

# The FRB's LTD, TLAC and Clean Holding Company Final Rules, Funding and European TLAC/MREL Developments

**March 2017**

# The Financial Stability Board Principles

# A timeline

- Financial Stability Board Proposal for Comment was issued in November 2014
- Comment period closed in February 2015
- FSB conducted a quantitative impact study (QIS) in which it collected information from G-SIBs
- The final TLAC principles were released on November 9, 2015.

# The FSB Principles

- Designed to facilitate orderly resolution of G-SIBs
  - 30 banks globally
  - Includes 8 US banks
- Calibration of minimum TLAC from January 1, 2019 of 16% of risk weighted assets (RWAs) rising to 18% from January 1, 2022 and from January 1, 2019, 6% of the Basel III leverage ratio denominator and from January 1, 2022, rising to 6.75% of the Basel III leverage ratio denominator
  - Phased in requirements for G-SIBs headquartered in emerging markets
  - Tier 1 and Tier 2 Capital is “eligible”
  - Other eligible TLAC that is not regulatory capital
- Additional TLAC may be required for individual G-SIBs based on risk factors
- Two elements: Risk-weighted TLAC ratio and a TLAC leverage ratio

# TLAC eligibility criteria

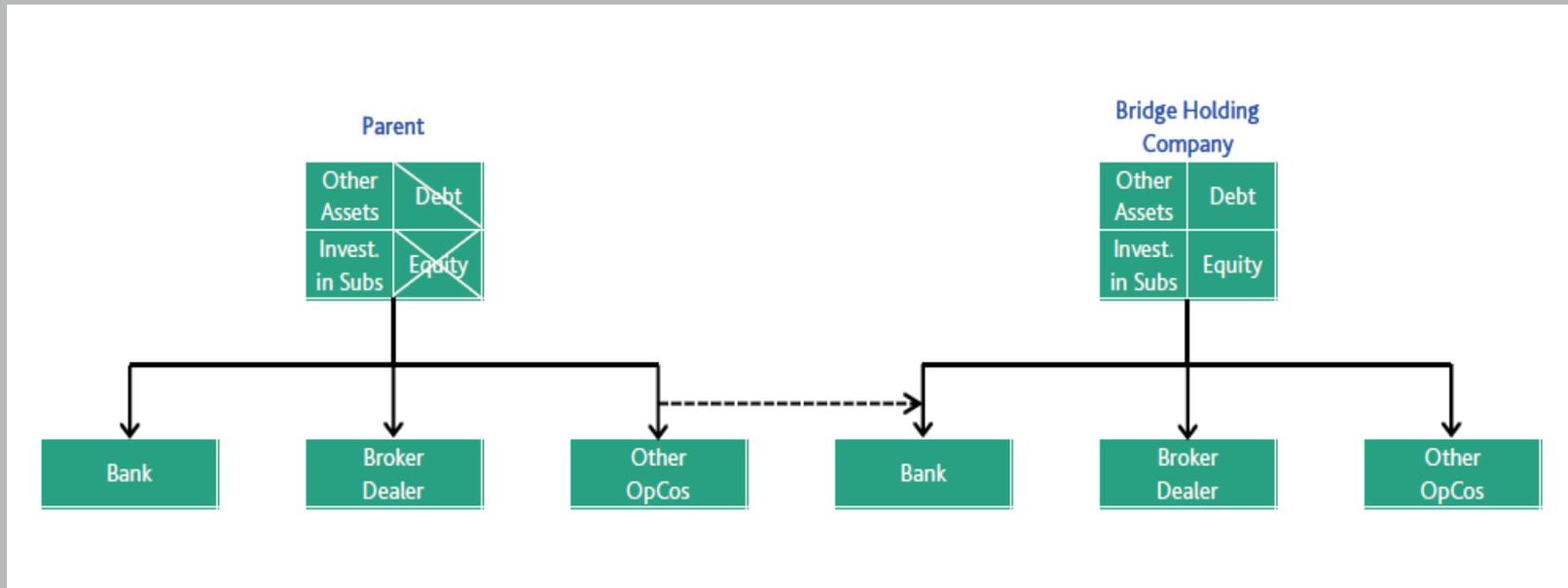
- TLAC Eligibility Criteria:
  - External TLAC must be issued and maintained by resolution entities (except, in some circumstances, regulatory capital issued by wholly and directly-owned funding entity will be eligible)
  - Paid-in, unsecured, not subject to netting
  - Perpetual or minimum remaining contractual maturity of one year (for any security with a redemption feature, first redemption date would be effective maturity date; “maturing” instruments would need to be replaced with new TLAC-eligible instruments)
  - Subject to certain limited exceptions, not funded directly by the resolution entity or a related party of the resolution entity
- Eligible TLAC must contain a contractual trigger or be subject to a statutory mechanism which permits the resolution authority to write down or convert to equity
- Certain instruments are not considered TLAC eligible, such as the following: insured deposits, liabilities arising from derivatives or debt instruments with derivative-linked features—e.g., structured notes, and non-contractual liabilities

