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Memorandum

Federal Reserve Adopts Final Rules Establishing Total Loss-Absorbing Capacity and "Clean Holding Company Requirements" for GSIBs

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On December 15, the Federal Reserve finalized rules that establish minimum required amounts of long-term debt ("LTD") and total loss-absorbing capacity ("TLAC") for the top-tier U.S. bank holding companies of global systemically important banking organizations ("GSIBs").[1] The final rules also impose restrictions referred to as "clean holding company requirements" on other liabilities that such entities may have outstanding. The final rules, which take effect January 1, 2019, apply capital and other requirements to both the top-tier bank holding companies of U.S. GSIBs and the U.S. intermediate holding companies ("IHCs") of non-U.S. GSIBs, but in each case aim to promote the financial stability of the United States by enhancing the resiliency and resolvability of covered GSIBs in the event of their failure or material financial distress without the need for government or taxpayer support. The following memo summarizes key features of the final rules.

LTD and TLAC Requirements for U.S. GSIBs

The final rules apply minimum LTD and TLAC requirements, each as described further below, to any U.S. bank holding company identified by the Federal Reserve as a GSIB under the Federal Reserve's GSIB surcharge rule.[2] To date, eight bank holding companies have been identified by the Federal Reserve as GSIBs and are therefore subject to the final rules, although other banking organizations may become subject to the final rule in the future.[3]

1 A copy of the final rules is available here.

2 12 C.F.R. § 217.402; 80 Fed. Reg. 49106 (Aug. 14, 2015).

3 The eight bank holding companies that have been identified as GSIBs to date are Bank of America, BNY Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo.

A. U.S. GSIB Minimum LTD Requirement

1. *Eligible External LTD for U.S. GSIBs*

Under the final rules, a U.S. GSIB will be required to maintain a minimum amount of loss-absorbing LTD instruments, or "external LTD," which the rules intend to be held by unaffiliated third-party investors. These debt instruments would be used to pass losses from the banking organization to investors in the event of the U.S. GSIB's resolution or replenish the U.S. GSIB's equity capital, although the final rules do not require that eligible external LTD contain an explicit "bail-in" mechanism (in contrast to the debt conversion mechanism that applies to the internal LTD of covered IHCs). To qualify as eligible external LTD, the debt must be paid in, issued directly by the U.S. GSIB, unsecured and not guaranteed, with "plain vanilla" features and governed by U.S. law.

Because the debt must be issued directly by the covered U.S. GSIB to be eligible, neither debt instruments issued by a subsidiary of the U.S. GSIB nor trust preferred securities issued to investors by a trust would qualify as eligible external LTD. The debt must also be unsecured, not guaranteed by the covered U.S. GSIB or a subsidiary of the covered U.S. GSIB, 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).

The requirement that external LTD instruments be "plain vanilla" generally prohibits 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 final rules 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 U.S. GSIB's insolvency, liquidation or failure to pay principal or interest if such failure continues for at least 30 days.[4] Instruments outstanding as of December 31, 2016 that include otherwise impermissible acceleration provisions or are governed by non-U.S. law are eligible for the grandfathering benefits discussed below.

In general, principal due to be paid in less than one year will not count towards an institution's minimum LTD, and any amounts due to be paid in one to two years are subject to a 50% haircut for

[4] This required 30-day cure period for failure to pay principal on eligible external LTD is not currently contained in most issuers' default provisions.

purposes of satisfying the minimum LTD requirement. Debt subject to a put right will be treated as if it were to mature on the day it first becomes subject to the put right. Despite the 50% haircut for purposes of satisfying the minimum LTD requirement, amounts due to be paid in one to two years will count at full value for purposes of satisfying the minimum TLAC requirement.

