BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: October 9, 2020

To: Board of Governors

From: Staff[1]

Subject: Draft final rule specifying a regulatory capital treatment of investments in certain debt instruments issued by global systemically important firms

ACTIONS REQUESTED: Approval of a draft final rule that would discourage large and internationally active banking organizations from investing in long-term debt instruments issued by U.S. or foreign global systemically important banking organizations (GSIBs). The draft final rule would be issued jointly with the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC). In addition, staff seeks authority to make technical or minor changes to the draft final rule prior to publication in the *Federal Register*.

EXECUTIVE SUMMARY:

- The draft final rule would reduce interconnectedness within the financial system and contagion risks associated with the failure of a GSIB, which are the largest and most complex firms.

- Under the draft final rule, category I and category II banking organizations—firms with higher systemic importance—would face an additional requirement with respect to investments they have in the "total loss-absorbing capacity" (TLAC) or similar debt instruments issued by U.S. or foreign GSIBs (TLAC debt).[2] Specifically, the rule

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[2] A category I banking organization is (1) identified as a global systemically important bank holding company or (2) a depository institution that is a subsidiary of a category I banking organization. A category II banking organization (1) has total consolidated assets of $700 billion or more, (2) has both $75 billion or more in average cross-jurisdictional activity and $100 billion or more in total consolidated assets, or (3) is a depository institution that is a subsidiary of a category II banking organization.

provides a stringent treatment for such investments by requiring that they be deducted from a firm's regulatory capital (deduction treatment).

- The draft final rule excludes certain hedged and market making exposures from the deduction treatment. This treatment would be similar to the Board's current rule for investments in capital instruments issued by a financial institution.
- The draft final rule is similar to the proposal from April 2019, with the following changes in response to comments:[3]
    - The draft final rule would rely on the 2019 revisions to the market making framework established by the Volcker rule to identify market making exposures;[4] and
    - Given their importance to market making, the draft final rule would not apply the deduction treatment to a limited amount of TLAC-related derivative exposures held for more than 30 business days.
- By discouraging banks from investing in debt instruments issued by the largest and most complex banks, the draft final rule would reduce interconnectedness and strengthen the financial system.
- The draft final rule would become effective on April 1, 2021.

DISCUSSION:

I. Background on the Draft Final Rule

The draft final rule builds off the Board's existing TLAC rule and capital rule. The Board's TLAC rule requires U.S. GSIBs and U.S. intermediate holding companies of foreign GSIBs (covered IHCs) to maintain outstanding minimum amounts of long-term debt and total loss-absorbing capacity.[5] The purpose of the TLAC rule is to require these firms to have sufficient loss-absorbing capacity to continue operating in the event of a bankruptcy or resolution proceeding. The Board's capital rule requires a banking organization to deduct certain

[3] 84 FR 13814 (April 8, 2019).

[4] 84 FR 61974 (November 14, 2019).

[5] 12 CFR part 252, subparts G and P.

investments in the capital instruments of other financial institutions from the firm's regulatory capital when determining its risk-based and leverage capital ratios.[6] This requirement reduces interconnectedness and contagion risks by discouraging firms from investing in the capital of other financial institutions.

Consistent with the capital rule, the draft final rule would require a banking organization to deduct investments in other firms' TLAC debt if, when aggregated with certain investments in other capital instruments, the investments exceed 10 percent of the banking organization's common equity tier 1 capital. The 10 percent threshold measures exposures on a "net long" basis, where exposures are calculated by offsetting gross long positions against qualifying gross short positions.[7] This provides a strong incentive for banking organizations to hedge effectively and minimize riskier "net long" exposures to TLAC debt.

Under the draft final rule, a banking organization is not required to deduct investments in TLAC debt instruments totaling up to five percent of its common equity tier 1 capital, measured on a gross long basis (five percent exclusion). For U.S. GSIBs, the five percent exclusion would only apply to market making exposures in TLAC debt instruments; for firms subject to category II standards, the five percent exclusion would apply to any TLAC debt instrument exposures.[8] The five percent exclusion is intended to support deep and liquid markets for TLAC debt instruments while simultaneously limiting interconnectedness among banking organizations.

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[6] 12 CFR 217.22(c).

[7] 12 CFR 217.22(h).

[8] The proposal would have required full deduction for any market making position held in excess of the 30-business-day limit. The draft final rule would remove this limit for synthetic exposures (i.e., derivative positions used in market making).

II. Overview of Public Comments

The agencies received ten comment letters on the proposal. As further detailed in the Appendix, commenters generally supported the overarching goal of the proposal to reduce interconnectedness by creating an incentive for category I and category II banking organizations to limit their exposure to GSIBs. However, commenters also expressed certain general concerns with the proposal and noted specific concerns with certain technical aspects.

In particular, several commenters argued that the proposal could reduce the depth of and liquidity in the market for debt instruments issued under the TLAC rule by limiting market making activities, particularly market making using derivatives. To address these concerns, commenters requested that the final rule: (1) define market making positions consistent with the Volcker rule; and (2) eliminate the 30-business-day holding time limit for market making exposures (which is not included in the Volcker rule). In particular, commenters argued that the 30-business-day limit is generally incompatible with how derivatives are used in market making.

III. Changes from the Proposal

The draft final rule would rely on the regulations implementing the Volcker rule to identify market making activities. This approach would decrease compliance burden by allowing firms to use a single standard to identify market making activities under the Volcker rule and the capital rule. Relative to the proposal, staff expect this change to result in a similar scope of identified market making activities.

