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Client Alert

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TLAC, and Then Some…

A Preliminary Assessment of the Federal Reserve Board's NPR

On Friday, October 30, 2015, the Federal Reserve Board ("Board") reaffirmed its commitment to both the bank holding company model and single point of entry resolution. In a departure from historical views of the purpose and function of bank capital, but building on a proposal by the Financial Stability Board ("FSB"), the Board proposed to require globally systemically important banks ("G-SIBs") to issue long-term debt for the purposes of capitalizing a bridge institution that would succeed the G-SIB in the event of the G-SIB's failure. The Board also proposed to limit the liability structure of G-SIBs and to limit other banking institutions' investments in G-SIBs in order to facilitate the resolution of G-SIBs. Specifically the Board issued a notice of Proposed Rulemaking ("Proposed Rule") seeking comment on: a proposed requirement for U.S. bank holding companies ("BHCs"), which are G-SIBs, to maintain a minimum amount of loss-absorbing instruments, including capital and a minimum amount of unsecured long-term debt. The intermediate holding companies, or IHCs, of foreign banking organizations ("FBOs"), with $50 billion or more in U.S. non-branch assets would be required to maintain a minimum amount of upstream loss-absorbing instruments, including a minimum amount of unsecured long-term debt. The Proposed Rule also introduces the concept of a "clean holding company" by imposing a number of significant restrictions on the other liabilities that a covered BHC may have outstanding.

This alert is intended to provide a brief overview, which we will supplement with a more detailed analysis in the coming days.

The Proposed Rule was issued as news circulated that the Financial Stability Board ("FSB") has come to agreement on its requirements for total loss absorbing capacity ("TLAC"). A leaked August 24, 2015 FSB TLAC term sheet published by various media outlets outlines an approach that, while theoretically consistent with the objectives underlying the Board's proposal, takes a different approach. The FSB solely sets out a TLAC requirement, not a long-term debt requirement. It is anticipated that the FSB TLAC final requirements will be released prior to or in conjunction with the mid-November G-20 meeting.

Underpinnings of the Proposed Requirements

The purpose of the Proposed Rule is to address concerns about "too-big-to-fail" and to facilitate the Dodd-Frank Act's resolution scheme under a single point of entry ("SPE") approach. The proposed SPE approach would require that the BHC of the failed G-SIB be placed in receivership while the subsidiaries would remain intact. Title II of the Dodd-Frank Act requires that the BHC be liquidated with losses imposed on the stockholders and creditors of the BHC. The stockholders of the BHC would bear the first losses and the claims of holders of the BHC's long-term debt obligations would be converted into equity that would be used to capitalize the successor entity, the bridge financial company. This approach assumes that the BHC truly functions as a holding company, that business is conducted by the entity through its operating subsidiaries, and that the holding company essentially operates as unified whole— assumptions that have been the cornerstone of the Board's approach to bank holding company supervision for decades. The bridge financial company would initially be capitalized by the bail-in of outstanding long-term debt of the failed BHC, which presumes that sufficient long-term unsecured debt would be outstanding at the holding company level in order to stabilize the bridge financial company.

External TLAC and External Long-Term Debt

The Proposed Rule would establish a two-pronged requirement—a long-term debt requirement and a separate TLAC Requirement.

A covered BHC would be required to maintain outstanding eligible external long-term debt at least equal to the greater of: (i) 6% of RWAs, plus the applicable G-SIB buffer, and (ii) 4.5% of total leverage exposure.

Eligible external long-term debt is unsecured, "plain vanilla" debt issued by the covered BHC and governed by U.S. law. Eligible external long-term debt with a remaining maturity of between one and two years is subject to a 50% haircut for purposes of the requirement. Debt with a remaining maturity of less than one year would not count toward satisfying this requirement.

A covered BHC would be required to maintain outstanding minimum levels of eligible external TLAC, or instruments issued by the BHC to third party investors, which are set in the proposal at not less than the greater of: (i) 18% of total risk-weighted assets ("RWAs") (on a fully phased-in basis), and (ii) 9.5% of the covered BHC's total leverage exposure.

Total eligible external TLAC would be the sum of the entity's Tier 1 capital issued directly by the covered BHC and the covered BHC's eligible external long-term debt. Tier 2 capital that meets the definition of eligible external long-term debt would count toward the external TLAC requirement.

An external TLAC buffer is added on top of the 18% risk-based capital component of the external TLAC requirement, which can be met only with common equity Tier 1 capital, and which equals the sum of 2.5%, any applicable countercyclical capital buffer, and the G-SIB surcharge as calculated under Method 1 of the G-SIB surcharge calculations.

