

Banking Agencies Finalize Rule on TLAC Deduction Framework

November 3, 2020

On October 20, 2020, the Federal Reserve Board (the “FRB”), the Federal Deposit Insurance Corporation (the “FDIC”) and the Office of the Comptroller of the Currency (the “OCC” and, collectively with the FRB and the FDIC, the “Agencies”), issued a final rule (the “Final Rule”) that modifies the framework for the capital treatment of advanced approaches banking organizations’ investments in unsecured debt instruments issued by non-U.S. and U.S. global systemically important banking organizations (“GSIBs”), including U.S. intermediate holding companies of non-U.S. GSIBs. In general, the Final Rule requires deductions from capital for direct, indirect, and synthetic exposures to certain unsecured debt instruments. The Agencies also adopted changes to related regulatory reporting forms and made technical revisions to the final total loss absorbing capacity rule (the “TLAC Rule”).¹ The Final Rule goes into effect on April 1, 2021.

Below is our summary of the Final Rule, including a comparison of how key issues were treated in the April 2019 proposed rule (the “Proposed Rule”). A redline showing changes to the current regulatory text is available [here](#).

Scope of Application

Consistent with the Proposed Rule, the Final Rule applies only to “advanced approaches banking organizations,” as that term was revised by the interagency tailoring final rule.² Advanced approaches banking organizations include (i) banking organizations subject to Category I standards, i.e., U.S. GSIBs, and (ii) banking organizations subject to Category II standards, i.e., banking organizations with (a) \$700 billion or more in total consolidated assets or (b) \$75 billion or more in cross-jurisdictional activity and more than \$100 billion in total consolidated assets. The Final Rule also applies to any subsidiary depository institution of such banking organizations. Currently, the advanced

¹ See 82 Fed. Reg. 8266 (Jan. 24, 2017).

² Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 84 Fed. Reg. 59230 (Nov. 1, 2019). For a detailed summary of the tailoring rules, please see our previous update [here](#).

approaches banking organizations are composed of the U.S. GSIBs and Northern Trust Corporation. In the preamble to the Final Rule, the Agencies indicate that they will continue to evaluate whether additional steps are warranted to address the systemic risks associated with other banking organizations' investments in covered debt instruments (defined below).

Scope of Covered Debt Instruments

Under the Final Rule, exposures of an advanced approaches banking organization to “covered debt instruments” are generally subject to deduction. A covered debt instrument could be issued by a U.S. GSIB’s top-tier parent holding company (a “covered BHC”), a U.S. intermediate holding company of a non-U.S. GSIB that is subject to the TLAC Rule (a “covered IHC”), or by a non-U.S. GSIB or its subsidiary that is not a covered IHC. The definition of covered debt instrument varies depending on whether the instrument is issued by a covered BHC, a covered IHC or a non-U.S. GSIB. In general, and as described in more detail below, the deduction is for debt instruments issued for the purpose of meeting minimum TLAC requirements, or for unsecured debt instruments that are *pari passu* or subordinated to such debt instruments.

Covered BHCs and Covered IHCs

The scope of covered debt instruments issued by a covered BHC or covered IHC is unchanged from the Proposed Rule. Under the Final Rule, the term covered debt instrument includes the following:

- *Covered BHC.* An unsecured debt instrument issued by a covered BHC and that is an “eligible debt security” as defined in the TLAC Rule.³ An eligible debt security generally refers to a type of long-term debt instrument that is considered to be loss-absorbing under the TLAC Rule, including that meets specified requirements, including having a remaining maturity of at least one year and being governed by U.S. law.
- *Covered IHC.* An unsecured debt instrument issued by a covered IHC and that is an “eligible Covered IHC debt security” as defined in the TLAC Rule.⁴ An eligible Covered IHC debt security similarly refers to a loss-absorbing long-term debt instrument.

³ See 12 CFR 252.61.

⁴ See 12 CFR 252.161. Under the TLAC Rule, certain covered IHCs are permitted to issue external long-term debt for purposes of satisfying their TLAC requirements.