As an added catchall, the final rules allow the Federal Reserve to order a U.S. GSIB 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. *Minimum External LTD Levels for U.S. GSIBs*

External LTD is a subcategory of the required minimum TLAC amount, but is subject to its own minimum requirement. The final rules require a covered U.S. GSIB to maintain eligible external LTD in an amount not less than the greater of: (i) 6% (plus any applicable GSIB surcharge) of the covered U.S. GSIB's total risk-weighted assets and (ii) 4.5% of the covered U.S. GSIB's total leverage exposure. In addition, any redemption or repurchase of eligible external LTD that would cause the U.S. GSIB to fall below these minimum external LTD levels (or the minimum TLAC levels described below) will require prior Federal Reserve approval.

B. U.S. GSIB Minimum TLAC Requirement

1. *Eligible External LTD for U.S. GSIBs*

For purposes of the minimum TLAC requirement, a U.S. GSIB's eligible TLAC consists of the sum of: (i) the GSIB's Tier 1 regulatory capital, including Common Equity Tier 1 ("CET1") capital and Additional Tier 1 capital, issued directly by the GSIB *plus* (ii) the GSIB's eligible external LTD. As noted below, however, only Tier 1 regulatory capital is eligible to satisfy the TLAC leverage buffer requirement, and only CET1 capital is eligible to satisfy the TLAC risk-weighted buffer requirement.

2. *Minimum TLAC Levels for U.S. GSIBs*

The final rules require a U.S. GSIB to maintain outstanding eligible TLAC in an amount not less than the greater of two components: (i) 18% of the U.S. GSIB's total risk-weighted assets and (ii) 7.5% of the U.S. GSIB's total leverage exposure.[5]

Each of the risk-weighted assets component and the leverage component of the minimum TLAC requirement is subject to an additional buffer requirement, analogous to the existing capital

[5] An institution's total leverage exposure is the denominator of the institution's supplementary leverage ratio under the Federal Reserve's capital rules.

conservation buffer and enhanced supplementary leverage ratio buffer under the Federal Reserve's Regulation Q.

For the risk-weighted assets component, the buffer requirement must be filled only with CET1 capital, in an amount at least equal to the sum of (i) 2.5% of risk-weighted its assets, (ii) any applicable countercyclical buffer and (iii) the GSIB surcharge applicable under "method 1" of the Federal Reserve's GSIB surcharge rule.[6] For the leverage component, the buffer requirement must be filled only with Tier 1 regulatory capital, in an amount at least equal to 2% of the U.S. GSIB's total leverage exposure.

If a U.S. GSIB fails to maintain its required buffer amount for either the risk-weighted assets or leverage component, it would be subject to restrictions on capital distributions and discretionary bonus payments, including an outright prohibition on such distributions and payments if the U.S. GSIB's applicable buffer level were less than or equal to 25% of the minimum buffer level mandated by the rule.

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

Similar to the requirements for minimum LTD and TLAC applicable to U.S. GSIBs, minimum LTD and TLAC standards also apply to U.S. IHCs established pursuant to Regulation YY and controlled by a foreign banking organization ("FBO") that would be identified by the Federal Reserve as a GSIB either under the Basel Committee's assessment methodology or, if it were subject to Regulation Q, under the Federal Reserve's GSIB surcharge rule.

A. Covered IHC Minimum LTD Requirement

1. Eligible LTD for Covered IHCs

A covered IHC's eligible LTD will be subject to many of the same requirements as apply to eligible LTD for U.S. GSIBs. For covered IHCs, eligible LTD must be paid in, issued directly from the covered IHC and governed by U.S. law, as well as unsecured, not guaranteed by the IHC or a subsidiary, and not subject to any other seniority-enhancing arrangement.

