November 4, 2015

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

SUMMARY

On October 30, 2015, the Federal Reserve approved for publication and comment Proposed Rules[1] that would impose loss absorbency requirements on U.S. G-SIBs ("*Covered BHCs*")[2] and U.S. intermediate holding company subsidiaries ("*Covered IHCs*") of global systemically important foreign banking organizations.[3] The Proposed Rules are among the most potentially significant and impactful regulations that have been issued by the U.S. Federal banking regulators in response to the popular narrative regarding the causes and consequences of the financial crisis of 2008. The Proposed Rules, alongside related measures taken by regulators in other jurisdictions, are widely viewed as a major step in addressing the concern that certain large financial institutions would need to be resolved with extraordinary government support and taxpayer expense—that they are "too big to fail".

The Proposed Rules' key components include:

- For both Covered BHCs and Covered IHCs, two separate but related requirements, described in the Preamble to the Proposed Rules as "complementary":
  - ***A long-term debt ("LTD") requirement,*** which requires Covered BHCs and Covered IHCs to maintain an outstanding amount of eligible LTD that is not less than an amount equal to an applicable designated percentage of:
    - for all Covered BHCs and Covered IHCs, RWAs,
    - for all Covered BHCs and for Covered IHCs that are subject to the Federal Reserve's supplementary leverage ratio ("*SLR*"),[4] total leverage exposure, and
    - for all Covered IHCs only, average total consolidated assets,

    with the LTD requirement being the highest amount produced by those calculations; and

- ***A total loss absorbing capacity requirement,*** which requires Covered BHCs and Covered IHCs to maintain an outstanding aggregate amount of common equity Tier 1 capital ("*CET1*"), additional Tier 1 capital, and eligible LTD (together, "*TLAC*") that is not less than an amount equal to an applicable designated percentage of:
    - for all Covered BHCs and Covered IHCs, RWAs,
    - for all Covered BHCs and for Covered IHCs that are subject to the SLR, total leverage exposure, and
    - for Covered IHCs only, average total consolidated assets,

    with the TLAC requirement being the highest amount produced by those calculations, *plus*, in each case, buffers equal to:
    - for all Covered BHCs and Covered IHCs, 2.5%, *plus*
    - for all Covered BHCs and Covered IHCs, any applicable countercyclical capital buffer, *plus*
    - for Covered BHCs only, the G-SIB surcharge applicable to the Covered BHC under method 1 of the G-SIB surcharge rule.

    These buffers must consist only of CET1 effectively excluded from eligible TLAC and "sitting on top". Breaching these buffers would result in graduated restrictions on the Covered BHC's or Covered IHC's ability to make distributions (including dividends and share repurchases) and discretionary bonus payments.
- ***"Clean holding company" requirements,*** that, among other things, would:
    - prohibit the issuance of third-party short-term debt by Covered BHCs and Covered IHCs,
    - impose a cap—at 5% of the Covered BHC's TLAC—on the amount of a Covered BHC's liabilities (including operating liabilities but not including secured liabilities and liabilities ranking senior to eligible LTD) that do not qualify as eligible LTD for purposes of the TLAC requirement, unless those liabilities are senior to the eligible LTD or fall into other specified categories,
    - prohibit both Covered BHCs and Covered IHCs from entering into derivatives or other qualified financial contracts with unaffiliated third parties, and
    - prohibit both Covered BHCs and Covered IHCs from guaranteeing their subsidiaries' obligations if the beneficiary of the guarantee would have any default right arising from the insolvency of such guarantor.
- ***A Covered BHC cross-holding deduction requirement,*** that would require bank holding companies ("*BHCs*"),[5] state member banks, and savings and loan holding companies with $1 billion or more in total consolidated assets to deduct from their *own* Tier 2 capital, investments in all unsecured debt securities of Covered BHCs (not just unsecured debt securities that are eligible LTD for purposes of the LTD requirement), subject to (i) the thresholds in the Federal Reserve's capital rules for significant and non-significant investments in unconsolidated financial institutions that need not be deducted, and (ii) a limited exception for securities held as part of underwriting, but not market-making, activities.

The designated percentages, or calibrations, for the LTD and TLAC requirements are set forth in the table attached as Annex 1. As indicated, the calibrations for Covered BHCs are different from those that apply to Covered IHCs, and also differ between Covered IHCs that may be resolution entities (as discussed below) and those that may not.

The Proposal differs in important respects from the Financial Stability Board's (the "*FSB*") TLAC proposal, initially released in November 2014[6] and expected to be released in final form on November 9, 2015 (the "*FSB TLAC Proposal*"), as well as predictions by various commentators. Moreover, the Proposal rejects a number of recommendations advocated by industry participants when commenting on the FSB TLAC Proposal. Among other things:

- The FSB TLAC Proposal does not include a separate LTD requirement but, instead, requires that at least 33% of eligible TLAC be long-term debt or other non-capital instruments. The Federal Reserve's separate LTD requirement is likely to increase the shortfall, compared to the shortfall that would arise under the FSB's 33% test.
- The Proposal's definitions of eligible LTD differ in certain important respects from those advocated by industry participants. Significantly:
  - Eligible LTD of both Covered BHCs and Covered IHCs excludes structured notes, notes not governed by U.S. law, and any Tier 2 debt that does not meet the other eligibility criteria (for example, Tier 2 debt not governed by U.S. law).
  - Eligible LTD of Covered BHCs also:
    - excludes (but also subject to the 5% exceptions bucket referenced above) convertible securities (irrespective of whether they otherwise qualify as Tier 2 capital) and any debt that permits acceleration other than upon non-payment or a receivership or insolvency, and debt with a step-up feature, and
    - for purposes of the LTD requirement but not the TLAC requirement, applies a 50% haircut to otherwise eligible LTD that has a remaining maturity of less than two years but more than one year.
  - Eligible LTD of Covered IHCs also:
    - excludes any instrument that permits acceleration on *any* event (even in the event of non-payment or a receivership or insolvency),
    - must include a contractual provision providing for cancellation of the instrument or conversion into CET1 upon the Federal Reserve's determination (and issuance of a related order) that, among other things, the Covered IHC is in default or in danger of default or the FBO parent of the Covered IHC has been placed into a resolution proceeding in its home country, and
    - must be held by the top-tier FBO parent or an intermediate non-U.S. entity that directly or indirectly controls the Covered IHC.
  - Eligible internal LTD of Covered IHCs must represent the most subordinate debt claim in a receivership or insolvency, whereas eligible LTD issued by Covered BHCs could be senior or subordinate debt.
- Although the FSB TLAC Proposal states that G-SIBs' holdings of eligible external TLAC of other G-SIBs must be deducted from the investing G-SIBs' own TLAC or regulatory capital in a manner "generally parallel" to the Basel III requirements addressing cross-holdings of capital instruments,[7] the FSB assigned the Basel Committee the task of developing detailed provisions. The Proposed Rules move ahead of any Basel Committee proposal with detailed provisions that take an approach that is different from that advocated in comments to the FSB in several important respects, including:
  - not providing an exception for holdings arising out of market-making activities,
  - making the cross-holding capital deduction applicable to BHCs, state member banks and large savings and loan holding companies (and not just G-SIBs as contemplated by the FSB TLAC Proposal), and

- bringing within the scope of deductible instruments all non-Tier 2 unsecured debt securities of Covered BHCs, irrespective of maturity or ranking, and not just debt securities included within eligible TLAC as in the FSB TLAC Proposal.