# Internal TLAC

- Material sub-groups in jurisdictions outside of bank's home country must have "Internal TLAC"

# FRB Final Rule

# Single point of entry resolution



# FRB proposal

- The FRB released its proposal on October 30, 2015, which set forth for covered BHCs and covered IHCs an external TLAC requirement in the case of covered BHCs (and an internal TLAC requirement in the case of covered IHCs), a related TLAC buffer, a minimum long-term debt (LTD) requirement for covered BHCs (and a minimum internal long-term debt requirement for covered IHCs), and a “clean holding company” requirement
- The FRB proposal was premised on the view that TLAC alone would not be sufficient to facilitate SPOE resolution
- In addition, to avoid contagion risk, the FRB proposal also would have penalized banks generally for holding unsecured debt of a covered BHC

# Final FRB Rules

- On December 15, 2016, the FRB voted unanimously to adopt final rules that impose an external TLAC requirement in the case of covered BHCs (and a TLAC requirement in the case of covered IHCs, which has been modified from the proposal), related TLAC buffers, a minimum LTD requirement for covered BHCs (and a minimum LTD requirement for covered IHCs, which has been modified from the proposal), and a “clean holding company” requirement
- The final rules differ from the proposed rules only in certain modest respects

# Principal Differences

- Effective date of January 1, 2019 (in other words, no “phase in” period from 2019 to 2022)
- Grandfathering of outstanding LTD of covered BHCs issued prior to December 31, 2016 (including otherwise eligible LTD governed by non-U.S. laws and otherwise eligible LTD subject to acceleration clauses)
- FRB is allowed to order a G-SIB to exclude from its outstanding eligible LTD any debt securities with features that would significantly impair such debt securities to take losses (subject to notice and opportunity to respond)
- The final rule permits a MPOE approach for a resolution-covered IHC
- A resolution-covered IHC has the option to issue LTD externally to third parties (like a covered BHC) subject to certain conditions

- The final rule contains some modifications to the clean holding company requirement
  - Under the final rule, covered BHCs and covered IHCs are permitted to guarantee certain QFCs of their subsidiaries to the extent guarantees are permitted by regulations governing stays
  - The final rule imposes a 5% cap on external liabilities (other than those related to TLAC) unless the covered BHCs and covered IHCs issue eligible LTD as contractually subordinated debt
- The capital deduction for investments in the unsecured debt of covered BHCs and covered IHCs that was in the proposed rule is not included in the final rule; however, this issue is expected to be addressed jointly with the OCC and the FDIC

# External long-term debt

- The final rule includes both a minimum LTD requirement and a minimum TLAC requirement
- **Why a long-term debt requirement?**
  - In principle, the objective of the external LTD requirement is to ensure that each covered BHC has a minimum amount of eligible external LTD such that, if the covered BHC's going-concern capital is depleted and the covered BHC fails and enters resolution, the eligible external LTD will be sufficient to absorb losses and recapitalize the covered BHC by replenishing its going-concern capital (referred to in the preamble as a “capital refill” approach)
- **What is eligible external long-term debt?**
- Debt securities issued directly by the covered BHC that:
  - Are unsecured
  - Are “plain vanilla”

- Are governed by U.S. law (*commenters had requested that the FRB consider debt securities governed by the laws of at least certain foreign jurisdictions*)
- Only 50% of the amount of eligible external LTD that is due to be paid between one and two years can be used for purposes of the eligible external LTD requirement (although all of it would count in full for purposes of the external TLAC requirement)
- *The amount of eligible external LTD due to be paid in less than one year will not count toward the external TLAC or the external LTD requirement*
- **What is “plain vanilla” debt?**
  - The debt cannot contain an embedded derivative, have a credit sensitive feature (such as an interest rate that resets periodically based in whole or in part on the G-SIB’s credit quality), contain any contractual conversion or exchange features, or include acceleration rights, other than a right that is exercisable in the event of the covered BHC’s insolvency or a payment failure that continues for 30 days or more; no structured notes

- **What is the external LTD requirement under the final rule?**
  - A covered BHC must maintain outstanding eligible external LTD in amount not less than the greater of: 6% of total RWA plus the G-SIB surcharge, and 4.5% of total leverage exposure
- **Can a covered BHC redeem or repurchase outstanding external LTD?**
  - A covered BHC must seek FRB approval to repurchase or redeem where the repurchase or redemption would result in noncompliance with the requirement
- **Other relevant provisions**
  - The final rule includes a new provision that the FRB may, after notice and an opportunity to respond, order a G-SIB to exclude from its outstanding eligible LTD amount any debt securities with features that would hinder a resolution
  - No grace period during which a covered BHC that breaches the external LTD requirement can take voluntary actions to come into compliance without being subject to other regulatory consequences

