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INTERNATIONAL BANKING

Expert Analysis

‘Total Loss-Absorbing Capacity’ Proposal Comes to the United States

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On Oct. 30, 2015, the Federal Reserve Board issued a proposed rule requiring global systemically important banks (GSIBs) to meet new requirements to maintain a “total loss-absorbing capacity” (TLAC) ratio that can be met by a combination of additional regulatory capital and unsecured long-term debt.[1]

This proposal would apply to both U.S. bank holding companies classified as GSIBs and the U.S. operations of non-U.S. banking organizations classified as GSIBs. It is aimed at strengthening the resiliency of the GSIBs on an ongoing basis while providing for a more orderly resolution if a GSIB should fail. Comments are due on or before Feb. 1, 2016. Compliance is proposed to begin Jan. 1, 2019, and be fully phased-in by Jan. 1, 2022.

The proposed TLAC requirement and additional related proposals are quite complex. This month’s column provides a high-level general summary of the proposal. Non-U.S. banks classified as GSIBs with U.S. operations organized under an intermediate holding company (IHC) will be directly affected by this proposal and they will want to analyze whether the U.S. proposal may conflict with current or pending home country laws and regulations.

Background

The proposal builds on some of the financial stability reforms already promulgated as a result of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act, including prudential requirements such as enhanced capital and liquidity obligations for the largest banking organizations ($50 billion or more in total consolidated assets), and the requirement that each of these organizations submit an annual resolution plan describing how the organization would be resolved in the event of material financial distress or failure.[2]

The proposal also takes into account Title II of Dodd-Frank, which allows the Federal Deposit Insurance Corporation (FDIC) to resolve the failure of a large U.S. nonbank financial firm (e.g., U.S. bank holding company) if it is determined that the U.S. Bankruptcy Code, the normal course for failures of most business corporations, was insufficient to address the possible major financial stability consequences of the failure of such a large nonbank financial firm.

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The proposed TLAC requirement in particular stems from an international regulatory effort to shore up global financial stability after the recent economic crisis. The Financial Stability Board (FSB) is an international organization of banking and finance government officials that work on recommendations aimed at promoting global financial stability. The FSB interacts with other international regulatory groups such as the Bank for International Settlements (BIS), whose Basel Committee sets international regulatory capital standards, and the G20 group of global finance ministers. At the request of the G20, the FSB developed and published in November 2014 a set of proposals to strengthen the adequacy of the loss-absorbing capacity of GSIBs.[3]

> The proposed TLAC requirement stems from an international regulatory effort to shore up global financial stability after the recent economic crisis.

Under the FSB’s proposal, GSIBs would be subject to a minimum TLAC requirement equal to the greater of (a) an amount between 16 and 20 percent of a banking organization’s risk-weighted assets and (b) twice the Basel III tier 1 leverage ratio requirement. In addition, GSIBs would be expected to meet at least one-third of its TLAC requirement with certain types of long-term debt (LTD). The FSB proposal is expected to be finalized this month.

In the commentary accompanying the proposed rule, the Federal Reserve Board states that it has modeled its proposed TLAC requirement after the FSB proposal, but with a stricter LTD requirement.

Review of Key Terms

The proposal in many ways keys off of some of the current regulatory capital and prudential requirements. Here is a quick review of some of these key terms.

- Risk-weighted assets. A bank’s assets are “risk-weighted”—the riskier the asset, the more capital that must be reserved against it by the bank. Under the proposed rule, a bank subject to the proposed rule would calculate its risk-weighted assets using both its own regulator-approved internal risk models (required for large banking organizations like GSIBs) and the “standardized approach” set forth in the regulatory capital regulations, with the greater of the two numbers used for purposes of this proposed rule.[4]
- Risk-based capital. Tier 1 risk-based capital is composed primarily of common stock (Tier 1 common equity capital), and certain deeply subordinated debt instruments (additional Tier 1 capital). Tier 2 capital is composed of certain types of other subordinated debt instruments and specified additional elements. Tier 1 and Tier 2 capital make up the total risk-based capital. Regulations specify minimum capital ratios for banks and bank holding companies.[5]
- Leverage ratio. The leverage ratio is a Tier 1 capital to total consolidated assets ratio calculation.[6] The largest banking organizations also must meet a supplementary leverage capital ratio requirement.[7]
- GSIB surcharge. The eight banks that currently meet the definition of a GSIB under Federal Reserve Board rules adopted earlier this year must maintain an additional level of capital on top of the capital already required for the largest bank holding companies.[8]
- Capital conservation buffer: an additional layer of Tier 1 common equity.[9]

The Proposed Rule

There are four primary elements to the proposed rule.