- *Pari Passu Instruments Issued by Covered BHCs and Covered IHCs.* For covered BHCs and covered IHCs, covered debt instruments also include any instrument that is *pari passu* or subordinated to an eligible debt security. In addition, as in the Proposed Rule, the Final Rule explicitly excludes a debt instrument that qualifies as tier 2 capital under the capital rule, or that is otherwise treated as regulatory capital by the primary supervisor of the issuer, from the definition of covered debt instrument.

Accordingly, covered debt instruments include both TLAC-eligible long-term debt instruments and other unsecured debt instruments, such as structured notes, that are *pari passu* or subordinated to such TLAC debt.

Non-U.S. GSIBs

The definition of a covered debt instrument issued by a non-U.S. GSIB or by any of its subsidiaries (other than a covered IHC) departs in part from the proposed definition, primarily by narrowing the scope of *pari passu* or subordinated instruments that would be covered. The Final Rule includes such a covered debt instrument where:

- The instrument is eligible for use to comply with an applicable law or regulation requiring the issuance of a minimum amount of instruments to absorb losses or recapitalize the issuer or any of its subsidiaries in connection with a resolution, receivership, insolvency, or similar proceeding of the issuer or any of its subsidiaries; or
- The instrument is *pari passu* or subordinated to any such instrument, provided that if the issuer may be subject to a special resolution regime, in its jurisdiction of incorporation or organization, that addresses the failure or potential failure of a financial company and any instrument described above is eligible under that special resolution regime to be written down or converted into equity or any other capital instrument, then an instrument is treated as *pari passu* or subordinated to any such instrument if that instrument is eligible under that special resolution regime to be written down or converted into equity or any other capital instrument ahead of or proportionally with any such instrument described in the bullet above.

Accordingly, the Final Rule generally excludes from the definition of covered debt instrument an unsecured debt instrument issued by a non-U.S. GSIB that cannot be written down or converted into equity under a special resolution regime. The Agencies note that, for example, if the special resolution regime applicable to the non-U.S. GSIB provides that deposits are excluded from bail-in, then those deposits are not covered debt instruments under the Final Rule.

As with unsecured debt instruments issued by covered BHCs or covered IHCs, the Final Rule excludes a debt instrument that qualifies as tier 2 capital under the capital rule, or that is otherwise treated as regulatory capital by the primary supervisor of the issuer, from the definition of covered debt instrument issued by a non-U.S. GSIB.

Deduction Required

The Agencies' current capital rules generally require a banking organization to deduct investments in capital instruments issued by unconsolidated financial institutions that would qualify as regulatory capital if issued by the banking organization itself or that is part of the GAAP equity of the unconsolidated financial institution. For example, an investment by a banking organization in the tier 2 capital of another banking organization would be deducted from the investing banking organization's own tier 2 capital. This deduction is subject to certain thresholds below which a deduction is not required. For an advanced approaches banking organization, the specific deductions required depend on whether the investment is "significant" (i.e., represents more than 10 percent of the issued and outstanding common stock of the unconsolidated financial institution) and whether the investment is in the form of common stock or a more senior instrument.

Under the Agencies' current capital rules, a banking organization also must deduct any investment in its own regulatory capital instruments and any investment in regulatory capital instruments held reciprocally with another financial institution. For example, an investment by a banking organization in its own tier 2 capital must be deducted from tier 2 capital.

Under the Final Rule, advanced approaches banking organizations' investments in covered debt instruments would be subject to, and included within, this same deduction framework that currently applies to regulatory capital instruments.