- **Grandfather provision**

- Certain outstanding LTD of covered BHCs issued prior to December 31, 2016 counts toward the external LTD and external TLAC requirements

- **Acceleration provisions and incentives to redeem**

- Eligible external LTD cannot have a contractual right to acceleration of payment of principal or interest, other than on the occurrence of either an insolvency event or a payment default event that continues for 30 days or more, except that eligible external LTD instruments are permitted to give a holder a put right as of a future date certain, subject to certain conditions

# External TLAC

- **What is eligible external TLAC?**
  - The sum of (1) common equity Tier 1 capital and AT1 capital issued directly by the covered BHC (excluding minority interests), plus (2) the covered BHC's eligible external LTD that is due to be paid after one year or more
    - **The proposal had been based on the “remaining maturity” of the debt, rather than the unpaid principal amount “due to be paid”**
- **What is the required amount of eligible external TLAC?**
  - An amount not less than the greater of 18% of the covered BHC's total RWAs and 7.5% of the covered BHC's total leverage exposure
  - In addition, there are two separate external TLAC buffers
    - **Same as the proposal, except the leverage component of the external TLAC requirement is reduced from 9.5% to 7.5%, and the FRB has adopted a 2% buffer on top of the leverage component**

- **TLAC Buffers for covered BHCs**
  - ***TLAC Leverage Buffer***: the final rule reduced the minimum amount of the leverage component of the external TLAC requirement (from 9.5% to 7.5%) and a 2% buffer has been added over the leverage component of the external TLAC requirement. This buffer must be filled solely with T1 capital and breach of this buffer subjects the BHC to limits on capital distributions and discretionary bonus payments
  - ***TLAC RWA Buffer***: the TLAC buffer for the RWA component of the external TLAC requirement is equal to 2.5% plus the GSIB surcharge applicable to the covered BHC under method 1 of the GSIB surcharge rule plus any applicable countercyclical capital buffer. This buffer must be filled solely with CET1. Breach of this buffer subjects the BHC to limits on capital distributions and discretionary bonus payments
- Limitations on distribution and discretionary bonus payments will be based on the more restrictive of these two buffers

# Eligibility of Specific Securities

- Eligible LTD cannot include contractual provisions for conversion into or exchange for equity
  - A convertible debt instrument is viewed as a debt instrument with an embedded stock call option
- Debt with a “survivor put”: the date on which debt is due to be paid is the date that the holder first has a contractual right to request or require payment of principal—as a result, debt with a survivor put would be treated as having matured on the first day it became subject to a put right, or the date of issuance, and it would not qualify as eligible LTD

# Structured notes

- A “structured note” is a debt instrument that:
  - 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;
  - Has an embedded derivative or similar embedded feature that is linked to one or more equity securities, commodities, assets, or entities;
  - Does not specify a minimum principal amount that becomes due and payable upon acceleration or early termination; or
  - Is not classified as debt under U.S. generally accepted accounting principles.
- Definition clearly applies to both principal-protected and non-principal protected structured notes.

- The final rule makes clear that 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 satisfy the proposed requirements in all other respects
- These requirements are applicable only at the BHC level, so, they would not be applicable to: structured bank notes or to market-linked CDs

# IHCs

# IHCs of Foreign G-SIBs

- A covered IHC is any US IHC (FBOs with consolidated global assets of \$50 billion or more and consolidated U.S. assets of \$10 billion or more must establish an IHC) that is controlled by a FBO that is a G-SIB
- A covered IHC's eligible TLAC equals the sum of the Tier 1 regulatory capital issued from the covered IHC to the foreign parent that controls the covered IHC, and the covered IHC's eligible LTD
- Significant changes were made from the NPR to the final rules in relation to covered IHCs—for example, the final rules include a number of provisions that facilitate the resolution of a FBO under a MPOE approach

# SPOE or MPOE

- **Is the covered IHC expected to enter resolution?**
  - If so, it is referred to as a resolution covered IHC in a MPOE resolution strategy, or operate outside of resolution proceedings (a non-resolution covered IHC) while its foreign parent entity is resolved under a SPOE approach
  - A resolution covered IHC (adopting a MPOE approach) has the option either to: issue capital and LTD to third parties, as will covered BHCs, or to issue LTD internally
  - A non-resolution covered IHC will be required to issue LTD either to a foreign parent or to a directly or indirectly wholly owned foreign subsidiary of the top-tier foreign parent (internal TLAC and LTD)

