Financial Services Management

U.S. TLAC Requirements

Cite

FRB, Final Rule, Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations

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Impact Assessment

- With TLAC, a key plank in the U.S. platform preventing TBTF for very large banks is complete.
- With a very limited grandfather for existing LTD, no transition period, and a shorter deadline, the new rule may require significant and often costly changes to GSIB debt-issuance practices.
- TLAC could shrink net interest margins absent increases in loan demand and/or in holdings of higher-earning assets that offset the funding and capital costs of a larger balance sheet. If GSIBs do not shrink deposit gathering, then higher-risk assets may be favored absent supervisory constraints.
- IHCs of FBOs that are either designated GSIBs or would be so designated under the FRB's methodology will be subject to U.S. TLAC of increasing stringency based on parent resolution strategy. In most cases, TLAC will be tougher than required by the home regulator. This will further ring-fence U.S. operations and heighten pressure to do the same for large U.S. banks in host jurisdictions.
- FRB cost-benefit analysis concludes the final rule will cost GSIBs less and have little adverse macro impact that is significantly offset by TLAC's major contribution in reducing GSIB externalities.

Overview

The FRB has unanimously approved the final version of its proposed standards[1] requiring U.S. GSIBs and the IHCs of foreign banks determined by the FRB's methodology to be GSIBs to hold total loss-absorbing capacity (TLAC) largely in the form of eligible long-term debt (LTD). Covered companies that fall short will be subject to new sanctions on capital distributions and discretionary bonuses regardless of the degree to which capital distributions are otherwise permitted. To ensure that LTD meets the FRB's expectations for loss-absorbing capacity, the final rule also limits liabilities issued by covered top-tier holding companies and required that this parent company be a "clean" BHC that readily assures liquidity sufficient to ensure orderly resolution under both the U.S. Bankruptcy Code and OLA. Although the final rule is modified in significant respects from the NPR, it will still require strategic changes by covered companies, changes intended to ensure that U.S. rules now effectively preclude taxpayer bail-out and thus ensure a reliable end to too-big-to-fail banks. The final rule does not impose a capital penalty for holding TLAC by other GSIBs, but this may be pursued shortly with a new rule from the FRB, OCC, and FDIC.

Impact

The U.S. TLAC approach is markedly different from the global one finalized in 2015 by the Financial Stability Board[2] and recently expanded upon with guidance on internal TLAC.[3] The global standards rely largely on equity to form a loss-absorbing buffer, an approach reflected in the "bail-in" rules many nations have issued that require large banks to have contingent capital ahead of debtors and national governments so that taxpayer-bail-outs are made far less likely. The FRB approach eschews reliance on equity as a TLAC buffer on grounds that equity is dissipated by the time a BHC is insolvent, meaning that debt instruments are the only reliable funding source for a buffer that can be converted into bail-in capital to ensure that single-point-of-entry (SPOE) resolutions are viable alternatives to government intervention and taxpayer bail-out.

As the final rule indicates, the FRB views its equity standards[4,5,6] as critical to going-concern resilience; TLAC is intended to provide gone-concern resolvability in concert with resolution-plans. The FRB and FDIC have taken a tough stand on these resolution plans, but the most recent review of those from U.S. GSIBs has given conditional approval to the living wills of all but

1 See **TLAC3**, *Financial Services Management*, November 10, 2015.

2 See **TLAC4**, *Financial Services Management*, November 24, 2016.

3 See Forthcoming FedFin Report.

4 See **CAPITAL199**, *Financial Services Management*, July 10, 2013.

5 See **CAPITAL200**, *Financial Services Management*, July 15, 2013.

6 See **CAPITAL201**, *Financial Services Management*, July 19, 2013.

one GSIB.[7] This has led many to assert that the combination of tough TLAC and resolution-plan requirements ensures an end to TBTF. This is generally accomplished through SPOE strategies, but the final rule has made some concessions to IHCs with parents favoring multiple-point-of-entry (MPOE) approaches in recognition of the FSB's acceptance of this alternative resolution strategy.