Deduction from Tier 2 Capital

Under the corresponding deduction approach, a banking organization must apply any required deduction to the component of capital for which the underlying instrument would qualify if it were issued by the banking organization. Under the Final Rule, an advanced approaches banking organization must treat an investment in a covered debt instrument as an investment in a tier 2 capital instrument for purposes of the deduction framework. Accordingly, investments in an advanced approaches banking organization's own covered debt instruments, any investment in covered debt instruments held reciprocally with another financial institution, and investments in covered debt instruments issued by an unconsolidated financial institution generally would need to

be deducted from tier 2 capital. In this way, the Final Rule departs from the typical practice of requiring “like for like” deductions because investments in covered debt instruments would not be deducted from a banking organization’s TLAC-eligible long-term debt.

Under the corresponding deduction approach, if a banking organization does not have sufficient capital to fully effect a deduction, any amount of the investment not already deducted must be deducted from the next, more subordinated capital component. The Final Rule applies this aspect of the corresponding deduction approach as well to covered debt instruments.

Significant and Non-Significant Investments in Covered Debt Instruments

Under the Final Rule, the deduction an advanced approaches banking organization must make depends on whether the banking organization has a “significant” or “non-significant” investment in the unconsolidated financial institution. A “significant” investment is defined as ownership of more than 10 percent of the common stock of an unconsolidated financial institution, and a “non-significant” investment is defined as ownership of 10 percent or less of the common stock of an unconsolidated financial institution.

Investments in covered debt instruments issued by an unconsolidated financial institution in which the advanced approaches banking organization has a “significant” investment must be deducted from tier 2 capital. In addition, and consistent with the Proposed Rule, investments by an advanced approaches banking organization in covered debt instruments issued by an unconsolidated financial institution in which the advanced approaches banking organization has a “non-significant” investment must be deducted from tier 2 capital to the extent the investments (along with any additional investments in the capital of unconsolidated financial institutions) exceed 10 percent (the “10 percent threshold”) of the advanced approaches banking organization’s common equity tier 1 capital less all deductions from and adjustments to common equity tier 1 capital elements required under section __.22(a) through section __.22(c)(3) of the capital rule, net of associated deferred tax liabilities (the “CET1 Adjustments”).

In each case, the deduction applies to an “investment in a covered debt instrument,” which is defined in the Final Rule to mean the net long position in a covered debt instrument, including direct, indirect, and synthetic exposures to the debt instrument. The definition excludes any underwriting positions held by the advanced approaches banking organization for five or fewer business days. For an advanced approaches banking organization, the Final Rule adds to the definition of an “indirect exposure” an investment in an investment fund that holds a covered debt instrument and adds to the

definition of “synthetic exposure” an exposure whose value is linked to the value of an investment in a covered debt instrument.

Investments in Own Covered Debt Instruments and Reciprocal Cross Holdings

As noted above, under the Final Rule, investments in an advanced approaches banking organization’s own covered debt instruments and any investment in covered debt instruments held reciprocally with another financial institution generally must be deducted from tier 2 capital. The Agencies declined to adopt commenters’ request that there be a separate five percent threshold for market making in an advanced approaches banking organization’s own covered debt instruments.

Net Long Position Calculation

Under the capital rule, the amount of a banking organization’s investment in its own capital instrument or in the capital of an unconsolidated financial institution subject to deduction is the banking organization’s net long position in the capital instrument, and the banking organization may net certain short positions against a gross long position in the same instrument to determine the net long position.

The Final Rule follows this same general approach and provides that an advanced approaches banking organization would determine its net long position in an exposure to its own covered debt instrument or in a covered debt instrument issued by an unconsolidated financial institution in the same manner as currently provided for investments in the capital of an unconsolidated financial institution or investments in an institution’s own capital instruments. Accordingly, the calculation of the net long position in a covered debt instrument takes into account direct investments as well as indirect exposures held through investment funds.

In addition, the capital rule currently includes three options used to measure a banking organization’s gross long position in capital instruments that it holds indirectly through an investment fund.⁵ The Final Rule adopts these three options from the capital rule in order to determine the gross long position in a covered debt instrument held in an investment fund.

Finally, the Agencies note in the preamble that in keeping with the Proposed Rule, the Final Rule provides that the amount of a covered debt instrument includes any contractual obligation the advanced approaches banking organization has to purchase such covered debt instrument for purposes of any deduction required for investments in the capital of an unconsolidated financial institution.