- The IHC must certify to the FRB on the later of June 30, 2017, or one year prior to the date on which the covered IHC is required to comply with the covered IHC TLAC and LTD requirements as to its planned approach
  - The FRB will review the IHC's certification and the FRB has the discretion to determine that an entity that is certified to be a non-resolution covered IHC is a resolution-covered IHC (or vice versa), in which case, the IHC will have an additional one-year (or longer) period in which to comply

# Calibration of IHC Requirements

- **What is the TLAC requirement?**
  - For SPOE, a non-resolution covered IHC would be required to keep outstanding eligible internal TLAC at least equal to the greater of: (i) 16% of the IHC's total RWAs, (ii) 6% of total leverage exposure (for those IHCs subject to the supplementary leverage ratio (SLR)), and (iii) 8% of average total consolidated assets as computed for purposes of the US Tier 1 leverage ratio
  - For MPOE, resolution covered IHC would be required to keep outstanding eligible TLAC at least equal to the greater of: (i) 18% of the covered IHC's total RWAs, (ii) for covered IHCs subject to the SLR, 6.75% of total leverage exposure, and (iii) 9% of average total consolidated assets as computed for purposes of the US Tier 1 leverage ratio
    - A buffer applies only in respect of the RWA component of the TLAC requirement

- **What is the minimum eligible LTD requirement?**
  - Eligible LTD will at least equal the greater of (i) 6% of total RWAs, (ii) for covered IHCs subject to the SLR, 2.5% of total leverage exposure, and (iii) 3.5% of average total consolidated assets
    - **The RWA component has been reduced from the proposal (7%) to 6%; the SLR component has been reduced from 3% to 2.5%, and the TCAs component from 4% to 3.5%**

# Eligible LTD for IHCs

- **What are the requirements for eligible LTD for IHCs?**
  - Same general requirements as those applicable to eligible external LTD for covered BHCs
  - Same grandfather provision as available to covered BHCs
  - Covered IHCs may adopt either contractual subordination or structural subordination for their eligible LTD
  - Eligible internal LTD must include a contractual trigger pursuant to which the FRB could require the covered IHC to convert or exchange the LTD into CET1 without the covered IHC's entry into a resolution proceeding if:
    - FRB determines that the covered IHC is in default or in danger of default, and
    - Any of the following apply: the top tier FBO or any subsidiary outside the United States is put into resolution, the home country supervisory authority consents to the conversion or does not object following 24 hours' notice, or the FRB provides a written recommendation to the UST that the FDIC should be appointed as receiver

- **There are a number of differences from the proposal:**
  - **The final rule removes FRB's ability to require cancellation of debt and requires only ability of the FRB to require conversion or exchange;**
  - **The final rule permits eligible internal debt securities to have the same acceleration clauses as eligible external LTD;**
  - **Eligible external debt securities are not required to be contractually subordinated; and**
  - **Final rule allows for possibility of partial conversion or exchange of less than all of the eligible internal debt securities of the IHC.**

# The Clean Holding Company

# Clean Holding Company

- **What is the clean holding company requirement?**
  - The proposal sets out a “clean holding company” requirement, which has two parts:
    - First, a covered BHC is prohibited from
      - Engaging in short-term borrowings (any debt instrument with an original maturity of less than 365 days, including short-term deposits and demand deposits, issued to any person, unless the person is a subsidiary of the covered BHC),
      - Entering into QFCs (the final rule contains some changes that address credit support issues),
      - Issuing guarantees of subsidiary liabilities that could create cross-default, set-off or netting rights for creditors of the subsidiary, but exempts guarantees subject to a FRB stay rule restricting default rights or any similar rule of another U.S. banking agency

- Second, a covered BHC's third-party non-contingent liabilities (other than those related to eligible external TLAC) that are pari passu with or junior to its eligible external LTD to a cap of 5% of the value of its eligible external TLAC
- The final rule modifies the treatment of the 5% cap
  - Covered BHCs and covered IHCs have the option to contractually subordinate their eligible LTD to other third party liabilities without the need for the 5% cap
  - A BHC can satisfy the external LTD requirement with either senior or subordinated debt instruments
  - A covered BHC that chooses to issue all of its external LTD with a contractual subordination provision would not be subject to the 5% cap
- The preamble also makes it clear that the cap does not limit a covered BHC's ability to issue structured notes out of subsidiaries

# Disclosures

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- A covered BHC and a resolution-covered IHC must publicly disclose a description of the financial consequences to unsecured debtholders of the covered BHC or the resolution-covered IHC, as the case may be, of the entity's entry into a resolution proceeding in which the covered BHC (or resolution-covered IHC) is the only entity that would enter resolution
- The required disclosure may be made:
  - On the entity's website, or
  - In a public report or regulatory filing
- Also, such disclosures must be included in the offering documents for all eligible LTD

