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Regulatory Capital Treatment of Investments in TLAC-Eligible Debt

Federal Banking Agencies Propose Regulatory Capital Deductions for Investments by Advanced Approaches Banking Organizations in TLAC-Eligible Debt

SUMMARY AND BACKGROUND

Earlier this month, the OCC, the Federal Reserve, and the FDIC issued a proposal[1] that would require "advanced approaches" banking organizations[2] to deduct from their own regulatory capital certain investments in unsecured debt instruments issued by U.S. G-SIBs, foreign G-SIBs, and subsidiaries of foreign G-SIBs, including their U.S. intermediate holding company subsidiaries ("*Covered IHCs*"), for purposes of satisfying total loss-absorbing capacity ("*TLAC*") requirements. The agencies note that the proposal is intended to recognize the systemic risk posed by banking organizations' investments in G-SIBs' debt "and to create an incentive for advanced approaches banking organizations to limit their exposure to GSIBs."[3]

The proposal builds on the Federal Reserve's final TLAC rule issued in December 2016 ("*TLAC Rule*"),[4] which requires U.S. G-SIBs and Covered IHCs to maintain a minimum amount of TLAC, consisting of Tier 1 capital (excluding minority interest) and eligible long-term debt instruments. The Federal Reserve's 2015 proposal for the TLAC Rule would have required banking organizations subject to the Federal Reserve's capital rules (including bank holding companies and state member banks) to deduct investments in the unsecured debt of U.S. G-SIBs from their Tier 2 capital in accordance with the deductions framework for investments in capital instruments.[5] The TLAC Rule did not implement the proposed deductions. Rather, the Federal Reserve noted that it would work with the OCC and the FDIC towards a proposed interagency approach regarding the regulatory capital treatment of holdings of unsecured debt issued by U.S. G-SIBs.

In October 2016, the Basel Committee published its final standard on the regulatory capital treatment of holdings of TLAC instruments issued by G-SIBs.[6] Notably, in order to facilitate market-making activities, the final Basel standard included a new threshold below which holdings of TLAC-eligible debt would not need to be deducted from Tier 2 capital. The final Basel standard also provided that G-SIBs must deduct holdings of their own TLAC-eligible debt from their TLAC resources instead of Tier 2 capital.

The proposal differs from the Federal Reserve's 2015 proposed deductions in three primary ways. First, the proposal would allow advanced approaches banking organizations to hold limited amounts of, and conduct limited market-making in, debt instruments that may otherwise be subject to deduction. The proposal would accomplish this by implementing a new threshold similar to the threshold included in the final Basel standard. In contrast, the Federal Reserve's 2015 proposal did not provide an exception for holdings arising out of market-making activities.

Second, under the proposal, unsecured debt issued by foreign G-SIBs and their subsidiaries, including their IHCs, would be subject to potential deduction. In contrast, the Federal Reserve's 2015 proposal would have applied only to unsecured debt issued by U.S. G-SIBs.

Third, the proposal would apply to advanced approaches banking organizations that are subject to the capital rules of the OCC, Federal Reserve, or FDIC. In contrast, the Federal Reserve's 2015 proposed deductions would have applied to both advanced approaches and non-advanced approaches banking organizations, but only those subject to the Federal Reserve's capital rules.

The proposal differs from the final Basel standard in two key aspects. First, it would require U.S. G-SIBs to deduct holdings of their own TLAC-eligible debt from Tier 2 capital instead of their TLAC resources. Second, unlike the final Basel standard, there would not be an exemption for debt instruments that are *pari passu* or subordinated to TLAC-eligible debt but are also excluded from TLAC under Section 10 of the final TLAC Term Sheet issued by the Financial Stability Board ("*FSB*") in November 2015.[7]

Comments on the proposal are due June 7, 2019. Key aspects of the proposal are discussed in greater detail below.

KEY ASPECTS OF THE PROPOSAL

- ***Definition of "Covered Debt Instruments."***
    - The proposal would provide for deductions from Tier 2 capital for certain investments by advanced approaches banking organizations in "covered debt instruments" issued by U.S. G-SIBs and foreign G-SIBs, as well as Covered IHCs and other subsidiaries of foreign G-SIBs.

