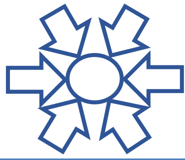

Financial Services Management

Long-Term Debt Requirements

Cite

FRB, OCC, FDIC; Notice of Proposed Rulemaking; Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions

Recommended Distribution

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Website

https://www.fdic.gov/news/board-matters/2023/2023-08-29-notice-dis-a-fr.pdf

Impact Assessment

- LTD is intended to reduce moral hazard, giving regulators greater resources with which to avert failure as well as reduce FDIC resolution costs.
- These benefits are only likely if the agencies allow LTD-investor losses, action dependent on both agency and White House strength of purpose, effective resolution planning, and FDIC execution.
- Existing resolution standards related to both the FDIC and OLA are all designed also to ensure that parties other than the FDIC and taxpayers take the first loss in the event of failure and provide sufficient funding to avert or reduce its cost. The agencies do not clarify the relationship of these LTD requirements with current or planned resolvability requirements.
- The capital-refill model underlying the proposal assumes a certain level of capital independent from stress-test results also intended to ensure ample, resilient capitalization, using a bank's own funds in addition to all this third-party investment as bullet-proofing. The ability of banks to operate profitably as well as counter-cyclically is uncertain.

Overview

Building on an advance notice of proposed rulemaking,[1] the banking agencies have issued several proposals to enhance the resolvability of large banking organizations not covered by stringent GSIB standards. Among these is a proposal mandating long-term debt (LTD) to increase regional-bank total loss-absorbing capacity (TLAC) and, the agencies believe, reduce resolution costs and/or increase the FDIC's options, thus avoiding the systemic designation and costly resolutions that occurred for regional banks earlier this year. The LTD requirements for category II, III, and IV banking organizations do not go as far as those mandated for GSIBs,[2] based instead exclusively on a "capital-refill" construct in which eligible LTD is issued in amounts the agencies believe sufficient to provide enough capital-equivalent funding to achieve the proposal's expected results.

[1] See **RESOLVE48**, *Financial Services Management*, October 21, 2022.

[2] See **TLAC6**, *Financial Services Management*, December 21, 2016.

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The NPR's impact analysis lays out why it believes this is likely and thus why the proposal's benefits significantly outweigh the "moderate" costs it anticipates for covered companies. However, as detailed below, the agencies' impact analysis is also based on certain actions they expect covered companies to take that are not clearly certain or even likely; the impact analysis also does not address how this proposal interacts with proposed capital standards that would increase LTD requirements above those projected in the NPR, nor are other rules with likely impact on final results assessed in a forward-looking fashion.

Impact

The U.S. approach to TLAC is loosely based on global standards first issued by the Financial Stability Board in 2015[3] to require TLAC at the parent-company level and, later, also for major subsidiaries ("internal" TLAC).[4] However, the global TLAC standards principally focus on additional capital buffers with a particular focus on contingent-capital instruments that force equity investors to bear risks ahead of resolution to increase the odds of recovery or, at the least, lower resolution costs to stakeholders and taxpayers as well as resulting systemic risk.

In contrast, the U.S. approach to TLAC for GSIBs focuses principally on LTD because the FRB does not believe capital is likely to be a meaningful buffer since its value erodes significantly, if not entirely, as a banking organization's condition weakens. Although contingent capital did reduce Credit Suisse's resolution costs earlier this year, the amount by which it did so was relatively small and remains in dispute.

As detailed below, the TLAC approach proposed for regional banks is expressly founded on a "capital-refill" construct, in which the ownership and economic purpose of regional banks may well be intended as essentially steady-state banks that are de facto utilities without the guarantee of stable, predictable earnings accorded to public utilities. This may be warranted by virtue of other benefits taxpayers provide to insured depositories, but none of these is supposed to apply to parent holding companies subject either to bankruptcy or OLA resolution. The LTD proposal does not explain why it applies both to holding companies and IDIs, perhaps creating market impressions that shareholders and short-term creditors take less risk at parent companies due to large holdings of both external and internal debt ensuring it can never fail at loss to them.

