

Final TLAC Rule: Federal Reserve Responses to FBO Comments

December 16, 2016

Yesterday, the Federal Reserve Board (the Board) issued its final rule regarding Total Loss-Absorbing Capacity (TLAC).¹ The rule, among other things, imposes TLAC and long-term debt (LTD) requirements on the U.S. intermediate holding companies of non-U.S. global systemically important banks (Covered IHCs).

The rule is largely consistent with the Board’s proposal,² but does address some of the comments of foreign banking organizations (FBOs) on key issues, including by permitting Covered IHCs of “multiple point of entry” (MPOE) firms to issue TLAC and eligible external long-term debt (eLTD) to third parties and by slightly reducing the LTD requirements applicable to Covered IHCs.

The rule retains the proposal’s requirement that eligible internal LTD (iLTD) include a contractual provision permitting its conversion into common equity outside insolvency proceedings. However, in response to industry comments, the Board revised the rule in ways that should support the characterization of iLTD as debt, rather than equity, for U.S. tax purposes. Any uncertainty lingering overnight regarding the tax characterization of iLTD was eliminated this morning by companion guidance issued by the Internal Revenue Service (the IRS) clarifying that the IRS will treat iLTD as debt.³

The table below summarizes the FBOs’ main comments on the Board’s TLAC proposal and the relevant provisions of the Board’s rule. The table includes a separate section for comments specifically concerning MPOE Covered IHCs.

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For more information on the global implementation of the TLAC standard, visit www.clearygottlieb.com/TLAC

¹ The pre-publication draft of the final rule is available at: <https://www.federalreserve.gov/aboutthefed/boardmeetings/20161215openmemos.htm>.

² The proposal is available at: <https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-29740.pdf>.

³ The IRS’s Revenue Procedure is available at: <https://www.irs.gov/pub/irs-drop/rp-17-12.pdf>.



FBO Comment	Final Requirement
Calibration	
Internal TLAC	
<p>The internal TLAC calibration should be no higher than 75% of the equivalent external TLAC requirements</p> <ul style="list-style-type: none"> • 13.5% of risk-weighted assets (RWA) • 4.125% of Supplementary Leverage Ratio exposure • 5.635% of Tier 1 leverage exposure 	<p>The internal TLAC calibration <u>remains unchanged at approximately 90%</u> of equivalent external TLAC requirements</p> <ul style="list-style-type: none"> • 16% of RWA plus a buffer (described below) • 6% of Supplementary Leverage Ratio exposure • 8% of Tier 1 leverage exposure
<p>The internal TLAC calibration should be subject to reduction on an institution-specific basis</p>	<p>The preamble states that the Board may consider case-by-case adjustments in the future</p>
<p>Covered IHCs subject to the Supplementary Leverage Ratio should not need to comply with the Tier 1 leverage ratio component of the internal TLAC requirement</p>	<p>The Board did not accept this comment</p> <ul style="list-style-type: none"> • Covered IHCs subject to the Supplementary Leverage Ratio must also comply with the Tier 1 leverage ratio component
Internal LTD	
<p>The iLTD requirement should be eliminated</p>	<p>The iLTD requirement was retained, without alignment to the FSB standard</p>
<p>If the iLTD requirement is retained, the rule should align with the FSB standard so that it is a “regulatory expectation” that 33% of a Covered IHC’s internal TLAC will consist of LTD</p> <ul style="list-style-type: none"> • 4.5% of RWA • 1.375% of Supplementary Leverage Ratio exposure • 1.875% of Tier 1 leverage exposure 	<p>However, the RWA component was lowered by 100 basis points, the Supplementary Leverage Ratio component was lowered by 50 basis points and the Tier 1 leverage exposure component was also lowered by 50 basis points</p> <p>The iLTD calibrations of the rule are</p> <ul style="list-style-type: none"> • 6% of RWA (down from 7%) • 2.5% of Supplementary Leverage Ratio exposure (down from 3%) • 3.5% of Tier 1 leverage exposure (down from 4%)
<p>If the iLTD requirement is not aligned with the FSB standard, the calibrations should reflect the assumption of “balance sheet depletion”</p> <ul style="list-style-type: none"> • 100 basis points reduction in the LTD RWA ratio • 50 basis points reduction in the LTD leverage ratios 	

