BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: October 22, 2015

To: Board of Governors

From: Governor Tarullo DT

Subject: Proposed rule establishing total loss-absorbing capacity, long-term debt, and clean holding company requirements for U.S. global systemically important banking organizations and U.S. intermediate holding companies of foreign global systemically important banking organizations, and related requirements

Attached are a memorandum to the Board and a draft *Federal Register* notice of proposed rulemaking that would establish long-term debt, total loss-absorbing capacity (TLAC), and clean holding company requirements for U.S. global systemically important bank holding companies (covered BHCs) and U.S. intermediate holding companies of foreign global systemically important banking organizations (covered IHCs). The proposal would promote the financial stability of the United States by enhancing the resolvability of covered BHCs and covered IHCs under both the U.S. Bankruptcy Code and Title II of the Dodd-Frank Act, reducing the risk to financial stability from the failure of a foreign GSIB that is the parent of a covered IHC, and enhancing the resiliency of covered BHCs and covered IHCs.

The proposal would require firms to maintain outstanding a minimum amount of unsecured long-term debt that could be converted to equity in order to absorb losses and recapitalize the firm's operating subsidiaries in resolution. The proposal would also require covered BHCs and covered IHCs to maintain at least a minimum level of TLAC, composed of regulatory capital and eligible long-term debt, and to maintain related buffers, composed of common equity tier 1 capital. Any covered BHC that already meets the existing capital requirements and capital buffers would be able to come into compliance with the proposal solely by issuing additional long-term debt.

Additionally, the proposal would impose restrictions on the operations of covered BHCs and covered IHCs to further promote resolvability and resiliency and would apply a regulatory capital deduction treatment to investments by certain Board-regulated institutions in the unsecured long-term debt instruments of covered BHCs. Most of the proposed requirements would apply as of January 1, 2019, with certain higher requirements to be phased in on January 1, 2022.

Although the proposed inclusion of a TLAC requirement along with the long-term debt requirement modestly increases the overall complexity of the proposal, the TLAC requirement also provides a number of additional benefits. The TLAC requirement, which differs from the long-term debt requirement in that it can be met with going-concern capital, would increase the resiliency of the largest, most systemic banking organizations by increasing their loss-absorbing capacity. In addition, the Financial Stability Board has been developing total loss-absorbing capacity standards for GSIBs. Accordingly, the proposed TLAC requirement would help promote comparability of loss absorbency standards internationally.

Staff seeks the Board's approval of the attached draft notice of proposed rulemaking, and requests authority to make technical and minor changes to the document prior to publication in the *Federal Register*.

The Committee on Bank Supervision has reviewed the proposed rule, and I believe it is ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: October 22, 2015

To: Board of Governors

From: Staff[1]

Subject: Proposed rule establishing total loss-absorbing capacity, long-term debt, and clean holding company requirements for U.S. global systemically important banking organizations and U.S. intermediate holding companies of foreign global systemically important banking organizations, and related requirements

ACTIONS REQUESTED

Approval to invite public comment on the attached draft proposed rule ("proposal") and accompanying Federal Register notice that would (i) establish an external long-term debt requirement ("external LTD requirement"), an external total loss-absorbing capacity requirement ("external TLAC requirement"), and a related external TLAC buffer for top-tier U.S. bank holding companies identified by the Board as global systemically important banking organizations ("covered BHCs");[2] (ii) establish an internal long-term debt requirement ("internal LTD requirement"), an internal total loss-absorbing capacity requirement ("internal TLAC requirement"), and a related internal TLAC buffer for U.S. intermediate holding companies of foreign global systemically important banking organizations ("covered IHCs"); (iii) impose restrictions on the operations of covered BHCs and covered IHCs ("clean holding company requirements"); and (iv) require state member banks, bank holding companies and savings and loan holding companies with over $1 billion in total consolidated assets, and U.S. intermediate holding companies of foreign banking organizations to apply a regulatory capital deduction treatment to their investments in the unsecured debt of covered BHCs. Staff also seeks approval to make technical and minor changes (e.g., wording and formatting) to the draft Federal Register documents in order to prepare them for publication.

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[1] Messrs. and Mmes. Gibson, Van Der Weide, Bouchard, Horsley, Climent, Booker, Teller, Healey, Savignac, and Beall (Division of Banking Supervision and Regulation), and Alvarez, Schaffer, McDonough, Schwarz, Giles, Buresh, Frischmann, and Strazanac (Legal Division).

[2] The eight firms currently identified as covered BHCs are Citigroup Inc., JP Morgan Chase & Co., Bank of America Corporation, The Bank of New York Mellon Corporation, Goldman Sachs Group, Inc., Morgan Stanley, State Street Corporation, and Wells Fargo & Company.