- In addition to applying the TLAC buffers set forth above, the Proposed Rules also include for both Covered BHCs and Covered IHCs a restriction on dividends and discretionary bonus payments not contemplated by the FSB TLAC Proposal. This additional restriction would prohibit a Covered BHC or Covered IHC from making distributions and discretionary bonus payments in an amount exceeding retained earnings for the previous four quarters unless the entity's applicable TLAC buffers have not declined as compared to its buffers at the end of the preceding quarter.[8] This could create serious issues for organizations confronting one-time extraordinary charges.

Of particular importance for Covered BHCs, the Proposal does not grandfather outstanding instruments that would not qualify as eligible LTD. Nor does the Proposal address the consequences for a Covered BHC that is not able to comply with the 5% exceptions bucket because, for example, it has outstanding long-term ineligible debt that does not include redemption provisions exercisable prior to the Proposed Rules coming into effect.

Furthermore, a significant immediate concern is that much of the debt that is currently on the books of Covered BHCs would not constitute eligible LTD if the Proposed Rules are adopted in their current form. In addition to the securities noted above, even plain vanilla senior debt would be ineligible if it could be accelerated for reasons other than insolvency proceedings or payment default — for example, if the securities provided for an acceleration right upon the issuer's violation of covenants contained in the securities' governing instruments. This restriction, combined with the 5% limitation on non-eligible liabilities, may force a massive restructuring of G-SIBs' outstanding debt financing in order to achieve compliance. *Starting immediately, Covered BHCs must consider whether to modify the standard terms for new issuances of senior debt to address the status of those securities under the Proposed Rules, particularly if outstanding senior debt securities are not ultimately grandfathered. Modifications could involve making such new issuances "senior subordinated" (meaning senior to Tier 2 subordinated debt but subordinated to existing and future senior debt, potentially including structured notes, that are not subordinated by contract) or including an early redemption right if under the final version of the Federal Reserve's rules the new issuances do not qualify as eligible LTD. Those modifications also will have associated costs.*

The Federal Reserve estimates that the eight U.S. G-SIBs that are Covered BHCs would have shortfalls relative to the Proposal's LTD and TLAC requirements totaling approximately $120 billion and that the increase in their annual funding costs would be in the range of $680 million to $1.5 billion.[9] It is not clear whether these estimates take into account the actual eligibility of the outstanding LTD of those entities, the just-mentioned balance sheet restructurings, or the loss of liquidity that would result from the lack of an exemption for market-making activities. In any event, other factors that will affect the ultimate shortfall include the separate LTD requirement, the addition of buffers to the TLAC requirement, and the strict limitations on eligible LTD. The Preamble also states that the Federal Reserve is assuming that those costs will be passed on to consumers in the pricing of products offered by the entities subject to the Proposed Rules.[10]

The Proposed Rules would become effective January 1, 2019, except for increases in the RWA component of the TLAC requirement, which would not apply until January 1, 2022.[11] The Proposed Rules do not provide for any "grandfathering" of existing debt.

The Proposed Rules and the Preamble are available here, and a memorandum of the Federal Reserve's staff, including a useful executive summary of the Proposal at pages 2 to 4, is available here.

The Federal Reserve requests comments on the Proposal by February 1, 2016.

BACKGROUND

The revisions to the regulatory framework applicable to financial institutions following the 2008 financial crisis have involved the most comprehensive set of new initiatives addressing the regulation of financial institutions since the Great Depression, both in the United States and internationally. Those initiatives can be divided broadly into two types of measures. The first category includes "going concern" measures intended to make large (and particularly the largest) financial institutions more resilient and able to withstand periods of stress as operating entities, whether the stress events are idiosyncratic for a particular institution or are systemic macro-events. The second includes "gone concern" measures intended to facilitate the resolution of failed financial institutions in an orderly manner without extraordinary government support and taxpayer expense. At the core of the going concern measures are the Basel III-based capital and liquidity regulations, special supplemental capital requirements, and related capital plan and stress testing requirements. At the core of the gone concern measures are resolution planning requirements and, now, LTD and TLAC requirements like those reflected in the Proposed Rules.

The Federal Reserve and other U.S. and international supervisors have been involved for several years in extensive discussion of resolution strategies, including the pros and cons of two possible strategies. The first contemplates a "*single point of entry*" approach, or "*SPOE*", in which generally only the non-operating top-tier holding company would enter into a bankruptcy or receivership in a failure. The second contemplates a "*multiple points of entry*" approach, or "*MPOE*", in which multiple entities within a corporate group, including operating entities, would enter into bankruptcy or receivership in a failure. Much of that discussion has been conducted under the auspices of the FSB and was embodied in the November 2014 FSB TLAC Proposal discussed above. The Proposed Rules represent the Federal Reserve's approach, subject to the public comment process, to implementing the FSB TLAC Proposal in the United States for Covered BHCs and Covered IHCs. The Preamble notes that although the Proposed

Rules are "primarily focused on implementing the SPOE resolution strategy, [they] would also substantially improve the prospects for a successful MPOE resolution strategy".[12]

The Preamble also notes that an important objective of the Dodd-Frank Act included "ending market perceptions that certain financial companies are 'too big to fail' and would therefore receive extraordinary government support to prevent their failure".[13] A strong case can be made that, if Title II of the Dodd-Frank Act did not sufficiently mitigate those perceptions, the final rules implementing the Proposal's LTD and TLAC requirements do effectively end "too big to fail" in the United States. The achievement of this milestone should allow the supervisory restrictions on major acquisitions by U.S. G-SIBs—in place since the financial crisis—to be lifted by significantly reducing concerns about the feasibility of G-SIBs' resolution plans and otherwise reducing the need for further requirements and restrictions relating to "going concern" regulations.

DESCRIPTION OF THE PROPOSED RULES

COVERED BHCS—LTD AND TLAC REQUIREMENTS

The Proposed Rules would require a Covered BHC to maintain outstanding minimum levels of eligible external LTD ("*Eligible External LTD*") and eligible external TLAC ("*Eligible External TLAC*"), as well as buffers on top of the RWA component of the TLAC requirement.

