Client Alert

December 15, 2016

# TLAC's Back! Sifting Through the Federal Reserve's Final TLAC Rule

On December 15, 2016, the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") issued its final rules regarding total loss absorbing capacity (the "**Final TLAC Rule**") requirements for global systemically important banks ("**G-SIBs**") in the United States.[1] The Final TLAC Rule is intended to "build on, and serve as a complement to, the regulatory capital requirements in Regulation Q." The Federal Reserve originally proposed TLAC rules for G-SIBs in the United States (the "**TLAC Proposal**") on October 30, 2015, through a notice of proposed rulemaking, which would have required the bank holding companies of U.S. G-SIBs ("**covered BHCs**"), as well as top-tier U.S. intermediate holding companies of foreign G-SIBs ("**covered IHCs**"), to maintain a minimum amount of loss-absorbing instruments, including capital and a minimum amount of unsecured long-term debt ("**LTD**").

The following is an overview of the changes made in the Final TLAC Rule—we will provide a more detailed analysis in the coming days.

***Calibration of TLAC and LTD for Covered BHCs.*** The Final TLAC Rule retains the overall calibration of external TLAC and external LTD requirements in the TLAC Proposal, subject to certain modifications.

- Eligible External TLAC. Consistent with the TLAC Proposal, a covered BHC's eligible external TLAC is defined as the sum of the Tier 1 regulatory capital issued directly by the covered BHC and the amount of the covered BHC's eligible external LTD due to be paid after one year or more. However, under the Final TLAC Rule, the leverage component of the external TLAC requirement has been reduced from 9.5 percent to 7.5 percent.
- Eligible External LTD. Like the TLAC Proposal, eligible external LTD under the Final TLAC Rule is calibrated on the basis of a "capital refill" framework. Consistent with the TLAC Proposal, eligible external LTD under the Final TLAC Rule includes debt that is issued directly by the covered BHC that is: (i) unsecured; (ii) "plain vanilla"; and (iii) governed by U.S. law. Only 50 percent of the amount of eligible external LTD (due to be paid between one and two years) can be utilized to satisfy external LTD requirements. A covered BHC must maintain eligible LTD in an amount not less than the greater of (i) 6 percent (plus the G-SIB surcharge) of total risk-weighted assets ("**RWAs**") and (ii) 4.5 percent of total leverage exposure.
- TLAC Buffer. The Final TLAC Rule retains the TLAC buffer for the RWAs component of the external TLAC requirement but additionally adds a buffer for the leverage component of the external TLAC requirement. Specifically, the Federal Reserve has adopted a 2 percent buffer for the leverage component—to be filled

[1] *See Total Loss- Absorbing Capacity, Long-Term Debt, and Clean Holding Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations*, RIN 7100-AE37 (Dec. 15, 2016), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20161215a1.pdf.

solely with Tier 1 capital. A covered BHC's breach of the newly implemented TLAC leverage buffer would, like the external TLAC buffer for RWAs, subject it to limitations on capital distributions and discretionary bonus payments. However, since under the Final TLAC Rule a covered BHC would be subject to both a TLAC buffer and a TLAC leverage buffer, limitations on distributions and discretionary bonus payments would be based on the more restrictive of the two buffers.

***Effective Dates.*** While the TLAC Proposal contemplated a phase-in period until January 1, 2022, the Final TLAC Rule would apply as of January 1, 2019. Given the new grandfathering provision for existing LTD contained in the Final TLAC Rule, the Federal Reserve notes that such a provision should "mitigate the need for a longer phase-in period." However, the certification regarding resolution strategy for foreign banking organization (an "**FBO**") G-SIBs remains due on June 30, 2017.

***Grandfathering of Certain Types of Debt.*** The Final TLAC Rule differs from the TLAC Proposal by providing a grandfather provision for certain outstanding LTD of covered BHCs issued prior to December 31, 2016, that will count towards the external LTD and external TLAC requirements in the Final TLAC Rule. The grandfathered LTD is not subject to the limitations on acceleration and the requirement to be governed by U.S. law that will apply to eligible debt securities. In addition, the Final TLAC rule provides a grandfather clause for certain outstanding eligible external LTD of resolution covered IHCs (defined below) issued prior to December 31, 2016.