# Changes to Indentures

# Changes to Indentures

- Under the FRB final rule, in order to be eligible LTD, BHC debt cannot give holders a right of acceleration for principal or interest, except upon an insolvency or a payment default after a 30-day grace period.
- Result:
  - Acceptable events of default are bankruptcy, and non-payment of principal or interest after a 30-day grace period
  - Formerly, a non-payment of principal was an event of default without a grace period
  - Covenant default, cross-default, sinking fund non-payments and other events are no longer acceptable

- Recent supplemental indentures filed by, among others, JPMorgan, Citigroup, Morgan Stanley and Goldman amended their indentures generally in the following manner:
  - Sinking fund deposit and covenant defaults were removed
  - “Covenant Breach” was added
    - Breach of any covenant in the indenture (including the deposit of any sinking fund payment)
    - Not an event of default
    - But holders can sue on the contract
    - Damages uncertain – as opposed to acceleration upon an event of default
  - Merger clause clarified that all events of defaults and covenant breaches must be resolved prior to a merger, plus any “default” – defined to include any event that, after notice and lapse of time, would become an event of default or covenant breach – must be resolved
  - Generally, disallowed events of default put into a covenant breach
  - But: trustee can cause an acceleration of an event of default without any action by the holders
  - Holders seeking to enforce a covenant breach must satisfy the notice and indemnity provisions of the limitations on suits requirements

# EU Proposals Affecting US Banks

# Important Considerations

- European authorities have established a resolution approach that requires “bail-in,” or the imposition of losses on liabilities owed by a financial institution which would not, by their terms, be required to absorb such losses. Loss absorption can be by conversion of the liability into a common equity instrument or writing down/off the principal amount of the liability. This has the result of introducing complexity as different national regulators adopt different approaches.
- Bail-in, and the MREL requirement, interact with and, in part, may overlap with TLAC
- The EU Parliament recently proposed a framework that contemplates a requirement for an EU “IHC” for certain U.S. financial institutions

# TLAC and MREL

- **What's MREL?**
- Under the EU resolution approach, which is contained in the Bank Recovery and Resolution Directive, or BRRD, each Member State of the EU must set a minimum requirement for eligible (loss-absorbing) liabilities (MREL) expressed as percentage of the aggregate of an institution's own funds (capital) and total liabilities
- Minimum own funds are already established by the EU Capital Requirements Regulation by reference to risk-weighted assets
- Applies to all EU banks, not just to G-SIBs

# MREL Requirements

- **Required amounts:**
  - MREL will be set for each bank as an amount considered necessary to absorb losses, plus an amount deemed necessary by regulators
  - No minimum level of MREL is prescribed for non-GSII, but the TLAC-related provisions effectively set a floor on the level of MREL (“MREL Floor”) that must be assigned for GSII by their GSII resolution authority
  - Resolution authorities may set MREL levels for GSII higher than the MREL Floor in certain circumstances