The agencies' impact assessment does not consider this structural consequence nor does the interaction between the capital rewrite and LTD standards factor into most substantive determinations. Instead, as with the pending capital standards, the agencies lay out expectations of how banks would behave, leading the agencies to conclude that the proposal would lead to a "moderate" funding-cost increase outweighed by anticipated resolution readiness and cost improvements at broader benefit to financial stability. This may well prove the case, but it is unclear if the proposal must be finalized largely as is to achieve this overarching goal especially if pending changes to other key rules are taken into account. The impact analysis notes that these standards would slightly reduce covered-IDI deposit-insurance premiums; however, it also states that it is considering amending its risk-based premium assessment rules – i.e., that any such gain may not last.[5]

Scenarios that alter the agencies' assumptions are also not clearly considered; for example, the "moderate" cost impact derives from the expectation that banks would hold

3 See **TLAC4**, *Financial Services Management*, November 24, 2015.

4 See **TLAC8**, *Financial Services Management*, July 17, 2017.

5 See **DEPOSITINSURANCE116**, *Financial Services Management*, October 25, 2022.

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LTD instead of deposits and thus keep total funding costs in balance. This could, however, only occur if banks reject deposits as they were unwilling to do to do even under stress conditions or if the yield curve does not shift in ways that sharply increase LTD costs compared to readily liquid deposits. The proposal also does not consider the extent to which lending or other activities would suffer if funding shifts to longer-term instruments even though banks are sure to redesign asset allocation if funding maturities and costs are significantly altered.

Key rules that could make a major difference most importantly include the capital standards. As detailed below, the calculations determining LTD amounts under the "capital-refill" rise in lockstep with heightened capital requirements because more capital alters the amount banks must refill. The rationale for the capital rewrite is also to make banks more resilient and resolutions less costly, but neither that proposal nor the LTD one in concert with current GSIB standards and the planned surcharge rewrite[6] addresses the extent to which all of these resolution buffers and preventatives work in concert, at cross-purposes, or with unnecessary burden adversely affecting bank financial-intermediation and market-stabilization functions.

It is similarly unclear how LTD equivalent to the capital-refill calculation is to work in concert with current resolution standards and those proposed at the same time.[7] The law dictates that the FDIC resolve IDIs by imposing losses on uninsured depositors and third parties as long as this is the least costly way to do so, with the FDIC acknowledging that the reason it often pays uninsured depositors or subsidizes failed-bank purchases is because it has not developed effective internal protocols for handling large IDIs.[8] Dodd-Frank's orderly liquidation authority (OLA) is also designed to ensure that third-parties – not the FDIC or taxpayers – bear resolution costs to the greatest extent possible.[9] If large amounts of LTD are needed to ensure FDIC function and/or protect taxpayers, then the need not only for capital rules, but also other costs – e.g., higher FDIC premiums – is unclear. While each and every one of all these rules certainly reduces FDIC and taxpayer risk, there is a direct cumulative cost to banks and thus significant implications for their structure and purpose.

The FRB and FDIC have separately approved several significant proposals to change the manner in which banking organizations plan for and are resolved. These include significant changes to the FDIC's current IDI resolution-planning requirements which have been found wanting in recent crises at least in part due to the unusual and risky operations of IDIs involved as well as the FDIC's apparent failure to anticipate such events. The LTD proposal mandates internal LTD at IDIs in category II, III, and IV banking organizations even though the GSIB TLAC rules give systemic companies considerably more discretion as to how best to pre-position LTD to ensure successful IDI resolution. The agencies seek views on whether to reopen the GSIB rule to expressly mandate internal TLAC and/or LTD, a change that could significantly alter the cost of the TLAC rules for some GSIBs but perhaps better ensure resolution if a GSIB's structure is akin to that of a large regional holding company with only one or two U.S. -domiciled IDI subsidiaries.

In addition to these overarching considerations, the proposal has significant implications for specific types of covered firms. These include SLHBs, brought for the first time into this aspect of BHC regulation and the intermediate holding companies

6 See **GSIB22**, *Financial Services Management*, August 22, 2023.

7 See forthcoming FedFin reports.

8 See **MERGER9,** *Financial Services Management*, December 16, 2021.

9 See **SYSTEMIC30**, *Financial Services Management,* July 22, 2010.

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(IHCs) required of foreign banking organizations (FBOs) with non-branch assets over $50 billion in the U.S. IHCs have long pushed for like-kind rules to those for like-kind BHCs, but this proposal mandates separate standards for IHCs from those for BHCs and also differentiates IHCs under parents that do or do not have resolution plans expressly addressing the IHC. IHCs that are subsidiaries of foreign GSIBs are covered by the GSIB rules for the largest U.S. banking companies, leaving only one IHC under the proposed LTD standards. However, more could well come under them in time and the conclusion that this would have little impact seems unlikely to occur in practice. As a result, FBOs may limit their U.S. presence via IHCs to ensure they do not cross the $100 billion threshold, reducing their role acquiring other banking organizations and keeping more activities in the branches and agencies that trouble the regulatory agencies for other reasons.