The debt must have a remaining maturity of at least one year, and any amount due to be paid in one to two years is subject to a 50% haircut. An IHC's LTD instruments must generally be "plain vanilla,"

[6] The "method 1" surcharge was addressed in the Federal Reserve's GSIB surcharge rule from July 20, 2015 (80 Fed. Reg. 49082 (Aug. 14, 2015)). The surcharge, ranging from 0% or 3.5%, is comprised exclusively of CET1 capital and is based on a particular firm's "systemic indicator scores," reflecting size, interconnectedness, cross-jurisdictional activity, substitutability, and complexity relative to the other U.S. and foreign banking organizations identified by the Basel Committee and any other banking organization included in the Basel Committee's sample for a given year. A higher score generally results in a higher surcharge.

but may include the same acceleration provisions permitted for LTD instruments of U.S. GSIBs. Additionally, the Federal Reserve has the same catchall authority to order a covered IHC 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."

However, several features distinguish eligible LTD for covered IHCs from eligible LTD for U.S. GSIBs. While the final rules intend for eligible LTD of U.S. GSIBs to be held by unaffiliated third-parties, different requirements apply to the holders of a covered IHC's LTD, depending on the covered IHC's expected resolution scenario in the event of failure of its foreign parent. 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 must consist of internal debt securities held by a foreign parent or subsidiary. For covered IHCs that are themselves expected to go into resolution in the event of its foreign parent's failure ("resolution IHCs"), eligible LTD may, by contrast, may consist of either internal debt securities or external debt securities held by an unaffiliated third-party.

For both resolution and non-resolution IHCs, eligible LTD consisting of internal debt securities must include a contractual 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 without the covered IHC's entry into a resolution proceeding. This 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 FBO 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.

2. Minimum LTD Levels for Covered IHCs

As for U.S. GSIBs, eligible LTD for covered IHCs is a subcategory of the IHC's eligible TLAC subject to its own minimum requirement. The final rules require a covered IHC to maintain eligible LTD in an amount not less than the greater of: (i) 6% of the covered IHC's total risk-weighted assets, (ii) 2.5% of the covered IHC's total leverage exposure (if subject to the Supplementary Leverage Ratio) and (iii) 3.5% of the covered IHC'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 IHC falling below its minimum LTD or TLAC levels.

B. Covered IHC Minimum TLAC Requirement

1. *Eligible TLAC for Covered IHCs*

TLAC eligible to satisfy the final rules requirement for covered IHCs is defined similarly to eligible TLAC for U.S. GSIBs, consisting of Tier 1 regulatory capital (including CET1 and Additional Tier 1 capital) issued directly by the covered IHC plus the covered IHC's eligible LTD. Unlike for U.S. GSIBs, however, only Tier 1 regulatory capital issued to a foreign entity that directly or indirectly controls the covered IHC qualifies for purposes of the minimum TLAC requirement and, as described above, the restrictions applicable with respect to holders of eligible LTD will depend on the covered IHC's expected resolution scenario in the event of failure of its foreign parent.

2. *Minimum TLAC Levels for Covered IHCs*

The amount of eligible TLAC that a covered IHC will be required to maintain depends on whether the covered IHC is a "resolution" or a "non-resolution" IHC.

For non-resolution IHCs, the final rules require TLAC in an amount not less than the greater of: (i) 16% of the covered IHC's total risk-weighted assets, (ii) 6% of the covered IHC's total leverage exposure and (iii) 8% of the covered IHC's average total consolidated assets.

For resolution IHCs, the final rules require TLAC in an amount not less than the greater of: (i) 18% of the covered IHC's total risk-weighted assets, (ii) 6.75% of the covered IHC's total leverage exposure and (iii) 9% of the covered IHC's average total consolidated assets.

All covered IHCs will be subject to a TLAC buffer analogous to the risk-weighted assets TLAC buffer applicable to U.S. GSIBs. A covered IHC will be required to maintain a TLAC buffer equal to the sum of: (i) 2.5% of risk-weighted assets and (ii) any applicable countercyclical buffer. Similar to the TLAC buffer requirements applicable to U.S. GSIBs, the TLAC buffer for covered IHCs may be satisfied only using the IHC's CET1 capital, and shortfalls in the buffer would result in restrictions on the IHC's distributions and discretionary bonus payments (including an outright prohibition on such distributions and payments if the covered IHC's TLAC buffer level were less than or equal to 25% of the minimum level mandated by the rule).