EXECUTIVE SUMMARY

The proposal is intended to safeguard the financial stability of the United States by (i) enhancing the resolvability of covered BHCs under the U.S. Bankruptcy Code; (ii) enhancing the resolvability of covered BHCs under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"); (iii) enhancing the resolvability of foreign global systemically important banking organization ("GSIB") parents of covered IHCs under their home jurisdiction resolution regimes; and (iv) further increasing the resiliency of covered BHCs and covered IHCs. The proposal includes the following four complementary elements:

- **External LTD and TLAC Requirements for U.S. GSIBs**
  - <u>Scope</u>: U.S. GSIBs (referred to as covered BHCs).
  - <u>External LTD requirement</u>: External LTD is a subcategory of external TLAC, but has its own minimum requirement: the greater of 6 percent of RWAs plus the firm's surcharge under the Board's GSIB risk-based capital surcharge rule ("GSIB surcharge rule") <u>and</u> 4.5 percent of total leverage exposure (the denominator of the supplementary leverage ratio ("SLR")).
    - <u>Eligible external LTD</u>: Debt instruments that are issued directly by the covered BHC, are unsecured, are "plain vanilla," have a remaining maturity of at least one year, and are governed by U.S. law.
  - <u>External TLAC requirement</u>: The greater of 18 percent of risk-weighted assets ("RWAs") <u>and</u> 9.5 percent of total leverage exposure.
    - <u>Eligible external TLAC</u>: (i) Common equity tier 1 capital and additional tier 1 capital issued directly by the covered BHC plus (ii) eligible external LTD.
    - <u>External TLAC buffer</u>: Applies a buffer equal to 2.5 percent plus method 1 GSIB surcharge plus any applicable countercyclical capital buffer in addition to the 18 percent RWA component of the external TLAC requirement; breach would subject a covered BHC to restrictions on distributions and discretionary bonus payments.
  - <u>Impact analysis</u>: Six of the eight covered BHCs would currently have external TLAC shortfalls. The aggregate external TLAC shortfall of the covered BHCs would be approximately $102 billion, the aggregate external LTD shortfall would be approximately $90 billion, and the aggregate shortfall for the external LTD and TLAC requirements together would be approximately $120 billion. Staff estimates of the aggregate increased funding cost for the covered BHCs range from approximately $680 million to $1.5 billion annually.
  - <u>Transition period</u>: All requirements would apply as of January 1, 2019; the RWA component of the external TLAC requirement would be 16 percent as of January 1, 2019, and would increase to 18 percent as of January 1, 2022.

- Rationale: To improve the resolvability and resiliency of U.S. GSIBs, including their resolvability under a single-point-of-entry (SPOE) resolution strategy, by increasing their gone-concern and going-concern loss-absorbing capacity.

- **Internal LTD and TLAC Requirements for U.S. IHCs of Foreign GSIBs**
  - Scope: U.S. IHCs that are controlled by foreign GSIBs (referred to as covered IHCs).
  - Internal LTD requirement (for all covered IHCs): The greater of 7 percent of RWAs and 3 percent of total leverage exposure (if subject to the SLR) and 4 percent of average total consolidated assets.
    - Eligible internal LTD: Debt instruments that are issued directly by the covered IHC to a foreign entity that controls the covered IHC, are unsecured, are plain vanilla, have a remaining maturity of at least one year, are governed by U.S. law, are contractually subordinated to the third-party liabilities of the covered IHC, and are subject to a contractual provision pursuant to which the Board could order the covered IHC to convert them into equity under specified conditions.
  - Internal TLAC requirements:
    - For covered IHCs that are not expected themselves to enter resolution in the event of failure of the parent foreign GSIB ("non-resolution entity covered IHCs"): The greater of 16 percent of RWAs and 6 percent of total leverage exposure (if subject to the SLR) and 8 percent of average total consolidated assets.
    - For covered IHCs that are expected themselves to enter resolution in the event of failure of the parent foreign GSIB ("resolution entity covered IHCs"): The greater of 18 percent of RWAs and 6.75 percent of total leverage exposure (if subject to the SLR) and 9 percent of average total consolidated assets.
    - Eligible internal TLAC: (i) Common equity tier 1 capital and additional tier 1 capital issued directly by the covered IHC to a foreign entity that controls the covered IHC plus (ii) eligible internal LTD.
    - Internal TLAC buffer: Applies a buffer equal to 2.5 percent plus any applicable countercyclical capital buffer in addition to the 16 or 18 percent RWA component of the internal TLAC requirement; breach would subject a covered BHC to restrictions on distributions and discretionary bonus payments.
  - Transition period: All requirements would apply as of January 1, 2019; the RWA component of the internal TLAC requirement for resolution entity covered IHCs would be 16 percent and the RWA component of the internal TLAC requirement for non-resolution entity covered IHCs would be 14 percent as of January 1, 2019. These requirements would increase to 18 percent and 16 percent, respectively, as of January 1, 2022.
  - Rationale: To improve the resolvability and resiliency of covered IHCs and the resolvability of foreign GSIBs under an SPOE strategy by increasing the loss-absorbing capacity of covered IHCs.