⁵ See section __.22(h)(2)(iii) of the capital rules.

Exclusions

The Final Rule includes certain limited exclusions from the 10 percent threshold that applies to the deduction approach for non-significant investments. The exclusion available depends upon whether the advanced approaches banking organization is a GSIB or non-GSIB.

U.S. GSIBs

In general, U.S. GSIBs (or subsidiaries of U.S. GSIBs) may exclude certain market making exposures, defined as “excluded covered debt instruments,” from the 10 percent threshold, up to five percent of the U.S. GSIB’s common equity tier 1 capital (less the CET1 Adjustments), measured on a gross long basis (the “five percent market making bucket”). A U.S. GSIB must deduct, according to the corresponding deduction approach, its gross long position in excluded covered debt instruments that exceeds the five percent market making bucket. The five percent market making bucket complements an existing exclusion for underwriting positions held by banking organizations for five or fewer business days, which is replicated in the Final Rule with respect to covered debt instruments (as noted above).

Under the Final Rule, an “excluded covered debt instrument” is defined as an investment in a covered debt instrument that (i) is held in connection with market making-related activities, as defined in the regulations implementing section 13 of the Bank Holding Company Act (commonly known as the “Volcker Rule”), which should include market making-related hedging, provided that a direct exposure or an indirect exposure to a covered debt instrument is held for 30 business days or less; and (ii) has been designated by the U.S. GSIB as so excluded. Accordingly, in contrast to the Proposed Rule, the Final Rule includes a 30-business-day holding period limit only for market making positions in direct and indirect investments in covered debt instruments, and not for “synthetic exposures.” In addition, the Final Rule clarifies in this definition that there is no requirement under the Final Rule to assign investments as excluded covered debt instruments; rather, to the extent a U.S. GSIB has capacity, all investments in covered debt instruments could be held on a net long basis as non-significant investments in the capital of an unconsolidated financial institution subject to the 10 percent threshold.

In addition, the Final Rule addresses the treatment of excluded covered debt instruments that may no longer qualify as excluded, because the instrument has been held for more than 30 business days (as applicable) or otherwise. For such a position, a U.S. GSIB must deduct, according to the corresponding deduction approach, its gross long position.

The Agencies in the preamble note that they intend to monitor holdings of synthetic exposures “to ensure that the capital held for these positions is commensurate with risk and that such holdings do not raise safety and soundness concerns.” The Agencies also say that they “may” seek to issue an information collection to collect quarterly data on non-significant investments in the capital of unconsolidated financial institutions and excluded covered debt instruments.

Non-GSIBs

The Final Rule contains a simpler deduction approach for advanced approaches banking organizations that are not U.S. GSIBs. Any such banking organization can exclude from the deduction any direct, indirect, or synthetic exposure to a covered debt instrument that is a non-significant investment, measured on a gross long basis, up to an amount of five percent of the banking organization’s common equity tier 1 capital less the CET1 Adjustments (the “five percent Category II threshold”). Therefore, for these banking organizations, the exclusion is not restricted to investments held in connection with market making-related activities. Any amount in excess of the five percent Category II threshold would be subject to the 10 percent threshold on a net long basis.

TLAC Rule Amendments

The Final Rule includes certain technical revisions to the TLAC Rule, including the following:

- *TLAC buffers.* In 2018, the FRB and the OCC proposed revisions to the enhanced supplementary leverage ratio standards for U.S. GSIBs.⁶ The proposal also included certain proposed amendments to the TLAC buffer levels for both covered BHCs and covered IHCs under the TLAC Rule. The Agencies have finalized these changes. As background, the TLAC Rule imposes on covered BHCs and covered IHCs TLAC buffer requirements that must be maintained to avoid limitations on distributions and discretionary bonus payments. The Agencies amended the TLAC buffer levels—which measure a covered entity’s capital to satisfy the relevant buffer requirement—in the TLAC Rule to use the same haircuts applicable to long-term debt that are currently used to calculate outstanding minimum required TLAC amounts—i.e., by *not* including a 50 percent haircut on long-term debt instruments with a remaining maturity between one and two years. The clarification is positive because it leads to a covered BHC’s or covered IHC’s buffer level being higher; higher TLAC buffer levels are positive because payout limitations become more stringent as buffer levels decrease.