- "Covered debt instruments" would be defined to include:
  - For debt issued by U.S. G-SIBs and Covered IHCs, unsecured debt instruments that are TLAC-eligible for purposes of the TLAC Rule, or that are *pari passu* or subordinated to any such debt instruments, other than any debt instruments that qualify as Tier 2 capital.
  - For debt issued by a foreign G-SIB or any of its subsidiaries (other than a Covered IHC), unsecured debt instruments issued by a foreign G-SIB or any of its subsidiaries (other than a Covered IHC) for the purpose of absorbing losses or recapitalizing the issuer or any of its subsidiaries in connection with a resolution, receivership, insolvency, or similar proceeding of the issuer or any of its subsidiaries, as well as debt instruments that are *pari passu* or subordinated to such debt instruments, other than any debt instruments that are included in the regulatory capital of the issuer.
- The scope of debt instruments subject to potential deduction is broader under the proposal than under the final Basel standard.
  - Under the final Basel standard, liabilities that are excluded from TLAC under Section 10 of the FSB's final TLAC Term Sheet (referred to as "*excluded liabilities*") are not subject to deduction, even if they rank *pari passu* or are subordinated to a TLAC instrument. Examples of excluded liabilities include insured deposits, short-term deposits and structured notes.
  - The proposed definition of "covered debt instruments" would not, however, provide an exemption for excluded liabilities that rank *pari passu* or that are subordinated to TLAC-eligible debt.
    - According to the agencies, the absence of an exemption for these liabilities is consistent with the "clean holding company requirements" of the TLAC Rule, prohibits or limits the ability of U.S. G-SIBs and Covered IHCs to issue excluded liabilities that rank *pari passu* or that are subordinated to TLAC-eligible debt. The agencies also note that they did not propose to exempt excluded liabilities issued by foreign G-SIBs or their subsidiaries "[t]o provide symmetrical treatment" between liabilities issued by foreign G-SIBs and those issued by U.S. G-SIBs and Covered IHCs.[8]
    - Accordingly, an investment by an advanced approaches banking organization in an excluded liability may be subject to deduction if it ranks *pari passu* or is subordinated to TLAC-eligible debt, even though holding that investment would not be subject to potential deduction under the final Basel standard.

- ***Reciprocal Cross Holdings and Investments in an Advanced Approaches Banking Organization's Own Covered Debt Instruments.***
  - The proposal would require an advanced approaches banking organization to deduct from its own Tier 2 capital any investment in covered debt instruments held reciprocally with another banking organization.
  - The proposal would also require deductions for any investments of an advanced approaches banking organization in its own covered debt instruments. In contrast, under the final Basel standard, a G-SIB's holdings of its own TLAC-eligible debt that is not a regulatory capital instrument would be deducted from its own TLAC resources, instead of from Tier 2 capital. The Basel Committee explained that "[o]wn-funded TLAC would generally not appear to meet the TLAC eligibility criteria. However, to the extent that such positions are recognised, reducing TLAC resources would more accurately reflect a G-SIB's TLAC position than continuing to count such instruments in TLAC resources while deducting them from Tier 2 capital."[9]
- ***Deductions for Significant and Non-Significant Investments in Covered Debt Instruments Issued by Unconsolidated Financial Institutions.***
  - The deduction for investments in covered debt instruments would depend on whether the investment is treated as a "significant" or "non-significant" investment in an unconsolidated financial institution.