LTD Requirement for Covered BHCs

Under the LTD requirement, a Covered BHC would be required to maintain outstanding minimum levels of Eligible External LTD in an amount not less than the greater of (a) 6% plus the surcharge (expressed as a percentage) applicable to the Covered BHC under the G-SIB surcharge rule (most likely under method 2)[14] of RWAs,[15] and (b) 4.5% of total leverage exposure under the SLR.[16]

Eligible External LTD generally would be required to have the following characteristics:

- ***A maturity of greater than one year from initial issuance.***
- ***Issued directly by the Covered BHC:*** Debt instruments issued by a subsidiary would not qualify as Eligible External LTD, even if they would qualify as regulatory capital.
- ***Unsecured and unguaranteed:*** The Eligible External LTD cannot be secured or subject to a guarantee of the Covered BHC or a subsidiary of the Covered BHC or to any other arrangement that legally or economically enhances the seniority of the instrument (such as a credit enhancement).
- ***"Plain Vanilla":*** The Proposal excludes from Eligible External LTD any instrument that: (a) is a structured note; (b) has a credit-sensitive feature (such as an interest rate that is reset periodically based on an entity's credit quality); or (c) is convertible into equity prior to the Covered BHC's resolution.
- ***Free of acceleration rights:*** The Proposal also excludes from Eligible External LTD an instrument that includes a provision that gives the holder a contractual right to accelerate payment, other than on dates specified in the instrument or upon the occurrence of an insolvency or receivership or a payment default.

- ***Governed by U.S. law.***

Additionally, Eligible External LTD with a remaining maturity of between one and two years would be subject to a haircut of 50% for purposes of the LTD requirement.[17] This latter provision does not apply with respect to the TLAC requirement.

A Covered BHC would be prohibited from redeeming or repurchasing Eligible External LTD prior to its stated maturity date without the prior approval of the Federal Reserve if the redemption or repurchase would cause the Covered BHC's Eligible External LTD to fall below its LTD requirement.

The Proposal does not require Eligible External LTD to be contractually subordinated to other obligations of the Covered BHC. However, the "clean holding company" requirements described below prohibit a Covered BHC from having non-contingent liabilities to third parties, including debt obligations, in excess of 5% of the Covered BHC's Eligible External LTD unless those obligations would rank senior to the Covered BHC's Eligible External LTD in a proceeding under Title II of the Dodd-Frank Act or the U.S. Bankruptcy Code.[18] Taken together, the criteria for Eligible External LTD and the clean holding company requirements would permit a Covered BHC to maintain existing debt that is not Eligible External LTD only if such existing debt would rank senior to Eligible External LTD or remains within the 5% limit. As a result, if a Covered BHC has a significant amount of outstanding securities that would not qualify as Eligible External LTD, and if existing debt is not "grandfathered" under the rules as adopted, then the Proposed Rules would seem to provide that none of that existing indebtedness of the Covered BHC would constitute Eligible External LTD, and the Covered BHC may effectively be compelled to satisfy its entire LTD requirement with newly issued subordinated securities. In any event, as a threshold matter, given the possibility that the Proposal may be adopted in its current form, Covered BHCs will need to consider their strategy to meet the LTD requirement given the limitations on their ability to modify existing long-term debt, and will likely wish to take this concern into account with respect to issuances pending the finalization of the rule.

TLAC Requirement for Covered BHCs

Pursuant to the TLAC requirement, a Covered BHC would be required to maintain outstanding Eligible External TLAC in an amount not less than the greater of (a) 18% of the Covered BHC's RWAs, and (b) 9.5% of the Covered BHC's total leverage exposure.[19]

Eligible External TLAC would be defined as the sum of (i) the Tier 1 regulatory capital[20] of the Covered BHC issued directly by the Covered BHC, and (ii) the Covered BHC's Eligible External LTD.

A Covered BHC also would be required to maintain buffers (the "*External TLAC Buffers*") on top of the RWA component of the TLAC requirement. The sum of a Covered BHC's External TLAC Buffers would be equal to (a) 2.5% plus (b) the G-SIB surcharge applicable to the Covered BHC under method 1 of the

G-SIB surcharge rule (which generally ranges from 1% to 2.5%),[21] plus (c) any applicable countercyclical capital buffer. The External TLAC Buffers would be required to be composed solely of CET1. A Covered BHC's breach of its External TLAC Buffers would subject it to graduated limits on capital distributions and discretionary bonus payments as follows:[22]

Applicable TLAC buffer level	***Maximum applicable TLAC payout ratio (as a percentage of eligible retained income)***
Greater than the applicable TLAC buffers	No payout ratio limitation applies
Less than or equal to the applicable TLAC buffers, and greater than 75% of the applicable TLAC buffers	60%
Less than or equal to 75% of the applicable TLAC buffers, and greater than 50% of the applicable TLAC buffers	40%
Less than or equal to 50% of the applicable TLAC buffers, and greater than 25% of the applicable TLAC buffers	20%
Less than or equal to 25% of the applicable TLAC buffers	0%

The Federal Reserve analogized this capital distribution limitation to the capital conservation buffer applicable under the capital rules,[23] except that the applicable TLAC buffers would apply in addition to the TLAC requirement (rather than in addition to minimum risk-based capital requirements) and would incorporate only the applicable method 1 G-SIB surcharge (rather than the greater of the applicable method 1 G-SIB surcharge and the applicable method 2 G-SIB surcharge, as under the G-SIB surcharge rules). The Federal Reserve may permit a Covered BHC to make a distribution or discretionary bonus payment if the Federal Reserve determines that such distribution or bonus would not be contrary to the purposes of the TLAC buffer requirement or to the safety and soundness of the Covered BHC.[24]

COVERED IHCS—LTD AND TLAC REQUIREMENTS

The Proposed Rules would require a Covered IHC to maintain outstanding minimum levels of eligible internal long-term debt ("*Eligible Internal LTD*") and eligible internal TLAC ("*Eligible Internal TLAC*"), as well as buffers on top of the RWA component of the TLAC requirement.[25]

LTD Requirement for Covered IHCs

Under the LTD requirement, a Covered IHC would be required to maintain outstanding Eligible Internal LTD in an amount not less than the greater of:

- 7% of RWAs;
- 3% of the total leverage exposure (for Covered IHCs that are subject to the SLR); and
- 4% of average total consolidated assets, as computed for purposes of the U.S. Tier 1 leverage ratio.

A Covered IHC's Eligible Internal LTD is subject to several requirements that are the same or analogous to those applicable to Eligible External LTD. For example, Eligible Internal LTD must be:

- issued directly from the Covered IHC;
- unsecured; and
- governed by U.S. law.

Additionally, like the treatment of short-term debt under the definition of Eligible External LTD, Eligible Internal LTD with a remaining maturity of between one and two years would be subject to a 50% haircut in the calculation of Eligible Internal LTD, and Eligible Internal LTD with a remaining maturity of less than one year would not count toward the Internal LTD requirements.

The "plain vanilla" criteria for Eligible Internal LTD of Covered IHCs are different from those for Eligible External LTD of Covered BHCs. The criteria for both exclude structured notes and Tier 2 sub-debt that does not meet the other eligibility criteria (for example, Tier 2 sub-debt governed by foreign law). However, unlike Eligible External LTD, Eligible Internal LTD:

- excludes any instrument that permits *any* acceleration of the instrument (even for non-payment or receivership or insolvency);
- does not exclude convertible securities and debt with a step-up feature;
- must be the most subordinated debt claim in a receivership or insolvency; and
- must be held by the top-tier foreign banking organization parent or an intermediate non-U.S. entity that directly or indirectly controls the Covered IHC.