***Grace Period.*** The Final TLAC Rule does not include a grace period during which a covered BHC that breaches its external LTD requirement may take voluntary actions to nevertheless come into compliance with such a requirement without being subject to any other regulatory consequences. Accordingly, covered BHCs must comply with applicable minimum external LTD requirements at all times.

***Changes to Eligibility Criteria for External LTD.*** Under the Final TLAC Rule, eligible external LTD instruments are prohibited from: (i) being structured notes; (ii) having a credit-sensitive feature; (iii) including a contractual provision for conversion into or exchange for equity in the covered BHC; or (iv) including a provision that gives the holder a contractual right to accelerate payment (other than a right that is exercisable on one or more dates specified in the instrument, in the event of a covered BHC's insolvency, or the covered BHC's failure to make a payment on the instrument when due that continues for 30 days or more). Moreover, the Federal Reserve expressly noted that the Final TLAC Rule will not include as eligible LTD any instrument that qualifies as Tier 2 capital (e.g., certain forms of preferred stock and convertible debt) because they would not meet the "plain vanilla" debt requirement.

However, the Final TLAC Rule permits eligible external LTD to be subject to payment default event acceleration rights. The Final TLAC Rule revises the TLAC Proposal by providing that an acceleration clause relating to a failure to pay principal or interest must include a "cure period" of at least 30 days.

While the Final TLAC Rule adopts the TLAC Proposal's amortization haircut requirement applicable to external LTD, the Final TLAC Rule modifies the terminology from the remaining maturity of the unpaid principal amount to the amount to be paid. Therefore, the amount of eligible external LTD due to be paid between one and two years would be subject to a 50 percent haircut (for purposes of the external LTD requirement), while the amount of eligible external LTD that is due to be paid in less than one year would not count toward the external LTD requirement.

***Treatment of Structured Notes.*** As discussed above, the Final TLAC Rule (consistent with the TLAC Proposal) retains the prohibition on counting structured notes as eligible external LTD. The Federal Reserve explains that structured notes contain features that "make their valuation uncertain, volatile, or unduly complex," and they are "often liabilities of retail customers." We discuss structured notes in further detail below.

***Federal Reserve's Discretion to Exclude Certain Debt.*** The Final TLAC rule provides that the Federal Reserve may order a covered BHC or a covered IHC (after appropriate notice and response proceedings) 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."

***Governing Law.*** The Final TLAC Rule retains the requirement that LTD subject to foreign law not qualify as eligible external LTD. However, the Final TLAC Rule's definition of "eligible debt security" has been modified to allow debt instruments issued prior to December 31, 2016, and governed by foreign law to count toward the minimum LTD and TLAC requirements.

***Clean Holding Company Requirements.*** The Final TLAC Rule applies "clean holding company" limitations to the operations of the top-tier holding companies of U.S. G-SIBs and the top-tier U.S. IHC of foreign G-SIBs to further improve resolvability and the resiliency of their operations. However, like the TLAC Proposal, covered BHCs and covered IHCs are prohibited from issuing certain guarantees of its subsidiaries' liabilities if the liability provides default rights based on the resolution of the covered BHC or covered IHC. But the Final TLAC Rule exempts guarantees of liabilities that are subject to any future rule of the Federal Reserve, the Office of the Comptroller of the Currency (the "**OCC**") or Federal Deposit Insurance Corporation (the "**FDIC**," and together with the OCC, the "**Federal banking agencies**") restricting default rights.

***Capital Deductions for Smaller, Regional Banks.*** The Federal Reserve has deferred adoption of capital deduction requirements for state member banks, certain BHCs and savings and loan holding companies and certain IHCs formed to comply with the Federal Reserve's enhanced prudential standards for FBOs. Instead, the Federal Reserve will work with the other Federal banking agencies to adopt the deduction requirements on a coordinated basis at a later time to ensure that these requirements are applied consistently to all entities subject to the regulatory capital requirements of the Federal banking agencies.