- **Eligibility criteria:**

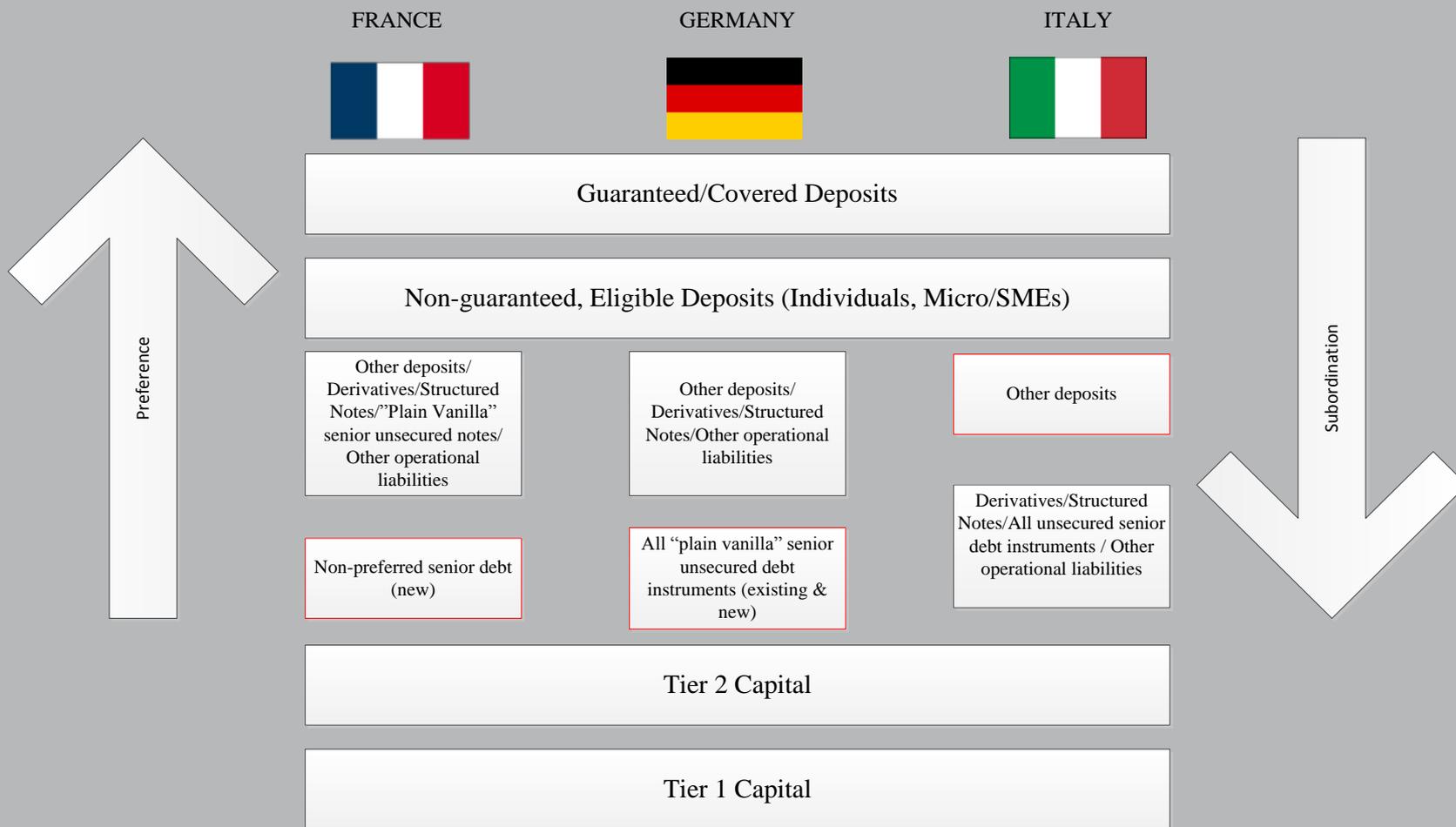
- Eligibility criteria for instruments counting towards the MREL Floor are more stringent than those for instruments counting towards MREL above the MREL Floor and for instruments counting towards MREL for non-GSIIIs
- EU Commission has proposed eligibility criteria for MREL (regulatory capital instruments, Tier 2 instruments with a residual maturity of at least one year, to the extent that such instruments do not count towards the entity's required Tier 2 capital during the final five years of the instrument's maturity, in accordance with the CRR)
- MREL criteria reflect the TLAC-eligibility criteria, but with certain additions and variations....
- Under FSB TLAC principles, TLAC eligible instruments can be subject to bail-in by virtue of a statutory mechanism or by the contractual terms; however, the EU Commission proposal specifies that only contractual bail-in bonds will be acceptable for MREL