Additionally, Eligible Internal LTD must include a contractual trigger pursuant to which the Federal Reserve could require the Covered IHC to cancel the Eligible Internal LTD or convert or exchange it into CET1 if:

- the Federal Reserve determines that the Covered IHC is "in default or in danger of default" (with that term defined the same way as in Title II of the Dodd-Frank Act); and
- any of the following circumstances apply:
  - the top-tier FBO or any subsidiary of the top-tier FBO is placed into resolution proceedings in its home country;
  - the home country supervisory authority consents (or does not object, within 48 hours) to the cancellation, exchange, or conversion; or
  - the Federal Reserve has made a written recommendation to the Secretary of the Treasury that the Federal Deposit Insurance Corporation should be appointed as receiver of the Covered IHC.

Covered IHCs will need to consider carefully the tax consequences of the criteria for Eligible Internal LTD. Some of them—particularly the contractual trigger described above, the absence of acceleration as a remedy in any circumstance, and the subordination requirement—may put pressure on whether these instruments will be treated as debt or equity for U.S. Federal income tax purposes, including withholding determinations.

Covered IHCs would be prohibited from redeeming Eligible Internal LTD prior to its stated maturity date without the prior approval of the Federal Reserve if such redemption would cause the Covered IHC's Eligible Internal LTD to fall below its Internal LTD requirements.

TLAC Requirement for Covered IHCs

Under the Internal TLAC Requirement, the amount of Eligible Internal TLAC that a Covered IHC would be required to maintain outstanding differs depending on whether the Covered IHC is or is not a "*non-resolution entity*". The Proposed Rules specify that a Covered IHC is a non-resolution entity if the home country resolution authority for its top-tier FBO has certified to the Federal Reserve that its planned resolution strategy for the FBO does not involve the Covered IHC or its subsidiaries entering a resolution or bankruptcy proceeding in the United States.[26] For purposes of this memorandum, we are using the term "*resolution entity*" to mean a Covered IHC that is not a non-resolution entity—that is, a Covered IHC as to which the home country resolution authority has not made the certification referred to above.

A Covered IHC that is a non-resolution entity would be required to maintain Eligible Internal TLAC in an amount not less than the greater of:

- 16% of the Covered IHC's RWAs;[27]
- 6% of the Covered IHC's total leverage exposure (for Covered IHCs that are subject to the SLR); and
- 8% of the Covered IHC's average total consolidated assets, as computed for purposes of the U.S. Tier 1 leverage ratio.

A Covered IHC that is a resolution entity would be required to maintain Eligible Internal TLAC in an amount not less than the greater of:

- 18% of the Covered IHC's RWAs;[28]
- 6.75% of the Covered IHC's total leverage exposure (if applicable); and
- 9% of the Covered IHC's average total consolidated assets, as computed for purposes of the U.S. Tier 1 leverage ratio.

Eligible Internal TLAC would be defined as the sum of (i) the Tier 1 regulatory capital (CET1 and additional Tier 1 capital) issued by the Covered IHC to its top-tier FBO parent or an intermediate entity that directly or indirectly controls the Covered IHC, and (ii) the Covered IHC's Eligible Internal LTD.

All Covered IHCs also would be required to maintain internal TLAC buffers (the "*Internal TLAC Buffers*") in addition to the RWA component of the TLAC Requirement. The Internal TLAC Buffers would apply in a similar manner as the External TLAC Buffers except that the Internal TLAC Buffers would not include a G-SIB surcharge component because Covered IHCs themselves are not subject to the G-SIB surcharge rule. Therefore, the sum of a Covered IHC's Internal TLAC Buffers would be equal to 2.5% plus any applicable U.S. countercyclical capital buffer. The Internal TLAC Buffers would be required to be filled solely with CET1. As with the graduated penalties for breaching the External TLAC Buffers requirement, set forth above, a Covered IHC's breach of its Internal TLAC Buffers requirement would subject it to limits on capital distributions and discretionary bonus payments.

CLEAN HOLDING COMPANY REQUIREMENTS

The Proposed Rules would subject the operations of both Covered BHCs and Covered IHCs (together, "*Covered Holding Companies*") to "clean holding company" limitations that would prohibit those entities from engaging in certain classes of transactions that could "pose an obstacle to the orderly SPOE resolution of a covered holding company or increase the risk that financial market contagion would result from the resolution of a covered holding company".[29] These limitations would apply only to the corporate practices and liabilities of the Covered Holding Company itself and would not directly restrict the corporate practices and liabilities of the subsidiaries of the Covered Holding Company. The Proposed Rules do not address the consequences of violating this provision.

Third-Party Restrictions Applicable to All Covered Holding Companies

Under the Proposed Rules' clean holding company requirements, a Covered Holding Company would be prohibited from having liabilities in the following categories:

- Third-party secured and unsecured debt instruments with an original maturity of less than one year:
  - The Preamble indicates that a debt instrument would be deemed to have an original maturity of less than one year if it would provide the creditor with the option to receive repayment within one year of the creation of the liability, or if it would create such an option or an automatic obligation to pay upon the occurrence of an event that could occur within one year of the creation of the liability (other than an event related to the Covered Holding Company's insolvency).
- Qualified financial contracts ("*QFCs*") with third parties:
  - The term "QFCs" incorporates the definition of the term in Title II of the Dodd-Frank Act, which defines QFCs to include securities contracts, commodities contracts, forward contracts, repurchase agreements, and swap agreements.[30] A Covered BHC would be able to enter into QFCs only with its subsidiaries, and a Covered IHC would be able to enter into QFCs only with its affiliates.
- Guarantees of liabilities of a subsidiary (in the case of Covered BHCs) or affiliates (in the case of Covered IHCs) if the Covered Holding Company's insolvency or entry into a resolution proceeding would provide the counterparty to the QFC default rights if the Covered Holding Company acting as guarantor enters into an insolvency or receivership proceeding other than under Title II of the Dodd-Frank Act, with the Federal Reserve's concern as discussed in the Preamble apparently being to avoid cross-default risk.
  - The Preamble emphasizes that guarantees by a Covered Holding Company of liabilities that are not subject to such cross-default rights would be unaffected by the restriction. Thus, for example, guarantees of agreements that are covered by the ISDA Resolution Stay Protocol limiting the exercise of default rights upon resolution should not be limited by this restriction.[31]
- Liabilities that are guaranteed by a subsidiary of the Covered Holding Company or that are subject to rights that would allow a third party to offset its debt to a subsidiary upon the Covered Holding Company's default on an obligation owed to the third party.