Another significant contrast between the LTD standards for regional banks and the TLAC/LTD ones for GSIBs is that those proposed here do not include the GSIB standards' enforcement triggers (e.g., the capital-distribution restrictions imposed on GSIBs). The agencies reserve their right to issue enforcement actions if regional banks, covered IHCs, or IDIs fall short, but this is neither mandatory nor likely to be done consistently.

Although the proposal is tailored in that it differs from the TLAC standards imposed on GSIBs, it does not differentiate LTD requirements for category II, III, and IV banking organizations despite the significant differences among them mandated in the agencies' tailoring rule.[10] Some commenters believe the failure to differentiate the requirement violates the 2018 law requiring tailoring, but the agencies may counter that the proposal does not impose requirements on banking's below the $100 billion mark and thus does tailor standards for smaller, but still regional, banking organizations. Whether this suffices remains to be seen if the industry chooses to challenge the rule.

What's Next

The FDIC board unanimously approved this NPR on August 29, as did the Federal Reserve. The OCC also released it on that date, with all the agencies seeking comment by November 30 (the deadline also set for the capital proposals noted above). A three-year transition following finalization would apply to entities that are covered at that time on a schedule related to partial compliance goals specific in the NPR. The agencies may accelerate or slow this transition – no rationale for either of these actions is provided, although powers are added to prevent evasion. The same three-year transition process would apply to entities that become covered after finalization of the TLAC rule, with prohibitions against charter conversion with regard to additional transition time. An IHC that becomes a GSIB for purposes of the TLAC rule would need to comply with LTD standards as it comes into compliance with the broader TLAC standard.

As noted below, the agencies are not only reopening the GSIB rule, but also seeking comment on several questions that might reopen the GSIB rule. No certain plan for doing so or schedule is suggested. Should the agencies decide to align the regional bank/GSIB rules, GSIBs could come under higher TLAC requirements due to the complex interaction of those demanded at both the parent and IDI level (see below).

10 See **SIFI27**, *Financial Services Management*, June 4, 2018.

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Analysis

I. LTD Standards

A. Coverage

The rule would cover:

- Category II, III, and IV BHCs and SLHCs;
- Category II, III, and IV IHCs that are not affiliated with foreign-designated GSIBs; and
- IDIs that are not associated with GSIBs and have over $100 billion in assets or are affiliated with such IDIs. Where these IDIs are part of a covered holding company, they would issue the requisite LTD to the parent company (internal TLAC). IDIs that are not consolidated subs of covered holding companies are allowed and those without parent companies would have to issue LTD externally to non-affiliated parties.

B. Required LTD

Based on a "capital-refill" construct, holding companies would need to issue outstanding eligible LTD in an amount that is the equal to six percent of total risk-weighted assets, 3.5 percent of average total consolidated assets, and 2.5 percent of total leverage exposure if the entity is under the supplementary leverage ratio (SLR, as would be the case under the parallel capital proposal).[11] Covered IDIs must hold the greater of the IDI's risk-weighted assets, 3.5 percent of total consolidated assets, and 2.5 percent of total leverage exposure (if subject to the SLR). This amount is deemed the amount needed to replenish a failed IDI's capital to that of a going concern based on the minimum leverage ratio and CET1 requirements plus the capital-conservation buffer. It is possible that internal TLAC could be greater than the total amount of external TLAC required at the parent company, with the agencies seeking comment on this point.

This is intended to give the FDIC in both single-point-of-entry (SPOE) and multiple point of entry (MPOE) resolutions an entity in compliance with its minimum capital ratio along with a significant buffer. In sum, LTD requirements would be set at seven percent of risk-weighted assets minus a one percentage point allowance for balance-sheet depletion – or a final ratio of six percent of RWAs. Where applicable the LTD requirement tied to eSLR would be reduced by a depletion allowance of 0.5 percentage points. It is unclear why the rule does not simply set the ratio in final form at its desired levels rather than using the formulas noted above.