    - An investment is "significant" if the banking organization owns more than 10% of the common stock of the issuer.
    - An investment is "non-significant" if the banking organization owns 10% or less of the common stock of the issuer.
  - Significant investments in covered debt instruments must be deducted in full.
  - Subject to the additional 5% threshold described below, the proposal would require an advanced approaches banking organization with non-significant investments in covered debt instruments to aggregate such investments with all non-significant investments in the capital of unconsolidated financial institutions. The advanced approaches banking organization would then deduct from its regulatory capital the amount by which the aggregate amount of non-significant investments in the capital and covered debt instruments of unconsolidated financial institutions exceeds 10% of the banking organization's Common Equity Tier 1 capital (after applying other adjustments). Holdings below this 10% threshold are risk-weighted instead of deducted.
- ***Additional 5% Threshold for Holdings of Covered Debt Instruments to Facilitate Market-Making.***
  - The proposal would provide an exception for non-significant investments in covered debt instruments to allow advanced approaches banking organizations to hold limited amounts of, and conduct limited market-making in, certain covered debt instruments issued by unconsolidated financial institutions.
  - Non-significant investments in covered debt instruments issued by unconsolidated financial institutions would not be subject to deduction if the aggregate amount of such covered debt instruments, measured by their gross long position, is 5% or less of the advanced approaches banking organization's Common Equity Tier 1 capital. If those investments exceed the 5% threshold, the excess would count against the 10% threshold for non-significant investments, or would be subject to deduction if that threshold had been exceeded.
  - For U.S. G-SIBs and depository institution subsidiaries of U.S. and foreign G-SIBs, the 5% threshold is subject to additional conditions. In order to designate investments in a covered debt instrument as "excluded covered debt instruments"—and, thus, subject to the 5% threshold—the investing banking organization must hold the covered debt instruments for 30 business days or less for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits.
    - To the extent (i) the investing banking organization holds an excluded covered debt instrument for more than 30 business days or (ii) the investment in the excluded covered debt instrument ceases to be held for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits, the excluded covered debt instrument would be subject to deduction from the advanced approaches banking organization's capital. In this case, the investment could not then be included within the 10% threshold for non-significant investments. Similarly, if the investing banking organization's excluded covered debt instruments, measured on a gross long basis, exceed 5% of its Common Equity Tier 1 capital, the excess is subject to deduction and may not be included within the 10% threshold for non-significant investments.
    - The agencies ask for comment on alternatives to the definition of "excluded covered debt instrument" and, specifically, whether the agencies should "consider as an alternative to 'held for the purpose of short-term or with the intent of benefiting from actual or expected short-term expected short-term price movements' a different standard, such as held available-for-sale or classified as a trading asset for accounting purposes."[10]
  - Notably and consistent with the final Basel standard, the 5% threshold would apply only to non-significant investments in covered debt instruments issued by unconsolidated financial institutions and would not apply to investments in a banking organization's own covered debt instruments, nor would the 5% threshold apply to non-significant investments in the capital of

unconsolidated financial institutions (such as subordinated debt that qualifies as Tier 2 capital or preferred stock that qualifies as additional Tier 1 capital).

- ***Proposal's Asymmetric Application of the Corresponding Deduction Approach.***
  - Under Basel III and the agencies' capital rules, the provisions addressing deductions for a banking organization's holdings of regulatory capital instruments issued by other banking organizations apply a "corresponding deduction approach," which generally requires that holdings of regulatory capital instruments be deducted from the corresponding regulatory capital component of the holder.
  - The proposal, like the final Basel standard, deviates from that approach. Under the proposal, investments in covered debt instruments would be treated as investments in Tier 2 capital and deducted from an investing banking organization's Tier 2 capital.
  - As under the corresponding deduction approach, if the investing banking organization would not have enough of the component of capital to give full effect to the required deduction (*e.g.*, insufficient Tier 2 capital), any amount of the investment that has not already been deducted would be deducted from the next, more subordinated component of capital (*e.g.*, Tier 1 capital).
- ***Calculation of Deductions and Net Long Position.***
  - The proposal would define an "investment in a covered debt instrument" as the net long position in a covered debt instrument, including direct, indirect and synthetic exposures to the covered debt instrument. This is consistent with the existing deduction framework in agencies' capital rules, which provide that the amount of an investment in capital instruments potentially subject to deduction is the net long position in the investment. As for investments in capital instruments, investments in covered debt instruments would also exclude underwriting positions held for five business days or less.
  - The calculation of a net long position would also take into account direct investments in covered debt instruments as well as indirect exposures to covered debt instruments held through investment funds and synthetic exposures, in each case in a manner consistent with the treatment of direct, indirect, and synthetic investments in capital instruments.
- ***Proposed Changes to Regulatory Reporting.***
  - The Federal Reserve also proposes to modify the FR Y-9C reports filed by U.S. bank holding companies, savings and loan holding companies, and intermediate holding companies to address the proposed deductions and to require U.S. G-SIBs and Covered IHCs to report their TLAC, TLAC-eligible LTD, and related ratios and buffers.
  - The agencies note that they intend in the future to propose changes to the Call Reports filed by depository institutions to address the proposed deductions.
- ***Potential Application to Non-Advanced Approaches Banking Organizations.***
  - The agencies have previously proposed to simplify the deduction framework for non-advanced approaches banking organizations[11] and note in the preamble to the proposal that they "recognize that the proposed approach is relatively complex and, as a result, are only proposing to apply it to advanced approaches banking organizations at this time."[12]
  - The agencies add, however, that they "intend to give further consideration" to how to address systemic risk associated with non-advanced approaches banking organizations' investments in covered debt instruments in order to "strongly discourage smaller banking organizations from investing in covered debt instruments."[13]