- **Clean Holding Company Requirements**
  - Scope: Covered BHCs and covered IHCs.
  - Prohibited holding company liabilities: Short-term debt issued to third parties; derivatives and other qualified financial contracts with external counterparties; certain guarantees of subsidiary liabilities or other arrangements that create disruptive default, set-off, or netting rights for subsidiaries' creditors; liabilities guaranteed by a subsidiary.
  - Capped holding company liabilities: Third-party non-contingent liabilities that are not related to TLAC or LTD and are pari passu with or junior to eligible external LTD, including customer products (e.g., structured notes) and operating liabilities (e.g., vendor liabilities, litigation liabilities, utilities, obligations to employees). Capped liabilities could not exceed 5 percent of the value of the covered BHC's eligible external TLAC.
  - Effective date: January 1, 2019.
  - Rationale: To improve the resolvability and resiliency of covered BHCs and covered IHCs by restricting the operations of those entities that could pose obstacles to orderly resolution.
- **Regulatory Capital Deduction for Investments in the Unsecured Debt of Covered BHCs**
  - Scope: State member banks, 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 foreign banking organizations ("Board-regulated institutions").[3]
  - Requirement: Investments in unsecured debt of covered BHCs that exceed certain thresholds would be deducted from regulatory capital.
  - Effective date: January 1, 2019.
  - Rationale: To reduce the systemic impact of a resolution of a covered BHC by limiting the financial sector contagion that could result from the imposition of losses on other banking organizations upon the failure of a covered BHC.

INTRODUCTION

Section 165 of the Dodd-Frank Act directs the Board to establish enhanced prudential standards for bank holding companies with total consolidated assets of $50 billion or more ("major financial companies") in order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing operations of such companies. The Board's implementation of section 165 addresses these risks through

[3] Staff intend to consult with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation regarding consistent regulatory capital treatment for investments by national banks, federal savings associations, state non-member banks, and state savings associations in the unsecured debt of covered BHCs.

two approaches. First, it seeks to reduce such companies' probability of failure through enhanced capital and liquidity requirements and heightened supervision.[4] Second, it seeks to reduce the potential negative impact on financial stability resulting from the failure of such a company through resolution planning and other efforts aimed at promoting the orderly resolution of such companies under the U.S. Bankruptcy Code and the resolution regime created by Title II of the Dodd-Frank Act ("Title II").[5]

The Board has made considerable progress in implementing the first approach. Along with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), the Board has implemented the Basel III capital rules and the portion of the Basel III liquidity rules related to the liquidity coverage ratio.[6] The Board also has adopted enhanced SLR standards and risk-based capital surcharges for U.S. GSIBs,[7] established a robust stress testing framework,[8] and created a Large Institution Supervision Coordinating Committee to strengthen the supervision of the most systemically important financial institutions operating in the United States.

U.S. regulators also have made substantial progress with respect to the second approach. The Dodd-Frank Act provides significant new authorities to the Board and the FDIC to address the failure of large, interconnected financial companies.[9] Pursuant to section 165(d) of the Dodd-Frank Act, the Board and the FDIC have been reviewing resolution plans, which are required to explain how a firm could be resolved in an orderly manner under the U.S. Bankruptcy Code were it to fail.[10] Title II creates a back-up authority to place financial companies into an FDIC receivership process if the Secretary of the Treasury determines that this course is necessary to protect the financial stability of the United States.[11]

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[4] *See* 12 U.S.C. 5365(a)(1)(A), 5371(b).

[5] *See* 12 U.S.C. 5381-5394.

[6] 79 FR 61440 (October 10, 2014).

[7] 80 FR 49082 (Aug. 14, 2015) (GSIB surcharge rule); 79 FR 24528 (May 1, 2014) (enhanced supplementary leverage ratio).

[8] 12 CFR 252.32, 252.35.

[9] 12 U.S.C. 5365 and 5384-5385.

[10] 12 U.S.C. 5365(d).

[11] *See* Section 203(b) of the Dodd-Frank Act.

Resolution of large financial firms will involve either a single-point-of-entry ("SPOE") resolution strategy or a multiple point of entry ("MPOE") resolution strategy.[12] Most of the U.S. GSIBs are developing plans that facilitate an SPOE approach in their 2015 resolution plans.

In an SPOE resolution, only the top-tier holding company of the failed banking organization would enter a resolution proceeding. The losses that caused the banking organization to fail would be passed up from the subsidiaries that incurred the losses and would then be imposed on the equity holders and unsecured creditors of the holding company. The expectation that the holding company's equity holders and unsecured creditors would absorb the banking organization's losses in the event of its failure would help maintain the confidence of the operating subsidiaries' creditors and counterparties, reducing their incentive to engage in potentially destabilizing runs. This would allow the subsidiaries to continue normal operations, without entering resolution or taking actions (such as asset firesales) that could pose a risk to financial stability.