The Proposed Rule solicits comment on an internal TLAC requirement for covered BHCs that would be designed to ensure that losses at holding company subsidiaries are passed upstream to the holding company where they can be absorbed by external TLAC.

"Plain Vanilla" Debt

Consistent with the FSB TLAC requirement, the Proposed Rule emphasizes the need to facilitate a quick and orderly resolution for a failed covered BHC. Valuing a complex instrument would create uncertainty during the resolution process. As a result, under the Proposed Rules, an eligible external long-term debt instrument would be prohibited from:

- Being structured notes (as discussed below);
- Having a credit-sensitive feature, such as a reset (similar to the regulatory capital requirements for Tier 2 instruments);
- Including a contractual provision for conversion or exchange into the equity of the covered BHC (such as contingent capital type instruments); or
- Including a provision that gives the holder a contractual right to accelerate payment (including automatic acceleration), other than a right that is exercisable on one or more dates specified in the instrument in the event of the covered BHC's resolution or on a payment default.

IHC Internal TLAC and Long-Term Debt

Again, to facilitate orderly liquidations in a cross-border context, a covered IHC would be subject to both an internal TLAC requirement and an internal long-term debt requirement. This would be debt, in the case of the long-term debt requirement, and capital and long-term debt in the case of the TLAC requirement issued from the covered IHC to its foreign parent so that the foreign parent (rather than another U.S. entity) bears losses in the event of a resolution.

The amount of the IHC requirements for internal TLAC depends on whether the foreign parent of the covered IHC will be separate be a resolution entity or will be resolved by the foreign home country authorities as a part of the resolution of the foreign parent.

Internal TLAC

A covered IHC that is not itself expected to enter resolution would be required to maintain internal TLAC in an amount not less than the greater of: (a) 16% of the covered IHC's RWAs, (b) for IHCs subject to the supplementary leverage ratio, 6% of the covered IHC's total leverage exposure, and (c) 8% of the covered IHC's average total consolidated assets computed for purposes of the U.S. Tier 1 leverage ratio.

An IHC that would be expected to undergo resolution would be required to maintain internal TLAC in an amount not less than the greater of: (a) 18% of the covered IHC's RWAs, (b) for IHCs subject to the supplementary leverage ratio, 6.75% of the covered IHC's total leverage exposure, and (c) 9% of the covered IHC's average total consolidated assets computed for purposes of the U.S. Tier 1 leverage ratio.

An internal TLAC buffer would apply to the RWA component of the internal TLAC requirement equal to the sum of 2.5% and any applicable countercyclical capital buffer (therefore equal to the existing capital conservation buffer applicable to covered IHCs).

Internal TLAC would be defined to include the sum of: (a) the Tier 1 regulatory capital issued by the covered IHC to its foreign parent and (b) the covered IHC's eligible internal long-term debt.

Internal Long-Term Debt

A covered IHC would be required to maintain outstanding eligible internal long-term debt in an amount not less than the greater of: (a) 7% of total RWAs; (b) 3% of the total leverage exposure, if applicable; and (c) 4% of average total consolidated assets, as computed for purposes of the U.S. Tier 1 leverage ratio. The long-term debt requirement does not depend on whether the IHC is a separate resolution entity.

An IHC's internal long-term debt is subject to requirements similar to those set forth above for external long-term debt. In addition, it must:

- Be issued to the foreign parent entity that controls the covered IHC;
- Be contractually subordinated to third-party liabilities of the covered IHC; and
- Include a contractual going-concern trigger that results in conversion to common equity.

The contractual conversion feature would allow the Board to require the covered IHC to cancel the eligible internal long-term debt or convert or exchange it into Tier 1 common equity on a going-concern basis if: (a) the Board determines that the entity is in danger of default, and (b) any of the following circumstances apply: (i) the top-tier FBO or any subsidiary outside of the United States is placed in resolution proceedings; (ii) the home country authority consents to the cancellation, exchange, or conversion, or does not object to such action after 48 hours' notice; or (iii) the Board makes a written recommendation to the Secretary of the Treasury that the FDIC should be appointed as receiver under Title II of the Dodd-Frank Act.