# TLAC: Role of Bank Senior Unsecured Debt as Bail-In Resource



Attributed to Credit Agricole

# National Statutory Approaches to MREL/TLAC Subordination

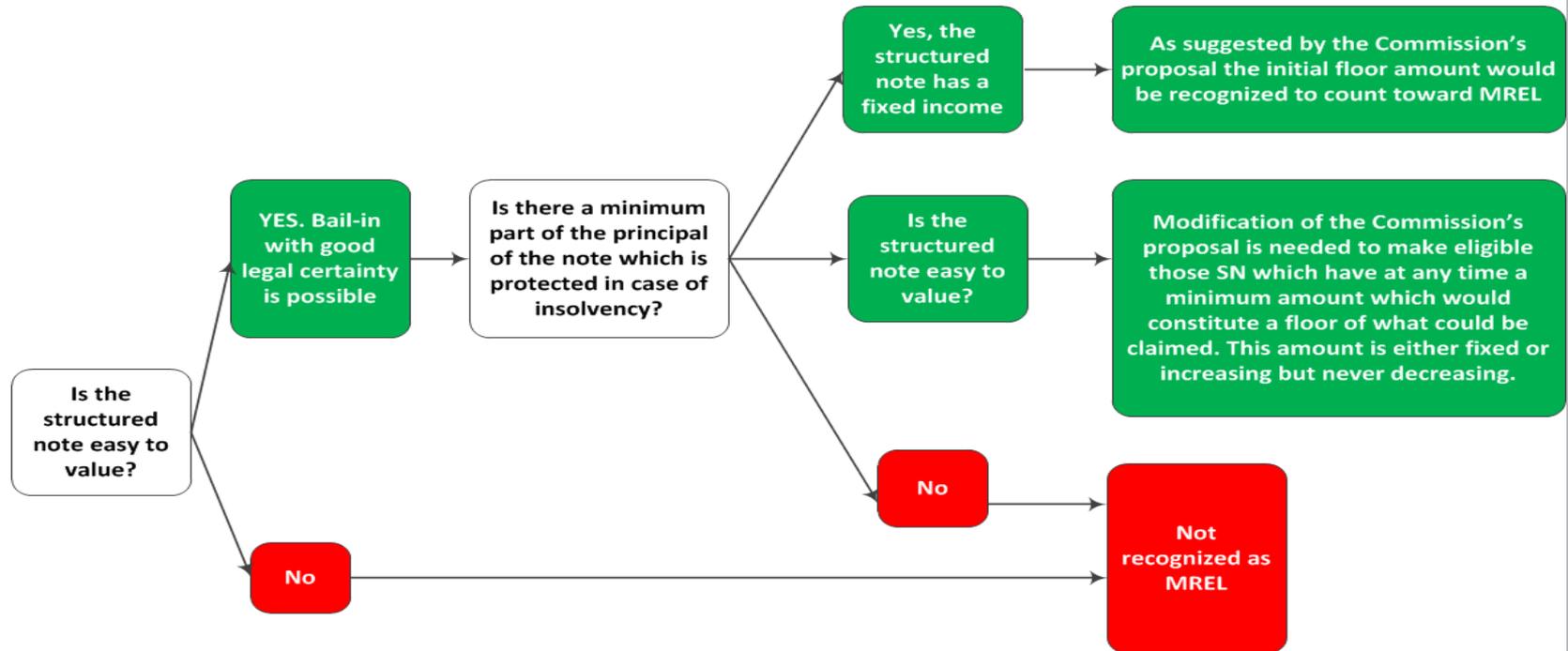


# Ongoing Discussions on TLAC

- Continuing discussions regarding the types of instruments that should count as MREL for non-G-SIBs (G-SIIs) and the types of instruments that should count toward TLAC
- Some structured notes, for example, could count towards MREL for non-GSIBs, including not only notes that have a fixed minimum amount payable, but also those where the minimum amount payable increases over the life of the note
- Not clear whether these types of notes if they count toward MREL also would count toward TLAC
- EC Council has outlined a scheme for evaluating the instruments

# Decision Tree

## ANNEX: Decision Tree



# EU IHC Proposed Requirement

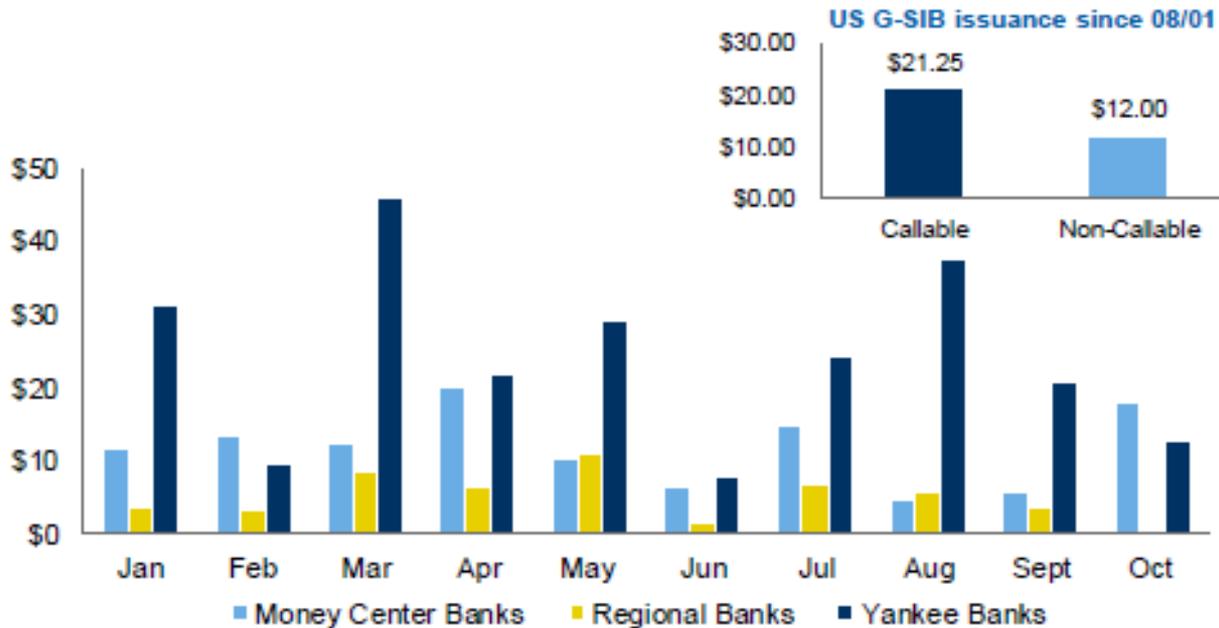
- The European proposals provide that, certain non-EU banking groups must establish an intermediate financial holding company in the EU
- Requirement will apply to G-SIBs and to non-G-SIBs if the total value of EU assets is at least €30 billion
- To calculate the value of EU assets, there must be included assets of all EU subsidiaries and all EU branches of the non-EU banking group
- The European entities would then be consolidated under the intermediate financial holding company, forming a European subgroup; the intermediate financial holding company must obtain authorization either as an EU bank or as an EU financial holding company or mixed financial holding company