FBO Comment	Final Requirement
Eliminate the 50% amortization haircut for instruments with an outstanding maturity of between one and two years	<p>The Board did not accept this comment</p> <ul style="list-style-type: none"> Principal due within one to two years is reduced by 50% for purposes of determining the amount of LTD (though not TLAC) a Covered IHC has issued
Covered IHCs subject to the Supplementary Leverage Ratio should not need to comply with the Tier 1 leverage ratio component of the iLTD requirement	<p>The Board did not accept this comment</p> <ul style="list-style-type: none"> Covered IHCs subject to the Supplementary Leverage Ratio must also comply with the Tier 1 leverage ratio component
Phase-in of Requirements	
No objection to the proposed rule's phase-in of the internal TLAC RWA requirement from 14% on January 1, 2019 to 16% on January 1, 2022	<p>The final rule eliminates the phase-in of the RWA component of internal TLAC</p> <ul style="list-style-type: none"> As of January 1, 2019, internal TLAC must equal 16% of RWA
Internal LTD Eligibility Criteria	
Contractual Conversion Requirement	
The contractual conversion requirement should be eliminated	<p>The rule maintains the contractual conversion requirement, but incorporates some modifications requested to address tax concerns</p> <ul style="list-style-type: none"> iLTD is not subject to cancellation The Board may convert to equity "some or all" of a Covered IHC's outstanding iLTD Acceleration and subordination limitations are aligned with those applicable to eLTD (although grandfathering of outstanding instruments is not) (see below) <p>The IRS issued a Revenue Procedure clarifying that the IRS will treat iLTD as debt</p>
<p>If the contractual conversion requirement is retained, the Board should modify it and/or work with the Treasury Department to address tax concerns</p> <p>The Institute of International Bankers developed proposed changes to the contractual conversion requirement to address the tax concerns and submitted these changes to the Board and Treasury⁴</p>	

⁴ The proposals are described in a supplemental letter submitted to the Board, available at: https://c.ybcdn.com/sites/iib.site-ym.com/resource/resmgr/IIB_Comment_Letters/20160701JointTradeTLACSupple.pdf.

FBO Comment	Final Requirement
Affirmative consent of home authorities should be required before triggering conversion, unless immediate conversion is needed to avoid systemic risks	<p>The Board did not accept these comments</p> <ul style="list-style-type: none"> • Instead, the time period in which home authorities may object to the Board’s determination has been shortened from 48 to 24 hours
Home country authorities should have longer than 48 hours to object to the Board’s determination to trigger conversion	
Regulatory Capital Instruments	
<p>Any instrument that satisfies regulatory capital requirements should count towards internal TLAC requirements</p> <ul style="list-style-type: none"> • Minority interests in consolidated subsidiaries should count as internal TLAC, and • Tier 2 instruments should count as iLTD 	<p>The Board did not accept these comments</p> <ul style="list-style-type: none"> • Minority interests do not count as internal TLAC • Tier 2 instruments count as iLTD only if they satisfy the iLTD eligibility requirement
If Tier 2 instruments do not count as iLTD, all instruments issued prior to the final rule should be grandfathered	No grandfathering of non-conforming Tier 2 instruments
Preferred Stock	
Preferred stock should count as iLTD, or at a minimum, Covered IHCs should be able to satisfy a portion of their iLTD requirement with preferred stock	Preferred stock does <u>not</u> qualify as iLTD
Permitted Holders of Internal TLAC	
Permit the issuance of internal TLAC and iLTD to any non-U.S. affiliate, not just to a foreign parent that “controls” the Covered IHC	<p>All Covered IHCs may issue iLTD to any foreign affiliate that is wholly owned, directly or indirectly, by the FBO</p> <ul style="list-style-type: none"> • “Wholly owned” is defined to permit 0.5% of the ownership of the entity to be held by a third party to establish corporate separateness or address bankruptcy concerns <p>(As described below, the rule permits Covered IHCs with an MPOE resolution strategy to issue eLTD externally to third-party investors)</p>
At minimum, permit the issuance of internal TLAC and iLTD to non-U.S. affiliates to the extent such issuance does not create a change-in-control risk	

FBO Comment	Final Requirement
Guarantees & Keepwells	
Covered IHCs should be able to satisfy iLTD requirements with collateralized parent guarantees	<p>The Board did not accept these comments</p> <ul style="list-style-type: none"> iLTD requirements must be satisfied with eligible internal debt instruments Internal TLAC must be satisfied with Tier 1 capital or iLTD
Covered IHCs should be able to satisfy a portion of internal TLAC requirements with uncollateralized guarantees, keepwells or similar parent support	
Consistency with eLTD Requirements	
iLTD instruments should be permitted to have the same acceleration clauses as instruments that satisfy the eLTD eligibility requirements	<p>iLTD is permitted to have the same acceleration clauses as eLTD issued by covered bank holding companies (<u>Covered BHCs</u>)</p> <ul style="list-style-type: none"> Upon specified dates Upon insolvency or resolution Upon non-payment of principal or interest for 30 days after due <p>Unlike eLTD, no grandfathering is provided for iLTD instruments issued before December 31, 2016</p>
Covered IHCs should be able to subordinate iLTD to operating liabilities either contractually or structurally by complying with the “clean-holding-company” requirements applicable to Covered BHCs	iLTD may be contractually or structurally subordinated
If Covered IHCs elect structural subordination, they should be permitted the same 5% allowance for non-TLAC liabilities as Covered BHCs are permitted	Covered IHCs that do not contractually subordinate iLTD may have unrelated liabilities equal to 5% of amount of iTLAC
Buffer	
Eliminate the internal TLAC buffer	<p>Covered IHCs remain subject to an internal TLAC buffer equal to 2.5% RWA <u>plus</u> any applicable countercyclical buffer</p> <ul style="list-style-type: none"> However, unlike for Covered BHCs, no leverage ratio TLAC buffer applies
If retained, the internal TLAC buffer should be no higher than 75% of the external TLAC buffer	