Whether IHCs in MPOE-focused parents can in fact operate as desired in the U.S. under TLAC will be more clear once each has advanced its living will with the FDIC and FRB and has also undertaken CCAR in the new framework. However, most foreign banks with large U.S. operations are likely to face significantly tougher TLAC requirements in the U.S. that further ring-fence their operations here from those of the rest of their parent foreign banking organization (FBO). This increases cost because both capital and liquidity will be trapped in the U.S. and could lead some companies to reduce their U.S. footprint or restructure it. With the European Commission already considering a proposal to force U.S. banks operating through branches into the equivalent of IHCs, these stringent TLAC standards could increase the odds of final action some have seen as retribution for the FRB's initial IHC regulation.[8]

Critics counter that TLAC will not ensure resolvability without rescue because the cost of the new standards will encourage GSIBs to take more risk. Part of the concern here is that the emphasis on LTD, not leverage capital, will essentially lever up the largest banks despite the significant capital requirements on which TLAC is based. As noted, the FRB believes that even large additional amounts of equity would be dissipated prior to insolvency, making LTD the best buffer for orderly resolution. Equity values would also drop – likely dramatically – as a GSIB weakens, meaning that equity at the time of insolvency would be of little recapitalization value unless the resolution authority "pulled the trigger" early in the GSIB's deterioration. This could perversely lead regulators to close GSIBs and risk systemic volatility, if not instability, for GSIBs that with more time could right themselves.

Although equity might not meet the FRB's objectives, large amounts of LTD that meets the rule's eligibility standards will clearly be more costly than many existing funding sources. To ease these costs, the final rule provides a limited grandfather for some currently-issued LTD, but it has not altered its stand against allowing deposits – even long-term ones – to count as TLAC-eligible LTD. Deposits are covered by the FDIC up to $250,000 regardless of maturity, likely leading the FRB to discount them because insured deposits would be paid out by the FDIC in the event the insured-depository in the GSIB fails either during the bridge resolution or thereafter. However,

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7 See *Client Report* **LIVINGWILL15**, December 15, 2016.

8 See **FBO3**, *Financial Services Management*, February 25, 2014.

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deposits are generally far less expensive than eligible LTD even for longer-maturity instruments. Banks that now rely on deposit funding would thus need to issue considerably more debt that would threaten profitability unless deposits are reduced – hurting customers unless alternative deposit capacity exists outside covered GSIBs – and/or increasing assets through higher-risk ones designed to offset the cost of the new LTD and applicable capital requirements.

As noted, the FRB reduced its estimate of the cost of the final TLAC approach. It did so in part by calculating the reduction from its initial cost estimate resulting from the grandfathering described above even though commenters from the GSIBs significantly disputed the initial cost estimates in ways that make the FRB's linear cost reduction an uncertain reflection of how the cost of LTD issuance will in fact affect GSIBs going forward, especially in a rising-rate environment and/or one with a steeper yield curve. Rating agencies have also suggested that the greater risk to which LTD-holders are put would lead to rating downgrades for future issuances; these would of course also hike funding costs. Aggregate cost analyses also do not reflect significant differences in cost and strategic impact based on each GSIB's business model.

Another concern of TLAC critics is that the market for eligible LTD may rely on other large financial-services firms, creating contagion risk across the financial system due to a new type of inter-connectedness. Long-pending single-counterparty credit limits might constrain this to some degree,[9] but the FRB proposed also that TLAC held by a regulated banking organization carry so large a capital penalty as to force holdings outside the banking system. This requirement is not included in the final rule, but that is not because the Board has abandoned it. Rather, it has recognized that any such capital charge would apply very asymmetrically unless the OCC and FDIC agreed to it. The Board has deferred action on this capital penalty until an inter-agency rule mandating it is imposed. The OCC is likely quickly to agree to this, but the FDIC's position is less certain. FDIC Chairman Gruenberg promptly endorsed TLAC upon finalization of the FRB's rule, but Vice Chairman Hoenig strongly opposes TLAC. A penalty charge would assuage some of his concerns, but not to the point at which he might be willing to facilitate TLAC issuance.

