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Memorandum

Federal Banking Agencies Propose Rules Expanding Long-Term Debt and "Clean Holding Company Requirements" to Non-GSIB Banking Organizations

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On August 29, 2023, the federal banking agencies jointly proposed rules that would significantly expand the scope of banking organizations required to issue and maintain a minimum amount of qualifying long-term debt ("LTD") to include depository institution holding companies (*i.e.*, bank holding companies, and savings and loan holding companies) that are subject to the Federal Reserve's Category II, III or IV enhanced prudential standards (including Category II, III and IV U.S. intermediate holding companies of foreign banking organizations), as well as insured depository institutions ("IDIs") that have at least $100 billion in total assets or are affiliated with IDIs that have $100 billion in total assets. Under the proposal, only debt instruments with certain loss-absorbing features (related to, for example, subordination, term, and acceleration) would qualify as eligible LTD.

The proposed rules would also impose restrictions referred to as "clean holding company requirements" on other liabilities that covered entities may have outstanding, as well as amend the Federal Reserve's existing "total loss absorbing capacity" ("TLAC") rule applicable to global systemically important banking organizations ("GSIBs") to improve harmony between provisions within the TLAC rule and address items that have been identified through the administration of the existing TLAC rule.

The final rules would be subject to a proposed three-year transition period. The following memo summarizes key features of the proposed rules.

LTD Requirements for IDI Holding Companies

A. SCOPE OF APPLICATION

The proposed rules would require minimum LTD, as described further below, for all depository institution holding companies (*i.e.*, bank holding companies and savings and loan holding companies) that are subject to the Federal Reserve's Category II, III or IV enhanced prudential standards, as well as Category II, III and IV U.S. intermediate holding companies ("IHCs") of foreign banking organizations. In addition, minimum LTD standards would also apply to IDIs that have at least $100 billion in total assets or are affiliated with an IDI that has at least $100 billion in total assets (other than IDIs that are consolidated subsidiaries of U.S. GSIBs). This scope of application under the proposal would generally result in all banking organizations with at least $100 billion in total assets being subject to a minimum LTD requirement.

B. MINIMUM LTD LEVELS

The proposed rules would require a covered entity (including both a covered holding company and a covered IDI) to maintain eligible LTD in an amount not less than the greater of: (i) 6% of the covered entity's total risk-weighted assets, (ii) 2.5% of the covered entity's total leverage exposure (if subject to the Supplementary Leverage Ratio) and (iii) 3.5% of the covered entity's average total consolidated assets (as computed for purposes of the U.S. Tier 1 leverage ratio). Prior approval requirements also apply to redemptions or repurchases of eligible LTD that would result in a covered holding company falling below its minimum LTD levels.

These required minimum LTD levels for covered entities, calibrated by the agencies under a "capital refill" framework, would be consistent with the levels of LTD currently required to be maintained by U.S. IHCs of non-U.S. GSIBs, and are only moderately less than the minimum LTD levels currently required to be maintained by U.S. GSIBs. Notably, the proposal would also not differentiate the amounts of minimum LTD required to be maintained among Category II, III and IV covered holding companies or their IDI subsidiaries.

C. INTERNALLY VS. EXTERNALLY ISSUED LTD

Under the proposal, certain covered entities would be required to issue the minimum LTD internally to a consolidated parent entity, while other covered entities would be required to issue the minimum LTD externally to unaffiliated third-party investors.

- *Covered U.S. Holding Companies*: Any covered U.S. holding company (other than a covered IHC of a foreign banking organization) may only issue eligible "external" LTD to satisfy the proposed LTD requirement.
- *Covered IHCs of Foreign Banking Organizations*:
  - For covered IHCs that are not expected to go into resolution in the event of its foreign parent's failure, but rather would be maintained as a going concern while the foreign parent entity is resolved ("non-resolution IHCs"), eligible LTD would be required to consist of internal LTD held by a foreign parent or wholly owned subsidiary of the foreign parent.
  - For covered IHCs that are themselves expected to go into resolution in the U.S. in the event of its foreign parent's failure ("resolution IHCs"), eligible LTD may consist of either internal LTD or external LTD.
- *Covered IDIs*:
  - Any covered IDI that is not controlled by a parent entity may only issue eligible "external" LTD to satisfy the proposed LTD requirement.
  - Any covered IDI that is a consolidated subsidiary of a covered entity or a non-U.S. GSIB IHC may only issue eligible "internal" LTD to satisfy the proposed LTD requirement.