The final rules do not impose a buffer with respect to the leverage TLAC component for covered IHCs, since covered IHCs are not subject to the Federal Reserve's enhanced supplementary leverage ratio.

Clean Holding Company Requirements

In addition to the minimum LTD and TLAC requirements described above, the final rules include certain restrictions on the ability of covered U.S. GSIBs and 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 final rules prohibit a U.S. GSIB or covered IHC 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 is permitted);[7]
- 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 institution.

These restrictions will apply only to contracts entered into on or after January 1, 2019.

The final rules cap the value of a covered institution's third-party non-contingent liabilities (other than instruments used to satisfy the institution's minimum TLAC and external LTD levels) that are permitted to be pari passu with or junior to its eligible external LTD at 5% of the value of the institution's eligible external TLAC. Capped liabilities include debt instruments with derivative-linked features (*e.g.*, structured notes), litigation liabilities, obligations to employees and external vendor or other operating liabilities. A covered institution would not be subject to this cap if all of its eligible LTD were to represent the most subordinated debt claim of the institution.

Regulatory Capital Deductions for Investments in Covered Institutions

While the October 2015 proposed rules would have required all institutions regulated by the Federal Reserve to deduct from its regulatory capital the net long position of its investments in the unsecured debt of a covered U.S. GSIB, the final rules do not include this requirement. Instead, the Federal Reserve indicated that it intends to work with the OCC and the FDIC towards a proposed interagency approach regarding regulatory capital treatment for investments in GSIB-issued debt instruments, which would allow for consistent application for all banking organizations.

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

Public Disclosure Requirements

The final rules require each U.S. GSIB to publicly disclose a description of the financial consequences to unsecured debtholders of the covered firm's entry into a resolution proceeding in which the covered firm is the only entity that would enter resolution. This disclosure may be provided on the U.S. GSIB's website or in public financial reports, and must also be included in the offering documents for all new issuances of eligible external LTD securities.

Resolution IHCs that issue external LTD instruments to unaffiliated third-party investors are also subject to the same disclosure requirements.

Although the final rules do not require covered institutions to provide regular reports on their eligible LTD and TLAC amounts, the Federal Reserve has indicated that it intends to propose such reporting requirements in the future.

Grandfathering and Compliance Dates

After the release of the October 2015 proposed rules, commenters noted that nearly all outstanding LTD issued by U.S. GSIBs includes standard market acceleration provisions, and that a significant fraction of outstanding LTD instruments is governed by foreign law. Absent an explicit grandfathering provision, these characteristics would render the existing outstanding LTD ineligible under the rules, creating a significant LTD shortfall and compliance burden.

In response to these comments, the Federal Reserve included in the final rules explicit grandfathering provisions, allowing U.S. GSIBs to count towards their minimum LTD requirement debt instruments issued prior to December 31, 2016 that are governed by foreign law or that include payment acceleration provisions if such instruments otherwise satisfy the requirements of eligible external LTD.

Resolution IHCs with outstanding external LTD instruments issued to unaffiliated third-parties are also entitled to these same grandfathering benefits. However, the final rules do not allow for grandfathering of any outstanding internal LTD instruments, as the Federal Reserve assumes that the burden to issue fully compliant instruments to affiliates should be low.

In light of the added grandfathering provisions, the Federal Reserve determined that its proposed phase-in period would be unnecessary. Accordingly, covered firms will be required to comply with the final rules in all respects, including the clean holding company requirements, by January 1, 2019. Going forward, any institution that becomes designated by the Federal Reserve as a GSIB (or that becomes an IHC whose parent FBO would be designated by the Federal Reserve as a GSIB) must comply with the final rules within three years.

For more information regarding the final TLAC rules, please contact any member of the Firm's Financial Institutions Group.

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