- The Preamble notes that such upstream guarantees are uncommon among Covered Holding Companies (particularly due to considerations under Section 23A of the Federal Reserve Act[32]) and that therefore the principal effect of the proposed prohibition would be to prevent the future issuance of such guarantees by material non-bank subsidiaries.[33]

Additional Restrictions Applicable Only to Covered BHCs

In addition, as noted above, the Proposed Rules' clean holding company requirements would cap the amount of a Covered BHC's unsecured non-contingent third-party liabilities, other than Eligible External LTD and Eligible External TLAC, that can be *pari passu* with or junior to its Eligible External LTD at 5% of the value of its Eligible External TLAC. The Preamble notes that, in addition to excluding from the cap Eligible External TLAC, instruments that were Eligible External TLAC when issued and have ceased to be eligible (for example, because their remaining maturity is less than one year), so long as the holder of the instrument does not have a currently exercisable put right, and payables (for example, dividend- or interest-related payables) that are associated with such liabilities would be excluded as well.

The Federal Reserve expects this cap to cover debt instruments with derivative-linked features (for example, structured notes);[34] external vendor and operating liabilities (for example, accounts payable for utilities, rent, fees for services, and obligations to employees); and liabilities arising other than through a contract (for example, liabilities created by a court judgment). The Preamble notes that liabilities subject to the 5% cap fall into two categories. The first consists of liabilities that could be subjected to losses alongside Eligible External TLAC without potentially undermining SPOE resolution or financial stability. This category includes structured notes. The second category includes liabilities that, if subjected to losses alongside Eligible External TLAC, could potentially undermine SPOE resolution or financial stability. This category includes vendor liabilities and obligations to employees, among others.

Notably, this requirement would take effect on January 1, 2019, and does not incorporate a grandfathering provision. As noted above, Covered BHCs will therefore need to consider options for bringing their existing liabilities into conformance with this requirement, given the practical limitations on their ability to modify existing long-term debt.

Finally, this proposed cap is not applicable to Covered IHCs because the Internal LTD requirements already would prohibit Covered IHCs from having any non-TLAC-related third-party liabilities that are *pari passu* with or subordinated to Eligible Internal LTD by requiring that Eligible Internal LTD be contractually subordinated to all third-party debt claims.[35]

REGULATORY CAPITAL DEDUCTION FOR INVESTMENTS IN THE UNSECURED DEBT OF COVERED BHCS

Under the Proposed Rules, bank holding companies (including Covered IHCs that are bank holding companies)—not just those that are Covered BHCs or Covered IHCs or their subsidiaries—state member banks, and savings and loan holding companies with total consolidated assets of at least

$1 billion[36] would be required to apply a regulatory capital deduction treatment to any investments in unsecured debt instruments issued by Covered BHCs (including unsecured debt instruments that do not qualify as Eligible External LTD) (each, a "*Covered Debt Instrument*"). The definition of Covered Debt Instrument would include all unsecured debt of Covered BHCs other than Tier 2 subordinated debt already subject to deduction under the capital rules and, accordingly, is not limited to unsecured debt that is Eligible External LTD for the issuer. The definition of "*investment in a covered debt instrument*" would be defined as a net long position in a covered debt instrument, including direct, indirect, and synthetic exposures to a covered debt instrument. This definition would exclude underwriting positions held for five or fewer business days (with special provisions contemplated to provide additional relief for "failed underwritings"), but not market-making positions.

The deduction would be subject to provisions, including thresholds, based on those for the existing deductions of capital instruments under the Federal Reserve's capital rules. For example, if the relevant institution owned less than 10% of the common equity of an issuer not consolidated with the institution, each of the institution's investments in the issuer would be a "non-significant investment in the capital of an unconsolidated financial institution" and, as such, would require the investing institution to make a deduction only if all such investments exceed 10% of the institution's Tier 1 capital. If a deduction is required, the institution would apply the deduction against its Tier 2 capital (notwithstanding that the issuer's underlying debt instrument may not be a capital instrument) to the extent the institution has sufficient Tier 2 capital and, if it does not, to the next higher form of capital (that is, first additional Tier 1 and then CET1). Positions that are not deducted in accordance with the foregoing would continue to be risk-weighted in the ordinary course under the capital rules.

CONSIDERATION OF DOMESTIC INTERNAL TLAC FRAMEWORK

The Preamble notes that while the Proposed Rules are designed to ensure that Covered Holding Companies have sufficient loss absorbing capacity to absorb significant losses and then be recapitalized,[37] the Proposed Rules do not include measures to ensure that Covered BHCs and Covered IHCs have in place adequate mechanisms for transferring severe losses from their operating subsidiaries to the Covered BHC or Covered IHC as part of an SPOE resolution strategy. To address this consideration, the Federal Reserve is considering imposing a domestic internal TLAC ("*Domestic Internal TLAC*") framework on Covered BHCs and Covered IHCs with respect to each of their material operating subsidiaries.[38] The size of the requirement with respect to a given material operating subsidiary would depend on the subsidiary's RWA, its total leverage exposure, or both.

Under the Domestic Internal TLAC framework the Federal Reserve is considering, Domestic Internal TLAC would be divided into:

- assets held by the Covered BHC or Covered IHC that would enable the Covered BHC or Covered IHC to make contributions to subsidiaries that incur severe losses in order to recapitalize those subsidiaries ("*Contributable Resources*"); and
- a Covered BHC's or a Covered IHC's debt and equity investment in a particular subsidiary ("*Prepositioned Resources*").

The reason for the distinction is that Contributable Resources at the holding company level can be allocated among subsidiaries based on the losses they incur, thereby mitigating misallocation risk, whereas Prepositioned Resources sit at a particular subsidiary and cannot easily be used to recapitalize a different subsidiary that incurs unexpectedly high losses. Prepositioned Resources can, however, help ensure that recapitalization is indeed available to the particular subsidiary if needed.

Contributable Resources

Contributable Resources may be required to consist entirely or substantially of assets that would qualify as high-quality liquid assets ("*HQLA*") under the U.S. liquidity coverage ratio.[39] The Federal Reserve believes that the HQLA requirement would offer two additional advantages. First, it would provide the subsidiary that receives those resources with additional liquidity as well as capital. Second, it would ensure that the assets contributed by the Covered BHC or Covered IHC to the subsidiary are assets that the subsidiary is eligible to hold (for example, that the assets are not equity securities, which U.S. depositary institution subsidiaries generally cannot hold).

Industry participants, in informal discussions with representatives of the Federal Reserve and other U.S. banking agencies in recent years, have advocated that, if a Contributable Resources requirement is imposed, any asset that is freely transferable and has reasonably ascertainable value should be an eligible Contributable Resource. The Federal Reserve's ultimate proposal in this regard is likely to generate extensive comment.

Prepositioned Resources

Prepositioned Resources would consist of a Covered BHC's or Covered IHC's debt and equity investments in a material operating subsidiary. If a material operating subsidiary were to incur significant losses, such losses could be transferred to the Covered BHC or Covered IHC through equity automatically, while a debt investment could be used to absorb losses through the forgiveness of the debt, conversion of the debt into equity, or another economically comparable procedure. To qualify as Prepositioned Resources, the Federal Reserve contemplates that the debt could be required to be:

- unsecured;
- plain vanilla;
- with a remaining maturity of at least one year; and
- of lower priority than all third-party claims on the subsidiary.