The FRB's approach is based on what it calls the "capital-refill" model – that is, TLAC should be sufficient to ensure adequate capital after all losses are absorbed. As a result, TLAC should increase as these capital rules increase to ensure the amount of needed "refill" is sufficient based on revised capital standards. The final rule thus emphasizes that TLAC will be reconsidered as the GSIB capital framework changes. The capital-refill approach also means that the basic TLAC standards are adjusted to reflect the balance-sheet adjustments likely as a GSIB approaches failure. The NPR provided this balance-sheet adjustment – a significant TLAC reduction – only for U.S. GSIBs; the final rule provides it also for IHCs.

9 See **CONCENTRATION9**, *Financial Services Management*, March 14, 2016.

What's Next

The FRB adopted this rule on December 15.[10] The rule is effective sixty days after publication in the *Federal Register*. Its implementation is accelerated from the NPR, with covered companies now required to hold sufficient TLAC by January 1, 2019. No disclosure standards are included in this final rule; any on which the Board decides would be separately proposed.

Analysis

A. External TLAC for U.S. GSIBs

1. Framework

Under the final rule, a covered BHC is subject to an external LTD requirement equal to seven percent of risk-weighted assets plus the applicable GSIB surcharge, minus a one percentage point allowance for balance-sheet depletion. This results in a requirement of 6 percent plus the applicable GSIB surcharge of risk-weighted assets. Without the one percentage point allowance for balance-sheet depletion, the risk-weighted assets component of the external LTD requirement would require it to maintain eligible external LTD equal to the full amount of its minimum common equity tier 1 capital ratio plus buffer. The one percentage point allowance for balance-sheet reduction prior to failure depletes risk-weighted assets as well as capital.

A similar balance-sheet adjustment applies to the leverage TLAC component. GSIBs are required to hold eligible LTD equal to 4.5 percent of total leverage exposure, reflecting a balance-sheet adjustment of 0.5 percent.

Prior approval is necessary for redemption or repurchase of LTD that would bring a GSIB below its external TLAC standard. The Board also retains the right to disallow LTD that would otherwise be eligible TLAC following a notice and comment process with the affected GSIB. There is no grace period for failing to comply with minimum TLAC standards.

Eligible external TLAC is the sum of tier 1 regulatory capital (common equity tier 1 capital and additional tier 1 capital) issued directly by the covered BHC (excluding any Tier 1 minority interests).

2. Eligible External LTD

Eligible LTD must be:

- paid in and issued directly by the BHC, a requirement the FRB views as essential to advancing SPOE resolutions. Contractual subordination is not required;
- unsecured;
- has a maturity of more than one year from the issuance date:
- be "plain vanilla" as defined in the rule. LTD that qualifies as Tier 2 capital is not eligible unless it meets all the criteria. Structured notes (other than those with certain payment-default acceleration clauses) remain ineligible, as do notes with mandatory equity-conversion triggers; and
- governed by U.S. law. The FSB standards allow recognition of foreign law under certain circumstances.

As noted, the final rule grandfathers debt issued before December 31, 2016 with certain acceleration clauses or if the debt is issued under foreign law. Regardless of these provisions, the Board retains the right to disallow certain LTD instruments that may appear compliant following notice and comment to the affected firm. A fifty percent haircut is applied to debt with maturities or put rights between one and two years for LTD but not total TLAC purposes; principal paid on debt with maturities of less than one year does not count towards LTD or TLAC purposes – standards tougher than the FSB's TLAC requirements.