(1) U.S. GSIBs (covered BHCs). Covered BHCs are the U.S. bank holding companies that qualify as GSIBs under the Federal Reserve Board’s capital surcharge rule.

Covered BHCs would be required to maintain minimum levels of eligible external TLAC and eligible external LTD.

The minimum external TLAC requirement generally would be calculated as the greater of 18 percent of the covered BHC’s total risk-weighted assets and 9.5 percent of its total leverage exposure as calculated under the supplementary leverage capital rule.[10]

A covered BHC’s TLAC amount is (subject to certain exclusions) the sum of its Tier 1 common equity, additional Tier 1 capital and a certain percentage of

its eligible external LTD. An additional Tier 1 common equity TLAC buffer as defined in the proposed rule would be imposed in addition to the risk-weighted assets component of the TLAC calculation.

The minimum external LTD requirement is calculated as the greater of (i) 6 percent of the covered BHC's total risk-weighted assets plus its surcharge under the GSIB surcharge rule and (ii) 4.5 percent of total leverage exposure as calculated under the supplementary leverage capital rule. Debt that would be eligible to satisfy this requirement must be issued directly by the covered BHC to third-party investors with a remaining maturity of at least one year, and be unsecured, nonconvertible to equity, considered "plain vanilla" (a term meaning without certain complex features such as derivatives), have no ability to accelerate payment, and be governed by U.S. law.

Covered BHCs not in compliance could face restrictions on their distributions and discretionary bonus payments.

(2) Non-U.S. GSIBs (covered IHCs). Covered IHCs are those intermediate holding companies that large non-U.S. banking organizations with at least $50 billion in U.S. nonbranch assets were required to form under the prudential requirements.[11] The proposal would cover those IHCs owned by non-U.S. banking organizations that would qualify as GSIBs under the U.S. GSIB rules, international GSIB standards or home country rules.

In contrast to covered BHCs, covered IHCs would be required to maintain minimum levels of internal TLAC and internal LTD.

Calculation of the minimum internal TLAC requirement depends on whether the IHC could expect to enter a resolution proceeding itself, or whether only the top-tier non-U.S. parent of the IHC would enter a resolution proceeding.

If the covered IHC is not expected to enter a U.S. resolution proceeding in the event of failure of the parent non-U.S. GSIB (a "non-resolution entity covered IHC"), the minimum TLAC requirement would be calculated as the greater of (i) 16 percent of total risk-weighted assets, (ii) 6 percent of total leverage exposure (if subject to the supplementary leverage capital rule) and (iii) 8 percent of average total consolidated assets.

For a covered IHC that is expected to enter a resolution proceeding in the event of failure of the parent non-U.S. GSIB (a "resolution entity covered IHC"): the minimum TLAC requirement is higher, calculated as the greater of (i) 18 percent of the IHC's risk-weighted assets, (ii) 6.75 percent of total leverage exposure (if subject to the supplementary leverage capital rule) and (iii) 9 percent of average total consolidated assets.

A covered IHC's TLAC amount is (subject to certain exclusions) the sum of its common equity tier 1 capital and additional tier 1 capital issued directly by the covered IHC to a non-U.S. GSIB that directly or indirectly controls the covered IHC, plus eligible internal LTD. An additional TLAC capital buffer would be added to the risk-weighted assets component of the calculation.

The minimum internal LTD requirement would be calculated as the greater of (i) 7 percent of the covered IHC's total risk-weighted assets, (ii) 3 percent of total leverage exposure (if it is subject to the supplementary leverage capital requirement) and (iii) 4 percent of average total consolidated assets. Debt instruments that would qualify for this requirement are those that are issued directly by the covered IHC to a non-U.S. entity that directly or indirectly controls the covered IHC. In addition, similar to the requirements for the covered BHC external LTD, the instruments must be unsecured, "plain vanilla," have a remaining maturity of at least one year, and be governed by U.S. law. However, in order to qualify as eligible internal LTD, additional required features include a contractual provision pursuant to which the Federal Reserve Board under specified conditions could order the covered IHC to convert the debt into Tier 1 common equity, or be cancelled.