- ◦ For any covered IDI that is a consolidated subsidiary of a company other than a covered holding company, U.S. GSIB or non-U.S. GSIB, or a covered IDI that is controlled but not consolidated by another company, eligible LTD may consist of either internal LTD (to the extent held by a parent that consolidates the covered IDI) or external LTD.

D. LTD ELIGIBILITY REQUIREMENTS

1. Eligible External LTD

To qualify as eligible external LTD, the debt must be paid in, issued directly by the applicable covered entity in denominations of at least $400,000 to a non-affiliate, governed by U.S. law, unsecured and not guaranteed, with "plain vanilla" features and a maturity of greater than one year from issuance.

Because the proposal would require that the debt be issued directly by the covered entity to be eligible, neither debt instruments issued by a subsidiary of the covered entity nor trust preferred securities issued to investors by a trust would qualify as eligible external LTD. The proposal would also require that the debt be unsecured, not guaranteed by the covered entity or an affiliate of the covered entity, and not subject to any other arrangement that legally or economically enhances the seniority of the instrument (such as a credit enhancement provided by an affiliate).

In addition, the proposal would require eligible LTD issued by a covered IDI to be contractually subordinated so that the claim represented by the LTD in the receivership of the IDI would be junior to deposit and general unsecured claims.

The requirement that external LTD instruments be "plain vanilla" would generally prohibit the inclusion of structured notes, instruments with credit-sensitive features, or instruments with contractual rights to equity conversion. This requirement would generally disqualify certain instruments that qualify as Tier 2 capital, such as certain forms of preferred stock and convertible debt, although other Tier 2 capital instruments that otherwise satisfy the criteria for eligible external LTD will count towards the minimum required LTD levels.

The proposal would also generally prohibit contractual rights that permit acceleration of payment for eligible external LTD, but allow for put rights as of a future date certain (subject to the maturity requirements discussed below) and for payment acceleration in the event of the covered entity's insolvency, resolution or failure to pay principal or interest if such failure continues for at least 30 days. Instruments outstanding as of the publication of final rules that include otherwise impermissible acceleration provisions, are issued in denominations of less than $400,000, or (in the case of IDI-issued debt), are not contractually subordinated to general unsecured creditors are eligible for the grandfathering benefits discussed below.

In general, principal due to be paid in less than one year would not count towards an institution's minimum LTD, and any amounts due to be paid in one to two years would be subject to a 50% haircut for purposes of satisfying the minimum LTD requirement. Debt subject to a put right would be treated as if it were to mature on the day it first becomes subject to the put right.

As an added catchall, the proposed rules would allow the applicable federal banking agency to order a covered entity to exclude from its outstanding eligible LTD any debt securities with features that would "significantly impair the ability of such debt security to take losses."

2. Eligible Internal LTD

The requirements for eligible internal LTD would generally be the same as those for eligible external LTD. However, eligible internal debt securities are subject to two key distinctions from eligible external debt securities under the proposed rule. First, eligible internal LTD issued by an IDI must be issued to and remain held by a company that consolidates the covered IDI, generally an upstream parent. Second, eligible internal LTD would not be subject to a minimum principal denomination requirement. In addition, eligible internal LTD issued by a covered IHC may include credit sensitive features, but would be required to include a contractual conversion provision pursuant to which the Federal Reserve could require the IHC, under certain circumstances, to convert or exchange some or all of the internal LTD into CET1 capital of the IHC without the covered IHC's entry into a resolution proceeding. This conversion provision must be triggered if both (a) the Federal Reserve determines that the covered IHC is "in default or in danger of default," and (b) any of the following circumstances apply:

(i) the top-tier foreign banking organization or any of its subsidiaries have been placed into home-country resolution proceedings;

(ii) the home country supervisory authority consents to the conversion or exchange or does not object to the conversion or exchange following 24 hours' notice; or

(iii) the Federal Reserve has made a written recommendation to the Secretary of the Treasury that the FDIC should be appointed as receiver of the covered IHC under the "orderly liquidation authority" of the Dodd-Frank Act.