***5 Percent Liability Cap.***

- <u>Covered BHCs</u>. The Final TLAC Rule, like the TLAC Proposal, caps the amount of a covered BHC's third-party liabilities (excluding those related to eligible external TLAC and eligible external LTD) that can be *pari passu* with or junior to its eligible external LTD at 5 percent of the value of its eligible external TLAC. However, the Final TLAC Rule incorporates a new provision that stipulates that in the event the covered BHC chooses to contractually subordinate all of its LTD, there will be no cap on the amount of its non-contingent liabilities.
- <u>Covered IHCs</u>. The Final TLAC Rule adopts different caps for non-resolution covered IHCs and resolution covered IHCs (each defined below):
    - for non-resolution covered IHCs, the aggregate amount of unrelated liabilities that a non-resolution covered IHC owes to persons that are non-affiliates of the covered IHC may not exceed 5 percent of the covered IHC's total TLAC amount; and
    - for resolution covered IHCs, the cap is equal to 5 percent of the covered IHC's total TLAC on the aggregate amount of unrelated liabilities that a resolution covered IHC may owe to any person other than a subsidiary of the covered IHC.

***Additional Changes Relating to Covered IHCs.*** The following provides a brief overview of changes related to covered IHCs in the Final TLAC Rule.

- <u>Establishment of "Resolution Covered IHCs" and "Non-Resolution Covered IHCs"</u>. Unlike under the TLAC Proposal, a covered IHC that is expected to enter resolution that adopts the MPOE resolution strategy (a "**resolution covered IHC**") may, under the Final TLAC Rule, have the option to issue capital and LTD externally to third parties in a fashion similar to covered BHCs. A covered IHC that is not expected to enter an MPOE resolution would be required under the Final TLAC rule to issue LTD internally (a "**non-resolution covered IHC**"). Specifically, the capital and LTD of a non-resolution covered IHC must be issued either to a foreign company that controls the covered IHC (i.e., a foreign parent) or to a directly or indirectly wholly owned foreign subsidiary of the top-tier foreign parent consistent with the SPOE resolution strategy.

- Treatment of MPOE Approach to Resolution. Under the Final TLAC Rule, whether a covered IHC has the option to issue debt externally to third-party investors depends on whether the covered IHC (or its subsidiaries) is expected to enter resolution if a foreign parent entity fails (i.e., the MPOE strategy). The Final TLAC Rule, unlike the TLAC Proposal, permits a resolution covered IHC (which expects to enter into resolution in the United States based on its FBO parent's MPOE resolution strategy) to have the option to issue its capital and debt internally to the FBO parent or to a foreign wholly owned subsidiary of the FBO parent or externally to third-party investors. However, the Final TLAC Rule, like the TLAC Proposal, requires non-resolution covered IHCs that are not expected to enter resolution proceedings in the United States (due to its parent adopting the SPOE strategy) to issue debt internally to the FBO parent or to a wholly owned subsidiary of the FBO parent.

To address the concerns of several commenters to the TLAC Proposal, the Final TLAC Rule requires the top-tier FBO with U.S. non-branch assets equal to or greater than $50 billion, rather than the home country resolution authority, to certify to the Federal Reserve whether the planned resolution strategy of the top-tier FBO involves the covered IHC or its subsidiary entering resolution, receivership, insolvency, or similar proceedings in the United States. Such a certification must be provided by the top-tier FBO to the Federal Reserve on the later of: (i) June 30, 2017; or (ii) one year prior to the date on which the covered IHC is required to comply with the covered IHC TLAC and LTD requirements of the Final TLAC Rule.

- TLAC Calibration. Resolution covered IHCs would be required to maintain outstanding eligible TLAC that is the greater of: (i) 18 percent of the covered IHC's total RWAs; (ii) 6.75 percent of the covered IHC's total leverage exposure (if applicable); and (iii) 9 percent of the covered IHC's average total consolidated assets. However, non-resolution covered IHCs would be required to maintain the greater of: (i) 16 percent of the covered IHC's total RWAs; (ii) 6 percent of the covered IHC's total leverage exposure (if applicable); and (iii) 8 percent of the covered IHC's average total consolidated assets.
- LTD Calibration. The minimum eligible LTD requirements have been "adjusted downward" by the Federal Reserve in the Final TLAC Rule to reflect the "same balance-sheet depletion assumption afforded to the calibration of the eligible external LTD requirements of U.S. BHCs." Therefore, all covered IHCs, irrespective of whether they are resolution covered IHCs, will be required to maintain outstanding eligible LTD in an amount that is the greater of: (i) 6 percent of total RWAs; (ii) 2.5 percent of the total leverage exposure (if applicable); and (iii) 3.5 percent of average total consolidated assets.
- Acceleration Clauses for Eligible LTD. The TLAC Proposal has been modified in the Final TLAC Rule to permit eligible LTD issued by covered IHCs (whether external or internal LTD) to have the same acceleration clauses that are permitted for eligible external LTD issued by covered BHCs.
- Contractual Subordination. Covered IHCs will have the option to adopt contractual subordination or structural subordination for their eligible LTD. Such changes will, according to the Federal Reserve, allow covered IHCs to "issue LTD … on similar terms as covered BHCs under the [Final TLAC Rule] and, therefore reduce the burden on covered IHCs and help ensure national treatment and competitive equality."
- Contractual Conversion Trigger. Eligible internal LTD must contain a contractual trigger pursuant to which the Federal Reserve could require the covered IHC to convert or exchange the internal LTD into common equity Tier 1 capital and without the covered IHC needing to enter into a resolution proceeding in certain circumstances if: (i) the Federal Reserve determined that the covered IHC is in default or in danger of default; and (ii) *any* of the following applies: (a) the top-tier FBO or any subsidiary outside the United States is placed into resolution proceeds, (b) the home country supervisory authority consents to the

