHCs of Foreign GSIBs

Under the draft final rule, as under the proposal, the specific LTD and TLAC requirements that apply to a Covered IHC depend on its resolution strategy. A non-resolution covered IHC would be expected to remain a going concern under the FBO parent's SPOE resolution strategy. A resolution covered IHC would be expected to enter resolution in the United States under the FBO parent's MPOE resolution strategy.

Under the proposal, all LTD and TLAC issued by a Covered IHC was required to be issued internally to a foreign parent. A number of foreign bank commenters contended that resolution Covered IHCs that are expected to be resolved pursuant to an MPOE resolution strategy and thus would be expected to enter a resolution proceeding in the same manner as a Covered BHC should be permitted to issue eligible LTD and capital externally to third parties in the same manner as a Covered BHC. The draft final rule would permit resolution Covered IHCs to issue eligible LTD and capital externally to third parties in a manner similar to Covered BHCs in addition to issuing debt internally. Non-resolution Covered IHCs would still be required to issue all of their eligible LTD and capital internally.

1. Covered IHC LTD Requirements

A. Eligible LTD issued by a Covered IHC

a. Eligible External LTD issued by a Resolution Covered IHC

The draft final rule would allow a resolution Covered IHC to issue external LTD to unaffiliated third parties and certain foreign affiliates of the Covered IHC that would not be permitted to hold internal LTD. External LTD issued by a resolution Covered IHC generally would be subject to the same requirements under the draft final rule as those imposed on the external LTD issued by a Covered BHC, as described above. Moreover, the same grandfathering provisions that apply to external debt issued by Covered BHCs also apply to external debt issued by resolution Covered IHCs. The rationale for grandfathering is the same as that for Covered BHCs, as described above.

b. Eligible Internal LTD Issued by a Covered IHC

As noted, a resolution Covered IHC may issue internal LTD at its option; a non-resolution Covered IHC is required to issue internal LTD. Under the draft final rule, LTD issued by a Covered IHC would qualify as eligible internal LTD if it meets the same requirements as those imposed on eligible external LTD and certain additional eligibility criteria to help ensure the internal LTD's loss-absorbing features.

First, internal LTD would need to be held by a parent foreign entity that controls the Covered IHC, or by a foreign wholly-owned subsidiary of its foreign GSIB parent. This requirement would help ensure the reliable conversion of such securities into equity, and avoid change-of-control problems involving a Covered IHC that could disrupt the resolution of the Covered IHC or its foreign GSIB parent.

Second, as under the proposal, internal LTD would be required to contain a contractual provision pursuant to which the Board could, in certain circumstances, order the Covered IHC to convert the LTD into equity of the Covered IHC on a going-concern basis (that is, without the Covered IHC's entering a resolution proceeding). Several commenters indicated that the elements required by the conversion trigger could cause the internal LTD to be treated as equity instead of debt for U.S. tax purposes. The draft final rule would retain the conversion trigger requirement for internal debt as the benefits of a conversion trigger requirement for internal debt outweigh its potential costs, including when taking into account all of the information provided by commenters. The draft final rule would, however, amend the eligibility requirements for internal LTD in light of comments received on the proposal.

In particular, the draft final rule reflects four changes that are consistent with the Board's policy objectives and that may allow firms to treat the eligible internal LTD as debt under U.S. tax law. First, the draft final rule provides that the Board would only have the ability to require the conversion of the internal LTD into equity, and not the cancellation of the debt. Second, the draft final rule gives the Board the ability to require the conversion of some or all of the internal LTD, as opposed to always requiring all of the internal LTD to convert into equity. Third, the draft final rule allows internal LTD to have acceleration clauses on the same terms as external LTD. Fourth, the draft final rule allows internal LTD to be structurally subordinated in a similar manner to external LTD.

Under the draft final rule, the Board could order the conversion of such LTD into equity if (1) the Board determines that the Covered IHC is "in default or in danger of default"; and (2) any of the following circumstances apply: (i) the top-tier foreign banking organization is placed into resolution proceedings, (ii) the home country supervisory authority consents to the conversion, or does not object to the conversion following 24 hours' notice, or (iii) 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.[10]

[10] The draft final rule shortens the period that a home country supervisor would have to object to the conversion of the internal LTD from 48 hours to 24 hours. This change reflects consultation with certain foreign regulatory authorities and reflects the concern that a firm can collapse precipitously in a financial crisis. The Federal Register notice explains that the Board expects to consult early with a foreign regulatory authority if a Covered IHC is experiencing stress.