FBO Comment	Final Requirement
<p>Clarify that distributions or bonus payments are not limited simply because the Covered IHC incurs a loss, as long as the Covered IHC continues to comply with the internal TLAC buffer</p>	<p>The Board did not provide an express clarification on this point</p> <ul style="list-style-type: none"> • However, so long as a Covered IHC remains above its buffers and within its capital plan approval, it should not be subject to automatic restrictions on its ability to make capital distributions or discretionary bonus payments
<p>Breaches of the internal TLAC buffer should be addressed through the supervisory process, not automatic limitations on distributions</p>	<p>The Board did not accept this comment</p> <ul style="list-style-type: none"> • Breaches of buffers result in immediate restrictions on a Covered IHC's ability to make capital distributions (although the Board retains discretion to grant exceptions)
GSIB and SPOE Designations	
GSIB Designation	
<p>GSIB determinations should be made using only the Basel Committee on Banking Supervision (<u>BCBS</u>) methodology, not both the BCBS and Board methodologies</p>	<p>The Board did not accept these comments</p> <p>An FBO is considered a GSIB if</p> <ul style="list-style-type: none"> • The FBO determines it is a GSIB under the BCBS methodology • The Board determines that the FBO is a GSIB under the BCBS methodology, or • The Board determines that the parent FBO or Covered IHC is a GSIB under the Board's capital rules <p>Under the Board's capital rules, a banking organization is deemed a GSIB based on the Board's method 1 test which the Board characterizes as generally consistent with the BCBS methodology</p>
<p>If the Board methodology is retained, clarify that only the Board's method 1, which relies on numerical thresholds and not the Board's discretion, will be used</p>	
<p>If the Board methodology is retained, address risk of overstating indicators arising from use of spot EUR-USD calculation</p>	

FBO Comment	Final Requirement
SPOE Certification	
<p>Home-country resolution authorities should not have to certify that an FBO’s resolution plan is “single point of entry” (<u>SPOE</u>)</p> <ul style="list-style-type: none"> • The Board should determine which FBOs are SPOE firms based on interaction with Covered IHCs, FBOs and home authorities, and • The default should be SPOE 	<p>FBOs, not home authorities, must certify whether a Covered IHC is a “non-resolution covered IHC” or a “resolution covered IHC”</p> <ul style="list-style-type: none"> • FBOs must provide notice of any change of a Covered IHC’s status as a resolution entity • The Board has discretion to override an FBO’s certification • If a Covered IHC’s status changes or the Board overrides the certification, the Covered IHC has one year (subject to extension by the Board) to come into compliance
<p>The Board should develop objective criteria for identifying MPOE Covered IHCs</p>	
<p>At minimum, the Board should coordinate with home authorities to ensure that SPOE Covered IHCs are not misclassified</p>	
MPOE Considerations	
<p>MPOE Covered IHCs should be able to issue TLAC instruments to third parties</p>	<p>MPOE Covered IHCs have the option to issue</p> <ul style="list-style-type: none"> • eLTD to third parties, subject to same restrictions as Covered BHCs regarding eLTD, or • iLTD, subject to same requirements as SPOE Covered IHCs <p>Both types of LTD may be used to satisfy an MPOE’s LTD requirements</p>
<p>MPOE FBOs should have flexibility as to which U.S. entity is treated as the Covered IHC</p>	<p>The Board did not accept this comment</p>
<p>The TLAC calibration for MPOE Covered IHCs should be less than that of both the external TLAC calibration for Covered BHCs and the internal TLAC calibration for SPOE Covered IHCs</p>	<p>The rule’s TLAC calibrations for MPOE Covered IHCs are unchanged</p> <ul style="list-style-type: none"> • 18% of RWA • 6.75% of Supplementary Leverage Ratio exposure • 9% of Tier 1 leverage exposure <p>MPOE Covered IHCs are subject to the same LTD and buffer calibrations as SPOE Covered IHCs</p>
<p>If MPOE Covered IHCs are not allowed to issue TLAC externally, they should be subject to the same calibration as SPOE Covered IHCs</p>	

FBO Comment	Final Requirement
<p>The final rule should contain a mechanism to ensure that the sum of internal TLAC requirements applicable to an MPOE FBO is not greater than the external TLAC requirements that would apply were the FBO an SPOE FBO</p>	<p>The Board did not accept this comment</p>
<p>Domestic Prepositioning</p>	
<p>The Board should not impose domestic internal TLAC</p>	<p>The Board did not propose domestic prepositioning in the final rule or indicate whether it intends to do so in the near future</p>
<p>If domestic internal TLAC is imposed, Covered IHCs should be given the flexibility to use contributable or prepositioned resources</p>	