conversion, or does not object to the conversion following 24 hours' notice, or (c) the Federal Reserve makes a written recommendation to the Secretary of the U.S. Treasury that the Federal Deposit Insurance Corporation should be appointed as receiver of the covered IHC. Such changes "provide flexibility consistent with the purposes of the [Final TLAC Rule] and … respond to concerns raised by commenters regarding the contractual conversion trigger…."

- Disclosure Requirements. The Final TLAC Rule requires resolution covered IHCs that issue external debt to be subject to the same disclosure requirement applicable to covered BHCs. Accordingly, the resolution covered IHC, like the covered BHC, must publicly disclose the financial consequences to unsecured debtholders of the covered BHC's entry into a resolution proceeding in which the covered BHC is the only entity that would enter resolution.
- TLAC Buffer for Covered IHCs. Unlike for covered BHCs, the Final TLAC Rule does not add an additional buffer over the leverage component of the covered IHC's TLAC requirement. However, covered IHCs would still be subject to an RWA-related TLAC buffer equal to 2.5 percent. The buffers in the Final TLAC Rule are designed to be consistent with the buffers in Regulation Q, which only includes a buffer over a leverage requirement for covered BHCs.

## Additional Analysis on the Treatment of Structured Notes

Eligible external LTD instruments will not include most types of structured notes as they are not "plain vanilla" debt securities. The Federal Reserve continues to believe that the complexity of these instruments would diminish the prospects for an orderly resolution of a BHC.

As discussed above, the Final TLAC Rule's definition of "structured note" remains largely consistent with the TLAC Proposal. A "structured note" is a debt instrument that: (i) has a principal amount, redemption amount or stated maturity that is subject to reduction based on the performance of any asset, entity, index, or embedded derivative or similar embedded feature; (ii) has an embedded derivative or similar embedded feature that is linked to one or more equity securities, commodities, assets, or entities; (iii) does not specify a minimum principal amount that becomes due upon acceleration or early termination; or (iv) is not classified as debt under U.S. generally accepted accounting principles.

In response to comments on the TLAC Proposal submitted by the Structured Products Association, the definition of a structured note *does not include* a non-dollar-denominated instrument or an instrument whose interest payments are based on an interest rate index (for example, a floating-rate note linked to the federal funds rate or to LIBOR) that otherwise satisfies the requirements. Accordingly, a variety of lightly structured notes, such as "fixed-to-floating rate notes," would be eligible debt securities.

Notwithstanding the concerns and comments of market participants, the limitation for notes linked to equities, commodities and other assets applies both to "principal protected" and to "non-principal protected structured notes." Due to the Federal Reserve's concerns about structured notes, outstanding instruments of this kind will not be "grandfathered" as eligible external LTD.

## Authors

Lloyd Harmetz
New York
(212) 468-8061
lharmetz@mofo.com

Oliver Ireland
Washington D.C.
(202) 778-1614
oireland@mofo.com

Anna Pinedo
New York
(212) 468-8179
apinedo@mofo.com

### About Morrison & Foerster

We are Morrison & Foerster—a global firm of exceptional credentials. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life sciences companies. We've been included on *The American Lawyer*'s A-List for 13 straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.  For more updates, follow Thinkingcapmarkets, our Twitter feed: www.twitter.com/Thinkingcapmkts.

*Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.*

 