It should be noted that no grandfathering provisions have been adopted for pre-existing internal LTD as the burden of full compliance for internal LTD by Covered IHCs should be low given that the issuer and investor are affiliates.

B. Calibration of LTD requirements for Covered IHCs

The draft final rule would require a Covered IHC to meet an LTD requirement equal to the greatest of (1) 6 percent of the Covered IHC's RWAs, (2) 2.5 percent of the Covered IHC's total leverage exposure (if the Covered IHC is subject to the SLR), and (3) 3.5 percent of the Covered IHC's average total consolidated assets. Consistent with several comments, the LTD requirements for Covered IHCs in the draft final rule are reduced as compared to those in the proposal, which would have required Covered IHCs to meet an LTD requirement equal to the greatest of (1) 7 percent of the Covered IHC's RWAs, (2) 3 percent of the Covered IHC's total leverage exposure (if the Covered IHC is subject to the SLR), and (3) 4 percent of the Covered IHC's average total consolidated assets, to reflect the same balance sheet depletion afforded to Covered BHCs – i.e., the expectation that pre-failure losses would slightly reduce the balance sheet size of such firms post-failure. Consequently, a smaller dollar amount of new capital would be required to restore the Covered IHC's capital levels to the minimum required levels. Though certain commenters requested that the Board eliminate the LTD requirements for covered IHCs, the final rule does not eliminate the requirement for the reasons discussed above.

2. TLAC requirements for Covered IHCs

a. Requirement for Eligible Covered IHC TLAC

In the case of a non-resolution Covered IHC, eligible TLAC is composed of: (1) common equity tier 1 capital (excluding minority interests issued out of subsidiaries) issued by the Covered IHC and held by the foreign parent or foreign wholly-owned subsidiary of the foreign parent and additional tier 1 capital issued directly by the Covered IHC and held by the foreign parent or a foreign wholly-owned subsidiary of the foreign parent plus (2) eligible internal LTD. In the case of a resolution Covered IHC, eligible TLAC is comprised of (1) common equity tier 1 capital (excluding minority interests issued out of subsidiaries) and additional tier 1 capital issued directly by the Covered IHC plus (2) eligible internal and external LTD.

b. TLAC Calibration for Covered IHCs

As in the proposal, the calibration of the TLAC requirements for Covered IHCs generally follows the same rationale as the calibration of the TLAC requirements for Covered BHCs, and different TLAC requirements would apply to resolution Covered IHCs and non-resolution Covered IHCs.

As noted, the Covered IHC TLAC requirement for a non-resolution Covered IHC is the greatest of (1) 16 percent of RWA, (2) 6 percent of total leverage exposure (if applicable), and (3) 8 percent of average consolidated assets as defined for the purpose of the U.S. tier 1 leverage ratio. This requirement is lower than the requirement for resolution Covered IHCs, in recognition of the greater likelihood that a non-resolution Covered IHC would receive support from its foreign GSIB parent if the parent is resolved, and the benefits of allowing the foreign GSIB parent to preserve flexibility to allocate some amount of resources to subsidiaries that have incurred losses in an SPOE resolution of the foreign GSIB. Several commenters requested that the calibration be lowered further, but the draft final rule adopts the proposal's calibration to help ensure sufficient loss absorbing capacity is available at the non-resolution Covered IHC.

The TLAC requirement for resolution Covered IHCs is similar to the requirement for Covered BHCs since both Covered BHCs and resolution Covered IHCs would be expected to enter a resolution proceeding. A resolution Covered IHC is required to maintain outstanding eligible TLAC in an amount not less than the greatest of (1) 18 percent of the Covered IHC's RWAs, (2) 6.75 percent of the Covered IHC's total leverage exposure (if applicable), and (3) 9 percent of the Covered IHC's average total consolidated assets, as computed for purposes of the U.S. tier 1 leverage ratio. This TLAC calibration has been adopted in the final rule as proposed without modification and the rationale for doing so tracks that for Covered BHCs.

Like Covered BHCs, Covered IHCs also would be subject to an RWA-related TLAC buffer that is similar to the capital conservation buffer in the Board's regulatory capital rules for bank holding companies. Any breach of the buffer would result in restrictions on distributions and discretionary bonus payments. Unlike the requirements for Covered BHCs, the draft final rule does not impose a buffer with respect to the leverage TLAC component for Covered IHCs because Covered IHCs are not subject to the Board's enhanced supplementary leverage ratio.[11]

C. <u>Clean holding company requirements</u>

The draft final rule applies "clean holding company requirements" to Covered BHCs and Covered IHCs ("Covered Firms") that would prohibit or limit these entities from entering into

[11] 12 CFR 217.10(c)(4).

certain financial arrangements that could create obstacles to orderly resolution. These restrictions help to ensure that LTD will be available to absorb losses in an orderly manner, consistent with the resolution strategy of the Covered BHC or Covered IHC. The subsidiaries of Covered BHCs and Covered IHCs would not be subject to these restrictions and could continue to enter into such arrangements.