Covered IHCs not in compliance could face restrictions on their distributions and discretionary bonus payments.

(3) Additional Restrictions on Certain Holding Company Liabilities. This part of the proposal applies to both covered BHCs and covered IHCs.

Under the proposal, covered BHCs and covered IHCs generally would be prohibited from issuing certain types of liabilities including the following: short-term debt issued to third parties; derivatives and other qualified financial contracts with third parties; certain guarantees of subsidiary or affiliate liabilities or other arrangements that create default, set-off, or netting rights for subsidiaries' creditors; and covered BHC or covered IHC liabilities guaranteed by a subsidiary.

> The eight banks that currently meet the definition of a GSIB under Federal Reserve Board rules adopted earlier this year must maintain an additional level of capital on top of the capital already required for the largest bank holding companies.

Additional covered BHC liabilities as specified in the proposal will not be able to exceed 5 percent of the value of the covered BHC's eligible external TLAC.

(4) Regulatory Capital Deduction for Investments in the Unsecured Debt of Covered BHCs. Entities under the jurisdiction of the Federal Reserve Board (state-chartered banks that are members of the Federal Reserve System, bank holding companies and savings and loan holding companies with over $1 billion in total consolidated assets, and IHCs formed to comply with the board's enhanced prudential standards for non-U.S. banking organizations) generally will be required to deduct from their regulatory capital any investments in unsecured debt issued by covered BHCs (including external eligible LTD) in excess of certain thresholds. At the moment, the proposed rule is only applicable to state-chartered member banks; the Federal Reserve Board will be consulting with the Office of the Comptroller of the Currency and the FDIC regarding proposing a similar requirement with respect to banks under their respective jurisdictions.

Proposed Disclosure Rules

Finally the Federal Reserve Board is proposing that a covered BHC would be required to publicly disclose in both offering documents for all of its eligible debt securities, and on its websites or in other public financial reports, the fact that holders of a covered BHC's eligible external LTD are subject to loss ahead of other creditors of the covered BHC or its subsidiaries. While not included in this proposal, the Federal Reserve Board noted that it also was considering proposing that both covered BHCs and covered IHCs regularly report publicly their amounts of TLAC and eligible LTD held in compliance with any final TLAC regulation.

Conclusion

This proposal is aimed only at the world's largest, most complex banking organizations where financial difficulty or failure would be expected to have a material adverse effect on global financial stability. Banking organizations now will have the chance to voice their opinion as to whether this proposal would accomplish its professed goal.

To assist in focusing commenters' thinking, the Federal Reserve Board asks 70 different questions to consider. Non-U.S. banks need to review these proposals in light of current and pending laws and regulations not only in their home country jurisdictions but also in other jurisdictions in which they have major banking operations to identify any possible conflict and compliance issues. Commenters should attempt to quantify the realistic costs of compliance because that will be useful information for the Federal Reserve Board to receive.

Update

After this column had been submitted for publication, on Nov. 9, 2015, after reviewing comments made on the proposed standard and conducting impact studies, the FSB issued its final TLAC standard. Generally speaking, a banking organization will be expected to meet the following minimum standards: (a) 16 percent of its risk-weighted assets starting Jan. 1, 2019, rising to 18 percent Jan. 1, 2022, and (b) a Basel III leverage ratio denominator requirement of 6 percent starting Jan. 1, 2019, rising to 6.75 percent Jan. 1, 2022. It also would be expected to meet at least one-third of its TLAC requirement with LTD as described in the standard.

The Basel III leverage ratio denominator generally is the banking organization's total exposure measure, which is the sum of its on-balance sheet, derivative, and securities financing transaction exposures; and its off-balance sheet items. Banking organizations should review the Federal Reserve Board's proposal in the light of the FSB final TLAC standard.

1. See Oct. 30, 2015, Federal Reserve Board press release and link to text of proposed rule, at www.federalreserve.gov.
2. Pub. Law 111-203, July 21, 2010, section 165.
3. Financial Stability Board, "Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in resolution," Nov. 10, 2014, available at www.fsb.org.
4. See 12 CFR Part 217.
5. See 12 CFR §§217.10. 217.20.
6. See 12 CFR §217.10(b)(4).
7. See 12 CFR §217.10(c)(4).
8. See 12 CFR §217.403.
9. See 12 CFR §217.11.
10. The risk-weighted assets requirements would be phased in over a two-year period.
11. 12 CFR §252.153.

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