The alternative to an SPOE resolution is an MPOE resolution. An MPOE resolution generally would entail separate resolutions of different legal entities within the financial firm and could potentially be executed by multiple resolution authorities across multiple jurisdictions.

The proposal would improve the resiliency of covered holding companies by requiring covered BHCs and covered IHCs to maintain substantially more loss-absorbing capacity. The proposal would also facilitate the resolvability of large financial firms under either an SPOE or MPOE approach. The proposal should reduce liquidity run risk at covered holding companies by mandating that they have a more substantial base of stable funding that is structurally subordinated to funding at the operating subsidiary level. This should facilitate the continued operation of operating subsidiaries of a large financial firm even if the parent or another part of the firm is in resolution. The proposal would also improve market discipline by incentivizing holders of covered BHC debt to impose greater discipline on covered BHCs, including through market pricing of covered BHCs' eligible external LTD.

The proposal would help to ensure that a covered IHC is able to be recapitalized in the context of a cross-border resolution of its foreign parent without the need to place the covered

[12] On December 10, 2013, the FDIC issued for public comment a notice that describes in detail how it would implement the SPOE approach in the context of a resolution under Title II. *See* The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy (6741-01-P) (December 10, 2013), available at http://www.fdic.gov/news/board/2013/2013-12-10_notice_dis-b_fr.pdf.

IHC into a resolution proceeding. This would reduce the risk to U.S. financial stability from the failure of the foreign GSIB parent of a covered IHC and would encourage cooperation between U.S. and foreign authorities during the resolution of the foreign GSIB parent. The proposal also would improve the ability of U.S. authorities to conduct an orderly resolution of a covered IHC separate from its foreign GSIB parent, if necessary.

OVERVIEW OF THE DRAFT PROPOSED RULE

The proposal has four requirements: (i) external LTD and TLAC requirements for covered BHCs; (ii) internal LTD and TLAC requirements for covered IHCs; (iii) "clean holding company" limitations on the operations of covered BHCs and covered IHCs; and (iv) deductions from regulatory capital of investments in the unsecured debt of covered BHCs.

A. External LTD and TLAC Requirements for U.S. GSIBs

1. Calibration

Covered BHCs would be required to maintain outstanding eligible external LTD equal to the greater of (i) 6 percent of RWAs plus the applicable GSIB capital surcharge and (ii) 4.5 percent of total leverage exposure. Covered BHCs would also be required to maintain outstanding eligible external TLAC equal to the greater of (i) 18 percent of RWAs (when fully phased in) and (ii) 9.5 percent of total leverage exposure.

2. Eligible External LTD

Eligible external LTD would be defined to be debt securities that are issued directly by the covered BHC, are unsecured, are plain vanilla (rather than being structured notes or containing derivative-linked features), and are governed by U.S. law. Eligible external LTD with a remaining maturity of less than two years would be subject to a 50 percent haircut and eligible external LTD with a remaining maturity of less than one year would cease to count towards the external LTD requirement.

The proposal would require that eligible external LTD be issued directly by the covered BHC rather than by a subsidiary to ensure that the eligible external LTD can be used to absorb losses incurred by any legal entity in the banking organization and to ensure that it can be written down during an SPOE resolution of the covered BHC, without the need for any other entity to enter resolution. To achieve this loss absorbency, the proposal would require that eligible external LTD be unsecured so that it can serve its purpose of absorbing losses in resolution; a secured creditor is generally protected from losses to the extent of the value of the collateral that secures the debt. The proposal would also provide that eligible external LTD be “plain vanilla” rather than containing derivative-linked or other exotic features to ensure that the loss-absorbing debt is available for write-down in resolution and is not unduly difficult to value. One implication of this requirement is that structured notes would not count as eligible external LTD. External debt would be considered “long term” under the proposal if it has a remaining maturity of at least one year, to ensure that it will not run off (and thus become unavailable to absorb losses) between the time when the covered BHC begins to experience severe stress and the time when it enters a resolution proceeding; the 50 percent haircut for debt with a remaining maturity of less than two years serves the same interest.

This proposal includes a separate external LTD requirement in order to address the too-big-to-fail problem. Unlike existing equity, long-term debt can be used as a fresh source of capital subsequent to failure. Imposing an external LTD requirement accordingly would help to ensure that a covered BHC would have a known and observable quantity of loss-absorbing capacity at the point of failure. Thus, the proposed external LTD requirements would more assuredly enhance the prospects for the successful resolution of a failed covered BHC and thereby address the too-big-to-fail problem than would external TLAC requirements alone.