Clean Holding Company Requirements

In addition to the minimum LTD requirements described above, the proposed rules include certain restrictions on the ability of covered holding companies (including covered IHCs) to enter into financial arrangements that could impede the entity's orderly resolution or increase the risk that financial market contagion would result from the entity's resolution. Specifically, the proposed rules would prohibit a covered holding company from:

- engaging in borrowing with an original maturity of less than one year from third parties (including through deposits);
- entering into "qualified financial contracts" with third parties (although entering into credit enhancements of qualified financial contracts issued by subsidiaries is permitted);[1]

[1] "Qualified financial contracts" include securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and similar agreements as determined by the FDIC.

- issuing guarantees of subsidiary liabilities that could create cross-default rights or set-off and netting rights for its subsidiary's creditors (unless the liability is subject to requirements of the Federal Reserve or other banking agencies restricting such default rights); and
- entering into agreements with "upstream guarantees" of its liabilities from a subsidiary of the covered holding company.

These restrictions will apply only prospectively to contracts entered into after the post-transition period effective date of a final rule.

The proposed rules would cap the value of a covered institution's third-party non-eligible LTD liabilities that are pari passu with or junior to its eligible external LTD at 5% of the value of the institution's total tier 1 capital (excluding minority interests) and eligible LTD amount.

Regulatory Capital Deductions for Investments in Covered Institutions

Existing capital rules discourage cross-holdings of LTD by other banking organizations by requiring U.S. GSIBs and Category II banking organizations to apply regulatory capital deductions for investments in external LTD issued by another banking organization. The proposal would expand the current deduction framework in the capital rule to require capital deductions for investments by U.S. GSIBs and Category II banking organizations in the eligible external LTD issued by entities covered by the proposal.

The proposal would not itself otherwise amend the capital rule's deduction framework. Notably, however, the recently released Basel III reforms proposal would subject Category III and IV banking organizations to the LTD deduction framework, and would apply a heightened risk weight to investments in LTD issued by other banking organizations that are not deducted.

Grandfathering and Compliance Dates

The proposal would include explicit grandfathering provisions allowing covered entities to count towards their minimum *external* LTD requirement debt instruments issued prior to the publication of final rules that include payment acceleration provisions, are issued in denominations of less than $400,000, or (in the case of IDI-issued debt), are not contractually subordinated to general unsecured creditors, in each case if such instruments otherwise satisfy the requirements of eligible external LTD.

In addition, eligible legacy external LTD issued by a consolidated subsidiary IDI of a covered entity may be used to satisfy the minimum external LTD requirement applicable to the IDI's parent covered holding company, as well as any internal LTD requirement applicable to the subsidiary IDI itself. However, the proposed rules do not allow for grandfathering of any outstanding internal LTD instruments, on the assumption that the burden to issue fully compliant instruments to affiliates should be low.

The agencies propose to provide covered entities and covered IDIs (regardless of whether the covered IDI is required to issue internal or external LTD) three years to achieve compliance with the rule. Over that three-year period, covered entities would need to meet 25% of their LTD requirements by one year after finalization of the rule, 50% after two years of finalization, and 100% after three years.

Technical Changes to Existing TLAC Rules

Finally, the proposed rule would make some conforming and other changes to the existing LTD and "clean holding company" rules for U.S. GSIBs and IHCs of foreign GSIBs. These would include conforming changes to require minimum denominations for eligible LTD and to apply the 50% haircut to eligible LTD approaching maturity for purposes of compliance with both the minimum TLAC and LTD requirements, technical clarifications to the "clean holding company" requirements (*e.g.*, to permit covered holding companies to enter underwriting agreements, share repurchase agreements and director and officer compensation agreements) and enhanced disclosure requirements. The proposed rule would also specifically authorize the Federal Reserve to require LTD and TLAC levels greater or less than the minimum requirements specified in the rule.

To read our overview of the federal banking agencies proposed rules and guidance, please click here. Additional detail regarding the proposals relating to resolution planning is available here.

For further information regarding this memorandum, please contact any member of the Firm's Financial Institutions Group, including those listed below.

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