The agencies will review these LTD-amount calculations in light of evolving capital regulation; it is unclear if these are proposed with current or pending rules in mind. The agencies also reserve the right to demand more LTD when needed.

11 See **CAPITAL231**, *Financial Services Management*, August 4, 2023.

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As noted, the internal TLAC requirement for regional IDIs does not apply to GSIBs. The agencies seek comment on whether that rule should be reopened to do so.

C. Conditions

Companies would be barred from redeeming or repurchasing eligible LTD prior to maturity without prior agency approval if the action causes LTD amounts to fall below required minimums. The agencies further reserve the right, after notice and a chance for comment, to exclude certain instruments from eligible LTD. Agency enforcement actions are possible when LTD falls below requisite levels.

D. Eligibility

In general, external LTD would have to be:

- directly issued by the top-tier company;
- unsecured and unstructured;
- have a maturity of more than one year, with a fifty percent haircut for LTD principal due to be paid in more than one but less than two years;
- have "plain vanilla" features detailed in the NPR;
- have a minimum denomination larger than $400,000 to discourage retail holdings; and
- be subject to U.S. law.

In addition, internal LTD would have to be:

- unlike holding-company LTD, subordinated to junior and unsecured claims;
- issued and held by an upstream entity that is generally itself covered by LTD requirements;
- have credit-sensitive features as desired; and
- lack a minimum denomination requirement.

These requirements vary somewhat for IHCs and are based on whether the IHC files a U.S. resolution plan. The FRB retains the right to recategorize an IHC regardless of the company's plans for U.S. or non-U.S. resolution based on factors such as the extent to which the foreign banking organization has significant activities outside the IHC and the relationship of the IHC to the parent company. Forced internal LTD to equity conversions are also possible under stress scenarios detailed in the NPR.

E. Legacy LTD

Some existing external LTD would count towards minimum requirements even if not all of the above conditions are met if the legacy LTD has certain otherwise-permissible features. External LTD issued by a subsidiary IDI may also count as parent external LTD under certain circumstances.

F. Clean Holding Companies

The banking agencies propose requirements for covered parent companies akin to those mandated for GSIBs designed to prevent undue amounts of external secured or unsecured short-term debt or complex liabilities to third parties that undermine the value of LTD or otherwise complicate resolution of subsidiaries other than that under

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Title II of the Dodd-Frank Act establishing orderly liquidation authority.[12] The agencies acknowledge that this may be problematic to companies that plan MPOE resolutions, but note that SPOE resolution may be required under stress despite advance planning. Covered IHCs would also be subject to restrictions on non-contingent liabilities to third parties; FRB staff estimate that this would have little practical effect except with regard to IHCs planning for U.S. resolution and their FBO parents and sister companies (where the resolution benefit of the restriction is said to outweigh other considerations).

Comment is sought on the implications of this provision in light of current funding strategies, QFCs, and other restrictions.

G. Capital

The proposal would reiterate provisions in the pending capital framework requiring deduction from capital for holdings of other covered banking organizations' external LTD to limit contagion risk and interconnectivity.[13] The agencies are aware of the redundancy of this proposal and the pending capital rule, but seem to think it valuable, asking questions on other issues such as how legacy LTD should be treated and the extent of the limited exemption for LTD held in connection with market-making activities.

II. GSIB TLAC Standards

Changes in this NPR to this rule are largely technical or make conforming changes (e.g., with regard to the maturity haircut) to align GSIB standards with those proposed here. Although the impact of these changes is said to be "modest" under current capital rules, the maturity haircut would increase the number of GSIBs falling short under the proposed capital regime. New GSIB disclosures regarding TLAC are also proposed.

III. Request for Comment

Views are also sought on many additional aspects of the proposal including:

- interactions with current and proposed rules (e.g., pending capital changes);
- imposing LTD requirements based on standards other than those used to categorize banking companies in the tailoring rule (e.g., reliance on uninsured deposits);
- other ways to calculate LTD and whether factors such as uninsured-deposit levels should be considered;
- whether the Board should require additional holding-company LTD if a subsidiary IDI goes into receivership and, if so, if this also should be required of GSIBs;

[12] See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

[13] See **CAPITAL230**, *Financial Services Management*, August 1, 2023.

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- whether IDIs should be allowed to issue external LTD, perhaps alleviating the parent-company requirement;
- the treatment of legacy LTD and the impact of the proposed transition; and
- the need for longer or different transition schedules and/or implementation plans.

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