DISCLOSURE REQUIREMENTS

The Proposed Rules include disclosure requirements that would apply to Covered BHCs but not Covered IHCs. The absence of disclosure requirements applicable to Covered IHCs reflects the fact that their Eligible Internal LTD and Eligible Internal TLAC must be held by the top-tier FBO parent or an intermediate entity that controls the Covered IHC.

The Proposed Rules would require a Covered BHC to publicly disclose a description of the financial consequences to its unsecured debtholders of the Covered BHC's entry into a resolution proceeding. Such disclosures would be required to be made on the Covered BHC's website or in public financial reports or other public regulatory reports, provided that the Covered BHC publicly provides a summary table indicating the locations of such disclosure. A Covered BHC also would be required to disclose the required information in the offering documents for all of its Eligible External LTD.

The Federal Reserve intends to propose a rule that would require Covered BHCs and Covered IHCs to report publicly their amounts of Eligible External LTD, Eligible External TLAC, Eligible Internal LTD, and Eligible Internal TLAC, as applicable, on a regular basis. It has not offered a contemplated timeframe for this rulemaking.

OBSERVATIONS

FIRST ORDER PLANNING ITEMS FOR COVERED BHCS

The Proposed Rules have critical implications for Covered BHCs' funding and capital plans. It is essential that Covered BHCs in the short term undertake two key tasks in this regard:

- Review all outstanding debt instruments (whether senior or subordinated and whether or not they are capital instruments) with a view to determining which ones would or would not qualify as Eligible External LTD under the Proposed Rules and, for those that do not qualify, begin to frame an approach for addressing the ineligible debt securities (whether by seeking modifications to the Proposed Rules or, potentially, by ultimately redeeming or repurchasing ineligible debt securities).
- *Consider whether to modify the standard terms for new issuances of senior debt to address the status of those securities under the Proposed Rules, particularly if outstanding senior debt securities are not ultimately grandfathered. Modifications could involve making such new issuances "senior subordinated" (meaning senior to Tier 2 subordinated debt but subordinated to existing and future senior debt, potentially including structured notes, that are not subordinated by contract) or including an early redemption right if under the final version of the Federal Reserve's rules the new issuances do not qualify as eligible LTD. Those modifications also will have costs.*

FIRST ORDER PLANNING ITEMS FOR FBO PARENTS OF COVERED IHCS

The Proposed Rules also have critical implications for the funding strategies of Covered IHCs. It is essential that the FBO G-SIBs that are the parents of entities being designated or established as Covered IHCs review their implementation plans submitted to the Federal Reserve earlier this year for those IHCs, as well as their funding plans for those IHCs more generally, with a view to whether the Proposed Rules' restrictions on debt and equity qualifying for purposes of the LTD and TLAC requirements as applied to the Covered IHCs are consistent with their implementation and funding plans. The Proposed Rules' most important constraint in this regard is likely to be the requirement that all LTD, CET1, and additional Tier 1 capital counted for purposes of the numerators of the LTD and TLAC requirements as applied to Covered IHCs must be held by "a company that is incorporated or organized outside of the United States that directly or indirectly controls" the Covered IHC.[40] That requirement may be inconsistent with the implementation and funding plans of some FBO parents of Covered IHCs and conversations they have had with U.S. and foreign regulators. The Proposed Rules appear to permit Covered IHCs to issue LTD, CET1, and additional Tier 1 securities to unaffiliated third parties, but those securities will not count in the numerators of the LTD and TLAC requirements.

RING-FENCING IMPLICATIONS FOR COVERED BHCS' FOREIGN OPERATIONS

Two aspects of the Proposal's LTD and TLAC requirements for Covered IHCs may raise ring-fencing considerations for foreign regulators in their comparable provisions addressing material subsidiaries of Covered BHCs in their jurisdictions. One is the requirement, noted above, that LTD, CET1, and additional Tier 1 capital eligible for inclusion in the numerators of the LTD and TLAC requirements as applied to Covered IHCs be issued to the FBO parent or an intermediate non-U.S. entity of the FBO parent. The other is the ability of the Federal Reserve to give an internal debt conversion order, discussed above,[41] that causes the Eligible External LTD of the Covered BHC held directly or indirectly by the FBO parent to be canceled or converted into CET1, and to give such an order without the consent or agreement of the FBO parent's home country regulator.

Neither of these provisions is entirely consistent with the FSB TLAC Proposal. That proposal does not require that cross-border internal TLAC be held by the foreign parent resolution entity, nor does it permit a host country regulator to "bail in" internal TLAC issued by a material subsidiary in its jurisdiction without the home country resolution authority's agreement. The Preamble comments on the first provision (that is, the requirement of internal parent ownership) that the requirement "would ensure that losses incurred by the U.S. intermediate holding company of a foreign G-SIB would be upstreamed to a foreign parent rather than . . . transferred to other U.S. entities", and "would minimize the risk that such losses pose to the financial stability of the United States, regardless of whether the covered IHC enters a resolution proceeding".[42] Regarding the second provision (relating to a possible internal debt conversion order), the Preamble describes the provision as "a compromise between the interests of home and host regulators".[43] Whether foreign regulators impose comparable provisions for material subsidiaries of U.S. G-SIBs in their jurisdictions remains to be seen.

UNDERWRITING AND MARKET-MAKING ACTIVITIES

All BHCs (whether or not Covered BHCs or Covered IHCs) that have or will have significant securities subsidiaries will want to consider carefully the Proposed Rules' requirements for deduction from capital of investments in unsecured debt of Covered BHCs—in particular whether market-making operations will be constrained by the absence of any exception for market-making activities. Because market-making in most cases will involve debt securities that can be treated as non-significant investments with a deduction not applying unless all such non-significant investments exceed 10% of the BHC's Tier 1 capital, the 10% threshold may provide sufficient flexibility to engage in normal market-making without constraint. The issue requires careful analysis, however, on a BHC-by-BHC basis.

THE FEDERAL RESERVE'S APPARENT ANTICIPATION OF INDUSTRY CONCERNS

The Federal Reserve's comments in the Preamble, to an unusual degree, provide background and explanation of key aspects of the Proposal that are likely to be subjects of industry comments. Examples include the Preamble's extensive discussion of its calibration methodologies,[44] including its recitation that the calibration of the SLR and historical leverage components assume that the Covered BHCs' and Covered IHCs' total assets will decline substantially during periods of stress;[45] its analysis of the economic cost and macroeconomic implications of the Proposed Rules;[46] and the acknowledgement that Covered BHCs' and Covered IHCs' increased funding costs will be passed on to consumers in the pricing of banking products.[47] Commenters will want to review this staff commentary carefully.