3. Eligible External TLAC

Eligible external TLAC would be defined to be the sum of (i) common equity tier 1 capital and additional tier 1 capital issued directly by the covered BHC and (ii) eligible external LTD. With respect to the RWA component of the external TLAC requirement, an external TLAC buffer, modeled on the capital conservation buffer under the Board’s capital rules, would apply in addition to (rather than as a part of) the external TLAC requirement.[13]

The external TLAC buffer would sit on top of the 18 percent risk-based capital component of the external TLAC requirement and could be met solely with the common equity tier 1 capital of the covered BHC. The external TLAC buffer would equal the sum of 2.5 percent, any applicable countercyclical capital buffer, and the GSIB surcharge applicable under method 1 of the Board’s GSIB surcharge rule. The external TLAC buffer would differ from the capital conservation buffer under the Board’s capital rules—which is equal to the sum of 2.5 percent, any applicable countercyclical capital buffer, and any applicable GSIB surcharge—

[13] *See* 12 CFR 217.11(a).

solely in that the external TLAC buffer would use only the method 1 version of the GSIB surcharge rather than the greater of the method 1 surcharge and the method 2 surcharge. A covered BHC that did not fully meet its external TLAC buffer would be subject to restrictions on distributions and discretionary bonus payments as under the capital conservation buffer. Any covered BHC that already meets the existing capital requirements and capital buffers would be able to come into compliance with the proposal solely by issuing additional long-term debt.

Although the proposed inclusion of an external TLAC requirement along with the external LTD requirement modestly increases the overall complexity of the proposal, the inclusion of the external TLAC requirement provides a number of additional benefits. The proposed external TLAC requirement, which differs from the proposed external LTD requirement in that it can be met with going-concern capital, would increase the resiliency of the largest, most systemic banking organizations by increasing their loss-absorbing capacity. In addition, the Financial Stability Board has been developing total loss-absorbing capacity standards for GSIBs. Accordingly, the proposed external TLAC requirement would help promote comparability of loss absorbency standards across international jurisdictions.

4. Rationale for Calibration

The purpose of the proposal is to enhance the resolvability and resiliency of covered BHCs and covered IHCs, including through loss-absorbing capacity requirements that would be sufficient to maintain market and regulatory confidence during a failure scenario. Staff conducted several types of analysis to inform the calibration of the proposal.

First, staff applied a "capital refill" framework to inform the calibration of the external LTD requirement. A key premise of this framework is that the external LTD requirement should be sufficient to recapitalize the firm to at least its going-concern capital levels following a complete depletion of its going-concern capital. This framework relies on the quantitative sufficiency and transparency of, and market familiarity with, the existing regulatory capital rules. The capital refill framework implies an LTD requirement of 7 percent of RWAs plus any applicable GSIB surcharge, and 3 percent of total leverage exposure (5 percent for firms subject to the enhanced SLR). These figures were adjusted downward slightly in order to arrive at the final requirements, to account for the reduction in the firm's balance sheet that would accompany the assumed capital depletion.

Staff also looked at data on the historical returns on risk-weighted assets (RORWA) experienced by large U.S. bank holding companies ("U.S. BHCs") to assess the size of potential losses that a U.S. BHC might sustain as a way of gauging the amount of loss-absorbing capacity needed to ensure that a firm could be recapitalized following significant losses. Staff examined the historical distribution of losses relative to RWAs for U.S. BHCs, focusing on firms with losses that could be large enough to require a U.S. federal banking agency to intervene and place the firm into resolution. Staff used this subset of loss data to build a distribution of losses that would be expected of a U.S. BHC beyond those that triggered intervention. This data was then used to determine the amount of gone-concern loss-absorbing capacity needed to recapitalize the operations of the firm to an adequate level in resolution at various levels of confidence, taking into account the systemic importance of the firm. The required amount of loss-absorbing capacity implied by this analysis ranges from 7 percent to 16 percent of RWAs.

Additionally, staff analyzed the losses of select U.S. financial firms during the 2007-2009 financial crisis, including U.S. BHCs that participated in the Supervisory Capital Assessment Program ("SCAP") as well as other U.S. financial firms that were not BHCs during the period of review. For each firm, the analysis combined historical loss data, government solvency support, and loss projections from the SCAP to assess contemporaneous loss expectations during the financial crisis and the losses that could have occurred in the absence of government intervention. Staff estimated that the bank holding company with the most severe loss experience incurred losses and recapitalization needs equal to roughly 19 percent of RWAs. The proposed calibration of the external TLAC requirement is consistent with this high-water mark from the financial crisis.

The proposed calibration of the external TLAC requirement is also consistent with the November 2014 proposal of the Financial Stability Board ("FSB") for a TLAC standard, which was calibrated in significant part based on an international analysis of global bank failures. The

FSB's TLAC proposal would require each GSIB to meet an external TLAC requirement of 16 to 20 percent of RWAs.

