FedFin Client Report

Thursday, December 15, 2016

U.S. TLAC Rule: Significant Concessions, But Still Very Stringent

Client Report: **TLAC5**

Executive Summary

As anticipated, the FRB today unanimously finalized the U.S. TLAC standards, continuing to differentiate these from global requirements (see FSM Report **TLAC4**) with a focus on a buffer of long-term debt (LTD), not equity as the mechanism to ensure orderly resolution. The most significant change in the final rule is grandfathering of current debt that meets all but a few of the rule's eligibility standards, a change that along with lower RWAs and more capital at covered entities leads to a decrease in the shortfall from $120 billion when the proposal was issued (see FSM Report **TLAC3**) to $70 billion, according to FRB staff. However, the bulk of these costs will fall on the four GSIBs that have yet to issue sufficient TLAC, with costs now and overall increases in funding costs over time to be particularly problematic for companies that rely on large amounts of retail deposits. Because TLAC's cost would rise at any covered company that sought to grow its assets, all U.S. GSIBs and affected IHCs are also under another regulatory pressure to reduce what Chair Yellen has called their "systemic footprint." The final rule will be effective in 2019, faster than contemplated by the NPR and continues to apply to the IHCs of foreign banks designated as GSIBs. For these companies, the final rule continues to require higher TLAC when parent companies rely on multiple-point-of-entry resolution strategies, but changes have been made to facilitate compliance to some degree for both SPOE and MPOE entities. The final rule no longer includes a capital penalty for holding another bank's TLAC, but this is likely soon to advance via an inter-agency rulemaking. FDIC Vice Chairman Hoenig remains strongly opposed to TLAC, but he would likely support this penalty to limit inter-connectedness.

Chair Yellen today emphasized that TLAC is essential to ensure that GSIBs internalize their failure cost and the rest of the Board supported the rule despite some questioning from Messrs. Fischer and Powell about the value of TLAC in bankruptcy resolutions. The status of these rules under the Trump Administration is uncertain but the FRB's action today will stand unless or until it is reversed by a

Federal Financial Analytics, Inc.
1140 Nineteenth Street, N.W., Washington, D.C. 20036
Phone (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com www.fedfin.com

subsequent FRB (not likely until at least 2018) or overturned by a Congress increasingly focused on forcing only bankruptcy resolutions without added regulatory requirements. This report analyzes today's meeting and provides a summary of the new rule; in-depth analysis will follow.

Analysis

Chair Yellen emphasized the need for large banks to bear the cost of their failure. Noting that large U.S. banks are far stronger than before, she argued that this rule will advance financial stability and economic growth.

Gov. Tarullo linked TLAC to ending TBTF, noting that TLAC will ensure market discipline because investors and regulators will understand that bail-out is not possible. Mr. Tarullo also noted that the resolution plans are critical, with recent action (see Client Report **LIVINGWILL14**) showing that the FRB and FDIC are prepared to sanction banks that remain TBTF. He strongly defended the LTD approach of the U.S. rule versus the equity-buffer approach in the global standards. The FRB's approach also dramatically reduces run-risk, Mr. Tarullo emphasized, stressing its complementary relationship with the LCR.

In presenting the final rule, staff noted that:

- LTD is subject to eligibility criteria, modifying the NPR generally in only technical ways. LTD must be issued by the BHC, be plain vanilla, and be subject to U.S. law. Maturities must be over one year. Acceleration clauses remain barred, but eligible LTD with these clauses are grandfathered. Debt governed under foreign law is also grandfathered.
- LTD adequacy is measured by both a risk-based and leverage measure, with firms required to maintain the greater of 6 percent plus the surcharge applicable under the GSIB surcharge rule of total RWAs and 4.5 percent of total leverage exposure. TLAC minimums are equal to Tier 1 equity capital plus long-term debt. TLAC must be the greater of 18 percent of total RWAs and 7.5 percent of total leverage exposure, along with a TLAC buffer similar to the capital-conservation buffer. However, the leverage-based TLAC buffer now is 2 percent of the total leverage exposure to make the TLAC rule compatible with the SLR.
- Breaches of the TLAC buffer would lead to a prohibition on discretionary capital distributions and bonuses.

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- For IHCs, the rule will track those for U.S. GSIBs but depend on the parent company's resolution strategy. The final rule continues the proposed conversion trigger with changes to protect its status as debt. MPOE-focused IHCs may issue certain debt to private investors as well as their parent companies. Foreign banks now also get the same balance-sheet depletion effect allowed for U.S. GSIBs. TLAC requirements remain as proposed, with a lower standard for SPOE firms.
- All covered firms must have clean holding companies that bar relationships such as short-term borrowing and QFCs with third parties, although the final rule now allows certain BHC guarantees. No capital deductions are required for TLAC, with this issue to be considered in an inter-agency rulemaking.
- The deadline is January 1, 2019 without an extended phase-in period due to the FRB's view that the final rule is less burdensome.

Chair Yellen emphasized the shortfall drop. Asking about how the U.S. rule compares to foreign TLAC standards, staff indicated that the U.S. approach is generally comparable with the exception of the LTD standard.

Vice Chairman Fischer asked about how TLAC fits into all the resolution rules. Staff said TLAC advances these rules by ensuring orderly resolution in bankruptcy and under OLA. Mr. Fischer suggested that equity is a reasonable alternative to debt, leading staff to reiterate why the U.S. approach focuses on LTD. Staff also said that foreign banks are likely to meet TLAC using considerable amounts of LTD reducing the practical impact of the differences.

Mr. Tarullo laid out the rationale for TLAC, validating the LTD approach. He also asked if there is a market for TLAC-mandated LTD and if market inter-connections would become problematic in a GSIB insolvency. Staff indicated that the bulk of U.S. GSIB LTD is held by non-bank financial institutions. The pending capital rule would also create a strong disincentive for banks to hold TLAC LTC.

Gov. Powell raised the bankruptcy-versus-OLA question, asking staff to explain why TLAC is valuable in both situations. Staff noted that the clean-BHC requirements advance rapid resolution in both scenarios.

Gov. Brainard had no questions.

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