In response to comments, the draft final rule would remove the 30-business-day holding limit for market making using derivatives. This removal would recognize that long-term derivative exposures are an integral part of market making practice for TLAC instruments. The preamble to the draft final rule would state that the agencies would monitor firms' use of market making derivative exposures held for longer than 30 business days to ensure that firms hold capital commensurate with risk and that such positions do not raise safety and soundness concerns. The draft final rule would retain the proposal's deduction treatment for direct and indirect investments in TLAC debt instruments held for more than 30 business days.

IV. Regulatory Reporting

The proposal included revisions to the FR Y-9C report to (1) implement the deduction framework for exposures to TLAC debt instruments and (2) require U.S. GSIBs and covered IHCs to disclose their ratios of TLAC and long-term debt that are required under the TLAC rule. The Board proposed similar revisions earlier this year in the FR Y-14 report.[9]

The draft final rule would finalize these revisions to the FR Y-9C and FR Y-14 generally as proposed, along with minor technical modifications suggested by commenters.

V. Impact Assessment

The draft final rule is not expected to increase required capital amounts for banking organizations subject to the draft final rule. Required capital amounts would only increase as a result of the draft final rule if a banking organization's net long exposures to TLAC debt instruments and certain investments in capital instruments of other financial firms exceed the 10 percent threshold. Currently, no banking organization subject to the draft final rule has exposures exceeding the 10 percent threshold.

9 85 FR 15776 (March 19, 2020).

VI. Technical Revisions to the Board's TLAC Rule

In 2018, the Board issued a notice of proposed rulemaking that, among other items, included minor proposed amendments to the Board's TLAC rule.[10] The proposal included revisions to ensure that the buffers in the TLAC rule measured long-term debt consistently, that the term "external TLAC risk-weighted buffer" was used consistently, that new covered IHCs have three years to conform to most of the requirements of the TLAC rule, and that the same language is used to determine long-term debt amounts for both covered IHCs and U.S. GSIBs. The Board received minimal comments on these proposed revisions to the TLAC rule, and the comments received were supportive. The draft final rule would adopt these revisions without change, except for updates to citations that have changed since the proposal was issued.

RECOMMENDATIONS: For the reasons discussed above, staff recommends that the Board approve the attached draft final rule. Staff also recommends that the Board authorize staff to make technical or minor changes to the attached materials prior to publication in the *Federal Register*.

[10] 83 FR 17317, 17322 (April 19, 2018).

Appendix: Thematic Comment Summary

The agencies received ten comment letters on the proposal.

Scope of applicability

- A commenter asked the agencies to expand the scope of the rulemaking to firms subject to Category III and IV standards while another commenter asked that the rulemaking be expanded to all regulated banking organizations, including community banks.

"Covered debt instrument" definition

- Commenters asked for a revised definition of "covered debt instrument" that would reduce the amount of instruments subject to the deduction treatment by removing (1) "excluded liabilities" issued by foreign GSIBs and (2) instruments *pari passu* or subordinated to TLAC.
- A commenter asked that the definition exclude instruments that no longer count toward TLAC requirements due to having less than one year of remaining maturity.
- Commenters indicated that firms cannot reasonably track which instruments are "covered debt instruments" and therefore may preemptively include all unsecured debt issued by GSIBs in the deduction framework.

Deduction mechanics

- Commenters suggested that deductions should be made from a firm's own common equity tier 1 capital or the agencies should outright "ban all holdings of TLAC."
- Commenters requested that GSIBs be able to apply the deduction treatment to a firm's TLAC debt instruments, rather than tier 2 capital.
- A commenter requested that "excluded covered debt instruments" exceeding the 10 percent threshold, the five percent exclusion, or held for more than 30 business days should be deducted on a "gross long" basis, consistent with the proposal.
- Commenters requested that "excluded covered debt instruments" within the five percent exclusion – and thus not subject to deduction – should be measured on a "net long" basis.
- Commenters asked the agencies to recognize additional short positions when calculating the "net long" exposure by allowing short positions to offset long positions in instruments that are *pari passu* or subordinated to the long position.

U.S. GSIBs: five percent exclusion for market making purposes

- A commenter requested that U.S. GSIBs not be given any exclusion for investments in TLAC related to market making.
- Commenters asked that final rule's criteria be aligned with the existing identification of market making-related activities in the regulations implementing the Volcker rule. Specifically, commenters asked that the definition of "excluded covered debt instrument" be revised to include a permitted market making position, or permitted hedge of a market making position, under the Volcker rule.

- Commenters asked for removal of the 30-business-day limit from the five percent exclusion for U.S. GSIBs participating in market making activities.

Additional five percent exclusion

- Commenters requested that the agencies create another separate five percent exclusion for market making in a GSIB's own TLAC instruments.

Recalibrate existing deduction thresholds in the capital rule

- Commenters requested that the agencies recalibrate the current 10 percent of common equity tier 1 capital threshold for investments in unconsolidated financial institutions to allow more TLAC instruments to avoid deduction treatment. They advocated increasing the threshold to 10 percent of TLAC for GSIBs and 10 percent of total capital for non-GSIB advanced approaches banking organizations.

Transition provisions

- Commenters requested that the agencies provide 18 months before firms must effectuate the deduction treatment. This would give firms more time to build out systems to track which TLAC instruments are subject to the draft final rule.
- A commenter requested that the agencies not require deduction of any unsecured debt instrument until the information necessary to determine whether the instrument is a "covered debt instrument" is available.

Disclosure and reporting

- Commenters requested that the agencies require additional disclosures related to TLAC, such as the nature of TLAC investments and more transparent disclosure that highlights risk of bail-in for purposes of market pricing.
- Commenters made certain technical suggestions with regard to the Call Report, FFIEC 101, and the FR Y-9C.