5. Impact

Staff estimate that six of the eight U.S. GSIBs would have shortfalls relative to the proposed external TLAC requirement, that the aggregate shortfall relative to the proposed external TLAC requirement would be approximately $102 billion, that the aggregate shortfall relative to the proposed external LTD requirement would be approximately $90 billion, and that the aggregate shortfall relative to the external LTD and TLAC requirements when imposed together would be approximately $120 billion. The Board does not currently collect information from the U.S. GSIBs on their eligible external LTD as that term is defined in this proposal, but staff have estimated shortfalls on the basis of supervisory information.

Staff has analyzed the likely path of the U.S. GSIBs to come into compliance with the proposal and estimates that the aggregate increased annual funding cost for the U.S. GSIBs will lie within the range of approximately $680 million to $1.5 billion.

B. Internal LTD and TLAC Requirements for U.S. IHCs of Foreign GSIBs

1. Calibration

Under the proposal, a covered IHC—defined as a top-tier U.S. intermediate holding company that is required to be formed under the Board's enhanced prudential standards rule[14] and is controlled by a foreign GSIB—would be subject to internal LTD and TLAC requirements. Foreign GSIBs would include companies that identify themselves to the Board as such and those that the Board determines would satisfy the assessment methodology and the higher loss absorbency requirement for global systemically important banks issued by the Basel Committee on Banking Supervision.

Each covered IHC would be required to keep outstanding an amount of eligible internal LTD with an aggregate principal amount that is at least equal to the greater of: (i) 7 percent of

[14] The Board's enhanced prudential standards rule generally requires a foreign banking organization with total consolidated non-branch U.S. assets of $50 billion or more to form a single U.S. intermediate holding company over its U.S. subsidiaries. 12 CFR 252.153, 79 FR 17329 (May 27, 2014).

RWAs; (ii) for covered IHCs that are subject to the SLR, 3 percent of total leverage exposure; and (iii) 4 percent of average total consolidated assets.

The internal TLAC requirement applicable to a covered IHC would depend on whether the covered IHC (or its subsidiaries) is expected to enter a resolution proceeding if the foreign GSIB parent fails. This turns on whether the foreign GSIB parent of the covered IHC is expected to be resolved with an SPOE strategy or an MPOE strategy. A covered IHC would be a non-resolution entity covered IHC if authorities in the home country of its parent foreign GSIB provide a certification to the Board indicating that the covered IHC is a non-resolution entity covered IHC.

Each resolution entity covered IHC would be required to keep outstanding an amount of eligible internal TLAC that is at least equal to the greater of: (i) 18 percent of the covered IHC's total RWAs (when fully phased in); (ii) for covered IHCs that are subject to the SLR, 6.75 percent of the covered IHC's total leverage exposure; and (iii) 9 percent of the covered IHC's average total consolidated assets.

Each non-resolution entity covered IHC would be required to keep outstanding an amount of eligible internal TLAC that is at least equal to the greater of: (i) 16 percent of RWAs (when fully phased in); (ii) for covered IHCs that are subject to the SLR,[15] 6 percent of total leverage exposure; and (iii) 8 percent of average total consolidated assets.

2. Eligible Internal LTD

The proposal would generally require eligible internal LTD to meet the same conditions applicable to eligible external LTD. Eligible internal LTD would also be subject to the following three additional requirements.

First, eligible internal LTD (like eligible internal TLAC) would be required to be held by a foreign parent entity of the covered IHC (and not by an external investor). The purpose of this requirement is to ensure the reliable conversion of such securities into equity and avoid change-

[15] Under the IHC rule, U.S. intermediate holding companies with total consolidated assets of $250 billion or more or on-balance sheet foreign exposure of $10 billion or more are required to meet a minimum supplementary leverage ratio of 3 percent. 12 CFR 252.153(e)(2); 79 FR 17329 (March 27, 2014).

of-control disputes that could disrupt the resolution of the foreign GSIB or the resolution of the covered IHC itself.

Second, eligible internal LTD would be required to be contractually subordinated to the covered IHC's third-party liabilities. The purpose of this requirement is to ensure that the foreign GSIB parent generally would absorb the covered IHC's losses ahead of any third-party creditors and counterparties of the covered IHC. The requirement should improve the resiliency of the covered IHC, reduce the risk of third-party challenges to the recapitalization of the covered IHC, and reduce the risk of a change in control in connection with the recapitalization.

Third, eligible internal LTD would be required to contain contractual provisions pursuant to which the Board could order the covered IHC to cancel the internal LTD or convert it into equity on a going-concern basis (that is, without the covered IHC's entering a resolution proceeding) upon the occurrence of certain specified conditions. To make this finding under the proposal, the Board would consider whether the covered IHC is "in default or in danger of default"[16] and whether either (i) the home country resolution authority has placed the foreign GSIB parent into resolution proceedings (or taken similar resolution actions), (ii) the home country supervisory authority has consented to the cancellation or conversion or has failed to object to it promptly, or (iii) the Board has recommended to the Secretary of the Treasury that the covered IHC be resolved pursuant to Title II of the Dodd-Frank Act. The purpose of this requirement is to ensure that the covered IHC can transfer losses to a foreign parent without itself entering resolution.