QUESTIONS RAISED FOR COMMENT

The Federal Reserve posed a number of important questions for comment, including, notably:

- whether Covered BHCs currently have outstanding Tier 2 capital instruments that would not count as Eligible External LTD and whether any such Tier 2 instruments should count as Eligible External LTD and Eligible External TLAC;[48]
- whether the proposed SLR total leverage exposure component of the TLAC requirement should be replaced with a TLAC requirement equal to 7.5% of total leverage exposure with a capital conservation buffer equal to 2% of total leverage exposure that would apply in addition to that total leverage exposure requirement;[49]
- whether currently outstanding instruments that meet all other requirements should be allowed to count as Eligible External LTD despite containing features that would be prohibited under the Proposal—that is, "grandfathering" of existing instruments;[50]
- whether Eligible External LTD should be permitted to include acceleration clauses that relate to payment default events;[51]
- whether the proposed U.S. governing law requirement for Eligible External LTD is necessary or appropriate;[52]
- whether the purpose of the proposed prohibition on short-term debt instruments in the Proposed Rule's clean holding company requirements would be served by a further requirement that Covered Holding Companies not redeem or buy back their liabilities without prior regulatory approval;[53]
- for the purposes of the clean holding company requirements, the appropriate treatment of pre-existing notes that would require redemption or create a put right upon the occurrence of an event that could (but may not) occur within one year of issuance;[54]
- whether the prohibition on third-party QFCs should be subject to an exception for derivatives contracts that are intended to hedge the exposures of the Covered Holding Company and, if so, the appropriate scope of any such exception, as well as whether the definition of "qualified financial

contracts" provides an appropriate scope for this prohibition and, in particular, whether the scope should be narrowed to permit Covered Holding Companies to enter into certain third-party QFCs or broadened to prohibit additional classes of transactions;[55]

- the appropriate size of the exceptions bucket as a percentage of a Covered BHC's Eligible External TLAC;[56]
- whether a grandfathering of existing liabilities that would be subject to the proposed exceptions bucket would be appropriate;[57]
- whether the Federal Reserve should impose Domestic Internal TLAC framework on Covered Holding Companies, and how such requirements should be implemented;[58] and
- whether, in a Domestic Internal TLAC framework, Contributable Resources and Prepositioned Resources should be required to be subject to a capital contribution agreement that would impose upon the Covered Holding Company a legal obligation to recapitalize the subsidiary upon the occurrence of a trigger outside the firm's discretion, as well as whether any Domestic Internal TLAC framework proposed by the Federal Reserve should treat foreign subsidiaries of Covered Holding Companies differently from their domestic subsidiaries.[59]

* * *

ENDNOTES

[1] This memorandum uses the term(s) "*Federal Reserve*" to mean the Board of Governors of the Federal Reserve System; "*Proposal*" to mean the Federal Reserve's proposal as released on October 30, including both the proposed rules ("*Proposed Rules*") and the preamble to the Proposed Rules (the "*Preamble*"); "*G-SIB*" to mean a global systemically important bank; "*Dodd-Frank Act*" to mean the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010; "*Basel Committee*" to mean the Basel Committee on Banking Supervision; and terms used in or by reference to the Federal Reserve's capital rules, 12 C.F.R. Part 217, with their meanings as defined in those rules or related acronyms—for example, "*RWAs*" for total risk-weighted assets.

[2] The U.S. G-SIBs, and therefore the Covered BHCs, are top-tier U.S. bank holding companies that are identified as systemically important under the Federal Reserve's capital rules, 12 C.F.R. Part 217. Eight bank holding companies currently meet this test: Citigroup Inc., JP Morgan Chase & Co., Bank of America Corporation, The Bank of New York Mellon Corporation, The Goldman Sachs Group, Inc., Morgan Stanley, State Street Corporation, and Wells Fargo & Company.

[3] Under the Federal Reserve's enhanced prudential standards rules adopted pursuant to Section 165 of the Dodd-Frank Act, 12 C.F.R. Part 252, foreign banking organizations with $50 billion or more of U.S. non-branch assets are required to establish intermediate holding companies ("*IHCs*") for their ownership interests in U.S. companies commencing July 1, 2016. The Federal Reserve noted in the Preamble that global systemically important FBOs, for purposes of identifying Covered IHCs, will include FBOs identified as systemically important under either the Basel Committee's assessment methodology for identifying G-SIBs or the G-SIB provisions in the Federal Reserve's capital rules. *See* Preamble at 53. Although the Federal Reserve has not heretofore provided a full list of non-U.S. G-SIBs that will be required to form IHCs as of July 1, 2016, we believe this list will include Barclays PLC, BNP Paribas S.A., Credit Suisse AG, Deutsche Bank AG, Mitsubishi UFJ Group, Inc., Banco Santander, S.A., and UBS Group AG.

[4] Each Covered BHC and each Covered IHC has over $250 billion in total consolidated assets and is therefore subject to the SLR.

[5] Any bank holding company that is subject to the Federal Reserve's Small Bank Holding Company Policy Statement is exempt from the Federal Reserve's Regulation Q and, by extension, these deduction requirements. *See* 12 C.F.R. 225.2(r).

[6] FSB, Consultative Document, *Adequacy of loss-absorbing capacity of global systemically important banks in resolution* (Nov. 10, 2014).

[7] *Id.* at Term Sheet ¶ 18.

[8] This provision is similar in some respects to the Federal Reserve's policy on dividends that may be paid by large bank holding companies as set forth in a 2009 supervisory letter. Federal Reserve, *SR 09-4, Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies* (Feb. 24, 2009, Rev. Mar. 27, 2009).

[9] Preamble at 51.

[10] *Id.*

[11] One revision of a typographical error in the existing capital rules would become effective on April 1, 2016. *See* Preamble at 94.

[12] *Id.* at 10-11.

[13] *Id.* at 5.

ENDNOTES (CONTINUED)

14 For additional information on the G-SIB surcharge rule, see our memorandum to clients entitled *Bank Capital Requirements: Federal Reserve Board Approves Final Common Equity Surcharge for U.S. Global Systemically Important Banks* (July 29, 2015), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_7_29_2015.pdf.

15 The Preamble notes that this calibration incorporates a one percentage point allowance for balance sheet depletion. *See* Preamble at 27.

16 The total leverage exposure component of this calibration incorporates a 0.5 percentage point allowance for balance sheet depletion. *See id.* at 28.

17 Proposed Rules § 252.62(b)(ii).

18 *See* Proposed Rules § 262.64(b)(2)(iv).

19 *See* Proposed Rules § 252.63(a). As part of the phase-in of the TLAC requirement, the RWA component would be equal to 16% of the Covered BHC's RWAs beginning on January 1, 2019, and would be equal to 18% of the Covered BHC's RWAs beginning on January 1, 2022. Proposed Rules § 252.63(a)(1)(i)-(ii).

20 Tier 1 regulatory capital includes CET1 and additional Tier 1 capital, excluding any Tier 1 minority interests.

21 80 Fed. Reg. 49082 (Aug. 14, 2015).

22 This table appears, in substantially similar form, in Table 1 to § 252.63 of the Proposed Rules and Table 1 to § 252.164 of the Proposed Rules.

23 12 C.F.R. § 217.11.

24 Proposed Rules § 252.63(c)(4).

25 The term "internal" dictates that these instruments would be required to be issued internally within the foreign banking organization, from the Covered IHC to a foreign parent entity that controls the Covered IHC.