# Market Reaction

# Market Reaction

- Thus far, there has been active issuance by financial institutions of TLAC qualifying securities
- There has been no notable pricing differentiation for TLAC versus non-TLAC issuance or as between domestic and foreign bank supply

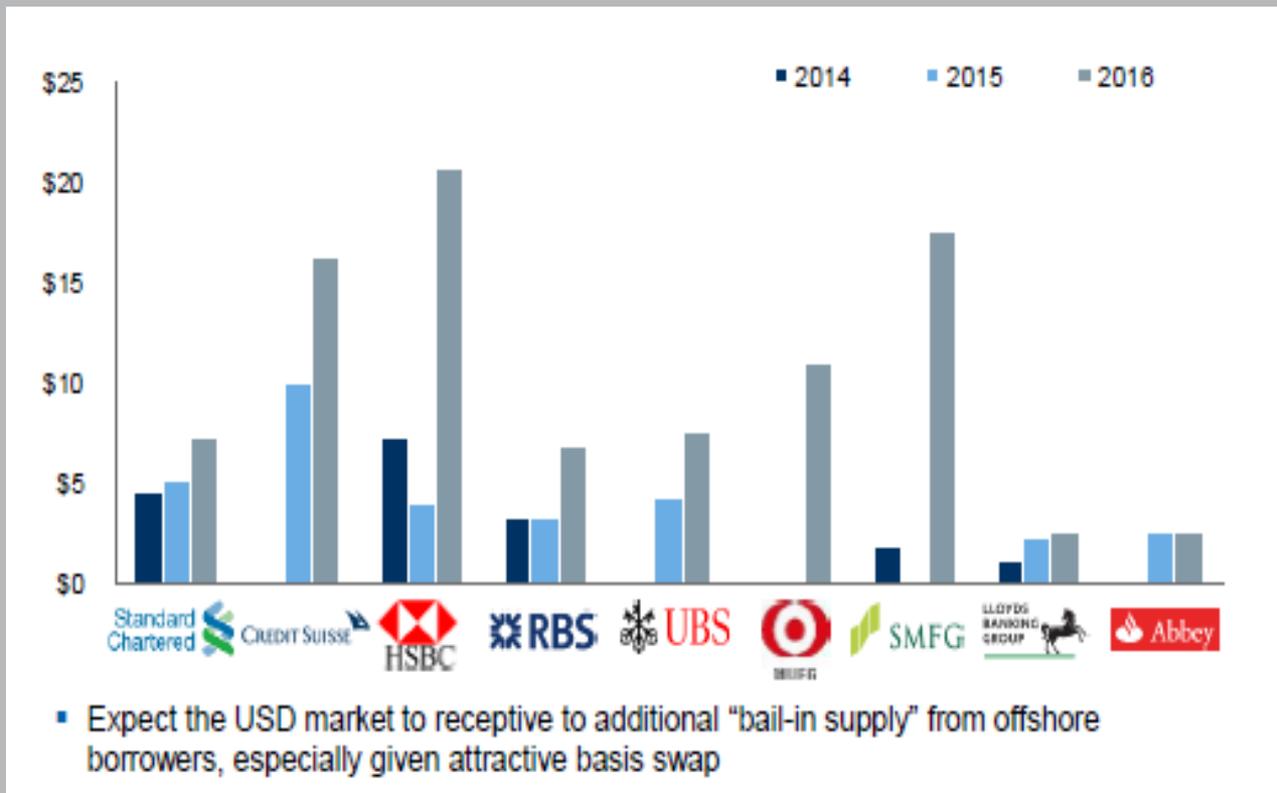
## Sector Snapshot: Financial Supply Overview (\$bn)



- Yankee banks dominated the calendar for FI issuance in late summer, with US G-SIBs very active in October, especially in callable format.

Attributed to RBC Capital Markets

Market reaction, cont'd.



Attributed to RBC Capital Markets