In contrast to eligible external LTD, eligible internal LTD is designed for use in the context of a cross-border resolution of a foreign GSIB, in which the covered IHC generally would not itself enter resolution. Where the covered IHC does not enter resolution, the expectation is that the covered IHC and its material U.S. subsidiaries will remain open and operating during the resolution of the foreign GSIB. Therefore, the conversion into equity of eligible internal LTD is expected to be used primarily to avoid the covered IHC's entry into resolution and to enable it to continue normal operations during the resolution of its foreign

[16] The proposal would define "default or in danger of default" consistently with the definition of the phrase in section 203(c)(4) of the Dodd Frank Act (12 U.S.C. 5383(c)(4)).

GSIB parent, mitigating the risk that the failure and resolution of the foreign GSIB parent would pose to the financial stability of the United States.

3. Eligible Internal TLAC

Eligible internal TLAC would generally be defined to be the sum of (i) the common equity tier 1 capital and additional tier 1 capital issued from the covered IHC to a foreign entity that directly or indirectly controls the covered IHC ("foreign parent entity") and (ii) the covered IHC's eligible external LTD. With respect to the RWA component of the internal TLAC requirement, an internal TLAC buffer would apply in addition to (rather than as a part of) the internal TLAC requirement.

The internal TLAC buffer would sit on top of the 16 or 18 percent risk-based capital component of the internal TLAC requirement and could be met solely with the common equity tier 1 capital of the covered BHC. The internal TLAC buffer would equal the sum of 2.5 percent and any applicable countercyclical capital buffer, and would therefore be equal to the existing capital conservation buffer applicable to covered IHCs under the Board's capital rules. A covered IHC that did not fully meet its internal TLAC buffer would be subject to restrictions on distributions and discretionary bonus payments as under the existing capital conservation buffer.

4. Rationale for Calibration

The rationale for the calibration of the proposed internal LTD and TLAC requirements generally tracks the rationale for the calibration of the proposed external requirements. Consistent with the capital refill framework, the proposed internal LTD requirement is somewhat lower than the proposed external LTD requirement because covered IHCs are not subject to the GSIB surcharge rule and enhanced SLR that apply to covered BHCs. Additionally, the proposed internal TLAC requirements for non-resolution entity covered IHCs are slightly lower in recognition of the greater likelihood that the covered IHC will receive support from its foreign GSIB parent if the foreign GSIB parent fails and of the need for the foreign GSIB parent to retain a quantum of loss-absorbing capacity that can be flexibly allocated to subsidiaries that have incurred losses in an SPOE resolution of the foreign GSIB.

C. Clean Holding Company Requirements

In an SPOE resolution of a U.S. GSIB, the covered BHC would enter resolution while its subsidiaries would continue to operate normally. To facilitate an SPOE resolution, the proposal would prohibit or limit covered BHCs from entering into certain financial arrangements that could create obstacles to orderly resolution. The proposed restrictions are commonly referred to as "clean holding company" requirements. The covered BHC's subsidiaries would not be subject to these restrictions and could continue to enter into such arrangements.

Under the proposal, a covered BHC would be prohibited from engaging in short-term borrowings from third parties, entering into qualified financial contracts ("QFCs") with external counterparties, issuing guarantees of subsidiary liabilities that could create cross-default rights or set-off and netting rights for its subsidiaries' creditors, or having liabilities that are subject to a guarantee from a subsidiary of the covered BHC (a so-called "upstream guarantee"). These restrictions serve three related goals. First, they seek to ensure that the risk of losses to and the imposition of losses on a covered BHC's creditors does not pose an undue risk to U.S. financial stability. Prohibiting a covered BHC from having third-party short-term creditors or QFC counterparties mitigates the risk that destabilizing funding runs or asset firesales could result from the covered BHC's failure. Second, the proposed restrictions seek to ensure that a covered BHC's subsidiaries do not take losses in an SPOE resolution of the covered BHC and are instead able to continue operating normally, for instance by preventing guarantees of the covered BHC's debt by its subsidiaries along with offset rights that could have similar effects. Third, the proposed restrictions seek to limit the complexity of a covered BHC's operations so as to facilitate an orderly resolution of the covered BHC.