26 Proposed Rules § 252.164(d).

27 As part of the phase-in of the Internal TLAC Requirement, the RWA component would be equal to 14% of the Covered IHC's RWAs beginning on January 1, 2019, and would be equal to 16% of the Covered IHC's RWAs beginning on January 1, 2022.

28 As part of the phase-in of the Internal TLAC Requirement, the RWA component would be equal to 16% of the Covered IHC's RWAs beginning on January 1, 2019, and would be equal to 18% of the Covered IHC's RWAs beginning on January 1, 2022.

29 Preamble at 69.

30 *See* 12 U.S.C. § 5390(c)(8)(D).

31 *See* Preamble at 77.

32 12 U.S.C. § 371c.

33 *See* Preamble at 79.

34 The proposed definition of "Structured Notes" was designed to avoid capturing debt instruments that pay interest based on the performance of a single index but to otherwise capture all debt instruments that have 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. In addition, the definition captures debt instruments that have more than one

embedded derivative (or similar embedded feature) or are not treated as debt under generally accepted accounting principles. *See* Preamble at 81.

35 *See id.* at 70, 81.

36 Because the Federal Reserve is the applicable regulator only for BHCs, state member banks and savings and loan holding companies, its capital rules (which the Proposed Rules would amend to implement these required deductions) do not apply to national banks or state non-member banks. The Federal Reserve indicated in the Preamble at page 94 that it is conferring with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, as the applicable regulatory authorities for national banks and state non-member banks, respectively, concerning the need to bring their capital rules into alignment with the deduction provisions of the Proposed Rules.

37 Preamble at 25.

38 *Id.* at 87-90.

39 79 Fed. Reg. 61440 (Oct. 10, 2014).

40 *See* the definition of "eligible internal debt security" in Proposed Rules § 252.161 and the restrictions on a Covered IHC's "internal total loss-absorbing capacity amount" in Proposed Rules § 252.154(c).

41 Proposed Rules § 252.163.

42 Preamble at 61.

43 *Id.* at 68.

44 *See, e.g.*, *id.* at 24-29 and 56-60.

45 *See id.* at 27-28.

46 *See id.* at 46-53. The Federal Reserve's extensive discussion of the costs and benefits of the proposed TLAC Requirement and the proposed LTD requirement is an apparent nod to congressional criticism that the Federal Reserve has not taken these considerations into account in its development of prior rulemakings.

47 *See id.* at 51.

48 *Id.* at 30 (Question 7).

49 *Id.* at 34 (Question 9).

50 *Id.* at 41 (Question 16).

51 *Id.* (Question 17).

52 *Id.* at 45 (Question 22).

53 *Id.* at 74 (Question 42).

54 *Id.* at 75 (Question 43).

55 *Id.* at 76 (Question 44).

56 *Id.* at 86 (Question 55).

57 *Id.* (Question 56).

58 *Id.* at 90 (Question 64).

59 *Id.* (Question 65).

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Stefanie S. Trilling (+1-212-558-4752; trillings@sullcrom.com) in our New York office.

CONTACTS

New York

Jason J. Cabral	+1-212-558-7370	cabralj@sullcrom.com
Whitney A. Chatterjee	+1-212-558-4883	chatterjeew@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Elizabeth T. Davy	+1-212-558-7257	davye@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelm@sullcrom.com
Michael T. Escue	+1-212-558-3721	escuem@sullcrom.com
Jared M. Fishman	+1-212-558-1689	fishmanj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Andrew R. Gladin	+1-212-558-4080	gladina@sullcrom.com
Wendy M. Goldberg	+1-212-558-7915	goldbergw@sullcrom.com
Erik D. Lindauer	+1-212-558-3548	lindauere@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Camille L. Orme	+1-212-558-3373	ormec@sullcrom.com
Rebecca J. Simmons	+1-212-558-3175	simmonsr@sullcrom.com
Donald J. Toumey	+1-212-558-4077	toumeyd@sullcrom.com
Marc Trevino	+1-212-558-4239	trevinom@sullcrom.com
Mark J. Welshimer	+1-212-558-3669	welshimerm@sullcrom.com

	Michael M. Wiseman	+1-212-558-3846	wisemanm@sullcrom.com
Washington, D.C.			
	Eric J. Kadel Jr.	+1-202-956-7640	kadelej@sullcrom.com
	William F. Kroener III	+1-202-956-7095	kroenerw@sullcrom.com
	Stephen H. Meyer	+1-202-956-7605	meyerst@sullcrom.com
	Jennifer L. Sutton	+1-202-956-7060	suttonj@sullcrom.com
	Andrea R. Tokheim	+1-202-956-7015	tokheima@sullcrom.com
	Samuel R. Woodall III	+1-202-956-7584	woodalls@sullcrom.com
Los Angeles			
	Patrick S. Brown	+1-310-712-6603	brownp@sullcrom.com
London			
	Mark J. Welshimer	+44-20-7959-8495	welshimerm@sullcrom.com
Tokyo			
	Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com

Annex 1

PROPOSED LTD AND TLAC REQUIREMENTS
(ON A FULLY PHASED-IN BASIS)

	Covered BHCs	Covered IHCs
Minimum LTD Requirements	External Minimum LTD equal to the *greater of*: • (x) 6% of RWAs *plus* (y) applicable GSIB surcharge (likely Method 2); *and* • 4.5% of total leverage exposure (the denominator of the SLR).	Internal Minimum LTD equal to the *greater of*: • 7% of RWAs; • 3% of total leverage exposure (if subject to SLR); *and* • 4% of average consolidated assets (the denominator in the historical U.S. leverage ratio).

Minimum TLAC Requirements	External Minimum TLAC equal to the *greater of*:
	• 18%[1] of RWAs; *and*
	• 9.5% of total leverage exposure.
		Internal Minimum TLAC for
		• SPOE Non-Resolution Covered IHC equal to the *greater of*:
		    ○ 16%[2] of RWAs;
		    ○ 6% of total leverage exposure (if subject to SLR); *and*
		    ○ 8% of average consolidated assets.
		• MPOE Resolution Entity Covered IHC equal to the *greater* of:
		    ○ 18%[3] of RWAs;
		    ○ 6.75% of total leverage exposure (if subject to SLR); *and*
		    ○ 9% of average consolidated assets.

TLAC Buffer Requirements[4]	External TLAC Buffer composed of CET1 equal to: • 2.5%; *plus* • Method 1 GSIB surcharge; *plus* • any applicable countercyclical buffer.	Internal TLAC Buffer composed of CET1 equal to: • 2.5%; *plus* • any applicable countercyclical buffer.

---

1 16% as of January 1, 2019 and 18% as of January 1, 2022.

2 14% as of January 1, 2019 and 16% as of January 1, 2022.

3 16% as of January 1, 2019 and 18% as of January 1, 2022.

4 Dipping below the required buffer amount results in phased restrictions on dividends, other capital distribution, and discretionary bonus payments