⁶ 83 Fed. Reg. 17317 (Apr. 19, 2018).

- *Applicability of TLAC Rule to covered IHCs.* The Final Rule fixes a technical error in the rule text relating to initial applicability of the TLAC Rule to a covered IHC. The TLAC Rule now provides that a new covered IHC is subject to the TLAC Rule three years after the *later of* the date on which: (a) the U.S. non-branch assets of the non-U.S. GSIB that controls the covered IHC equaled or exceeded \$50 billion; and (b) the foreign banking organization that controls the covered IHC became a GSIB. The revision is helpful because it clarifies that a new covered IHC will always have at least three years to conform to the requirements of the TLAC Rule.

Reporting Requirements and Public Disclosure

In the Proposed Rule, the FRB proposed to modify the instructions to the Consolidated Financial Statements for Holding Companies (the “FR Y-9C”), Schedule HC-R, Part I and Part II, to effectuate the deductions for FRB-regulated advanced approaches banking organizations related to investments in covered debt instruments and excluded covered debt instruments. In October 2019, the Federal Financial Institutions Examination Council (“FFIEC”) separately proposed to modify the Consolidated Reports of Condition and Income for a Bank with Domestic and Foreign Offices (“FFIEC 031”), Consolidated Reports of Condition and Income for a Bank with Domestic Offices Only (“FFEIC 041” and, together with the FFIEC 031, the “Call Report”), and Regulatory Capital Reporting for Institutions Subject to the Advanced Capital Adequacy Framework (“FFIEC 101”) in a manner consistent with the changes to the FR Y-9C to effectuate the Proposed Rule’s deduction approach for investments in covered debt instruments. In March 2020, the FRB separately proposed conforming changes to the FR Y-14.

As part of the Final Rule release, the FRB finalized, as proposed, changes to the FR Y-9C and FR Y-14 to effect the deduction framework for investments in covered debt instruments. The Agencies note they will address comments submitted in connection with the FFIEC’s October 2019 proposal when those forms and instructions are finalized. The Agencies also confirm in the preamble to the Final Rule that the effective date of the Final Rule will precede any reporting requirements related to implementing the deduction framework for covered debt instruments.

In addition, as part of the Final Rule, the FRB finalized modifications to Schedule HC-R, Part I of the FR Y-9C by adding new items that would publicly disclose (i) the long-term debt and TLAC for covered BHCs and covered IHCs; (ii) long-term debt and TLAC ratios; (iii) TLAC buffers; and (iv) amendments to the instructions for the calculation of eligible retained income, institution-specific capital buffer, and distributions and

discretionary bonus payments for covered BHCs and covered IHCs. The FRB also finalized similar changes to the FR Y-14.

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Please do not hesitate to contact us with any questions.

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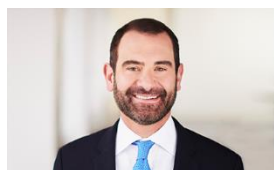
Greg Lyons
gilyons@debevoise.com



David L. Portilla
dlportilla@debevoise.com



Alison M. Hashmall
ahashmall@debevoise.com



Dave Sewell
dsewell@debevoise.com

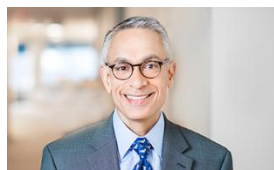


Nariné A. Atamian
naatamian@debevoise.com



Chen Xu
cxu@debevoise.com

Washington, D.C.



Satish Kini
smkini@debevoise.com



Will Giles
wgiles@debevoise.com