The proposal would also subject a covered BHC's third-party non-contingent liabilities (other than those related to eligible external TLAC) that are pari passu with or junior to its eligible external LTD to a cap of 5 percent of the value of its eligible external TLAC. These capped liabilities would include debt instruments with derivative-linked features (e.g., structured notes), litigation liabilities, and external vendor and operating liabilities (e.g., utilities, rent, fees for services, and obligations to employees). Structured notes contain features that could make their valuation uncertain, volatile, or unduly complex. Additionally, structured notes are often customer products, and the need to impose losses on financial institution customers in resolution may create obstacles to orderly resolution. While covered BHCs will necessarily have a certain amount of vendor and operating liabilities, such liabilities would be capped (to the extent that they are pari passu with or junior to eligible external TLAC) because they may need to be protected from losses in resolution, and so capping these liabilities diminishes the likelihood of a violation of the principle that no creditor (including eligible external LTD creditors) should recover less in a resolution proceeding than he would have received in a liquidation of the covered BHC under the U.S. Bankruptcy Code.

The proposal also would subject covered IHCs to most of the same clean holding company requirements that would apply to U.S. GSIBs. However, since eligible internal LTD would be required to be contractually subordinated to all of a covered IHC's third-party liabilities, the 5 percent cap proposed for covered BHC liabilities would have no additional effect on covered IHCs and therefore would not be applied to them.

D. Regulatory Capital Deduction for Investments in the Debt of Covered BHCs by Board-Regulated Institutions

All holders of the unsecured liabilities of a U.S. GSIB would be expected to suffer losses in resolution, as necessary, in order to recapitalize the firm without reliance on public sector capital support. To further mitigate the financial sector contagion that could result from the failure of a U.S. GSIB and the consequent imposition of losses on its unsecured creditors, the proposal would subject Board-regulated institutions to a capital deduction treatment for their investments in the unsecured debt of a covered BHC. In particular, state member banks ("SMBs"), BHCs and savings and loan holding companies ("SLHCs") with more than $1 billion in total consolidated assets, and IHCs formed to comply with the Board's enhanced prudential standards for foreign banking organizations generally would be required to deduct from their regulatory capital any investments in unsecured debt issued by covered BHCs (including eligible external LTD) in excess of certain thresholds, in parallel with the existing deduction treatment applicable to investments by Board-regulated institutions in the capital of unconsolidated financial institutions.

The proposed regulatory deduction treatment would apply only to investments in the covered BHC—that is, the top-tier bank holding company of a U.S. GSIB—and would not affect investments in the unsecured liabilities of the subsidiaries of a covered BHC.

Staff intend to consult with the OCC and the FDIC regarding consistent regulatory capital treatment for investments in the unsecured debt of covered BHCs by national banks, federal savings associations, state nonmember banks, and state savings associations.

E. Timing

1. External LTD and TLAC Requirements

Under the proposed rule, banking organizations that qualify as covered BHCs when the final rule is issued would be required to comply with the external LTD and TLAC requirements by January 1, 2019. However, calibration of the RWA component of the external TLAC requirement would be phased in over time, with an initial requirement of 16 percent of RWAs as of January 1, 2019, and a final requirement of 18 percent of RWAs as of January 1, 2022.

A firm that subsequently becomes a covered BHC would be required to comply within 3 years of becoming a covered BHC.

2. *Internal LTD and TLAC Requirements*

Under the proposed rule, companies that are covered IHCs when the final rule is issued would be required to comply with the internal LTD and TLAC requirements by January 1, 2019. However, calibration of the RWA component of the internal TLAC requirement would be phased in over time as follows. Non-resolution entity covered IHCs would be subject to an initial requirement of 14 percent of RWAs as of January 1, 2019, and a final requirement of 16 percent of RWAs as of January 1, 2022. Resolution entity covered IHCs would be subject to an initial requirement of 16 percent of RWAs as of January 1, 2019, and a final requirement of 18 percent of RWAs as of January 1, 2022.

A foreign banking organization that subsequently becomes required to establish a covered IHC would be required to comply within 3 years of becoming required to establish a covered IHC.

3. *Clean Holding Company Requirements for U.S. GSIBs and Covered IHCs*

The clean holding company requirements would become effective as of January 1, 2019. A firm that subsequently becomes a covered BHC or a covered IHC would be required to comply within 3 years of becoming a covered BHC or a covered IHC.

4. *Regulatory Capital Deduction for Investments in the Unsecured Debt of Covered BHCs*

The proposed regulatory capital deduction would become effective as of January 1, 2019.

CONCLUSION

Staff recommends that the Board approve the attached draft proposed rule to establish external LTD and TLAC requirements for covered BHCs, along with a related external TLAC buffer; to establish internal LTD and TLAC requirements for covered IHCs, along with a related internal TLAC buffer; to impose clean holding company requirements on covered BHCs and covered IHCs; and to impose a regulatory capital deduction approach for Board-regulated institutions' investments in the unsecured debt of a covered BHC. The Federal Register notice would provide the public until February 1, 2016, to comment on the proposal. Staff also seeks approval to make technical and minor changes to the draft Federal Register documents in order to prepare them for publication.

Attachment