Under the draft final rule, as under the proposal, Covered BHCs and Covered IHCs would be prohibited from engaging in short-term borrowings from third parties, entering into qualified financial contracts ("QFCs") with external counterparties, issuing certain guarantees of subsidiary liabilities that could create cross-default rights or set-off and netting rights for its subsidiaries' creditors, or from having liabilities that are subject to a guarantee from a subsidiary of the Covered Firm (a so-called "upstream guarantee"). In light of comments received on the proposal, the draft final rule also makes clear, however, that Covered BHCs and Covered IHCs would be permitted to guarantee certain QFCs of their subsidiaries, provided such guarantees would be permitted by regulations governing stays on QFCs issued by the Board or other federal banking agencies.

These restrictions serve three related goals. First, they seek to ensure that the risk of losses to and the imposition of losses on a Covered BHC's or Covered IHC's creditors does not pose an undue risk to U.S. financial stability. Prohibiting a Covered BHC or Covered IHC from having third-party short-term creditors or QFC counterparties mitigates the risk that destabilizing funding runs or asset fire sales could result from the Covered Firm's failure. Second, the proposed restrictions seek to ensure that a Covered BHC's or covered IHC's subsidiaries do not take losses in a resolution of the Covered BHC or Covered IHC and are instead able to continue operating normally. Third, the proposed restrictions seek to limit the complexity of a Covered BHC's or Covered IHC's operations so as to facilitate an orderly resolution of the firm.

In addition, under the draft final rule, a Covered Firm that has not contractually subordinated all of its eligible LTD to the claims of third-party creditors would be subject to a cap, equal to 5 percent of its TLAC, on third-party liabilities (other than those related to eligible TLAC) that are pari passu with or junior to its eligible LTD. The purpose of the 5 percent cap is to help ensure "structural subordination" of the eligible LTD of a Covered Firm. A Covered Firm has the option to contractually subordinate all of its eligible LTD to avoid the 5 percent cap.

Although some commenters requested that the Board exclude certain types of liabilities from this cap, the draft final rule adopts the cap without material change from the proposal. Liabilities subject to this cap would include debt instruments with derivative-linked features (e.g., structured notes), litigation liabilities, external vendor and operating liabilities (e.g., utilities, rent, fees for services, obligations to employees), and other long-term debt securities that would not meet the eligibility requirements for LTD. The cap on these types of liabilities is expected to limit the complexity of the operations of a Covered Firm and to facilitate an orderly resolution of a Covered Firm, or resolution of the parent of such a Covered Firm.

D. Compliance date

Under the draft final rule, Covered BHCs and Covered IHCs would be required to comply with the LTD, TLAC, and clean holding company requirements described above by January 1, 2019. A firm that subsequently becomes a Covered BHC or a Covered IHC would be required to comply with these requirements within three years of becoming a Covered BHC or a Covered IHC.

The proposed rule would have provided a transition period for the RWA component of the TLAC requirement (consistent with the FSB standard). The transition provision would have made a 16 percent requirement effective on January 1, 2019 and an 18 percent requirement effective on January 1, 2022. The draft final rule does not adopt this extended phase-in period because the draft final rule grandfathers most outstanding external LTD issued by Covered BHCs and Covered IHCs. This grandfathering lessens the impact of the draft final rule.

E. Capital Deductions

As noted, the proposal included regulatory capital deductions for investments by bank holding companies and state member banks in the unsecured debt of Covered BHCs and other GSIBs. Staff expects that this element of the proposal will be addressed jointly with the OCC and FDIC at a later time, which would allow for consistent application of the capital deduction to all entities subject to the regulatory capital requirements of the federal banking agencies.

CONCLUSION:

Staff recommends that the Board adopt the attached draft final rule and draft Federal Register notice to establish external LTD and TLAC requirements for Covered BHCs; to establish LTD and TLAC requirements for Covered IHCs; and to impose clean holding company requirements on Covered BHCs and Covered IHCs. Staff also seeks approval to make technical and minor changes to the draft final rule and Federal Register notice in order to prepare them for publication.

Attachment