Tier 2 capital that meets the eligible-LTD criteria also counts as TLAC.

3. Buffer

The TLAC buffer adds additional requirements so that TLAC remains sufficient even under stress. The risk-weighted buffer equals the sum of 2.5 percent of risk-weighted exposures plus the applicable GSIB surcharge under method one[11] and any applicable counter-cyclical capital buffer. The leverage buffer is two percent of total leverage exposures and is equal to that set by the supplementary leverage ratio. The risk-based buffer is CET1 capital; the leverage one is Tier 1. If the buffer is breached, both capital distributions and discretionary-bonus payments are limited according to schedules in the final rule. Companies are subject to both the leverage and risk-weighted buffers, but the toughest restrictions under either table of sanctions would apply.

10 See *Client Report* **TLAC5**, December 15, 2016.

11 See **GSIB7**, *Financial Services Management*, July 23, 2015.

4. Qualified Financial Contracts (QFCs)

To accomplish the FRB's "clean" holding-company construct, numerous restrictions are imposed on LTD issuance and related commitments. These include constraints on QFCs designed to limit parent-company downstream obligations that would complicate resolution. The final rule allows parents of covered companies (including IHCs) to guarantee subsidiary QFCs, but only if failure of the parent guarantor does not trigger early-termination rights or if the QFC is otherwise allowed. The FRB and other banking agencies have proposed rules limiting early-termination rights,[12] and the final version of these would thus govern permissible QFCs that do not invalidate TLAC.

B. Internal TLAC

The internal-TLAC framework for IHCs generally follows that for U.S. GSIBs with the following significant provisions of relevance to the IHCs in the U.S. that are subsidiaries of designated GSIBs or that could find their parents designated under the FRB rules noted above:

- IHCs that are subsidiaries of foreign GSIBs that intend to follow an MPOE resolution strategy may issue LTD and capital to their parent or a wholly-owned subsidiary of the foreign parent as well as to do so externally to third-party investors. SPOE-focused GSIBs must have their U.S. IHCs issue TLAC capital and LTD only to the parent or to wholly-owned subsidiary.
- Top-tier parents are to certify to the Board the resolution strategy they would adopt with regard to the IHC. The Board retains the discretion to reclassify IHCs based on its own view of likely resolutions, reclassifications that would then affect the manner in which debt and capital may be issued and how other TLAC requirements would apply. Issues that could lead the Board to reclassify an IHC include the extent of the parent bank's U.S. operations outside the IHC and intra-group risk.
- TLAC requirements for MPOE IHCs are the greater of 18 percent of RWAs and 6.75 percent of total leverage exposure. Firms are required to retain LTD equal to the greater of six percent of total RWAs and 2.5 percent total leverage exposure.
- TLAC for SPOE-focused IHCs are the greater of 16 percent of RWAs and six percent of total leverage exposure. Firms are required to retain LTD equal to the greater of six percent of total RWAs and 2.5 percent total leverage exposure.

12 See **QFC4**, *Financial Services Management*, May 17, 2016.

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- IHCs will be subject to TLAC if they trip the FRB's GSIB-designation criteria under the method-one approach described above or if their parent bank does so. The FRB decided to apply TLAC even to small IHCs if the parent triggers GSIB criteria on grounds that this is required under applicable U.S. national-treatment requirements.
- Applicable TLAC capital must be issued by the IHC.
- The IHC TLAC buffer applies only to risk-weighted capital and is 2.5 percent for both MPOE and SPOE IHCs.
- Proposed requirements for LTD contractual subordination are not included in the final rule, resolving a potentially significant tax risk for IHCs. The day after the FRB issued this final rule, the IRS confirmed that eligible LTD is not equity for tax purposes.
- The grandfather for acceleration clauses and foreign law does not apply to IHCs.
- The final rule does not reserve authority for the FRB to vary TLAC for IHCs on a case-by-case basis, but the Board is open to doing so at some later date.