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ENDNOTES

1 OCC, Federal Reserve, FDIC, *Regulatory Capital Treatment for Investments in Certain Unsecured Debt Instruments of Global Systemically Important U.S. Bank Holding Companies, Certain Intermediate Holding Companies, and Global Systemically Important Foreign Banking Organizations*, 84 Fed. Reg. 13814 (Apr. 8, 2019), *available at* https://www.govinfo.gov/content/pkg/FR-2019-04-08/pdf/2019-06344.pdf.

2 Currently, advanced approaches banking organizations are those with total assets of at least $250 billion or consolidated on-balance sheet foreign exposures of at least $10 billion, and depository institution subsidiaries of a company that meets one of those thresholds.

In October 2018 and April 2019, the agencies proposed to revise the framework for determining which banking organizations would be considered "advanced approaches" banking organizations. For additional information about these proposals, see our Memoranda to Clients: *Regulatory Tailoring for Large U.S. Banking Organizations: Federal Bank Regulators Propose Significant Revisions to the Application of Enhanced Prudential Standards and Capital and Liquidity Requirements for Large U.S. Banking Organizations* (Nov. 5, 2018), *available at* https://www.sullcrom.com/files/upload/SC-Publication-Regulatory-Tailoring-for-Large-US-Banking-Organizations.pdf, and *Regulatory Tailoring: Federal Bank Regulators Propose Significant Revisions to the Application of Prudential Standards for Foreign Banking Organizations, Seek Comment on Whether to Impose Standardized Liquidity Requirements on Their U.S. Branches and Agencies, and Propose Significant Revisions to Resolution Planning Requirements* (Apr. 8, 2019), *available at* https://www.sullcrom.com/files/upload/SC-Regulatory-Tailoring.pdf.

3 Proposal, 84 Fed. Reg. at 13818.

4 For additional information on the TLAC Rule, see our Memorandum to Clients: *Loss Absorbency Requirements: Federal Reserve Adopts Final TLAC and Related Requirements for U.S. G-SIBs and U.S. Intermediate Holding Company Subsidiaries of Non-U.S. G-SIBs* (Dec. 16, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Loss_Absorbency_Requirements_12_16_16.pdf.

5 For additional information on this proposal, see our Memorandum to Clients: *Loss Absorbency Requirements: Federal Reserve Proposes Loss Absorbency Requirements for U.S. G-SIBs and U.S. Intermediate Holding Company Subsidiaries of Non-U.S. G-SIBs, Projects $120 Billion Shortfall for Covered U.S. G-SIBs* (Nov. 4, 2015), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Loss_Absorbency_Requirements.pdf.

6 Basel Committee, *Standard: TLAC Holdings* (Oct. 2016), *available at* https://www.bis.org/bcbs/publ/d387.pdf ("*Basel Standard*"). For additional information on the Basel Standard, see our Memorandum to Clients: *Banking Organization TLAC Holdings: Basel Committee Issues Final Standard on Capital Treatment of TLAC Holdings* (Oct. 17, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Banking_Organization_TLAC_Holdings.pdf.

7 Financial Stability Board, *Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-Absorbing Capacity (TLAC) Term Sheet* (Nov. 9, 2015), *available at* http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

8 Proposal, 84 Fed. Reg. at 13819.

9 Basel Standard, at 2.

10 Proposal, 84 Fed. Reg. at 13820.

11 For additional information about this proposal, please see our Memorandum to Clients: *Bank Capital Requirements: Federal Banking Agencies Propose Capital Rule Simplifications to the Standardized Approach Calculations Applicable Primarily to Non-Advanced Approaches Banking Organizations* (Oct. 4, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_October_04_2017.pdf.

12 Proposal, 84 Fed. Reg. at 13818.

13 Proposal, 84 Fed. Reg. at 13818.

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