Clean Holding Company Requirement

In order to further simplify the process of resolving a G-SIB and to reduce the potential for liquidity pressures on the holding company, the Proposed Rule introduces a new concept of a "clean holding company." As a "clean holding company" a covered BHC would be prohibited from:

- Issuing short-term debt to third parties (including deposits) (defined as debt having maturities of less than one year);
- Entering into qualified financial contracts ("QFCs"), such as securities contracts, commodities contracts, forward contracts, repos, swaps, and security-base swaps;
- Having liabilities that are subject to upstream guarantees from the covered BHC's subsidiaries or that are subject to contractual offset rights for subsidiaries' creditors; or
- Issuing guarantees of its subsidiaries' liabilities if the issuance of the guarantee would result in the covered BHC's insolvency or resolution would be an event of default on the subsidiary's part.

A covered BHC's liabilities (other than eligible external TLAC and other than eligible external long-term debt) that are *pari passu* with or junior to its eligible external long-term debt would be capped at a maximum of 5% of the value of the covered BHC's eligible external TLAC. This limitation would apply only at the holding company level and not to subsidiaries of the covered BHC. The cap would not apply to eligible external TLAC or to instruments that were eligible external TLAC when issued but are no longer due to an approaching maturity as long as the holder of such instrument no longer has an exercisable put right, or to payables that are not associated with such liabilities. The NPR explains that structured notes are among the types of liabilities that would be expected to be subject to this cap.

Public Disclosure Requirements

A BHC would be required to disclose publicly that its unsecured debt would be expected to absorb losses ahead of other liabilities, including liabilities of the covered BHC's subsidiaries, in a resolution.

The required disclosure could be made on the covered BHC's website or in a publicly filed financial or regulator report and in the applicable offering documents. This is similar to the current disclosure requirements regarding the possibility of "bail-in" of certain unsecured senior debt instruments issued by entities subject to the Bank Recovery and Resolution Directive in Europe. We would expect to see additions to a variety of sections of U.S. offering documents, including the "Risk Factors" section, to address these terms.

The notice explains that the Board intends to propose a requirement for regular reporting by covered BHCs of their amounts of eligible external TLAC and eligible long-term debt, as well as by IHCs of their eligible internal TLAC and eligible internal long-term debt.

Investments by Other Banks in Unsecured Debt of Covered BHCs

In order to avoid the risk that the resolution of a G-SIB cause losses to other banking institutions, banks, savings and loans and other institutions having total consolidated assets of at least $1 billion as well as IHCs formed to address the enhanced prudential standards requirements would suffer a regulatory capital reduction for any investment in unsecured debt issued by covered BHCs.

Structured Notes and Long-Term Debt and TLAC

A "structured note" is defined as a debt instrument that (a) has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of a reference asset or embedded derivative, (b) has an embedded derivative that is linked to one or more reference assets, (c) does not specify a minimum principal amount due upon acceleration or early termination, or (d) is not classified as debt under U.S. GAAP. The proposed prohibition, therefore, applies both to principal protected and to non-principal protected structured notes. However, the definition expressly excludes non-dollar dominated instruments as well as some rate-linked notes, such as floating rate notes linked to LIBOR.

Since the Proposed Rule applies at the covered BHC only, the Proposed Rule does not affect structured bank notes (issued by a bank subsidiary) or market-linked certificates of deposit issued by a bank subsidiary. Of course, one also could envision structured notes issued by subsidiaries of the covered BHC (not guaranteed by the covered BHC).

"Replacement" Debt

The Proposed Rule provides that outstanding debt of a covered BHC that satisfies the eligibility criteria for external TLAC and for external long-term debt would qualify to meet the two requirements. In the NPR the Board suggests transition strategies noting that covered BHCs might consider replacing "near eligible debt" with eligible external long-term debt presumably through exchange offers or similar liability management exercises prior to issuing new qualifying debt. Footnote 60 of the draft text of the Federal Register notice notes that covered BHCs could meet a substantial portion of the anticipated funding shortfall by replacing near-eligible debt with eligible external long-term debt.

Compliance Dates

Covered BHCs are required to comply with the external long-term debt and TLAC requirement as of January 1, 2019; however, the proposal contemplates phasing in the RWA component of the external TLAC requirement in two stages, such that a 16% requirement would apply as of January 1, 2019 and the 18% requirement would apply as of January 1, 2022. Covered IHCs will be required to comply on the same schedule. The clean holding company requirement would become effective as of January 1, 2019. The regulatory capital deduction would become effective as of January 1, 2019.

Comment Period

The comment period will close on February 1, 2016. We believe that the Board is committed to the resolution strategy described in the NPR and will be reluctant to make wholesale changes in the key components of the Proposed Rule. Comments that are consistent with that resolution strategy are more likely to be viewed favorably.

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